ADB

Financial Sector Operational Plan

Asian Development Bank

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Note:
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Abbreviations

ABMI	–	Asian Bond Markets Initiative
ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
ASEAN	–	Association of Southeast Asian Nations
ASEAN+3	–	ASEAN, People’s Republic of China, Japan, and Republic of Korea
BPMSD	–	Budget, Personnel, and Management Systems Department
CGAP	–	Consultative Group to Assist the Poor
CoP	–	community of practice
CPS	–	country partnership strategy
DEfR	–	Development Effectiveness Review
DMC	–	developing member country
FSAP	–	Financial Sector Assessment Program
FSD	–	financial sector development
GDP	–	gross domestic product
IAIS	–	International Association of Insurance Supervisors
IED	–	Independent Evaluation Department
IMF	–	International Monetary Fund
IOSCO	–	International Organization of Securities Commissions
JFPR	–	Japan Fund for Poverty Reduction
OCO	–	Office of Cofinancing Operations
OCR	–	ordinary capital resources
OECD	–	Organisation for Economic Co-operation and Development
OREI	–	Office of Regional Economic Integration
PRC	–	People’s Republic of China
PSOD	–	Private Sector Operations Department
SMEs	–	small and medium-sized enterprises
SPD	–	Strategy and Policy Department
TA	–	technical assistance

Executive Summary

The Asian Development Bank (ADB) issued its long-term strategic framework, Strategy 2020, in April 2008 to its guide operations to meet the changing assistance needs of its developing member countries (DMCs). The strategy identified financial sector development (FSD) as one of the five focal areas of ADB's operations through 2020. This Financial Sector Operational Plan aims to articulate the financial sector agendas of Strategy 2020 and guide its implementation by ADB.

Asia and the Pacific has emerged as a dynamic center of global growth with high savings and strong exports. It attracts a high volume of private capital and investment, and has massive potential for domestic markets. Since the Asian financial crisis 1997–1998, the financial sector of the region has developed significantly. Banks in particular have strengthened their balance sheets, making them more resilient to external shocks. The region's middle-income economies also have made progress in developing the core of their domestic capital markets and nonbanking sectors.

Despite these achievements, the development of the region's financial sector still lags substantially behind that of developed economies as well as the region's manufacturing sector. The sector is dominated by banks, reflecting a lack of capacity in the region's nonbanking sectors and capital markets. This concentrates systemic risks and limits mobilization of long-term finance and risk capital. The regional integration of the financial sector is also lagging, as reflected in the region's inability to intermediate its own balance of payment surpluses.

DMCs differ widely in such characteristics as per capita income, growth rates, and population size and density. These differences have generated widely different levels of FSD and diverse sector landscapes across the region in spite of the common feature of bank dominance. Thus, ADB needs to tailor its assistance to focus on the priority areas of each DMC through the country partnership strategy process.

Nevertheless, DMCs share certain strategic agendas for FSD to varying degrees. First, DMCs, particularly low-income and conflict-affected economies, need to strengthen public confidence in their monetary and financial systems. ADB will support DMCs in strengthening public debt markets, central banking capacity, and financial infrastructure as a foundation for building public confidence. By doing so, ADB will support the development and reform of the banking sector.

Second, the region's financial sector needs to support greater domestic demand for more balanced economic growth. This requires more inclusive finance for inclusive economic growth, which is one of the three strategic agendas of Strategy 2020. ADB will promote enhanced financial access for the traditionally underserved, particularly poor households and small and medium-sized enterprises (SMEs). ADB will support broad-based household access to microfinance and housing finance, with appropriate regulation and consumer protection. For SME access to finance, ADB will support DMCs in enhancing both secured and non-secured lending regimes including trade finance. ADB will also support leasing, factoring and credit guarantee subsectors, and SME's access to equity and debt markets.

