125

Sectoral Policy Paper on Financial System Development

Published by

Federal Ministry for Economic
Cooperation and Development
Division of "Development Education and Information"

Friedrich-Ebert-Allee 40
53113 Bonn

Tel.: 0228 / 535-3774/5
Fax: 0228 / 535-3985
e-mail: poststelle@bmz.bund.de
homepage: http://www.bmz.de

responsible: Ulrike Haupt, Uwe Henrich
edited by: Klaus Glaubitt, Hanns Martin Hagen (KfW), Dirk Steinwand (GTZ)
Final editing: Antje Göllner-Scholz

January 2004

Table of Contents

1. Purpose of policy paper, definition of development sector 5

1.1 Purpose of policy paper 5

1.2 Definition of development sector 5

2. Role of financial system for partner countries 7

2.1 Context 7

2.2 Financial system as a key sector 7

2.3 Correlation between regulatory systems, economic development and financial systems 8

2.4 Correlation between national financial systems and international financial markets 9

3. Experience to date in financial system development 10

3.1 International experience 10

3.2 Bilateral development cooperation 11

3.3 Implications for German development cooperation 13

4. Guidelines for financial system development in partner countries 14

4.1 Objectives 14

4.2 Development principles 14

4.3 Target groups for assistance 15

4.4 Development strategies and implementation 16

4.4.1 Concurrent multilevel approach in financial system development 16

4.4.2 Measures geared to target groups 17

4.4.3 Instruments 19

4.4.4 Summary of assistance approaches in development cooperation 20

4.4.5 Summary of implementation guidelines 24

Acronyms ... 26

Annex ... 28

Monterrey Consensus (Excerpt) ... 28

Programme of Action 2015 ... 30

Practical examples of German development cooperation in financial system development ... 36

More In-depth Aspects of Financial Sector Development ... 43

Possible Implications of Basel II for Developing Countries ... 46

1. Purpose of policy paper, definition of development sector

1.1 Purpose of policy paper

The intention of the sectoral policy paper is to highlight the key **role of financial systems in economic and social development**. The capacity of the financial system depends in particular on the regulatory system, including legislation, and national macro-policy.

Setting up an efficient and stable financial system is both a major component of economic reform and a **precondition for its success, for entrepreneurial initiative to create jobs and economic growth. An operational, stable financial system facilitates poverty reduction, as envisaged in the Programme of Action 2015**.[1] Financial services are closely connected with all development programmes, e.g. rural development, gender issues, education and health, government decentralization and natural resource conservation.

The financial system development policy paper is a **decison-making aid** and it serves as a strategic guide for selecting, appraising, planning, implementing and ex post - evaluating projects and programs of German development cooperation. The policy paper applies to priority area strategies and projects undertaken by implementing agencies of German development cooperation, particularly DED, GTZ, InWEnt and KfW Group (KfW and DEG). The guidelines are applicable as soon as projects/programmes are defined under the respective BMZ country policy as eligible for assistance.[2]

This policy paper is also intended to help in advancing **lines of argument** for the German position in the development community. It also serves as a **guideline** for German non-governmental organizations (NGOs).

1.2 Definition of development sector

In the following, the term financial system is understood to mean **all financial institutions, financial markets and instruments as well as the regulatory framework, including the national currency and monetary system along with special legal standards governing the financial and banking markets**.

In a broader sense, the financial system also includes the **following standards and ancillary or service institutions**:

- Training and information facilities for financial institutions, such as banking academies, rating agencies, credit bureaux and business/economics media,
- Standards and institutions that secure agreements on economic exchange (e.g. bankruptcy law), safeguard the quality of economic/business information and standards for good corporate governance,
- Social value systems and codes of conduct that can compensate for the lack of formal contracts and bankable collateral - e.g. in the informal and semi-formal sector - through social control.

The **distinction between formal, semi-formal and informal financial sectors** has to do with the differing degree of regulation. As a rule, the semi-formal sector is not subject to overall banking or financial market regulation. The institutions are, however, formally registered. The informal financial sector consists of indigenous financial institutions, e.g. pre-cooperative, traditional thrift and lending societies with appropriate finance technologies, such as simplified loan appraisal, or group lending, as well as moneylenders and complex financial relations amongst extended families.

[1] Poverty Reduction - a Global Responsibility, Programme of Action 2015, the German Government's Contribution Towards Halving Extreme Poverty Worldwide, BMZ Material No. 106, April 2001.

[2] Where there is no specific BMZ strategy paper for a country, conducting a particularly intensive dialogue with the partner country can provide the basis for a decision on assistance (Section 1.1 and 1.2).

The financial sector falls under the **BMZ priority area** "Economic Reform and Development of a Social Market Economy" (WiRAM). This policy paper conforms with BMZ sectoral policies on micro and small enterprise promotion, MSTQ[3], vocational and technical education as well as the multisectoral policy on private sector development. In microfinance above all it is also an operationalization of the multisectoral policy on poverty reduction through self-help.[4] As far as possible, development approaches in the financial sector are devised for implementation as part of a comprehensive strategy for the above mentioned priority area or as a self-contained sub-strategy.

---

3 Acronym for Metrology, Standards, Testing and Quality Assurance Systems.

4 BMZ publication December 1990.

2. Role of financial system for partner countries

2.1 Context

Financial systems are key to developing a broader, deeper economy based on the division of labour. They provide ways of generating money and credit. They mobilize local resources and develop local capital markets. By way of lot sizing, small and micro deposits are transformed into larger loans for investment purposes. Maturity mismatches between the demand and the supply for credit are brigded (maturity transformation function). Risks are diversified and hedged (credit risk management function). Moreover, the financial system is responsible for clearing national and international payments transactions, an important pre-requisite for regional economic development.

The understanding of how financial systems work has improved steadily over the last 25 years. There is now a clearer appreciation of the connection between reforms at government level, institutional reforms, the mobilization of local resources and access of micro, small and medium-sized enterprises (MSME), broad sections of the population and particularly poor populations to financial services. Lending via special banks (development banks) was not sufficient to set the required development impetus in motion. A **paradigm shift** came about: The focus of interest shifted from **promoting certain target groups through directed lending via individual institutions to reforming the institutional setup to strengthen the stability and capacity of the financial system as a whole**.

Crucial in the final analysis, though, is still the increased readiness in partner countries themselves to introduce and implement general market mechanisms as the foundation for an efficient and competitive financial system as well.

This was the context in 1993/94 for preparing the first BMZ sectoral policy on financial system development, which entered into effect in September 1994 (BMZ Policy Paper No. 046).

This new policy paper takes into account the additional experience gained in the past 10 years. It replaces Policy Paper No. 046.

2.2 Financial system as a key sector

The UN Millenium Declaration in 2000 and the conferences in Monterrey (2002) and Johannesburg (also 2002) set out major development policy parameters that also attached high priority to the financial system.

The **Millenium Declaration** also underlines the role that financial systems play in building peace and prosperity.[5]

The **Monterrey Consensus**, to which the German Federal Government is committed, specifies very clearly the need to strengthen the financial sector (See Annex 1, excerpt from the Consensus Declaration. BMZ endorses the statements made in this and subsumes them in its sectoral policy.).

The **Johannesburg Conference** points to the role of a viable financial system for sustainable economic and social development accounting for natural resources.[6]

For an efficient and sound financial sector, the **central bank and financial market supervi-**

---

[5] The Millenium Declaration sets itself the overall goal of "a more peaceful, prosperous and just world." (Section I, Par. 1). It affirms the commitment to "making the right to development a reality for everyone and to freeing the entire human race from want." (Section III, Par. 11). Further, it specifies that: "Success in meeting these objectives depends, inter alia, on good governance within each country. It also depends on good governance at the international level and on transparency in the financial, monetary and trading systems. We are committed to an open, equitable, rule-based, predictable and non-discriminatory multilateral trading and financial system." (Section III, Par. 13).

[6] Plan of Implementation of the World Summit on Sustainable Development, particularly Nos. 82 - 84.

sion play a special role. By securing the stability of the currency, the central bank strengthens the capacity of the financial system. To do this, it must be as independent as possible from government directives in monetary policy. Under current framework legislation and international regulations (FATF[7] for example), the financial market supervisory authority is responsible for making sure that the financial system works and remains stable, i.e. the banking system, the securities market and the insurance sector.

The financial system in many partner countries still poses a development constraint. Regulatory interventions by governments that hamper growth are indicative of this problem, e.g. provisions on maximum interest rates, incoherent measures in economic policy, unstable framework conditions, random government interventions, particularly directed lending to state-owned enterprises. Crises in the financial sector often culminate in full-blown development crises.

Conversely, successful assistance in financial system development and reform in line with internationally established standards can speed up beneficial developments as a whole. Important here are contributions to improving access for all client target groups to financial services and closing financing gaps, thus remedying shortcomings and deficits in the local financial market. This applies also for the following finance deficits:

- **MSME financing gap:** Micro, small and medium-sized enterprises (MSME) in many countries have restricted access to loans and other financial services due to inadequate lending technologies and a frequent lack of interest on the part of established financial institutes in this target group. This problem may well be aggravated by Basel II.[8]

- **Environmental financing gap:** To reduce environmental pollution, new investments are needed in energy and resources, cleaner production technologies and investments in environmental protection technologies. Because these investments often yield low business profitability and incur higher risks, however, there is a lack of adequate investment finance. This has an adverse effect on the environment.

- **Rural financing gap:** On account of the special risks in agriculture, particularly amongst smallholders, and the frequent high transaction costs of rural financial systems, rural enterprises lack sufficient access to loans and other financial services.

- **Regional/Local authorities financing gap:** Delegating public tasks to regional or local authorities calls for at least partial financial autonomy and adequate access to finance. Access to suitable long-term finance on the national capital market is a prerequisite for municipalities to undertake projects in local infrastructure development.

2.3 Correlation between regulatory systems, economic development and financial systems

A social-market and ecologically viable regulatory system - resting on the cornerstones of certainty in law, competition and private property - is conducive to securing the 'right to development' (Millennium Declaration, cf. 2.2). This holds for all sections of the population.

A paramount development-policy goal in the interest of long-term social stabilization is the progressive inclusion of the poor and poorest in this process of development. In all its elements - particularly also with a view that strengthening private-sector corporate structures creates jobs - **this process is inexorably linked with the financial sector:**

- **Directly**, sustainable and efficient financial institutions can promote the poor in their economic, social and political development by providing appropriately tailored financial services.

[7] Recommendations of the OECD **F**inancial **A**ction **T**ask **F**orce on Money Laundering.

[8] See Annex 5 (Possible implications of Basel II).

- **Indirectly**, an efficient and stable financial system can support a pro-poor economic, social and environment policy.

The same basic elements and principles apply for the setup and mode of operation of the financial sector as for the regulatory system as a whole. A major condition for success in re-aligning, reforming and reorganizing the national economy or single economic sectors is a suitably geared financial system that acts as a motor to promote savings and investment in the national currency also and brings these into balance. "That requires a sound system of financial intermediation, transparent regulatory frameworks and effective supervisory mechanisms supported by a solid central bank".[9] - Price stability, in other words preventing high inflation, directly benefits the poor, as they suffer more from monetary devaluation than the owners of real assets.

2.4 Correlation between national financial systems and international financial markets

As a result of the liberalization of national and international financial markets, both markets are closely linked, affording opportunities and posing risks for the domestic financial sector. **The financial sector is undergoing rapid structural change worldwide**, driven by advances in information and communication technologies and the introduction of financial innovations and new financing technologies. New global market structures are emerging with processes of concentration on the one hand and relocations on the other. **In this process of global convergence, the financial systems in developing countries are at a structural disadvantage**; adjusting to international standards poses much larger problems than in advanced countries. Macroeconomic policy should therefore be geared to supporting and not endangering the domestic financial system. Structural policy in the financial sector must strengthen national institutions, while simultaneously preparing them for international competition.

The following interfaces between national and global financial markets need to be stressed in particular:

- The Asian and Russian financial crises in particular showed that the **extent of capital transfer deregulation** has a large influence on the stability of national financial systems.

- A **stable currency system** is essential for a functioning financial system.

- Moreover, the **international recommendations on crisis prevention and management** support the stability of national financial systems, such as the standards and codes introduced in recent years or those still in preparation (Financial Sector Assessment Programmes, Reports on Observance of Standards and Codes, Basel II, etc.).

[9] See Annex 1: Monterrey Consensus, Par. 17.

3. Experience to date in financial system development

3.1 International experience

The 1989 World Development Report was a milestone in the paradigm shift cited above (cf. 2.1). Where previously the financial sector was merely treated as an instrument for conduiting credit lines to a predefined clientele, developing an operational financial system became now accepted as an independent development goal. **Financial system development** became a **generally recognized development policy notion**.

This change had a number of far-reaching consequences for most multilateral - and after a delay also for most bilateral - donors:

In the customized segment of financial system development there was a shift from development programmes handled via public development banks towards building up private-sector **microfinance institutions** (MFIs). Particularly in the first half of the nineties, there was a distinct rise in the number of new small microfinance NGOs without a bank licence operating outside banking supervision. In tandem with this, a regional shift took place from promoting rural to urban areas and a sectoral move from agriculture and industry to small trader finance.

As the business activities of these microfinance institutions began to expand to include **savings mobilization**, this raised the issue of depositor security and drew donor attention increasingly in the second half of the nineties to methods of **regulating and monitoring** these MFIs.

