The Role of the IMF and World Bank in Financial Sector Reform and Compliance

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The IMF and the World Bank have responsibility respectively for exchange rate and currency stability, and reconstruction and development. The post-war agenda of exchange rate stability and reconstruction has been broadened to assist members with their efforts to achieve monetary and financial stability, create sustainable economic growth to reduce poverty, and enhance development; focusing on their capacity to improve the domestic infrastructure that is necessary in most cases to deal with the prescribed assistance the institutions provide.

The responsibilities of the two are distinguishable by the period over which they assist their members. The IMF's assistance has tended to be on a short-term basis, focusing on macro-economic matters; whereas the World Bank has concentrated on long-term development projects that focus on the micro-economic side. In the pursuit of these interdependent goals a considerable level of cooperation between the two institutions has evolved, notwithstanding an inevitable degree of tension on occasion when their policies seem to conflict with one another; this occurred especially during the 1990s and the financial crises experienced by a number of countries.

This has resulted in more formal coordination over the years to deal with such matters, although both still concentrate on their 'core asks'. Gilbert et al propose the core foci as 'the Fund on macro-economic and crisis resolution and macro-policy advice; and the Bank on longer-term development—including micro-economics and trade and industry issues—and poverty reduction'. This move from the traditional remits of responsibility is evidence of a growing influence of the two in the arena of a country's domestic policy; this is achieved through the conditions attached to their financial and technical assistance when domestic policies and legal and regulatory infrastructure are not sufficient to prevent or manage a crisis.

The evolving role of the IMF and World Bank

The responsibilities and functions of the IMF centre on its key purpose: to deal with 'international monetary problems' by acting as the forum for its members to 'consult' and 'collaborate' with it so as to 'facilitate' and 'promote' 'international monetary co-operation', 'growth of international trade' and 'exchange rate stability' to achieve financial and economic stability. The IMF seeks to achieve these broad purposes through its core functions: surveillance, financial assistance and technical assistance to ensure its members continuously adhere to its underlying purposes.

The traditional objective of surveillance is ensuring orderly exchange arrangements' among members. The IMF, in 'consultation' with its members by both bilateral and multilateral means, assesses individual members' economic and monetary policies against its purposes to ascertain whether they pose a risk to the stability of the international monetary system. It seeks to provide financial assistance to members experiencing balance of payment problems, on the basis that the individual member complies with the conditions set for such assistance so the IMF can be assured the money will be repaid.

This invariably requires the member country to adjust its economic and monetary policies, giving rise to a considerable level of coercive and unfettered leverage by the IMF to ensure changes are indeed made. The final function of the IMF is to provide technical assistance to its members, but without the same degree of compulsion as is attached to the other activities. Conditionality which generally refers to the designated policy and procedures attached to the assistance the IMF provides ensures to a certain extent the objectives of the assistance is achieved. It has, in many respects, generated a considerable level of controversy in light of the expansion of its policy remit to include matters at a micro level such as infrastructural reform. As Lastra notes the rationale for this expansion was the fact that the crisis stricken countries discussed above exposed considerable problems in this area thus exacerbating the financial problems they experienced.

The traditional functions as noted above have expanded considerably over the years, both formally through amendments of the Articles of Agreement and informally through policy pronouncements, to encompass a broader set of issues that underpin the stability of the international monetary system. This has widened the IMF's role from macro-economic policy matters to include microeconomic policy, to achieve inter alia 'financial and economic stability in its broadest sense' by acting as a forum for 'international cooperation to monitor economic developments on a global scale' and specifically addressing weaknesses in the overseeing of domestic financial markets.

The key issue highlighted is the risks now posed by such weaknesses in the financial system, both internally and externally to others. The traditional role of surveillance has been broadened from what Lastra coins ' “macro-surveillance” to microsurveillance” specifically focusing on financial system soundness by placing particular attention on 'weak financial institutions, inadequate bank regulation and supervision, and lack of transparency' as a result of its broad discretionary mandate articulated in the Articles of Agreement, These issues form part of the broader agenda of bilateral and multilateral surveillance the IMF undertakes periodically with members to 'lessen the frequency and diminish the intensity of potential financial system problems'; members are required to cooperate with the IMF, outlining how they will attempt to deal with any issues by drawing up a programme of reform. For example, the Article IV staff report for Tunisia in 2002 illustrated the work the authorities were undertaking in the financial sector area and progress towards implementing the findings from a Financial Sector Assessment Program (FSAP) assessment.