Third, the region needs to invest aggressively in infrastructure in the years ahead. To do so, it is necessary to develop capital markets and an institutional investor base that generate long-term finances and risk capital. ADB will support the development of capital markets, including subnational debt markets, and the enhancement of the access to long-term finances by infrastructure. ADB will also use its local currency bond issues to contribute to the market development. Contractual savings institutions such as pension funds and insurance companies form the core of the institutional investor base. Their development is driven by the need for financial security and risk management. ADB will support DMCs in reforming and improving social security systems, and strengthening the pension and insurance subsectors.

Fourth, as the financial sector extends its reach beyond its traditional customer base and takes on new risks, it is essential to ensure the sector's continued stability and integrity. ADB will support DMCs' efforts to improve the macro- and micro-prudential regulation and supervision of financial institutions and markets and promote their accountability and transparency. This will include the enhancement of risk management and corporate governance of individual financial institutions. ADB will also support the restructuring of banks and the establishment or strengthening of deposit insurance schemes; capacity building for financial crisis prevention, management, and resolution; and anti-money-laundering measures.

Finally, ADB will support the integration of the region's financial sector to facilitate the channeling of savings from net saving DMCs to net borrowing ones. To do so, ADB will support DMCs' regional initiatives in liberalizing capital accounts and foreign direct investment in the financial sector, adopting common standards for financial transactions and services across the region, and establishing financial infrastructure that supports cross-border transactions. ADB will also support DMCs in monitoring and managing resulting capital flows.

ADB has been regularly working on many of these identified areas such as the banking sector, financial inclusion, capital markets, contractual savings, financial stability, and regional financial integration. ADB also had occasional operations in central bank capacity building, housing finance, and capital flow monitoring and management. ADB will focus on enhancing the quality and developmental effectiveness of the established areas, while improving business models, knowledge, and expertise in the areas of limited experience. ADB will build a particular strength in the areas of financial inclusion and capital markets for infrastructure finance, which support the three pillars of the real economy: households, small and medium-sized enterprises, and infrastructure. ADB expects heavy operations in those areas.

Business Model and Product Lines

ADB will strengthen its lending and investment products with policy advice and technical assistance (TA) to support reforms and sustainable capacity building, while ensuring DMCs' commitment to reforms and absorption capacity. ADB will strengthen the programmatic approach in addressing interrelated FSD issues and use program loans as a platform for policy dialogue with DMCs. In doing so, ADB will strengthen coordination and collaboration between the sovereign and nonsovereign operations. As an analytical underpinning for the programmatic approach and program lending operations, ADB will continue to carry out periodic, comprehensive reviews of the financial sector, primarily as part of the country partnership strategy process. When appropriate, a separate sector review will be undertaken.

ADB will strengthen financial intermediation (credit line) operations with effective capacity building TA and policy reform support for participating financial intermediaries, while ensuring consumer protection and education. ADB will classify all projects involving a credit line intermediated through formal financial institutions partially or wholly as a financial sector project and have them vetted with the principle of market-based pricing as required by ADB's *Operations Manual* section.

ADB will try to selectively increase investment projects to strengthen financial infrastructure such as payments and settlement systems. These tend to be information technology-intensive and technically demanding. ADB will strengthen staff capacity and expertise to support DMCs in designing and managing such projects.

ADB will also seek to strengthen knowledge works, policy advice, and TA not directly linked to ADB-financed projects to support FSD. ADB will strengthen partnerships with international organizations and financial standard-setters to promote best practices, while facilitating knowledge transfer among developing countries. ADB will also further enhance its responsiveness to DMCs' calls for urgent advice and TA since the sector is often subject to rapid developments and risky situations (e.g., capital flows, asset bubbles, inflationary pressures, and exchange rate volatility).

ADB will seek to mobilize donor funds (e.g., Financial Sector Development Partnership Fund) to finance not only stand-alone non-lending works but also the knowledge-intensive services to support lending operations.

Skills and Resource Requirements

The enhancement of the quality and quantity of programs, projects, policy advice, and TA will require additional staff time, expertise, and resources. ADB will seek to strengthen staff capacity. ADB will improve the level of cooperation between operations and other departments as well as the ADB Institute.

ADB will develop expertise in areas of FSD by investing in staff training and new hiring, and will enable its staff to more directly participate in the delivery of policy advice and knowledge work, in addition to managing consultants to do so.