Parallel to this in particular, the **trust fund, Consultative Group to Assist the Poor (CGAP)**, supported by 30 donors, made vigorous efforts to professionalize existing MFIs by developing training materials, setting up internet portals and disseminating best practices.

To promote MFI growth and meet their growing demand for equity and outside capital, networks and funds have emerged in recent years specializing in **refinance** and **equity participation** in MFIs. As a rule, they are financed by syndicates made up largely of bilateral and multilateral donors, but increasingly of so-called socially responsive investors as well as individual private commercial investors, private commercial financial institutions for example.

In **financial sector reform**, the nineties were still by and large dominated by **deregulation measures** prompted by structural adjustment programmes. Major objectives of IMF and World Bank reform programmes were deregulating interest rates, reducing minimum reserves, lowering entry barriers for founding new financial institutions and unpegging exchange rates.

The hoped-for increase in foreign direct investments as a result, however, was confined to a few countries only. There was in contrast a distinct rise in far more volatile portfolio investment. The resultant **financial crises** that erupted in Mexico (1994), Southeast Asia (1997), Russia (1998) and Argentina (2001) - all with very adverse economic impacts on these countries - prompted the international donor community to change its views on this. **Stabilizing financial systems** now advanced to become a prime development goal, also for the multilateral development banks (particularly IDB and AsDB).

The **Financial Sector Assessment Programme (FSAP)** launched in this context by the IMF and World Bank is a major instrument for detecting the weak factors of financial systems in advanced and developing countries. It is designed to help avert financial crises. Together, the IMF and World Bank conduct a thorough diagnosis of the financial system and point out possible risk factors. FSAP was initially applied mainly to more advanced financial systems, but in the future, it will have to concentrate more on fundamental constitutive and operational factors of emerging financial markets, that is, foremost on the institutional and legal framework. FSAP is a major analytical instrument for development cooperation.

In recent years, the international community has made greater efforts in donor coordination. This process must be continued with the aim of converging donor contributions in one more streamlined manner. FSAP should be used more in this context by partner countries for coordinating the contributions of various donors.

3.2 Bilateral development cooperation

With its **financial sector policy drafted in 1994**, Germany was one of the first countries to **gear** its development strategy **to a systemic approach**. Beginning then, individual projects have been subsumed in a sector-policy approach that seeks to develop the financial system as a whole and not just improve the provision of services to particular target groups. As experience shows, this approach is gaining in importance. When projects failed to attain their objectives, this was mostly due to deficiencies in the sectoral framework, the choice of unsuitable partners (e.g. development banks with corporate governance problems) or the lack of a sustainable approach (e.g. unprofessionally managed credit funds). Successes were recorded where individual projects and programmes effected structural impacts, thus helping to advance financial system development.

Gearing the financial sector approach along systemic lines resulted in an **enlargement of the set of development cooperation instruments**. Besides classic credit lines, innovative instruments play a growing role, such as credit enhancement instruments and exchange risk cover mechanisms as well as local currency instruments and regional credit and equity funds. As a rule, these financial instruments are accompanied by training and consultancy measures with the aim of institution building and strengthening partner agencies. **Institution building** has thus come to replace directed lending to specific target groups, as in some cases favoured until the early nineties. The partner institutions in development cooperation are assisted in widening their range of financial services (e.g. microfinance products, environmental and housing loans, municipal infrastructure finance and leasing). Mortgage banks have been supported to improve housing finance. In the area of microfinance, microfinance institutions have also been assisted in introducing savings deposits, micro-insurance and payments services. Larger microbanks have also been assisted in introducing financial products for SME. Based on the microlending technology, the SME lending technology introduced here has proved effective.

Another result of the shift to a systemic financial sector approach has been an **expansion of the partner institutions**. While in the early 90s assistance was largely given to financial institutions in setting up and enlarging financial services to lower-income groups, the second half of the nineties saw the addition of projects aimed at **diversifying** financial markets and **stabilizing** and **professionalizing** the financial sector as a whole. Besides setting up and strengthening financial institutions, development measures were increasingly geared to establishing and extending training facilities and courses, forming associations and providing advice to central banks and banking supervisory institutions, focussing for example on microfinance and rural financial systems.

At the financial intermediary and service institution level (meso level) - provided an operational banking supervision was in place - **incentive oriented deposit insurance systems** were set up for banking groups to build confidence in the financial system and promote the mobilization of local savings.

In broadening and deepening the financial system, German development cooperation distinguishes amongst upgrading, downscaling, greenfield and linkage approaches. Evaluations of German (and international) experience show that no distinct precedence can be given to any of these approaches. Success and failure depend very much on local conditions and the objectives pursued. Additional questions that need settling include shareholder arrangements and exit strategy.[10]

[10] Experience in setting up microbanks particularly as against MSME loan departments in local banks and performance rating in downscaling projects will be evaluated and may be translated into appropriate criteria in a BMZ sectoral project possibly by the end of 2004. The same ap-

Upgrading NGOs into professional microfinance institutions has been applied in particular in Central and Latin America and in Africa. It became apparent that only a limited number of NGOs were ready and able to take this path due to their development policy mission. A thorough analysis of the latent resources should therefore always precede a decision on assistance. Similarily, only a restricted number of commercial banks are prepared and able to **downscale**, that is to set up a business segment for medium-sized, small and micro enterprises and lower-income groups. Favourable experience has been gained in Asia, Latin America and in Southeast Europe.

The **greenfield** approach, that is establishing new financial intermediaries, has proved successful in regions where there is a widespread lack of suitable financial service providers for MSMEs and lower-income brackets. This, however, calls for considerable initial investments in capacity building and personnel training. Limited-term subsidies with transparent exit strategies for setting up new financial intermediaries may therefore be necessary in business terms and make developmental sense. Positive experience has been gained above all in Eastern Europe, Central Asia and in Southern Africa.

Linkage, that is linking up banks with existing self-help groups, has proved to be a successful instrument, particularly for reaching very poor target groups, where access to financial services figures as part of a broader context of empowerment and direct poverty reduction. Efficient NGOs to set up viable self-help groups make up a major component of this approach. It is particularly widespread in South Asia.

The **developmental effectiveness of microfinance projects** is now somewhat better documented through impact analyses. The beneficial impacts include: higher and more diversified income for borrowers and the creation of new jobs thanks to credit-financed business expansion; risk mitigation through accumulated savings; increased expenditure on health and education by households thanks to improved management of income and expenditure flows; empowerment of underprivileged women in self-help groups by building up an independent economic base. In assessing developmental effectiveness, too little is still known about how improved access to financial services affects groups that (still) lack access.

Experience gained in German development cooperation shows that microfinance institutions can **mobilize savings** to a considerable extent and thus promote local resource mobilization. For broad sections of the population, particularly the poor, access to secure savings facilities is just as important as access to credit or payments transaction services. Moreover, local savings provide a source for mobilizing national resources. German development cooperation supports the mobilization of national resources via direct savings promotion and through measures to develop the local capital market (e.g. setting up deposit insurance systems, local currency instruments, projects for capital market development, particularly securitization). Nevertheless, savings mobilization places **heavy demands** on the professionalism of a MFI, particularly in risk management, even though microlending is gauged to be less crisis-prone than other lines of business and can contribute to stabilizing financial institutions in periods of turbulence (e.g. Bank Rakyat in Indonesia, FEFAD Bank in Albania, Caja Los Andes in Bolivia). Microfinance institutions have also proved effective in post-crisis situations and have been able to provide their financial services to benefit development under conditions of general instability.

In recent years, the international financial institutions in particular have stressed the urgent need to build up private financial institutions and call for the withdrawal of government institutions as financial service providers. Based on experience at home and the repercussions of overhasty privatization in many partner countries, German development cooperation **promotes a variety of ownership options depending on the local setting**. Of greater importance than the form and constellation of ownership here is corporate governance in partner institutions. Standards and institutional statutes must be designed to ensure the independence of management and lending decisions. Moreover, management must possess

---

plies for awarding management/consultancy assignments in the microbanking sector in general.

the necessary **professional qualifications, foresight and integrity**.

Apart from commercial financial institutions, **cooperatives, municipal banks and village banks** (for example savings banks) have contributed to improving financial services for clientele deprived of the facilities provided in the formal financial system. A number of state-owned banks, largely in Asia, have also undergone considerable reforms in recent years. These financial institutions play a particular role in providing rural populations and regional/local authorities with financial services, where purely commercial private-sector approaches still frequently fail.

3.3 Implications for German development cooperation

The German Federal Government bases its development policy measures on its **Programme of Action 2015**, based in turn on the Millenium Declaration. The Programme of Action 2015 outlines the fields of activity and the approaches which have priority for the German government. The section entitled, Reducing Debt - Financing Development, includes the following statement of intent: **"The German government will give increased support to the development of strong financial systems in the developing countries that contribute both to preventing global and regional financial crises and to the development of the private sector as well as the entrepreneurial potential of poor people in the partner countries."**[11]

From the experience gained in past years, we can draw the following definite conclusions for German development cooperation:

- Development approaches can **engage at different levels of the financial system at the same time** to achieve sustainable structural impacts. They must be treated as elements of a coherent strategy. They must be synchronized reform steps under the management of the partner country, conducted in concert with the IMF, the World Bank Group and the regional development banks in particular and be fitted into a streamlined overall strategy.

- German development cooperation should also contribute its special experience in financial system development by **coshaping and cofinancing the sectoral reform programmes** of the World Bank Group and the regional development banks.

- **The development measures must be tailored to client needs** (e.g. micro enterprises, SMEs, poor urban and rural households, local/regional authorities) **for various financial services** (e.g. loans, savings, payments transactions, insurance).

- Sufficient and sustainable **outreach amongst rural client target groups** calls for the appropriate adjustment of existing or the development of new finance instruments to meet the special conditions in rural areas and agricultural finance. These include above all improvements in risk management and the introduction and use of modern collateral arrangements as well as the deployment of economical distribution outlets in proximity to clientele (e.g. mobile branch offices) to reduce transaction costs.

- **There should be an open-minded approach to the assistance requirements of the private and public banking sectors.** It is not the ownership issue, but the form and contents of practical action - the corporate statutes and governance of the institution - that must be taken as the decisive benchmark for possible development cooperation in compliance with other development aid principles.

- The strategic **role played by the financial service provider and service institution level (e.g. associations, intercompany training institutions)** must be taken into account as a necessary substratum for sectoral and policy reform. In many partner countries today it is less the macroeconomic imbalances or the lack of

[11] Ibid., page 25; for more details see Annex 2, Excerpt from the Programme of Action [Chapter 3.4, Reducing Debt - Financing Development].

political will to carry out the necessary sectoral reforms but more the weaknesses in the institutional infrastructure (state administrations, central banks, supervisory authorities) that hamper the effective implementation of reform programmes. Moreover, it is the operational and customized financial intermediaries that decide to what extent disadvantaged sections of the population benefit from financial sector reforms.

- **Greater account should be taken of modern financial instruments**, such as global and regional equity funds, guarantees, exchange risk cover instruments, securitization, mezzanine finance.

- **The use of development approaches that cover more than one country should be stepped (e.g. regional funds), also in MSME promotion and capital market development**, particularly where the financial markets of single countries are very small.

- In anticipation of the Basel II Accord, German development cooperation should also cater suitably to the growing role of **risk management** and modern methods of loan appraisal and ratings in its development measures in lending as a **cross cutting task**.

4. Guidelines for financial system development in partner countries

4.1 Objectives

The aim is to assist the partner country concerned together with other donors in the sustainable development of efficient, inter-linked financial systems and viable institutions. Based on a stable monetary and currency system, these should be able to efficiently mobilize local financial resources as well and provide investors with the lending facilities they need nationwide. At the same time, the concern is to provide broad sections of the population, particularly the poor, access to financial services, including insurance.

The financial system should be broadened by enlarging the range of financial products and deepened by reaching new clientele via financial institutions. Ultimately, this will advance national development as a whole.

In each single case, there must be a sound rationale for the specific contribution development measures make to achieving these objectives.

4.2 Development principles

The development assistance principles for financial systems are based on the objectives, the experience of programmes to date in developing financial systems and institutions as well as on the guidelines and principles for TC and FC.

When implementing specific development measures, four principles need to be observed:

- **Subsidiarity**: Development cooperation must assist the partner country in establishing better framework conditions. Assistance should only be given where markets, private-sector institutions and self-help organizations are not yet able to provide the requisite facilities.

- Rationale for the **comparative advantage**: German development cooperation should concentrate on measures where it enjoys comparative advantages over partners in the development sector (see Annex 3). The positive and adverse experience gained in financial sector development needs evaluating in comparison with other bilateral and multilateral donors.

- **Integration** in the country's overall development process: Each development measure must constitute a useful element in the partner country's overall efforts

supported by the donor community.[12] It must fit as an integral component into the partner country's sectoral policy (open information policy, joint analytical work, possibly joint monitoring and evaluation).

- **Sustainability**: All development measures must meet the criterion of sustainability, so the intended improvements in the financial system must also remain in effect after the development measure has been completed.

Each project or program in the finance sector funded by the German government has to be justified accordingly.