Despite the perception that financial sector reform is a 'wholesale' part of Article IV consultation, in fact only two reports explicitly refer to financial sector matters, namely Tunisia and Iceland.

However, when a country is seeking financial support from the IMF the picture is very different: here the issue of financial sector reform features frequently, in addition to the traditional areas of IMF responsibility, in the Letters of Intent prepared by the member seeking support. For example, the Letter of Intent of the government of Thailand dated 1997 contained numerous references to its intention of making changes in the financial sector, such as legal and regulatory reforms.

To obtain financial support from the IMF these changes were of a short- and long-term nature, and designed ultimately to restore confidence in the financial system by closing insolvent banks, putting in place a deposit protection system and improving the approach to enforcement sanctions. These issues form part of the adjustment policy the member seeking assistance must put in place and adhere to in order to give the IMF the assurance to provide such assistance.

The IMF's technical assistance function has also evolved in light of its broader agenda to include financial sector reform, which incorporates the FSAP, by providing technical assistance on a voluntary basis. In more recent Letters of Intent, such as Turkey in 2006, the letter not only referred to the measures put in place to effect financial sector reform, but also expressed the intention to 'use the findings of the FSAP for Turkey to guide our future reform efforts in the financial sector'. This indicates the link between the compulsory and the voluntary parts of the IMF's role and the importance attached to financial sector reform, if necessary, in seeking financial support from the IMF. The voluntary aspect is important because not all members will require formal assistance but may nevertheless pose a threat to domestic or international stability, so some form of voluntary assessment programme was needed that specifically focused on bank regulation reform—especially given that weaknesses in this area were part of the reason for the Asian financial crisis.

The World Bank is primarily made up of two main agencies: the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA) and affiliate agencies. The role of the IBRD is aimed at reduction of poverty and sustainable development, although its initial responsibility was for assistance with the reconstruction of countries affected by war. The World Bank acts for its members as a facilitator for investment and technical assistance, broadly speaking to assist with the 'development of productive facilities and resources in less developed countries'. The investment (or loans as the case may be) it provides comes from both private means and its own resources, but the principal objective is to give financial assistance to members on the most reasonable terms and conditions. The IBRD raises most of its funds by selling its AAA-rated bonds to financial intermediaries in the international markets. The traditional objectives it tries to 'promote' are of a long-term nature: the 'growth of international trade', 'equilibrium of balance of payments' and 'investment for the development of the productive resources of members, focusing on raising productivity, the standard of living and conditions of labor in their territories', but avoiding interfering in the political affairs of the country. The purpose of the IBRD is relatively narrow in terms of its Articles of Agreement, but has obviously been interpreted broadly to cover the whole spectrum of development, from economics to health, education, environment, infrastructure and poverty alleviation: 'The Articles must receive a great measure of purposive interpretation to reflect the Bank's changing role as a development institution'. The objectives are continuously evolving rather than static and rigid, and need to be interpreted in the broad spirit rather than to the letter.