Operations departments and the FSD community of practice (CoP) will work together in (i) using experts across departments, (ii) strengthening the sector peer review process to enhance the quality of ADB operations, and (iii) ensuring effective implementation of this Operational Plan.

The Office of Regional Economic Integration (OREI) financial sector team will serve as the secretariat for the FSD CoP and will support the work of the operations departments. The FSD CoP will cooperate with the Economics and Research Department, Regional and Sustainable Development Department, ADB Institute, and other concerned CoPs to strengthen knowledge works in the financial sector.

ADB will seek to mobilize donor resources for scaled-up advisory and capacity building support in FSD. As the secretariat for the FSD CoP, the OREI financial sector team will work with the Office of Cofinancing Operations to mobilize and administer donor resources.

ADB will implement this Operational Plan in two phases. In the first phase, which will last 2 years, ADB will strengthen its operations in its established areas, while undertaking knowledge works in areas of limited experience to build expertise. In the second phase, ADB will aim to enhance business models in the areas of limited experience.The impact of the Operation Plan will be assessed at the end of the second phase. The FSD CoP will continually monitor the implementation of the plan, take stock of its status after the first phase, and make possible updates and revisions as necessary.

1 Introduction

1.1 The Asian Development Bank (ADB) issued its long-term strategic framework, Strategy 2020, in April 2008 to guide its future operations in pursuing its vision of an Asia and Pacific free of poverty. Strategy 2020 identified three complementary strategic agendas: (i) inclusive economic growth, (ii) environmentally sustainable growth, and (iii) regional integration. It also identified financial sector development (FSD) as one of the five core areas of ADB operations, together with infrastructure, environment, education, and regional cooperation and integration.

The Asian Development Bank issued its long-term strategic framework, Strategy 2020, in April 2008 to guide its future operations in pursuing its vision of an Asia and Pacific free of poverty

1.2 The financial system is the lifeline of the economy. By mobilizing and supplying finances and reaching out to users, the financial sector enables business and economic activities that would otherwise be impossible. When the sector takes too much risk, however, it can cause serious trouble to the economy, as has been painfully learned in past crises. The financial sector functions and develops in a complex and dynamic manner, and is built on the public's trust and confidence. As such, it is susceptible to market failures caused by asymmetric information, adverse selection, moral hazard, and systemic risks. The FSD is also influenced by factors such as per capita income, scale economies, competition, and corporate governance. Thus, the role of both the public and private sectors is crucial in supporting FSD.

1.3 Under Strategy 2020, ADB intends to strengthen its support for FSD at both national and regional levels by helping to develop financial infrastructure, institutions, products, and services. FSD also has important links with, or is an integral part of, other strategic agendas under Strategy 2020. For example, FSD contributes to inclusive growth by expanding access to finance, and is a critical dimension of regional integration. It can also support environmentally sustainable growth by financing environmentally friendly infrastructure or disaster risk.

1.4 This Operational Plan is prepared by the FSD Community of Practice (CoP) to articulate the FSD agendas of Strategy 2020 and guides its implementation by ADB.

2 Macroeconomic Context and Financial Sector Landscape

During 1981–2008, the region's average real gross domestic product growth was 7.3% a year, compared with the world average of 3.0%

2.1 Asia and the Pacific has emerged as a global growth center in recent decades. During 1981–2008, the region's average real gross domestic product (GDP) growth was 7.3% a year, compared with the world average of 3.0%. As of 2008, excluding Japan, the region's share of world GDP had increased to 25%. Many developing member countries (DMCs) have achieved rapid growth through export-promoting industrialization, while also mobilizing a high level of savings. As such, the region has maintained a surplus in the balance of payments and accumulated $4 trillion of foreign exchange reserves—nearly half of the world total. At the same time, regional integration in trade and investment has deepened, and cross-border value and supply chains have been strengthened (Appendix, Figure 1).