4.3 Target groups for assistance

We need to distinguish amongst the following target groups in development measures:

- **The legislative, executive and judiciary level** in connection with reforms and structural adjustments in the financial system, consisting in particular of the following:
  - Parliaments, due their special role in reform processes;
  - Finance and economics ministries on account of the effect of globalization on the national financial system, the need to reduce budget deficits and inflation as concerns the pricing of goods and services in cases where this is not determined by the market. This can be addressed through initiatives for new banking and capital market legislation;
  - Jurisprudence and the administration of justice to guarantee certainty in law, also in connection with developing appropriate contractual and securitization arrangements and their enforcement under civil law.
- **Central bank and financial supervision level** in connection with projects for strengthening the central bank and setting up effective banking and financial supervision (management and special staff), consisting in particular of the following:
  - Central bank;
  - Institutions for financial sector regulation and supervision.
- **Financial intermediary and service institution level**, consisting in particular of the following:
  - Formal, semi-formal and informal financial institutions that are ready and able as assimilated or assimilable parts of the financial system to extend improved and broader financial services to target groups through appropriate finance technologies;
  - Institutions that also strengthen the financial stability and efficiency of small financial institutions and enhance financial intermediation as a whole, such as APEX systems, facilities for payments transactions, loan guarantee funds, special purpose vehicles for debt securitization, holding companies and funds for equity investments in microfinance institutions, micropension funds and microinsurance;
  - Service institutions for the financial sector, such as associations and networks of financial institutions, deposit guarantee facilities, credit bureaux, rating agencies and training institutions for the financial sector;
  - Municipal authorities due to their special role in local economic development.

[12] In low-income countries, the Poverty Reduction Strategy Paper (PRSP) should contain suitable project and programme proposals as the basis for concerted donor contributions.

4.4 Development strategies and implementation

4.4.1 Concurrent multilevel approach in financial system development

Core issues in reforming a financial system include liberalization and stabilization. This is in part about rule of law and enforcement of legal rights but it also includes issues like collateral and liability, competition, monetary and currency stability, effective supervisory mechanisms, deregulation of interest rates - aiming at positive rates in real terms - as well as exchange rate policy and accountability of financial intermediaries for profit and loss, corporate governance and bankruptcy law.

Financial systems suffer from **shortcomings at different levels**. Development approaches to reform the financial system from the top down or develop it from the bottom up have been superseded by a **concurrent multilevel approach**. Depending on the actual problem complex, partner countries carry out measures at various levels simultaneously and in concert. All development cooperation instruments can be used in support of this.

The aim **at the legislative, executive and judiciary level** as well the central bank and financial supervision level is to improve the parameters for sustainable financial intermediation and the expansion of financial services. This is why **policy and central bank advice** is often concerned with liberalizing and stabilizing the national financial system. The **sequence of the necessary reform steps** depends on the given problem complex and must be defined by each country in a specific development strategy. In general, though, shock therapy with fast and complete deregulation has caused more harm than good in the past.

At **financial intermediary and service institution level**, relevant capabilities are often lacking. These include training and continuing education institutes, associations and networks, rating agencies and credit bureaux. In addition, there is a frequent lack of efficient APEX institutes to secure refinance and liquidity balance amongst financial institutions. Financial institutions are assisted in broadening and deepening their range of services. Often, there are not enough investors to provide equity and outside capital. Setting up special holdings or regional funds can help here.

The development approaches for the partner country should be based on a sound **financial sector analysis**, encompassing supply and demand in financial services as well as the macroeconomic, legal and institutional framework. **Duplication of existing or planned studies by other institutions (e.g. IMF, World Bank) must be avoided**.

The prime concern of **appraising the status quo in the financial sector** is to assess processes, prospects of success and constraints as well as ways of influencing these. It is often necessary to provide advice to the government and central bank beyond the financial intermediary level. Without prior systemic knowledge, isolated interventions by development projects - regardless of the level of intervention - can cause disruptions in the financial system.

Even under adverse general conditions there are ways to successfully build up and promote **customized financial service providers, particularly microfinance institutions**. These in turn have beneficial structural - if also restricted - impacts by improving the local financial system.

Every development cooperation programme for the financial system must be tailored to **country needs and conditions** and can also address a regional economic area.

Measures provided by implementing agencies in financial system development should harness the specialist expertise of German institutions, particularly savings banks and the cooperative banks, the Deutsche Bundesbank and the German Federal Financial Supervisory Office, but also the consulting sector, private microbank networks, commercial banks or other private enterprises.

4.4.2 Measures geared to target groups

German development cooperation can draw on a sophisticated and adaptable set of development approaches. Development measures in the financial system aim directly or indirectly at improving the provision of services for underprivileged client target groups and strengthening the stability and performance of the financial system.

Development cooperation for the **legislative, executive and judiciary** can provide financial system advice and sector-policy dialogue:

Many countries still suffer from considerable deficits in general legislation and financial institution regulation and monitoring. **This frequently also holds true for microfinance institutions (MFIs), which are often not properly licensed, regulated and supervised, and this in turn can jeopardize their sustainability.** Adequate control of financial institutions, effective supervisory mechanisms and a monetary and currency policy aimed at stability can build confidence and avoid distortions of competition. However, no regulations should be instituted that hamper the development of microfinance institutions without helping to stabilize the financial system.[13] At the same time though, care should be taken to ensure that no special provisions are established for deposit-taking microfinance institutions which would compromise standard requirements for the stability of banks, because this would only open regulatory loopholes for untrustworthy providers on the banking market.

At **central bank and financial supervision level**, providing advice to the central bank and setting up and strengthening securities commissions can contribute to improving the stability and efficiency of the financial system. Establishing deposit insurance systems in cooperation with central banks and financial supervisory authorities can also help in raising the confidence of the population in banks and MFIs and in mobilizing savings. These measures often constitute a component in reform packages based on the Financial Sector Assessment Programme (FSAP) conducted by the World Bank and IMF (see Annex 4). This also applies for related contributions by German development cooperation to financial sector reform programmes by the World Bank or regional development banks, e.g. via basket funding or cofinance.

Measures to promote and set up **financial intermediaries and service institutions** primarily seek to directly improve access to financial services for underprivileged client target groups. Promoting access to financial services, particularly lending, is not, however, a cure-all for the problems of developing countries and transition countries. Where there is a discernible **conflict between institutional sustainability** in the sense of long-term cost recovery and the **limited financial resilience of the poor, supplementary solutions must be sought**, such as basic education and training measures, basic health care measures, subsidies to business startups and direct advice. In the longer term, these ensure that poorer sections of the population also become eligible as bankable clients, able to pay cost-effective interest and charges.

Improving access for poorer client target groups to credit is also intended to ensure that these groups also apply the commercial loans for productive purposes, repay them in full and thus make tangible improvements to their conditions of life. This way, the viability and sustainability of the institution's own financial services are also improved. **To improve access to lending for the poor**, it is important to make them eligible and 'attractive' as contracting parties. The central questions of certainty in law, including collateral law, need to be settled in general. In part or even in full, the lack of 'classic' loan collateral can be compensated by **suitable microlending technologies** such as loans in good standing or group loans.

Besides assistance in institution building or adjusting existing organizational structures, development cooperation can support financial institutions in **broadening their range of financial services in response to demand**. This applies above all for the introduction of

[13] An example here are regulations on documentation required for credit ratings of micro/small enterprises or also regulations on requisite minimum equity for establishing a bank regardless of size.

financial services not yet provided or not available in competition. Aside from microloans and SME loans, this comprises savings products, including micropensions as well as payments transaction services, microinsurance products, housing finance, environmental loans and certain kinds of municipal loans. Promoting innovative, customized financial services helps improve facilities for underprivileged clientele, such as MSMEs, poor urban and rural households as well as regional/local authorities.

Setting up or reorganizing financial institutions, particularly MFIs, and introducing new financial services incur high institutional learning costs due to the necessary, specific training, the motivation of personnel and changes in the way financial institutions and their clients think and act as a result of using new financial products and finance technologies in a trial phase. To cut down these 'transaction costs', **limited-term and degressive subsidies** can be given to financial institutions in the above cases via development assistance funding on concessionary terms or as non-repayable grants. To set up a financial institution successfully, other key factors are a **broad equity base** and an ownership constellation that ensures a management balance between profitability and efficiency on the one side and sustainable relations to the target group on the other. This can be effected through FC trust fund investments or participating interests at own risk by the KfW Group.

Development **assistance to institutions in the financial system is only warranted where there are discernible prospects of long-term viability**. For overindebted or illiquid financial institutions, particularly convincing evidence must be adduced to justify their eligibility for promotion and their viability. Reasons and facts must be presented to prove that a rehabilitation scheme is tenable. All projects and programs must also help strengthen institutional capacity and improve earnings. Financial intermediaries should be assisted in confidence building. Confidence and reliability can only evolve, if there is no permanent dependence on donors. **In the long term, subsidies are an unsuitable instrument** to ensure efficiency and autonomy.

Special attention must be paid to the **level of interest and charges** - and quasi-interest charges, for example in Islamic Banking - when designing programmes for financial sector development.

Non-market loan interest favours clients that already have access to lending. Many development projects in poverty reduction have shown that borrowers are able to pay real positive interest rates on market terms. In financial system approaches promoted by development cooperation, loan interest rates should be in line with the market. Customized market segments with comparatively low interest are not ruled out here: To be sustainable, however, they require corresponding lower deposit rates geared to these segments (demand). **No interest subsidies should be granted for final borrowers that diverge from market conditions.**[14]

As the institutional level develops, it becomes **increasingly important to build up service providers for MFIs**. Development cooperation supports setting up associations and networks of MFIs, special training establishments and consulting firms as well as credit bureaux, information services, rating agencies and audit organizations. Development approaches such as MSME debt securitization can improve MFI access to the capital market and contribute to capital market development.

Expertise in setting up and managing microfinance institutions (MFIs) is already available in many countries through local experts. Smaller and larger microbank networks provide advice, training, information services and in limited measure refinance and equity capital from their regional or global funds. German development cooperation should harness the experience of these networks when providing its own advice, finance and exchange of expertise. Many MFIs still have no access to the above services and could benefit from an expansion of regional training and consulting facilities as well as from the establishment of regional and possibly global equity and debt funds. German development

[14] Special internationally agreed provisions for environmental loans under the Global Environment Facility (GEF) for example, notwithstanding.

cooperation should continue to support the establishment of new individual microfinance institutions with debt and equity instruments and project-flanking advisory and training measures.

German development cooperation's ties with national and international NGOs have repeatedly proved effective and should be enlarged in suitable cases.

4.4.3 Instruments

In financial system development it is necessary to **link up instruments and institutions closely**. This applies equally for German cooperation with multilateral institutions and with bilateral partners. Foremost, however, it applies for the German implementing agencies, particularly GTZ, InWEnt and the KfW Group.

Donor coordination increasingly takes place in **joint donor dialogue with the partner country**, e.g. in PRSP processes, where the donors - mostly under the leadership of multilateral institutions - agree with the partner on joint assistance for a programme in financial sector development (programme-based approach). In the case of **programme finance** by donors, a decision has to be taken on whether German development cooperation should participate in joint finance (e.g. cofinance or parallel finance for financial sector programme loans by the World Bank and regional development banks such as the AsDB and AfDB),[15] so as to make a proactive contribution of its expertise to sector-policy dialogue.

In financial system reform and development, all instruments of bilateral and multilateral development cooperation can be employed in principle. The **need for advice remains great**. Short-term, technical advice is increasingly provided by the IFIs and as part of joint donor initiatives. The major instruments of German development cooperation and its comparative advantage, in contrast, are located in medium-term and long-term in-process advice on a partnership basis. Besides the secondment of experts and North-South exchange, building national advisory capabilities and liaising South-South exchange play an increasing role.

Assitance is given through suitable development cooperation finance instruments in combination with advisory and training measures. This assistance serves to help in **setting up and developing financial institutions, which remain important for financial system development in developing countries, and in introducing financial services to meet target group needs. Major financial instruments in development cooperation** are grants, loans and composite and mixed finance.[16] As a rule, these instruments are flanked by suitable measures in personnel assistance.

Due to dynamic developments and rapid changes in the international financial system and in partner country financial sectors, a growing role is being played in development cooperation by **innovative development instruments**, such as guarantees for refinancing MFIs and partner banks, exchange rate hedging, local currency finance, equity investments and equity funds.

For some years now, **public-private partnership approaches (PPP) in financial sector development** have been increasingly applied in German development cooperation, particularly via innovative microfinance (see Annex 4). This development also needs to be supported as part of German development assistance measures. In poorer developing countries and in outreach to underprivileged sections of the population in particular, the private sector is often not prepared to make longer-term commitments without prior or flanking activities by official development assistance.

---

[15] This pertains in particular to our cooperation with the African Development Bank, which plays a prominent part on the African continent in setting banking and financial standards. On this, see BMZ Special No. 076, Combating Poverty - Our Goals in the Regional Development Banks, Goal 2 on page 29 and footnote 32 on page 28.

[16] In appropriate cases, development loans and guarantees, trust fund investments, equity investments and mezzanine finance by the KfW Group at its own risk.