The primary functions of the World Bank as a whole are said to be to act as a financial intermediary, a development research institution and a development agency.66 The IBRD and the IDA provide long-term finance for specific programmes over 15–20 years and 35–40 years respectively, depending on whether the individual country is classified as middle-income or low-income—the former do not have the financial need to seek assistance from the IBRD. The World Bank also assists members by providing what are termed 'knowledge services' through assessments and technical assistance on development matters; this is one of its most important roles. The loans provided by the World Bank fall into two broad categories: goods and services, and adjustment loans or 'structural adjustment loans'. The latter are for policy and institutional reforms: the 'programme of reforms . . . proposed by the country and negotiated with the World Bank to ensure the objective of the projects and the outcomes are achieved under the aegis of conditionality'.67 Non-compliance can ultimately lead to the withdrawal of a loan, or in most cases the threat of it being withdrawn, notwithstanding the fact that a country is not obliged to fulfill the measures set out in the programme; this is seen as its sovereign prerogative given the political, social and economic implications of the programme for the country. Financial sector reform has been on the World Bank's agenda for a considerable length of time (a lot longer than it has featured at the IMF), either through financial support for structural reform projects or technical assistance to a country's authorities to develop this area of the economy and improve the capacity to oversee the financial system through legislative changes and training. Structural adjustment loans have focused on a broad range of areas, including reducing government ownership and strengthening bank supervision.

For example, in the period 1993–2003 the World Bank provided $56 billion of assistance for financial sector reform projects, which equates to about 24 per cent of its budget, to improve economic growth and reduce poverty by enhancing the mobility of savings and investment across as broad a sector of the economy as possible to make it more inclusive. The size and complexity of the projects mean that the World Bank acts as the overall 'lead manager', with other donors, especially regional development banks, providing assistance such as technical and financial support. In these projects the state is at the centre and advocates the reforms, while the central bank and government departments are responsible for implementing the changes; this is in contrast to the general perception that changes in banking regulation and supervision are implemented by the central bank rather than being state led.

Support has focused on numerous projects relating to the infrastructure of the financial system; for instance, in the case of Egypt in 2006, which is no exception, the goal was to modernise bank regulation and its enforcement so as to comply with international standards. The changes were aimed at improving the efficiency of the banking system by enhancing market confidence and accountability of individual banks. In Paraguay in 2002 the focus was on mechanisms to deal with efficient bank resolution and provide an effective safety net to avoid small depositors losing their money when a bank fails or is closed. In Mexico in 199575 and the Philippines in 1998, technical assistance to strengthen financial sector oversight by improving their capabilities to deal with financial crisis was one of the main features of the loan. In the case of Pakistan where the reform efforts have been in place for a significant length of time compliance with the Basel Core Principles now stands at 22 out of the 25 Core Principles.

The IMF and World Bank Financial Sector Assessment Program:

A Diagnostic Tool

The FSAP diagnostic tool was introduced by the IMF and World Bank after the Asian financial crisis on a voluntary basis. This prompted the international community to respond with a whole host of initiatives to mitigate the risk of such episodes occurring again. The IMF and the World Bank set up the FSAP so their respective strengths and specialisms could be harnessed together to identify financial sector 'vulnerabilities' and deal with the 'development needs' of their members to reduce the likelihood of further financial crises and the disruption they cause to financial stability. Another objective of the FSAP is to determine the extent to which members comply with international standards of financial regulation and supervision in banking, securities and insurance business; this is either incorporated under the Assessment of Financial Sector Standards or in an individual Report on Observance of Standards and Codes (ROSC). The joint programme aims, 'to help countries to enhance their resilience to crises and cross-border contagion, to foster growth, by promoting financial system soundness and financial sector diversity'; its synergy connects the macro/micro prudential aspects of financial stability by linking it with the regulatory infrastructural needs of a country. The diagnostic focus of the FSAP then forms a platform for remedial work under the direction of the assessed country.

a) FSAP process and tools

The FSAP process has focused on the needs of developing, emerging and industrialized countries. It concentrates on what it terms 'systemically important countries', as well as countries at various stages of development that pose a systemic threat to international financial stability. For example, in the case of developed countries a 'vulnerability assessment' is undertaken to gauge the extent to which the banking system can withstand macro-economic shocks; In the case of emerging economies the FSAP process has to pay particular attention to the quality of regulation after financial crises and the diversity of the financial system, to assess whether the non-bank sector, for instance, can pose systemic risks to the overall well-being of the financial system. The priority set for developing countries is different, focusing on building the infrastructure of the financial system.

The response by those deemed systemically important differs from that of countries at other stages of development. For example, the former consider the FSAP as an external review from an international perspective to gauge whether they could weather episodes of international financial instability; the latter consider it as an opportunity for identifying gaps in existing regulation and supervision and initiating reforms with development objectives in mind.