2.2 Together with the economy, the financial sector and markets in the region have grown significantly during the past decade. In particular, middle-income DMCs have developed larger financial assets, nonbank financial institutions, and money and capital markets (Appendix, Figure 2). Many of these DMCs have adopted sound financial infrastructure such as electronic payments systems and central securities depositories. This has significantly increased the efficiency of banking operations and public confidence in banking systems and local currencies. Since the Asian financial crisis 1997–1998, the region has undertaken major efforts to recapitalize and restructure banks, as well as to strengthen prudential norms. Growth and profits further strengthened banks' balance sheet, reduced nonperforming loans (Appendix, Figure 3), and improved banks' resiliency against external shocks, as demonstrated in the wake of the recent global financial crisis.

Weak Foundations of Financial Systems in Low-Income and Conflict-Affected DMCs

2.3 Despite the achievements since 1997, the region's financial sector has yet to overcome many developmental challenges. FSD in **low-income and conflict-affected DMCs** is quite modest with small financial assets concentrated in the banking sector and only embryonic development in the nonbanking sector and capital markets (Appendix, Figure 4). Their money and government debt markets are hardly functioning, while the central banks lack the ability to survey the economy, formulate and execute appropriate monetary policy, and effectively supervise banks. The banking system lacks physical presence and networks, thus failing to offer adequate accessibility (Appendix, Figure 5). The DMCs suffer from a lack of public confidence in their financial and monetary systems, leading to dollarization. DMCs that only have access to the Asian Development Fund (ADF)—Afghanistan, Cambodia, Kyrgyz Republic, Lao People's Democratic Republic, Nepal, Tajikistan, Timor-Leste—are lagging in developing **financial infrastructure**. Some have adopted a basic interbank payments system but have yet to upgrade it as they try to develop their financial markets. Some of their leading banks, particularly state-owned ones, have not adopted a core banking system that consolidates accounts and reduces intra-bank payment float for more efficient banking operations.

Undiversified Financial System with Small Nonbanking Sector and Capital Markets

2.4 The region's **banking sector is substantially smaller than that of the Organisation for Economic Co-operation and Development (OECD)** (Appendix, Figure 6). Middle-income DMCs, and particularly low-income ones, have room to grow their banking sector further. However, the region's capital markets and nonbanking sectors are proportionally even smaller and less developed. While middle-income DMCs have made progress in developing their stock and government bond markets, their corporate bond and derivatives markets are underdeveloped, resulting in the **heavy reliance on the banking sector**. An undiversified financial system can threaten its structural and systemic stability. The bank dominance also leads to a lack of long-term finance despite the region's high aggregate savings and massive need to invest in infrastructure. Middle-income DMCs need to continue with efforts to diversify the financial sector by developing the nonbanking sector and capital markets. Low-income DMCs, on the other hand, need to prioritize developing their banking systems.

Financial Sector Development for Inclusive and Balanced Economic Growth

2.5 The recent global financial crisis highlighted the importance of balanced growth. While exports will continue to be a driver of growth for many DMCs, economies in the region need to stimulate domestic demand to sustain growth. FSD should be pursued to promote growth that is less dependent on external demand. This will require **enhanced financial inclusion** of the traditionally underserved, such as poor households and small and medium-sized enterprises (SMEs), leading to **inclusive growth**, one of the three strategic agendas of Strategy 2020. The region's large "base of the pyramid" and SMEs have yet to gain adequate access to financial services. Challenges of FSD in this regard include:

While exports will continue to be a driver of growth for many developing member countries, economies in the region need to stimulate domestic demand to sustain growth

(i) Microfinance for poor households. The region has both a public sector–led approach and private sector–driven one, with mixed results for each.
(ii) Mobile banking. Internet or mobile banking helps overcome the challenge of under-banking, particularly in DMCs with low population density or disconnected geography that make it difficult for banks to extend their branch networks (e.g., Philippines and Papua New Guinea).
(iii) Housing finance. Except for a few DMCs,[1] the region has not made notable efforts to systematically finance housing development, aside from the provision of low-cost public housing as part of social policy programs.
(iv) SME financing. Middle-income DMCs are making progress in improving the secured and nonsecured lending regimes with efficient collateral management systems and credit information bureaus. They are also trying to develop their leasing industry and SME equity markets. Low-income DMCs need to follow suit by prioritizing improving the lending regime.
(v) Trade finance. Continued efforts are needed to keep trade financing functioning even amid a financial crisis and/or liquidity crunch.