By providing equity, long-term loans and other concessionary funding flanked by advisory measures and sector-policy dialogue, development cooperation can improve the parameters for participation by private investors in microfinance institutions for example. A major contribution that development cooperation can also make is institution building, promoting policy dialogue and preparing the policy climate for PPP projects. Often, the advantage of PPP from the private sector standpoint is that development cooperation bears the costs and/or risks of a commitment in part or for a limited time. This way, the private sector can also get involved under less favourable conditions. For the partner government this means that urgently needed private investments in fixed assets and human resources are often only made with official development assistance (bridgehead function of development cooperation or crowding-in).

Experience with PPP projects for individual MFIs in recent years has shown that ethically motivated private investors are also increasingly interested in investments in privately and publicly sponsored global microfinance funds. These funds, sponsored by public implementing organizations or donors, NGOs and private investors, afford MFIs access above all to the equity capital that they urgently need for sustainable growth, particularly in countries where local capital markets are lacking or still at a rudimentary stage of development.

4.4.4 Summary of assistance approaches in development cooperation

The following table presents an outline of development cooperation approaches and instruments and the range of services for various target groups. **In practice, the individual development approaches are combined** over time in line with the actual sectoral and institutional developments as well as with the intended development policy impact in the partner country concerned. The measures are carried out by implementing organizations in line with this sectoral policy and on the basis of FC and TC guidelines. Annex 3 illustrates this with practical examples.

Typical development cooperation approaches	Typical development cooperation instruments and range of services
Legislative, executive and judiciary level	
• **Advice** to parliament and executive on **legislation** (Sections 4.4.1/4.4.2): e.g. banking supervisory law, licensing of MFIs, bankruptcy law, contractual and collateral law • **Advice to and finance for financial sector reform projects** (Sections 4.4.1/4.4.2): e.g. debt regulation, restructuring and recapitalization of institute groups, GATS negotiations as part of WTO negotiations	• Dialogue of German development cooperation representatives and implementing organizations with the partner country • Coordination of German contribution with bilateral and multilateral donors • Co-financing or parallel financing of sectoral reform programmes by multilateral development banks • Advice by long-term and short-term experts • Instruction and training • Provision of material and equipment where necessary
Central bank and financial supervision level	
• **Central bank advice** (Section 4.4.2) • **Setting up and strengthening financial market supervisory authorities** (Section 4.4.2)	• Dialogue of German development cooperation agencies with central bank and financial supervisory authority • Cofinancing or parallel financing of sectoral reform programmes by multilateral development banks • Advice by long-term and short-term experts • Instruction and training • Conferences/Symposia • Provision of material and equipment where necessary

Typical development cooperation approaches	Typical development cooperation instruments and range of services
Financial intermediary and service institutions level **a) Microfinance**	
• **Introduction of microfinance services** (Section 3.2): Deposit, lending, insurance and payment transactions products • Improvement of access for local MFIs to national and international capital market (Section 3.2) • **Upgrading approach** (Section 3.2): Conversion of NGOs to regulated MFIs • **Downscaling approach** (Section 3.2): Introduction of microlending facilities in local commercial banks • **Greenfield approach** (Section 3.2): Setting up commercial MFIs • **Linkage approach** (Section 3.2): Linking self-help groups and MFIs with local and international banks	• Training measures, advisory measures • Advice by long-term and short-term experts • Limited-term provision of non-repayable development cooperation grants to finance startup investments for MFIs or high institutional learning costs • Funding through credit lines, possibly in combination with credit enhancement facilities and other local currency instruments • FC composite loans and development loans • Trust fund investments and equity investiment by the KfW Group at its own risk within the framework of FC • Public-private partnership approaches (PPP, see Section 4.4.3 and Annex 4) • Regional development cooperation funds to promote microfinance • Mezzanine finance
b) SME finance	
• **Upscaling approach** (Section 3.2): Provision of SME loans through microbanks • **Downscaling approach** (Section 4.4.2): Introduction of SME lending in local commercial banks • **Leasing** (Section 3.2) • **Business startup finance**: provision of external and equity capital specially tailored for business startups • **Equity funds** (Section 4.4.3): Setting up or promoting equity funds participating in SMEs	• Funding through development cooperation credit lines and development loans, possibly in combination with credit enhancement facilities and other local currency instruments • Regional and global development cooperation funds to assist SME finance • Trust fund investments and equity investments by KfW-Group at own risk • Training measures, advisory measures • Advice by long-term and short-term experts • Mezzanine finance

Typical development cooperation approaches	Typical development cooperation instruments and range of services
c) Broadening the provision of financial products tailored to client groups (financial broadening)	
• **Housing finance** (Section 3.2/4.4.2) • **Environmental loans** (Section 2.2/4.4.2) • **Municipal infrastructure finance** (Section 2.2/4.4.2) • **Trade promotion in partner country** (Section 3.2)	• Funding through development cooperation credit lines and development loans, possibly in combination with guarantee facilities and other local currency instruments • Regional credit funds • Setting up and promoting mortgage financial institutions • Training and advisory measures • Mezzanine finance
d) Rural financial system	
• Assistance to MFIs, commercial and reorganized development banks **in introducing lending facilities for enterprises and households in rural regions** (Section 4.4.2) • Reform of agricultural development banks, assistance to MFIs and commercial banks in **upgrading agricultural lending** (Section 4.4.2)	• Training and advisory measures • Advice by long-term and short-term experts • Funding through development cooperation credit lines and development loans possibly in combination with local currency instruments • Regional credit funds
e) Service institutions for financial intermediaries	
• **Setting up banking and MFI associations** (Section 3.2) • **Audit and joint liability associations** (Section 4.4.2) • **Credit bureaux** (Section 4.4.2) • **Payments transaction systems** (Section 4.4.2) • **Intercompany training institutions** (Section 4.4.2) • **Banking associations** (Section 4.4.2)	• Training and advisory measures • Advice by long-term and short-term experts • Provision of information and equipment where necessary

Typical development cooperation approaches	Typical development cooperation instruments and range of services
f) Setting up and promoting specialist institutions and capital market development	
• **Deposit insurance systems** (Section 3.2) • **Refinance and institutional strengthening of APEX institutions** (Section 4.4.1) • **Guarantee facilities and loan guarantee funds** (Section 3.2 and Annex 3) • **Setting up and promoting holding companies and equity funds for MFIs** (Section 4.4.2 and Annex 4) • **Securitizing loan portfolios, primarily MSME loans** (Section 3.2)	• Training and advisory measures • Development cooperation credit lines, possibly combined with local currency finance instruments • Development loans • Limited-term provision of non-repayable development assistance grants to finance high institutional learning costs • Trust fund investments and equity investments by the KfW Group at its own risk • Mezzanine finance • Public-private partnership (PPP) approaches

4.4.5 Summary of implementation guidelines

Financial system projects and programs promoted by the German side in a partner country cannot encompass the full breadth and depth of the approaches and options described in this policy paper. Rather, the concern is to select development measures to meet the respective needs of the partner country in line with the capabilities of German development assistance. This cannot be prescribed by way of a general abstract priority list of contents. **What is important is to select development measures to suit the situation. When applying this policy it is essential to comply with the following procedural guidelines cited in the various sections**:

- The basis for financial sector development measures (priority area strategy paper) is setting the appropriate priorities in line with the respective country policy. Where there is no specific BMZ strategy paper for a country, conducting a particularly intensive dialogue with the partner country can provide the basis for a decision on assistance (Section 1.1 and 1.2).

- Development approaches can then engage concurrently at different levels of financial system development, but they must be justified and viewed as elements of a coherent strategy (Section 3.3). This calls for a thorough prior analysis of the financial sector. Overlaps with existing or planned studies of the partner country or other donors must be ruled out (Section 4.4.1).

- A rationale for the specific contribution of the development measures (project or programme) to objectives achievement in the financial sector must be provided in every individual case (Section 4.1). Particularly good reasons must be adduced for assistance in rehabilitation cases (Section 4.4.2).

- The grounds given for every development measure must account for the principle of subsidiarity, comparative advantages, integration and sustainability, as cited in Section 4.2.

- For each prospective set of development measures, consideration should be given to including the private sector (Section 4.4.3).

- Where the subaim of sustainable financial system development may clash with that of providing access for the poor, particularly close attention must be paid to the envisaged development approach's sustainability. If necessary, supplementary or preparatory development elements can be offered to facilitate access to lending for the poor (Section 4.4.2).

- When providing development measures a thorough examination must also be made of standards and statutes of the partner institutions (Section 3.2).

- In general, interest rates for final borrowers should not be subsidized (Section 4.4.2).

- Training in risk management must be incorporated as a multisectoral task in all development measures to do with lending (Section 3.3).

Provided no exceptional agreement is made with BMZ for the individual case, these procedural guidelines are binding for the implementing agencies of German development cooperation.

Acronyms

ACLEDA	Association of Cambodian Local Economic Development Agencies
AfDB	African Development Bank
AsDB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BMZ	German Federal Ministry for Economic Co-operation and Development
BRI	Bank Rakyat Indonesia
CEE	Central and Eastern Europe
CGAP	Consultative Group to Assist the Poor
CIM	Center für Internationale Migration und Entwicklung
CIS	Commonwealth of Independent States
DAC	Development Assistance Committee
DC	Development Co-operation
DED	German Development Service
DEG	German Investment and Development Company
DFID	UK Department for International Development
DGRV	German Co-operative and Raiffeisen Confederation
DTI	Deposit-Taking Institutions
EBRD	European Bank for Reconstruction and Development
EFBH	European Fund for Bosnia and Herzegovina
EU	European Union
FATF	Financial Action Taskforce
FC	Financial Co-operation
FDI	Foreign Direct Investment
FEFAD	Foundation for Enterprise Finance and Development
FINCA	Foundation for International Community Assistance
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
GATS	General Agreement on Trade in Services
GEF	Global Environment Facility
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
HIPC	Heavily Indebted Poor Countries
IDB	Inter-American Development Bank
IFC	International Finance Corporation
InWENT	Capacity Building International, Germany
IMF	International Monetary Fund
KfW	Kreditanstalt für Wiederaufbau
LDC	Least Developed Countries
M&E	Monitoring and Evaluation
Mercosur	Mercado Común del Sur
MEB	Micro Enterprise Bank of Kosovo
MF	Microfinance
MFI	Microfinance institutions
MSTQ	Metrology, Standards, Testing and Quality Assurance Systems
NGO	Non-Governmental Organization
OECD	Organization for Economic Co-operation and Development
ProFi	Promotion of Small Financial Institutions
PRSC	Poverty Reduction Support Credit (World Bank)
PRSP	Poverty Reduction Strategy Paper
PPP	Public-Private Partnership
PSP	Private Sector Participation
QIS	Quantitative Impact Studies
ROSCAS	Rotating Saving and Credit Association
ROSC	Report on Observance of Standards and Codes
SME	Small or Medium Enterprise
SHI	Self-Help Initiative
SIDA	Swedish International Development Co-operation Agency

TC	Technical Co-operation
UN	United Nations
USAID	United States Agency for International Development
WiRAM	Economic Reform and Development of the Market System
WTO	World Trade Organization

Annex 1

Monterrey Consensus (Excerpt)

II. Leading actions

Mobilizing domestic financial resources for development

10. In our common pursuit of growth, poverty eradication and sustainable development, a critical challenge is to ensure the necessary internal conditions for mobilizing domestic savings, both public and private, sustaining adequate levels of productive investment and increasing human capacity. A crucial task is to enhance the efficacy, coherence and consistency of macroeconomic policies. An enabling domestic environment is vital for mobilizing domestic resources, increasing productivity, reducing capital flight, encouraging the private sector, and attracting and making effective use of international investment and assistance. Efforts to create such an environment should be supported by the international community.

11. Good governance is essential for sustainable development. Sound economic policies, solid democratic institutions responsive to the needs of the people and improved infrastructure are the basis for sustained economic growth, poverty eradication and employment creation. Freedom, peace and security, domestic stability, respect for human rights, including the right to development, and the rule of law, gender equality, market-oriented policies, and an overall commitment to just and democratic societies are also essential and mutually reinforcing.

12. We will pursue appropriate policy and regulatory frameworks at our respective national levels and in a manner consistent with national laws to encourage public and private initiatives, including at the local level, and foster a dynamic and well functioning business sector, while improving income growth and distribution, raising productivity, empowering women and protecting labour rights and the environment. We recognize that the appropriate role of government in market-oriented economies will vary from country to country.

13. Fighting corruption at all levels is a priority. Corruption is a serious barrier to effective resource mobilization and allocation, and diverts resources away from activities that are vital for poverty eradication and economic and sustainable development.

14. We recognize the need to pursue sound macroeconomic policies aimed at sustaining high rates of economic growth, full employment, poverty eradication, price stability and sustainable fiscal and external balances to ensure that the benefits of growth reach all people, especially the poor. Governments should attach priority to avoiding inflationary distortions and abrupt economic fluctuations that negatively affect income distribution and resource allocation. Along with prudent fiscal and monetary policies, an appropriate exchange rate regime is required.

15. An effective, efficient, transparent and accountable system for mobilizing public resources and managing their use by Governments is essential. We recognize the need to secure fiscal sustainability, along with equitable and efficient tax systems and administration, as well as improvements in public spending that do not crowd out productive private investment. We also recognize the contribution that medium-term fiscal frameworks can make in that respect.