According to observations made after the pilot programme, most countries that participated wanted more attention to be paid to the 'implications of missing, incomplete, or informal markets for the stability and the development of a diversified financial sector'. The most recent review highlights similar sentiments wanting improvements in the assessment to reflect the development issues that are integral to the reform process.

The process of assessing observance of codes and standards consists of a premission, the mission and a post-mission assessment involving an international team of consultants and IMF and World Bank officials. The country first completes a questionnaire on its system of bank regulation in conformity with the Basel Core Principle methodology; this is then submitted to the 'mission chief'.

The mission involves an in-country Financial System Stability Assessment (FSSA) of the banking system and its regulation and supervision. The team holds discussions with institutions such as the central bank and the bank regulator and supervisor, and has meetings with figureheads in the banking industry.

The stress test forms a significant part of the FSAP process. It consists of assessing the extent to which a country's financial system can withstand instability arising from 'plausible shocks to key macroeconomic variables'. The assessment focuses on macro-economic shocks to the financial system to judge its robustness to withstand them. Stress tests could examine the implications of changes to interest and exchange rates for financial services firms.

The stress test is not a single, uniform model that is simply applied to all countries, ignoring the level of development; each assessment is designed around the country relative to the 'complexity of the financial system, and data availability, while also being mindful of the resource burden imposed on the central bank and supervisory authorities'.

For example, in the case of Gabon the stress tests focused on issues such as a government default on domestic debt repayments as a result of changes to oil production in the country and their effect on commercial banks servicing their debts. In Mexico the focus was on the resilience of the banking sector to withstand a slowdown to the US economy, which would have a significant effect on banking profitability. The position in Sweden was assessed by testing the resilience of the banking sector to real estate, exchange and interest rate shocks; it was found that banks were resilient to such changes.

The assessment of financial sector standards is the other significant part of the overall assessment of the financial system. The focus of the FSAP is on three areas:

i. Financial sector regulation and supervision;
ii. Institutional and market infrastructure;
iii. Policy transparency'.

It consists of assessing countries' financial systems in light of a variety of international standards in banking, securities and insurance business.

The international banking standards devised by the Basel Committee are a significant part of the FSAP process, which adopts the Basel Committee methodology to evaluate compliance with the Core Principles. Through the assessments a number of issues have over time been identified which would call into question the effectiveness of the regulatory regime in a country: examples are political interference in the authorization process or lack of legal immunity from law suits; a lack of powers to deal with unauthorised activities; a lack of criteria to ascertain whether a bank, shareholders or individual director are fit and proper; capital adequacy rules which are not adhered to or monitored effectively on either an individual bank basis or a consolidated basis; large exposures which are not monitored or reported; insufficient on-site assessment of banks; limited consolidated supervision of cross-sector or cross-border activities; ineffective enforcement by the regulators of standards and rules that actually exist; and limited cooperation between respective regulators to oversee banks that operate across borders.

The degree of compliance with the Basel Core Principles makes interesting, yet unsurprising, reading. The level of compliance is in many respects commensurate with the stage of development the country is at. Indeed, the forms of 'noncompliance' are also associated with the stage of development. Developing countries evidence a lower level of compliance than their transitional or advanced country counterparts.

In the case of developing countries, the lack of a formal licensing system that clearly identifies which businesses are regulated could lead to a situation where banks gradually pursue business they are not authorised to undertake and expose themselves to risks the regulator is not readily able to monitor and examine. John Head, for instance, warns against the use of entry requirements 'to shelter poorly-run existing banks'; rather, they should provide 'important protection against a host of dangers, including incompetent or untrustworthy managers, inadequate capitalization, sloppy lending practices'. Another significant concern is if the laws governing banking business are not effectively enforced.