Lack of Long-Term Finance for Infrastructure

2.6 Except for a few DMCs, the level of the region's investment in **infrastructure** has been modest, which is threatening to undermine the business environment and people's living standards.

[1] Malaysia established the National Mortgage Corporation, Cagamas, to refinance banks financing housing purchases. Thailand established the Secondary Mortgage Corporation and issued a law to enable securitization.

Financing infrastructure calls for mobilization of long-term savings by developing **capital markets** and **institutional investors.** Low-income DMCs have yet to develop their government debt markets to create additional fiscal room, while middle-income DMCs need to explore a potential role for subnational debt markets to finance infrastructure. In any case, public sector resources will be far from sufficient to meet DMCs' massive infrastructure financing needs. While many middle-income DMCs have succeeded in developing equity markets, corporate bond markets remain underdeveloped. DMCs also need to enable infrastructure projects to gain better access to risk and long-term capital through the capital markets.

2.7 Capital markets require the participation of institutional investors to mobilize long-term savings. Some larger middle-income DMCs with aging populations, such as the People's Republic of China (PRC) and Thailand,[2] are trying to increase a funded portion of their social security systems to ensure their sustainability. Others with young populations need to enhance the coverage and benefits of their systems. The insurance and pension sector should play a key role in meeting this challenge. However, the region's contractual savings institutions are still small. With the exception of a few countries,[3] private pension funds are in an embryonic state in middle-income DMCs and nonexistent in low-income ones. Within the modest insurance sector, life insurers dominate, helped by high savings rates. Meanwhile, middle-income DMCs have been promoting investment funds. Low-income DMCs have long way to go on this front.

The recent global financial crisis affected the trade and real sectors in Asia and the Pacific, which the region's financial sector withstood well because of adequate capital and liquidity

Need for Renewed Stability

2.8 The recent global financial crisis affected the trade and real sectors in Asia and the Pacific, which the region's financial sector withstood well because of adequate capital and liquidity. However, this resilience was the result not only of the financial sector's conservative business approach, but also its lack of innovation and competition. The sector is now trying to extend its reach beyond the traditional customer base to introduce new products and services, and intensify competition through regional and global integration. This creates new risks. It is, therefore, essential to pay renewed attention to its stability. As a high growth region, Asia and the Pacific is vulnerable to the procyclicality of prudential rules. In particular, middle-income DMCs whose financial sectors are increasingly internationalized need to address macro-prudential issues, work out arrangements for regulatory and supervisory cooperation, and strengthen the management of risks of contagion.

Financial Sector Development for Regional Monetary and Financial Integration

2.9 The region includes large net savings countries as well as large net borrowers. The region as a whole is also simultaneously a large exporter and an importer of capital. This reflects an inability of the region's financial system to intermediate surplus funds effectively. The regional integration of the financial sector is lagging behind that of the manufacturing sector, which is more open, competitive, and liberalized. The financial sector and markets in the region need to be integrated to allow the channeling of savings from net saving DMCs to net borrowing ones, which is a key to **regional cooperation and integration**, one of the three strategic agendas of Strategy 2020.

2 This is similar to the situation in higher-income economies (e.g., Republic of Korea and Singapore).

3 Malaysia and Singapore have provident fund schemes, and Kazakhstan developed second pillar pension schemes.

2.10 Regional financial integration requires liberalization of capital accounts, promotion of common standards for financial transactions, and establishment of financial infrastructure that supports cross-border transactions. However, rising **capital inflows** are causing anxiety among policy makers as those could fuel inflation, create asset bubbles, and possibly reverse suddenly. Although the large international reserves accumulated by many DMCs are the first line of defense against the reversal, they also partly reflect the global imbalances contributing to causing the capital flows.