16. Investments in basic economic and social infrastructure, social services and social protection, including education, health, nutrition, shelter and social security programmes, which take special care of children and older persons and are gender sensitive and fully inclusive of the rural

sector and all disadvantaged communities, are vital for enabling people, especially people living in poverty, to better adapt to and benefit from changing economic conditions and opportunities. Active labour market policies, including worker training, can help to increase employment and improve working conditions. The coverage and scope of social protection needs to be further strengthened. Economic crises also underscore the importance of effective social safety nets.

17. We recognize the need to strengthen and develop the domestic financial sector, by encouraging the orderly development of capital markets through sound banking systems and other institutional arrangements aimed at addressing development financing needs, including the insurance sector and debt and equity markets, that encourage and channel savings and foster productive investments. That requires a sound system of financial intermediation, transparent regulatory frameworks and effective supervisory mechanisms, supported by a solid central bank. Guarantee schemes and business development services should be developed for easing the access of small and medium-sized enterprises to local financing.

18. Microfinance and credit for micro-, small and medium-sized enterprises, including in rural areas, particularly for women, as well as national savings schemes, are important for enhancing the social and economic impact of the financial sector. Development banks, commercial and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance, including equity financing, for such enterprises, as well as an adequate supply of medium- and long-term credit. In addition, the promotion of private-sector financial innovations and public-private partnerships can also deepen domestic financial markets and further develop the domestic financial sector. The prime objective of pension schemes is social protection, but when those schemes are funded they can also be a source of savings. Bearing in mind economic and social considerations, efforts should be made to incorporate the informal sector into the formal economy, wherever feasible. It is also important to reduce the transfer costs of migrant workers' remittances and create opportunities for development-oriented investments, including housing.

19. It is critical to reinforce national efforts in capacity-building in developing countries and countries with economies in transition in such areas as institutional infrastructure, human resource development, public finance, mortgage finance, financial regulation and supervision, basic education in particular, public administration, social and gender budget policies, early warning and crisis prevention, and debt management. In that regard, particular attention is required to address the special needs of Africa, the least developed countries, small island developing States and landlocked developing countries. We reaffirm our commitment to the Programme of Action for the Least Developed Countries for the Decade 2001-2010,[17] adopted by the Third United Nations Conference on the Least Developed Countries, held in Brussels from 14 to 20 May 2001, and the Global Programme of Action for the Sustainable Development of Small Island Developing States.[18] International support for those efforts, including technical assistance and through United Nations operational activities for development, is indispensable. We encourage South-South cooperation, including through triangular cooperation, to facilitate exchange of views on successful strategies, practices and experience and replication of projects.

---

17 A/CONF.191/11.

18 Report of the Global Conference on the Sustainable Development of Small Island Developing States, Bridgetown, Barbados, 25 April-6 May 1994 (published by the United Nations, Order No. E.94.I.18 and corrections), Chap. I, Resolution 1, Annex II.

Annex 2

Poverty Reduction - a Global Responsibility Programme of Action 2015

The German Government's Contribution Towards Halving Extreme Poverty (excerpt)

Chapter 3.4: Reducing Debt - Financing Development

In order to attain the target of halving poverty by 2015, more financial resources need to be mobilized. The first priority must be for the developing countries to make greater use of their own resources and to introduce policy reforms to overcome the causes of inadequate financing. In particular, it is vital to increase domestic savings and to counter the national causes of capital flight. An efficient financial system at national and global level is a particularly effective means of minimizing risks and thus improving the mobilization of domestic and foreign private capital. Further sources of external development finance are official development cooperation and funds released through debt relief. The German government is actively involved in the ongoing discussions within the UN relating to financing for development and was active in the preparations for the International Conference on this topic that took place in spring 2002.

Debt Relief

Overindebtedness and high levels of debt service make it more difficult for poor developing countries to spend public funds on social sectors such as education and health. The poor people of these countries are particularly affected. This is why the reduction of debt and avoidance of future overindebtedness of developing countries continue to be important issues in international relations. Access to credit markets is essential for many developing countries because domestic savings are not sufficient to finance the investments needed. The current debt relief strategy, which makes debt relief contingent on pro-poor social and economic policy reform, should be continued. The volume of debt relief is dependent on countries' income and level of debt and is decided through a process of multilateral consultation.

The German government was one of the initiators of the Enhanced HIPC Initiative (1999 Cologne Summit) and has called for debt relief to be linked to the preparation of Poverty Reduction Strategy Papers (PRSPs). The level of debt faced by the HIPCs will be reduced by about two thirds through full implementation of the Initiative and the debt relief measures that have become possible to date. The German government supports the swift implementation of the debt relief initiative (see box in section 2.3).

Independently of the HIPC Initiative, the German government has since 1978 already cancelled some DM 13 billion in bilateral debt owed by developing countries. Moreover, it has been converting debt from Financial Cooperation into countries' own currencies in suitable cases, on condition that the local funds thus released are earmarked for development and environmental protection. For a long time now, German development cooperation funds for LDCs have been provided exclusively in the form of grants.

Official Development Assistance (ODA)

Official Development Assistance (ODA) is an extremely important source of development finance for the poorest developing countries due to the scarcity of resources and their lack of access to international financial markets. However, it also continues to be needed in more advanced countries, including newly industrialized countries, since they are home to a large proportion of the world's poor and their access to capital markets is usually inadequate (exclusion of vast regions and of large investment sectors such as the environment or social infrastructure), subject to great volatility, and sometimes very expensive. This is why ODA continues to be indispensable. Systematic use must be made of openings for further increasing the effectiveness and efficiency of development cooperation.

Private Sources and National and International Financial Systems

While international ODA has remained at an annual level of 50 to 55 billion US dollars throughout the past decade, foreign direct investment increased from 20 billion US dollars in 1990 to 190 billion US dollars in 1999. However, the large flows do not go to the poor countries because private investors consider the risks to be too high. The German government calls for the conclusion of a multilateral agreement on direct investment within the framework of the WTO, giving attention to the special situation of the developing countries. The intention is to facilitate their participation in worldwide investment flows that look to the long term. Export credit guarantees make an essential indirect contribution to facilitating finance for developing countries and thus strengthening their economic performance. Funds provided through German official development cooperation are more and more frequently combined with private-sector funds, with the former acting as a catalyst by facilitating finance which would not otherwise have been possible. This kind of combination is to be further developed. This relates, firstly, to credit finance and, secondly, to equity finance instruments, which are highly significant for small and medium-sized enterprises.

The financial and banking crises in Asia, Russia and Latin America between 1997 and 1999 have resulted in instability of those countries' economies, slumping growth rates, and increasing poverty, and have demonstrated the risk to other countries and regions of being "infected" by such crises. The international community has since realized that greater stability of the international financial system is an important foundation for lasting global growth and for poverty reduction. At the 1999 Cologne World Economic Summit, important proposals were made for strengthening the international financial system. Many developing countries have since launched efforts to improve their financial stability, among other things by means of strengthening the financial sector, introducing appropriate exchange rate systems, improved debt management, and the adoption of internationally agreed codes and standards.

The Financial Stability Forum (FSF) tabled some initial proposals in spring 2000 with regard to improved management of short-term capital flows and the introduction of international minimum standards for effective national financial systems. The German government supports enhanced cooperation between the IMF and the World Bank in strengthening the international financial system. The German government is in favour of continuing the policy of not guaranteeing comprehensive bail-out packages from the IMF in the case of financial crises. Private investors should contribute more to measures to prevent financial crises and to the cost of dealing with such crises in future, for instance by introducing clauses to that effect in borrowing agreements. In the event of a crisis, it may also be appropriate for developing countries to take measures to restrict the short-term outflow or even inflow of capital.

The German government's policy also supports the stabilization of the international financial system by strengthening national financial systems in the developing countries. Financial system development is an important strategic opening for poverty reduction in many developing countries for two reasons. For one, the establishment of special financial institutions, such as microfinance banks and support to membership-based savings and loan cooperatives and their associations, helps to link small and micro enterprises to the formal financial system. This broad-based contribution helps to push the financial frontier. Second, improvements in banking supervision, in insolvency legislation, in the legal system, and in the performance of medium-sized and large banks strengthen the entire financial system the 'nerve centre' of the economy - and contribute to macroeconomic stabilization, increased economic growth and to poverty reduction.

Financial system development

Stable and strong financial systems are an important foundation for market-based development processes that are driven by the private sector. They enable continuous mobilization of resources and savings and make these resources available to investors, which in turn increases the economy's general productivity. This makes it a key factor in enhancing per capita incomes. A strong financial system provides permanent access to financial services (loans, savings, transactions) even to disadvantaged players in the economy, such as micro, small and medium

enterprises in the formal and informal sectors. Under such conditions, poorer groups in the population are able to develop initiatives as entrepreneurs, realize profitable business ideas, create and sustain jobs and income, and enjoy improved participation in social development in general.

Development cooperation can help to sustain the development role of the financial system and, simultaneously, ensure its focus on target groups. To this end, financial sector projects are integrated into reform strategies aimed at improving the efficiency and the regulatory and monitoring function of a given country's entire financial infrastructure. Poverty reduction in this context means, for instance, the integration of new groups of clients, the development of new financial products, and the establishment of specialized microfinance institutions. German development cooperation has accordingly increased its cooperation with private providers of financial services or groups of investors that are willing to accept risks and have the right skills and that are interested in building viable relations with small and micro business players. Examples include ACLEDA Bank in Cambodia, FEFAD Bank in Albania, credit cooperatives in Uruguay, Financiera Calpia S.A. in El Salvador, and village banks in Mali. A genuine public-private partnership has successfully come about with the involvement of Commerzbank AG in setting up the Micro-Enterprise Bank in Kosovo.

Actions

The German government advocates swift implementation of the HIPC debt relief initiative, which enhances the poorest countries' capacity to reduce poverty by their own means; it also advocates the development of an international monitoring process to ensure that new debt remains at sustainable levels. The German government supports measures to improve official financial and budget policies and debt management in the respective countries.

The German government advocates measures to strengthen the international financial architecture with a view to improving the stability and functioning of financial markets; in that context, the reform measures proposed by the Financial Stability Forum (FSF) should be taken into account and developing countries' involvement should be increased.

The German government will give increased support to financial systems in the developing countries that contribute both to preventing global and regional financial crises as well as to the development of the private sector and of the entrepreneurial potential of the poor population in the partner countries.

The German government will step up German development cooperation funding for relevant cooperation with countries that are undertaking special efforts to reduce poverty (such as Bolivia, Mozambique, Vietnam and Yemen). In that context, it will test new ways of cooperation which strengthen countries' ownership. Examples include the decentralization of decision-making, efforts to make instruments more flexible, new forms of policy dialogue and advisory services, and cofinancing of sector-wide approaches and transferring the allocation of resources and accountability for their application to the partner if conditions allow.

The German government will uphold its goal of moving closer to the internationally agreed target of 0.7 percent of the gross national product being spent on development assistance. This goal will be pursued in keeping with the consolidation measures that are part of the German government's programme, Renewing Germany.

The German government is in favour of the World Bank and the IMF providing special assistance to countries whose poverty reduction strategies are at risk as a result of external shocks, such as high oil prices or major declines in export earnings.

The German government seeks to broaden its possibilities for mobilizing additional capital market funds for financial cooperation with those countries that offer an appropriate framework, by means of blended finance, composite finance, and, in future, subsidized interest rates.

The German government will take development policy aspects into account when granting guarantees for exports and direct investments.

The German government strongly advocates within the OECD, in accordance with the call made by the G7 meeting of Ministers of Finance in Okinawa in July 2000, that all government export credit agencies make a commitment to not provide or support finance for non-productive expenditure (such as armament) in HIPC countries and other low-income countries. The relevant OECD activities should be completed as quickly as possible.

The German government advocates a joint decision by the member states in the DAC, in accordance with the Okinawa G8 Communiqué, to untie Financial Cooperation with LDCs.

Yemen: Strengthening poor groups' self-reliance

The example of Yemen shows that poverty reduction is successful if the government, together with civil society representatives, is committed to a pro-poor reform policy and accepts poor population groups as active partners. The poor hold the key to fighting their own poverty if the general framework gives them the opportunities. German bilateral cooperation has laid a foundation for this over many years in the German-Yemeni priority cooperation areas of education, health and family planning, and drinking water supply and sanitation. A programme for strengthening the self-reliance of poor groups is being established on the basis of open dialogue and local planning processes with the participation of all stakeholders. The intention is to strengthen the voice and civil rights of the poor. In that effort, German bilateral cooperation concentrates on providing advice to the Yemeni government and on strengthening self-help groups (such as parents' groups regarding issues related to basic education). In drawing up its Poverty Reduction Strategy Paper (PRSP), the Yemeni government is expanding the current process on a broader basis in order to overcome institutional and administrative weaknesses.

Annex 3

German Development Cooperation Practice

(comparative advantages; practical examples)

1. Comparative advantages

A hallmark of Germany's financial sector is its broad institutional diversity. The German central bank, the *Bundesbank*, is held in high international esteem. In its historical development, the German banking system has evolved in diverse forms of ownership. It is undergoing structural change, which affords a large pool of knowledge and experience for developing countries that can be harnessed for development cooperation. Drawing on this, German development cooperation is developing its own profile in financial sector development that can provide special benefits in cooperation with partners.

As a financial institution, the **KfW Group (KfW and DEG)** has **good access** to banks and other **financial institutions in developing and transition countries**. As an implementing agency for German development cooperation as well as for other donors and as an active member of the donor community in exchanging experiences and best practices, KfW Group cooperates closely with multilateral institutions such as the World Bank Group, CGAP (Consultative Group to Assist the Poor), regional development banks like the EBRD and other donors and agencies.