The general findings in more advanced countries are 'minor' in comparison and show a high level of compliance; nevertheless, gaps raise concerns. For example, in some cases, surprisingly, regulators lack powers to request changes to the board of directors and senior management of banks, giving rise to quite serious oversight weaknesses. The lack of power to deal with issues of individual non-compliance is a very serious threat to prudent banking. Given that most bank failures arise from mismanagement, such findings are exacerbated when interlinked with the 'systemic' implications associated with advanced countries.

The position in emerging countries does differ as a result of their efforts to rectify problems, but issues to do with the efficacy of legal infrastructure still exist. As Arai notes, countries may simply wish to show the world that 'on paper' they tick the box for implementing the Core Principles, to make themselves an attractive marketplace for foreign investors, but the substance of the regulation and supervision may not be sufficient to oversee the risks within the marketplace.

The next section explores more specific country findings at different economic positions and levels of economic development.

b) Low/middle-income countries

Algeria is a country that has attempted to transform itself into a market-based economy in which the state plays less of a role; it has a 'fragile' banking system which has received 'pervasive state support and forbearance'.

Responsibility for banking supervision and regulation is divided between the Money and Credit Council, the Banking Commission and the Bank of Algeria (the central bank).

Banks are predominantly publicly owned, but with a gradual rise in the number of privately owned institutions. However, the banking system is considered fragile in light of the level of non-performing loans and insolvent institutions that are simply financially propped up by the state. The position in Algeria, shows a picture of a country that is faced with a considerable task to overcome despite progress in some areas. The 2004 report is far more explicit about the changes required in the structure of banking, strongly suggesting a move away from public-owned banks to private ownership, because of the moral hazard that would ensue from the country's 'unconditional' liquidity support to the public banks.

The main recommendation after the 2000 assessment was that 'the authorities should develop their capacity to enforce efficiently the existing regulations' and avoid regulatory forbearance. While the move towards privatisation was found to be necessary in 'divesting the state from the banking system', the recommendations focus, as a first priority, on the regulator having a better level of insight into the management of publicly owned banks and improving aspects of the authorisation, supervision, enforcement and accountability mechanisms.103 The 2003 report reiterates the issues pertaining to the fragility of the banking system found in 2000, and noted 'the authorities still need to make greater use of all supervisory tools and sanctions [and] expedite sanctions with respect to banks that fail to meet their obligations'.

Uganda, despite being one of the poorest countries in the world, 105 has got a relatively 'sound' banking system according to the IMF FSSA report. The economy is considered vulnerable to external shocks, however, particularly the agricultural sector, which plays a dominant part in its export earnings.

Responsibility for the banking system and prudential bank regulation and supervision lies with the Bank of Uganda. The position in Uganda is fairly typical of other developing countries, where compliance with the Core Principles is not consistent; nevertheless, inroads have been made to improve bank regulation and supervision by adopting a risk-based approach to the way they undertake their responsibilities. A move by the Bank of Uganda to close 'nonviable' banks is suggested, due to the opaque capital levels at some banks.

The 2003 assessment describes the importance of dismantling the formal arrangement between the Minister of Finance and the Bank of Uganda for consultation about 'revoking a bank license' or 'rejecting an application for a banking license', in order to avoid political capture of day-to-day regulation and supervision.

The banking system consists of a number of banks engaged in a range of financial services, but consolidated supervision of those activities is limited and it is therefore difficult for the regulator to see how the non-banking activities could impact on the bank. A more pressing issue highlighted is the scope of deposit insurance cover: this has been extended on a number of occasions to cover all deposits rather than limited to the original amount indicated, and there is a possibility of undermining market discipline by extending cover for prolonged periods of time.

The use of 'lender of last resort' has also been challenged in light of the liquidity support given to insolvent banks without good security. Another issue that is important to rectify, as it goes to the heart of effective bank supervision, is the point made by Justice James Ogoola: 'a strong, but secondary cause of bank failures was the consistently weak supervision by Bank of Uganda'.

For example, formal powers to remove management are rarely used. The assessment points out that 'effective supervision lies more with prompt and firm decisions by the supervisor than with the legal framework'.

The legal framework may not necessarily comply with the Basel Core Principles in its entirety, but the point highlighted is that regulators must ensure the rules they have are applied consistently.