In financial system development, **KfW Group** not only implements projects funded by the government budget but also **takes on own risks, such as in equity participation or development loans**. This way, we can provide special support to commitments by private investors in the financial sector or even enable investments that would otherwise not be made. As a result of this catalyst function, specialized microbanks have been established in Eastern Europe and in the Caucasus, some with private investor participation.

The high **capacity for innovation in financial sector development** is primarily due to **synergies** between Financial Cooperation and other KfW business lines. The financial products developed in domestic finance, such as housing finance, environmental finance, municipal finance and securitization can thus be suitably tailored for use in FC.

Via KfW Group, **German development cooperation provides a broad range of development instruments**. This comprises finance instruments such as equity and mezzanine finance, credit enhancement facilities and local currency finance. Through its microfinance projects and the innovations in environmental finance, housing finance, deposit insurance schemes and payment services, KfW Group improves the access of poor households, micro and small enterprises and municipalities in developing countries to appropriate financial services. As a rule, financial instruments are flanked by extensive advisory and training measures.

KfW Group is rated AAA by Moody's and Standard and Poor's. This is another reason why it can respond and adapt to demands for finance. The funds raised on the capital market can **supplement and in many cases multiply development cooperation funds** (development loans, mixed and composite loans and equity investments).

Via KfW Group, German development cooperation supports a multitude of financial institutions through appropriate development strategies and financial products. The institutional range is wide, spanning finance NGOs and nonblank financial institutions, microbanks and private and public commercial banks to institutionalized funds.

GTZ contributes to developing the organizational abilities of personnel and institutions in the partner countries and to creating a pro-development framework. Its operations centre on a long-term vision, **ownership** and **partnership**.

Combining advisory inputs for financial institutions, service providers and agencies with a sovereign mandate in the financial sector facilitates the provision of **integral strategic advice** of much greater value than isolated advisory services to individual institutions. Thanks to this systemic approach, the complementary advisory services needed for institutional success can be provided where it would be largely ineffectual for individual financial institutions due to the adverse general conditions, resulting in a misallocation of donor funds.

Via GTZ, German development cooperation works with multilateral institutions providing policy advice in financial system development. Best practices are exchanged in fora such as the **Consultative Group to Assist the Poor (CGAP)** and various **donor committees**. Here, GTZ does not just provide advisory services but is also involved in a consultative capacity in **drafting standards for financial system development worldwide** together with other major professional organizations.

The German Development Service (DED) **is also engaged in microfinance. Involvement in microfinance programmes affords very good opportunities not only to contribute to poverty reduction, but in particular to strengthen the economic and social status of women. These are not isolated individual measures, but rather comprise a concerted approach with other development cooperation agencies.**

On the provider side, assistance is given to existing microfinance organizations (upgrading, institutional strengthening) and to disseminating successful microfinance approaches (replication). On the demand or client side, the focus is on training target groups (self-help initiatives - SHI - and small entrepreneurs for example), while including and strengthening local organizations (NGOs) and animating target groups to mobilize their own resources (savings factor), to improve their organizational level and finally to link up with local financial service providers (linkage approach).

Including the **German Cooperative and Credit Union (DGRV) and the Foundation of Savings Banks for International Cooperation** has also proved effective in selected German development measures. The cooperative banks and savings banks were founded in Germany as an instrument to alleviate poverty and promote regional development. Their over 200-year history shows that local activity, social responsibility and profitability need not rule each other out. Combining banking professionalism (in competition) with performing a social role was and still is part and parcel of the mission of cooperatives and savings bank in Germany. Concentrating on private citizens, SMEs and business startups as their clientele, they make a major contribution to providing local basic financial services today.

To work successfully, decentralized finance institutions need to be efficiently networked with regional and national associations, training establishments, service providers, etc., as has been the long-standing practice of cooperatives and savings banks in Germany.

Athough the initial setup in developing and transition countries differs greatly, core elements of the cooperative and savings bank philosophy can be transferred successfully. These elements include: optimum coverage by branch offices, localized and hence fast decision-making channels, risk minimization through thorough familiarity with regional markets and client proximity.

So German development cooperation can - particularly by combining its implementing organizations - provide **all-around assistance** that is tailored to the respective actual needs of the partner country, the financial system and the project executing agency involved.

2. Practical examples of German development cooperation in financial system development

2.1 Example from Financial Cooperation

The following table illustrates FC development approaches and the instruments deployed using the example of the components of the FC commitment in the financial sector in Bosnia and Herzegovina (BiH):

Central bank and financial supervision level		
Project	**Development approach**	**Development cooperation instrument**
Federal Deposit Agency, BiH	• Advisory services and design for a deposit insurance system for Bosnia and Herzegovina (BiH) • Finance of initial capital stock needed to set up the bank	• FC loan • Advisory and training measures • Policy dialogue with central bank and financial supervisory authority
Central bank	• Policy dialogue	• Policy dialogue in introducing or adjusting basic legislation for regulation and supervision of MFIs
Institutional and intermediaries level		
Project	**Development approach**	**Development cooperation instruments**
ProCredit Bank, Bosnia and Herzegovina	• Greenfield approach: founding of a specialized bank to provide MSMEs, rural and urban households with suitable facilities for deposits, micro and housing loans and payments transaction services	• equity investment • FC loan • Training and advisory measures

European Fund for Bosnia and Herzegovina (EFBH)	• Setting up a regional fund to link local MFIs and banks to the international capital market • Finance from fund for MSME lending business and setting up housing loan business in local banks • Guarantees from the fund for refinancing local banks on the international capital market	• FC loans and grants • Loans and grants from the EU and other bilateral donors
Credit enhancement facility for local banks	• Guarantee for refinancing local banks and MFIs to enable them to gain access to the international capital market	• FC loan and grant

The results to date of the FC commitment in BiH are:

- Thanks to setting up a national **deposit insurance system**, the population of BiH has regained and increased its confidence in the banking sector.

- Set up by FC together with other bilateral and multilateral donors, the **ProCredit Bank, Bosnia** has developed very successfully since its inception at the end of the nineties. It now provides more than 15,000 clients with deposits, payments transaction services and loans and has advanced to become a leading provider of microfinance services in BiH. Despite its young age, ProCredit Bank has already crossed the sustainability and profitability threshold. Loan portfolio quality is very good, a sign of an adequate lending technology and successful training measures in microlending.

- Thanks to **the European Fund for Bosnia and Herzegovina (EFBH) administered by KfW and financed by BMZ, the EU and the Austrian and the Swiss governments**, a larger number of local **financial institutions** selected by quality criteria has been strengthened. Due to the assistance, they have been able to broaden their financial services (introduction of MSME loans and housing loans). The standards set for banks' access to funding and to EFBH-funded training and councel have had demonstrably benefited and impacted other financial institutions in BiH.

- The **credit enhancement facility** for banks has enabled eligible Bosnian banks to access to the international capital market. This has helped them to make a sustainable improvement to their funding and asset and liability management.

2.2 Example from Technical Cooperation

2.2.1 GTZ:

The **TC project, Promotion of Small Financial Institutions (ProFi) in Indonesia** seeks to give improved and long-term access to financial services for micro/small savers and borrowers. With its four components it adopts a systemic development approach, as shown below:

Central bank and financial supervision level		
Component	**Development approach**	**Development cooperation instrument**
Ministry of Finance	• Advice in developing a national strategy for microfinance • Advice in amending and adopting a special microfinance law	• Policy dialogue • Advice by long-term experts • Specialist conferences • Imparting international best practices
Central bank	• Technical assistance in setting up a deposit guarantee system for BPRs (People Credit Banks - secondary banks) • Assistance in introducing a risk-based surveillance of BPRs • Improving LPDs reporting (village banks on Bali)	• Policy dialogue • Advice by long-term experts • Specialist conferences • Imparting international best practices
Institutional and intermediaries level		
Component	**Development approach**	**Development cooperation instruments**
Certified training systems	• Direct assistance to the BPR association in East Java in developing training material and advisory services	• Advice by long-term experts • Imparting international best practices and expertise • Provision of material and equipment
Promotion of Non-banking Financial Institutions in Poor Regions	• Advice in consolidating MFIs NTB/NTT Provinces	• Policy dialogue • Advice by long-term experts • Cooperation with other donors (World Bank)

Project results to date are:

- A draft microfinance law has been prepared and has been submitted to the Indonesian government for approval.
- A proposal for setting up a deposit guarantee system for BPRs has been submitted to Bank Indonesia for approval.
- New provisions have been drafted and put into force, e.g. on capital adequacy, portfolio quality and reporting duties of BPRs.
- A new LPD ordinance in Bali has been adopted by the provincial parliament.
- The appointment of a National Task Force has opened the way for a national certification system.
- Detailed training materials for MFIs have been prepared.

2.2.2 DGRV and Savings Banks Foundation

Institutional and intermediaries level		
Component	**Development approach**	**Development cooperation instrument**
DGRV		
Promotion of a Cooperative System Ecuador	• Systemic approach to assist various units in the credit cooperative system: auditing, training, advice, Apex bank, EDP system	• Advice at different levels (including framework conditions, banking supervision) andTraining
Setting Up a Credit Cooperative System, especially Microfinance Uruguay	• Systemic approach for introducing new lending technologies and savings products	• Advisory services and training
Reorganization of the Cooperative System Bolivia	• Systemic approach to assist various units in the credit cooperative system: auditing, training, advice, Apex bank, EDP system	• Advice at different levels (including framework conditions, banking supervision) and Training
Savings Banks Foundation		
Advice to Associations in Mexico	• Strengthening the Mexican savings bank sector by setting up associations to supervise savings banks	• Advisory and training measures
Twinning Project with the Bulgarian Savings Bank DSK	• Strengthening a nationwide bank in key areas such as organization, personnel and lending	• Advisory and training measures
Twinning Project with the postal savings bank Post Bank Uganda	• Assisting the Post Bank towards independence and strengthening its institutional capabilities	• Advisory and training measures

2.3 Examples from the German Development Service (DED)

Institutional and intermediaries level		
Component	**Development approach**	**Development cooperation instrument**
DED		
Establishment of a Savings Bank for Entrepreneurs and Craftsmen in Togo	• Assistance to management	• Advice by long-term expert (development aid worker) • Finance of a local expert and further training

2.4 Example of collaboration between Financial and Technical Cooperation

In Uganda, Financial Cooperation (FC) and Technical Cooperation (TC) are collaborating in exemplary fashion in **developing the Ugandan financial system**. German development cooperation is assisting the partner country in the coherent implementation of a systemic development approach. It supports it at several levels in close concert with other donors. The development projects have been designed on the basis of a thorough weak-points analysis of the Ugandan financial sector, including the macroeconomic framework and the economic policy setting, and are assimilated in a sound sectoral strategy (development cooperation priority area strategy paper). The contributions of German development cooperation are bundled in a programme approach that combines the instruments of different development cooperation organizations (GTZ, CIM, KfW, DEG, Savings Banks Foundation).

By raising the quantity and quality of financial services and improving long-term access for underprivileged sections of the population to financial services, financial sector development can make a major contribution to implementing the Ugandan plan to eradicate poverty (overall goal). The target groups of German development cooperation are private households, SMEs and microenterprises in urban and rural areas.

German development cooperation in Uganda has adopted two strategic approaches to financial system development:

- Deepening the Ugandan financial system by
  - improving the (physical) infrastructure in the financial sector (including the payments transaction system) and developing related distribution channels (expanding the branch office network);
  - assisting Ugandan financial intermediaries with refinance lines/by helping to establish an Apex mechanism and capacity building measures, above all in microfinance and SME finance.
- Improving the quality of financial services by
  - improving the legal and institutional framework, particularly for the regulation of microfinance institutions and a functional capital market;
  - capacity building for decision-makers in the financial sector (central bank, associations, stock exchange, securities commission, management of individual financial institutions);
  - creating or upgrading appropriate financial services (leasing, microloans, savings products, payments transactions, agricultural lending, venture capital);
  - improving the Ugandan financial sector's integration in the East African

region, especially in harmonizing rules, instruments and procedures (particularly in payments transaction systems) as well as integration/cooperation of the postal savings banks in a regional savings banks association.

The implementation of the strategy is long-term and is staggered in consecutive phases. It is being carried out in close coordination or cooperation with other bilateral and multilateral donors (in particular DFID, SIDA, USAID, IWF).

In the programme approach, the following specific development cooperation instruments are being deployed:

- Finance for infrastructure measures, e.g. in establishing a functional payments transaction system (TC and FC);

- Institution building and policy advice to support ongoing reform (TC and CIM);

- Training and dialogue measures for human resource development (GTZ/TC and DSE/InWEnt);

- Cofinancing the PRSC (FC);

- Refinance for Ugandan financial institutions in introducing new financial products (FC);

- Provision of guarantee lines for innovative products and/or institutions (FC);

- Twinning projects between the German private sector (especially savings banks and chambers) and Ugandan financial institutions as well as PPP approaches.

The following table shows the approaches and interventions of development cooperation at the different levels of financial system development and illustrates how FC and TC instruments are dovetailed.

	FC	TC
Central bank and financial supervision level	• Payment transaction services (electronic clearing) • PRSC cofinance	• Advice in banking supervision • Regulation and supervision of MFIs • Strengthening the central bank in the performance of its duties in payment transactions
Intermediaries and institutional level	• Upgrading MFIs (conversion to licensed institutions) • Broadening product range by leasing and other innovative financial products	• Promoting associations and training establishments • Conversion of MFIs into licensed financial institutions
	• Funding MFIs	• Assistance to the State Post Bank Uganda

The comprehensive programme approach enables an efficient and coherent steering of the technical components and competencies in the service of an overriding goal.

Annex 4

More In-depth Aspects of Financial Sector Development

(collateral problem; private sector participation; Financial Sector Assessment Programme)

1. The collateral problem in the banking system

For lack of collateral, the formal lending markets in developing countries are more or less inaccessible to small traders and households with low income. As a consequence, investments cannot be made or the necessary funds must be raised on the informal lending market (e.g. moneylenders) at unfavourable conditions.

Hernando de Soto aroused considerable attention in development policy discussion with his argument that establishing a system of formal rights of ownership for small entrepreneurs would generate loan collateral and facilitate formal lending. This in turn could raise the productivity and income of the poor in considerable measure. Billions in 'dead' capital could be mobilized for collateral for formal loans, if formal legal title was conferred on the present informal wealth of the poor.[19]

De Soto's argument touches on a weakpoint of the financial system in many developing and transition countries where property relations are either unsettled or not secured in law. It is important to be able to make use of assets (mostly land and buildings) as loan collateral but primarily for **formal SMEs** in need of longer-term investment credit. Access to credit for these enterprises crucially depends on the ability to collateralize titles to assets and - what is frequently underestimated - on the banks' effective ability to assert their claims against delinquent debtors by legal means and actually realize the collateral. By assisting in legislation but also in setting up an operational system of land registration, development cooperation can make major contributions here.

[19] Hernando de Soto, The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else, London 2000.

Formal SMEs can also compensate for lack of loan collateral and insufficient equity capital by using innovative collateral and finance instruments. These include:

- **Loan guarantee facilities**: Under certain conditions, setting up guarantee funds to manage credit risk by an adequate incentives scheme and by a professionally organized loan guarantee mechanism may improve the access of small and medium borrowers to credit where other collateral is lacking. However, one important prerequisite is that the respective banks must take the first loss in case of a credit default.

- **Leasing**: Under leasing contracts, leasing goods remain the property of the lessor, which mitigates risk and facilitates finance. The leasing good is a capital goods for the entrepreneur and at the same time collateral for the capital provider.

- **Equity capital**: In equity participation, after appraising corporate policy, the capital provider's contribution participates in the risk, but also in the prospective yield on the investment. No collateral is necessary. On account of the lack of collateral for his equity contribution, the capital provider is accorded control and voting rights.

More **informal SMEs** and microenterprises can avail themselves of a whole range of alternatives to classical physical collateral:

- As a rule, **microfinance institutions** grant loans without physical collateral on the basis of the borrower's capability for loan repayment. It is common practice to gradually increase the maturity and the loan amount (character-based loans, graduation principle): In the first loan cycle, the borrower receives a small loan amount; in the next loan cycle, the bor-

rower can be granted a higher loan amount with a slightly increased maturity based on a positive record.

- **Rotating saving and credit associations** (ROSCAS): members of rotating savings and credit associations pay regular contributions into a fund that is disbursed in whole or in part to each member in a set sequence. They manage without physical collateral.

- **Group lending**: this involves mutual support groups where lending by an independent lender is regulated by means of joint debt. Repayment is not effected individually, but by the whole group. This exerts social pressure, which can be termed social collateral. This incurs little administrative cost; the loans frequently stem from the semi-formal or the informal financial sector.

- **Savings and credit cooperatives**: savings and credit cooperatives are the self-help organizations of their members. Each member is obliged to pay in one or several shares into a business. Each member has one vote. The lending business is based on mobilizing savings deposits - also microsavings. Security is provided by personal and/or physical collateral, primarily through the relationship to the group. In practice, this takes various shapes: from plain savings and credit pools to cooperative universal banks and syndicated systems.

- **Warehouse receipts**: with this instrument, stocks of farm produce can be taken as collateral. The producer receives a receipt for his stored goods, which he can use to obtain credit. At the end of the loan term, the stored goods are sold. In an efficient legal and institutional framework that minimizes transactions costs, this method can mobilize loans, level out market prices and improve food security.

In general then, informal and micro enterprises, which usually demand small loans where an appraisal and assessment of physical collateral would incur excessive transaction costs, can in combination with a suitable credit appraisal to assess future earnings (credit rating) and the personal credentials of the loan applicant (creditworthiness) mostly take recourse to non-traditional securities (household goods, items of furniture, merchandise, livestock, jewelry) or alternative security mechanisms (good standing, prior savings account, social control, group liability).

2. Public-private partnership (PPP) - approaches in financial sector development

Public-private partnership (PPP) in development cooperation is the name given to cooperation between government and the private sector in projects that combine beneficial development impacts with commercial gain for the enterprises involved. The private partner has its own interest in the long-term commercial success of the project; failure would bring it tangible disadvantages. This distinguishes PPP approaches from those of private-sector participation (PSP) - a subset of PPP, where private involvement does entail a significant contribution to equity. The private partners make a long-term commitment in the developing country and take commercial risks. Combining public and private contributions generates synergies.

The prospective developmental advantages of PPP are:

- Relief/Stabilization/Multiplication of public funds,

- Transfer of private-sector know-how,

- More efficient service delivery,

- Better supply to the market,

- Greater sustainability.

If at all, the economic, legal and social framework for an investment project only improve in the long term. Thus, vital to implementing PPP projects in development cooperation are decision-makers in politics, industry and organized labour who are amenable to cooperation with the private sector, a rule-of-law tra-

dition in the state, the application of the law and a suitable regulatory framework.

The financial sector is frequently not prepared to make longer-term commitments in poorer developing countries and to outreach the underprivileged sections of the population, without prior or flanking activities by development cooperation. By providing concessionary funds, equity and development loans flanked by suitable personnel support measures and sector policyshaping, FC can lay the groundwork for participation by the private investor. A major contribution that TC can make is also institution building, the promotion of policy dialogue and preparing the policy climate for PPP projects. From the private sector standpoint, the advantage of PPP is that development cooperation often bears the costs and/or risks of a commitment in part or for a limited time. This way, the private sector can also get involved under more difficult conditions. For the partner government this means that urgently needed private investments in fixed assets and human resources are often only made with development cooperation assistance (bridgehead function of development cooperation or crowding-in).

Public-private partnership approaches have gained increasing relevance in financial sector development by FC, particularly through innovative approaches in microfinance. In 9 microbanks in Eastern Europe and the Caucasus, FC has now managed to acquire private investors for equity investments. Commerzbank currently holds nearly 17 percent of the capital in these microbanks. Almost 18 percent is held by the private Internationale Mikro Investitionen AG (IMI). Apart from the KfW Group, other capital providers include IFC, with nearly 19 percent, and EBRD, also with about 19 percent of the equity.

The Commerzbank made its first equity investment with a share in the ProCredit Bank, Kosovo in early 2000 and has since invested in other microbanks. Aside from its function as capital provider, the Commerzbank contributes major banking expertise, such as in foreign payments transactions. An added factor is that German banks are widely known in Eastern Europe and the Caucasus and enjoy a good reputation there. The involvement of a German bank raises the confidence of the population in microbanks accordingly.

The commitment of private investors was preceded as of the mid-nineties by extensive development activities of the KfW group (KfW, DEG), which together with other donors and implementing agencies ventured into what was largely unknown territory in financial system development by setting up microbanks. Apart from dealing with purely business or operational banking problems and laying the legal foundation, the primary task was to set out an acceptable framework for this new type of financial intermediary.

Extensive initial investments in the shape of capital and comprehensive personnel support measures, as well as ongoing policy dialogue with the respective governments and regulatory authorities, laid the groundwork for private sector. It is safe to assume that the private sector would not have got involved if development cooperation had not borne part of the startup costs and FC and other donors and implementing agencies had not shouldered a part of the initial risk beforehand. Altogether, FC has succeeded in a relatively short time in making a new type of bank (microbanks), but also a new market segment (small and micro enterprises) attractive for the private sector.

Experience with PPP projects in the financial sector so far shows that increased and timely participation by the private sector positively affects the professionalism of the partner banks assisted and also on the stability and sustainability of the promoted institutions. This helps substantially in preparing the way at an early stage for the subsequent exit of German development cooperation and other bilateral and multilateral financial institutions.

Thanks to the success of these PPP projects, there is growing interest among private international investors in investing in privately and publicly sponsored microfinance funds. As compared with an individual commitment, (i) transaction costs are lower for the investors, (ii) the risks of founding microbanks for the poor are spread more widely and reduced through the participation of public financial institutions and their contribution of knowhow. Altogether, the funds facilitate the in

volvement of commercial, ethically motivated investors in financing microfinance institutions. Commercial finance and investment standards can help assimilate microfinance institutions into the national financial sectors of developing and transition countries.

3. Financial Sector Assessment Programme (FSAP)

The Financial Sector Assessment Program (FSAP) is a major instrument for assessing the national financial systems' vulnerability to crisis. FSAP was initiated in response to the financial crises in Asia and Russia and is jointly conducted by the IMF and the World Bank. Under the programme, the two institutions conduct extensive and detailed investigations into the stability of the financial sectors in developing, more advanced and advanced countries. The FSAP is designed to detect weaknesses in the domestic financial sector early on, so it is largely deployed as a diagnostic instrument.

The programme comprises the following analytical instruments for assessing the domestic financial sector: financial soundness indicators and a number of stress tests serve to detect risks to the stability of the national financial sector. Investigating compliance with standards and codes for the national financial sector serve to reveal institutional weaknesses. In this connection, the ROSCs (reports on observance of standards and codes) constitute a key element. These separately drafted reports assess compliance with the major internationally established codes for sound economic and financial practices in the respective states.

The FSAP is essentially an instrument to diagnose the soundness of the financial system, and in its current form it provides a suitable method for advanced financial systems. To be able to assess financial systems that are in the process of development, the analysis in developing countries will have to concentrate on factors that cause financial markets to fail or malfunction. In other words, it will depend foremost on the basic institutional and legal framework. Institutional reforms, for example, comprise the reorganization or privatization of state banks, setting up microbanks or credit information systems (e.g. modelled on the German SCHUFA).

Based on the FSAP, IMF and the World Bank prepare separate reports (Financial System Stability Assessment and Financial Sector Assessment resp.) for their executive directors. These two reports provide a suitable basis for technical and financial assistance by multilateral and bilateral donors.

Annex 5

Possible Implications of Basel II for Developing Countries

1. Objectives and conceptual design of the new Basel II set of supervisory rules

The agreement on capital requirements by the Basel Committee on Banking Supervision (BCBS) of 1988 (Basel I Accord) marked a milestone in the international harmonization of capital requirements in banking supervision. At the end of 1998, the Committee began to prepare a new version of the capital accord and presented proposals in three consultative papers.[20]

The objectives of this undertaking are as follows:

- Enhancing the security and stability of the global financial system,
- Improving competitive equality for market players,
- More thorough and adequate ascertainment of risk,
- Developing approaches for determining an adequate equity base that make proper provision for the degree of risk attached to a bank's positions and business transactions.

The new Basel Capital Accord (Basel II) is still addressed primarily to banks with international operations, but its overall design is also intended to apply for banks of various sizes in different business segments. With these supplementary targets, the Basel Committee is building on the Basel I Accord, which is now a capital requirements standard in banking supervision in over 130 countries.

In effect, the new Basel Capital Accord (Basel II) will consist of three mutually supporting pillars:

- Minimum capital requirements to cover various types of risk (credit risk, market rate risk, operational risk, etc.),
- Directives on qualitative financial supervision with close contacts between the supervisors and the banks,
- Strengthening market discipline through added disclosure obligations.

A central element in the minimum capital requirements setup is the introduction of the scheme (already anticipated in 1996 with the treatment of market rate risks) for ascertaining banking business risks, comprising the credit risk and operational risk segments.[21] This scheme prescribes standardized methods for quantifying risks as a starting point, but is also amenable to recognizing the Institutions' own, more risk-sensitive methods for specifying capital requirements and promotes their application in a certain way. Basel II will not make any substantive changes here. Alongside a standard approach with different exposure ratings, the proposals of the Basel Committee regarding credit risk, include provisions for recognizing in-house rating methods, provided the institutions meet certain quantitative and qualitative requirements in their analysis. In the internal ratings-based approach (IRB), the institutions can choose between a simple and an advanced option. In the simple IRB approach, only the probability of default of the borrower needs to be estimated by the bank itself. However, in the advanced method it must estimate the other risk parameters (loss rate on borrower default, amount of outstanding debt on bankruptcy) as well. Most of the principal banks in the G10 countries can be expected to opt for the IRB approach, which is fully in line with the intent of the BCBS. Smaller institutions can seek to comply with IRB primarily via centralized associations.

[20] BCBS: New Capital Adequacy Framework, June 1999; The New Basel Capital Accord, January 2001; The New Basel Capital Accord, April 2003.

[21] So-called in-house models.

2. Capital regulations for loans to small and medium-sized enterprises in advanced economies

The envisaged new capital regulations provide for more exact supervisory measurement and underwriting of banking risks, and of credit risk in particular. This will, amongst other things, mitigate the adverse effects of calculating risks regardless of the economic circumstances (e.g. misallocation of capital, banks' risk or capital arbitrage). A more discriminating approach will replace the old methods of averaging credit risk in the general and small and medium-sized sector. Under the modified standard approach, loans in future will be assigned on the basis of external ratings to the risk-weighting classes 20 percent, 50 percent, 100 percent or 150 percent. Unrated loans or borrowers will continue to be weighted at 100 percent and underwritten with 8 percent equity capital.

Whereas loans to small and medium-sized enterprises amount to less than EUR 1 million, Basel II allows for reducing the risk weighting attached to these loans from 100 percent to 75 percent. This would reduce the lending bank's regulatory equity capital costs for these loans by a quarter.

The IRB approach provides for dividing bank loans in future first by various portfolios, including enterprises, banks, government sector and private customers. The banks can classify small to medium-sized enterprises in line with their own in-house risk management either as businesses or private clients.

3. Relevance of Basel II for developing countries

3.1 Essentials

Most institutions and financial institutions which are entrusted with supervising roles in developing countries and are attending the Basel negotiations are interested observers: They know that sooner or later the Basel outcomes will become relevant for them, too. So far, banks from developing countries have also been involved in the model calculations.[22] Through its offices in Hong Kong and Mexico, the BIS is also seeking to bring the supervisors from these regions into the consultative process. Overall, the concern is also to improve risk management and reform lending culture. Finally, this new vision must also be imparted to the borrowers.

As net capital importers, the developing countries are following Basel II closely because they fear that the influx of international capital will be rechannelled or cost more. Nevertheless, there ought to be more winners than losers amongst the developing countries in this connection. In any case, the rigid allocation by country group (OECD and non-OECD) and sector (public budgets and banks on the one hand and the 'others' on the other) will be abandoned and superseded by a sophisticated risk assessment, which will increase the overall efficiency of international credit allocation and induce countries to adopt a stability-focused policy .

3.2 Repercussions on financial sectors in developing countries

Only countries represented in the BCBS will be obliged to implement Basel II, and these will not need to do so in full.[23] Nevertheless, other countries will feel its effects via the

[22] Quantitative Impact Studies (QIS); three rounds have been carried out so far, parts of the banking industry have called for a fourth. Over 350 financial institutions from 43 countries with various size and business activity profiles took part in QIS3 (findings published in May 2003).

[23] In the USA, the bulk of banks have evidently been exempted from this as 'non-complex banks' (unlike the German example with all-inclusive implementation regardless of size and legal status of the lending institution in anticipation of a pending EU directive).

normative impact of the Basel standard. The IMF and the World Bank will likely press for compliance as part of the ROSC[24] in the medium term and include it as a component in their FSAP.[25]

Basel I, for example, was originally (1988) only geared to banks with international operations in the G10 countries, but in the end the standard has come to apply worldwide. In recognition of the higher risks in their financial systems and their overall economic development, a good number of developing countries have taken up a Basel Committee suggestion and even raised their minimum capital ratio to above 8 percent.[26] Thus, the BCBS and a representative group of emerging-market countries jointly developed the 25 Principles for Effective Banking Supervision[27] for less developed countries with less robust financial systems.

The second consultative paper for Basel II itself, though, leaves the question open as to who must apply it or for whom it is intended, even if the prime addressees are large banks,[28] and the designation 'bank' may well be a substitute for 'supervised, deposit-taking institutions'.

The ultimate aim of the new standard is to make the national financial systems safer, including those of developing countries. The new standard seeks to build confidence in these financial systems, and in the first pillar, to raise the efficiency of the banking industry by spreading lending conditions more widely to better reflect actual, individual borrower risk.[29] The reforms are thus expected to have such beneficial effects in the long run as to raise the degree of monetization in economies, enabling the banks to operate on a broad and secure basis and lowering interest permanently due to economies of scale and lower loan loss rates.

Even though many developing countries did not introduce a capital ratio criterion until 10 years after Basel I - though this was mostly adjusted 'upwards' - implementing Basel II could be faster. Banks with international operations in developing countries with access to the international capital market will be more interested here than other types of financial institution, which may be more reluctant. There will, however, be no uniform speed amongst the various countries. Instead a broad field of 'slower' and 'faster' countries will emerge. The same applies for emerging markets, where the international banks will likely urge their supervisors to implement the standard rapidly. Regional alliances (Mercosur, the Andean Community, ASEAN, etc.) ought to prescribe regionally binding minimum standards (that can always be overidden nationally, as in the EU). It is already clear that the implementation will take disparate forms.

This also holds for the different types of financial intermediaries: In a number of developing countries, the majority of deposit-taking institutions (DTIs) are not supervised adequately, if at all. These unsupervised DTIs would therefore also not be obliged to comply with Basel II via national standards.

Altogether then, no common standard can be expected to apply for the timetable and scope of applying Basel II amongst the developing countries. Each country will go its own way here. It is conceivable that developing coun-

---

[24] Reports on the Observance of Standards and Codes.

[25] Financial Sector Assessment Programmes.

[26] Exchange rate and debt crises usually also hit the financial sector hard, recent examples being Argentina and Uruguay. Ongoing economic downturns can also cause financial systems to break down.

[27] Issued in 1997 by BCBS and fleshed out with a Core Principles Methodology in 1999.

[28] BCBS: Overview of the New Basel Capital Accord, January 2001 (e.g. p.2: "suitable to all kinds of banks around the globe", ".. all significant banks after a certain period of time"; p.7: "suitable for application to banks of varying levels of complexity and sophistication"; p.6 "… to enhance competitive equality".

[29] While in Germany the aggregate balance sheet total in the commercial banking system ranges around 300 percent of GDP, this ratio is distinctly lower in Latin America for instance, with extremes of 22 percent in Venezuela and 92 percent in Brazil (figures for 1999 and now tending much lower); cf.. Hawkins, J./Mihaljek, D.: The banking industry in the emerging market economies: competition, consolidation and systemic stability - an overview, in: BIS: The banking industry in the emerging markets, BIS Working Paper No. 4, August 2001.

tries, particularly the so-called emerging markets[30] will

- apply approaches at least modelled on Basel II,
- retain Basel I and adopt elements from the second and third pillar, or
- improve the present (Basel I) standard.

In all three cases, the measures will be tailored to national needs and conditions.

3.3 Impacts of the first pillar (minimum capital requirements)

Interest costs in almost all developing countries pose a major problem, particularly for micro, small and medium-sized enterprises (MSME). Interest charged is generally high; spreads between interest receivable and interest payable often amount to 10 percentage points or more. Looking to the future, it is unclear as to what effect the new capital accord will have on the costs of lending, especially as nothing is yet known about the exact specification of the accord and its implementation in the developing countries. In any event, however, there will be a redistribution amongst different types of borrowers. Altogether, Basel II may even make things easier for MSMEs in some developing countries. Consultations on this are still ongoing.

There would, though, be grounds for concern if MSMEs had to bear higher interest costs, not because of a possible higher credit risk - which would conform fully with the intention of Basel II - but because the financial institutions providing them with credit are unable to make use of the relatively more favourable IRB approach due to their size and must apply the standard method.

Heavier demands on banking supervisors, as well as on the institutions, call for more personnel, better trained, qualified and therefore more costly staff.[31] This will also raise the costs for the institutions indirectly as the budgets of the supervisors are mostly passed on in full to the supervised institutions, which pass these on in turn via loan interest.

Centralized approaches, via associations for example, will play a greater role in keeping the costs of implementation and training within limits. This will also apply in particular for appropriate IT setups. For small non-banking institutions in particular, this process ought to make for greater cohesion in the sector (as intended, without, however, softening the current dividing lines between cooperatives and other, small DTIs for example). This increased cohesion could also enable the use of the IRB approach in the first pillar.

Due to the already pronounced business cycles, the procyclical bias[32] for which Basel II has been criticized can have a very adverse effect on developing countries. Here the national standards authorities will have to take appropriate countervailing measures. The same applies for Basel II's possible discrimination of long-term loans. Since the scope for maturity transformation is limited by the predominance of short-term bank deposits anyway, greater pressure for more short-dated lending would prove counterproductive.[33]

3.4 Impacts of the second and third pillar (financial supervision and disclosure requirements)

Stepping up ongoing supervision and self-assessment by the institutions will make heavy

[30] Cf. Crockett, Andrew: Central banking, financial stability and Basel II, paper delivered in Manila, 13 Feb. 2003; Heinrich, Gregor (BIS): Los retos del Nuevo Acuerdo de Capital para los países en desarrollo y la función del BIS, paper presented in Cartagena, Colombia, June 2003, p.9.

[31] Exceptions are states where supervision is incorporated into the central bank and the costs of supervision cannot be calculated separately from central bank operations (such as payment transactions and monetary policy - examples being Argentina or Brazil).

[32] Increased loan costs in recession due to poorer borrower ratings.

[33] The only remedy here so far has been via capitalized pension insurance schemes that have no maturity transformation problems and take on long-term bank loans by way of securitization.

demands on all those involved, but is ultimately unavoidable, even without Basel II. External auditors and the internal audit will play an even greater role, because supervisors will not be able to cope with their tasks without heavy reliance on both. Basel also provides for this elsewhere.[34] In all, supervision will take on a more proactive role and early warning systems will become increasingly important as a result.

Greater market discipline through transparency or public disclosure are also important for developing countries. Access to risk (credit information) centres, more frequent and detailed publications of balance sheet figures, rating of finance companies themselves as market players, etc. need including and promoting here. In part, the developing countries have made quite a lot of progress in these areas.[35]

[34] BCBS: The relationship between banking supervisors and banks´ external auditors, Basel Committee Publication No. 87, January 2002; Internal audit in banks and the supervisor´s relationship, Basel Committee Publication No. 84, August 2001.

[35] Cf. Arzbach, Matthias, Álvaro Durán and Luis Humberto Ramírez: Monitoreo de Cooperativas de Ahorro y Crédito por parte de las Superintendencias Bancarias, June 2003.

4. Recap

Basel II is still in a state of flux; there is no assurance of its adoption by the end of 2003 and implementation by the end of 2006 as scheduled. Many developing countries can be expected to gradually adopt the Basel II standard. Many points of criticism (such as the disadvantages for MSMEs) have been addressed after the various trial calculations (quantitative impact studies - QIS) and hardships have been remedied or mitigated. This process is still pending. For this reason also, it is presently difficult to estimate what methods small DTIs will use. Of particular importance would seem to be equal treatment in the financial regulation of institutions that engage in the same type of financial activity (i.e., a level playing field).

Training measures at various levels and in all institutions in the financial sector must be accorded a prominent role in German development cooperation in connection with implementing Basel II. The measures should be aimed both at institutions entrusted with supervision and the sectors promoted. The measures should work to stimulate and increase dialogue between both groups in order to prepare for exchange between supervisors and financial institutions as called for in the second pillar.

Germany is gaining major experience from the mandatory application of Basel II in smaller institutions. The centralization of relevant approaches in the German savings bank and cooperative banking sector can also be of value for related advice in partner countries.

The capital requirements in the Basel II standard approach ought to remain more or less at the same level as in Basel I. As a result of more discriminate risk assessment for loans to borrowers in countries with good and to those with lower credit standing,. the costs of refinancing for banks in some developing countries ought to increase substantially. As access for banks from these developing countries to the international financial market worsens as a result, the finance problems of MSMEs in particular may escalate.

Due to higher risk sensitivity overall, as sought by Basel II, smaller and medium-sized institutions will probably look to upgrade their risk assessment methods. In this process, their information requirements on client position and business outlook will increase. So MSMEs must be generally prepared to provide their bank or also the rating company with more detailed and transparent information on business developments.

Even though discussions on the new capital standard are still ongoing, it is already apparent that Basel II will affect a basic change in the way that the supervisors and the financial institutions work. Developing countries may find the new standard useful as it heightens risk awareness amongst supervisors and institutions, promotes stability, and ultimately increases the breadth and depth of the financial markets. National authorities will be responsible for applying the standard appropriately as "required" in respective countries, and will consult with the sectors concerned. As a rule, the supervisors are already aware that Basel only represents the bottom line.

Finally, the standard should also be applied to smaller financial institutions, provided they take deposits. This would support expanding the supervisory scope in countries where the treatment of non-banking institutions has been more lax. It is doubtful whether a further segmentation through standards at least approaching Basel II in one part of the financial system and inadequate standardization and supervision in another (also deposit-taking) sector would be viable. The resulting incentive to regulation arbitrage[36] would then be detrimental to the Basel II's actual objectives. Basel II standards and possibly derivative national standards in developing countries are high, but this should not be cited to support the argument that all small DTIs (in the legal status of

[36] That is, exploiting regulatory discrepancies between different types of intermediary. For example: money laundering via unregulated institutions; borrowing from intermediaries not linked to credit information centres and hence increased loan loss rates in the regulated segment also, etc.

a cooperative, for example) need not be brought under supervision. Adequate creditor protection and social equity can only be guaranteed with all-inclusive supervision.

Comprehensive international efforts for suitable training are needed. If these are successful and the positive trends prevail, Basel II can ease access for broad sections of the population to financial services, also in currently underserved regions.