2.11 Regional cooperation and integration is instrumental in addressing these challenges. DMCs have formed several subregional groups. Among those, the Association of Southeast Asian Nations (ASEAN) and ASEAN+3[4] have a particularly strong drive for regionalism. By 2015 ASEAN is aiming to form an ASEAN Economic Community, which will integrate domestic financial sectors and markets. ASEAN+3 has been promoting a regional bond market through the Asian Bond Markets Initiative (ABMI) and supporting liquidity safety nets through the Chiang Mai Initiative Multilateralization. ADB has been supporting both and is serving as the secretariat for ABMI.

[4] ASEAN+3 includes ASEAN plus People's Republic of China, Japan, and Republic of Korea.

3 ADB's Past Financial Sector Development Operations and Performance

ADB has supported financial sector development with various modalities including loan, grant, technical assistance (TA), nonsovereign loan and equity, TA cluster, and multitranche financing

3.1 ADB has supported FSD with various modalities including loan, grant, technical assistance (TA), nonsovereign loan and equity, TA cluster, and multitranche financing. Financial sector operations since 1966 have accounted for 10.8% of total ADB operations in number and 11.9% in amount (Table 1).[5] More recently, however, the financial sector lending volume and share have varied widely year to year, with a spike in crisis years, while diversifying from lending to non-lending operations because of DMCs' growing demand for more sophisticated technical and knowledge support for policy reforms, capacity building, and institutional development.

Table 1 Share of Financial Sector and Financial Sector Development of Total ADB Operations

	Number of Projects		**Amount of Projects** ($ million)	
	Historical	**Past 10 Years**	**Historical**	**Past 10 Years**
Finance Projects	**1,206 (10.8%)**[b]	**425 (9.55%)**	**23,619 (11.9%)**	**8,841.0 (9.11%)**
Loan	243 (2.18%)	58 (1.30%)	18,910 (9.56%)	5,323 (5.49%)
TA	552 (4.96%)	198 (4.45%)	273 (0.14%)	130 (0.13%)
Nonsovereign[a]	214 (1.92%)	91 (2.05%)	4,261 (2.16%)	3,249 (3.35%)
Others	197 (1.77%)	78 (1.75%)	175.1 (0.09%)	140.0 (0.14%)
FSD Projects	**269 (2.42%)**	**141 (3.17%)**	**8,796.0 (4.45%)**	**2,420.5 (2.50%)**
Loan	51 (0.46%)	30 (0.67%)	8,692.0 (4.40%)	2,127.7 (2.19%)
TA	119 (1.07%)	80 (1.80%)	74.3 (0.04%)	53.4 (0.06%)
Nonsovereign	3 (0.03%)	3 (0.07%)	224.9 (0.11%)	142.0 (0.15%)
Others	96 (0.86%)	28 (0.63%)	111.3 (0.06%)	97.4 (0.10%)
All Projects	**11,138 (100%)**	**4,449 (100%)**	**197,729 (100%)**	**97,005.5 (100%)**

ADB = Asian Development Bank, TA = technical assistance.

[a] Nonsovereign loans and equity.

[b] The numbers in parentheses are shares of total.

Source: ADB database (as of 31 December 2010), Office of Regional Economic Integration consultant calculations.

5 If differently categorized projects that contain financial sector elements such as credit lines are included, the share of financial sector operations would be higher. However, data to account for those are not available.

Performance by Subsector

3.2 Under ADB's project classification system, the financial sector comprises nine subsectors (Table 2).[6] Under this classification, FSD is defined as a subcategory of financial sector operations that covers multiple subsectors and generates a sector-wide impact. Most of these are program lending operations addressing a range of policy and regulatory reform issues. This section discusses FSD as a specific subsector operation, while the rest of this Operational Plan refers to it as a general concept.

3.3 During the past decade, ADB has been operating actively in five subsectors: FSD, banking systems, microfinance, insurance and contractual savings, and money and capital markets. In terms of project and TA success ratings, ADB has historically performed well in FSD, microfinance, and money and capital markets subsectors, but needed improvement in SME finance and leasing, and housing finance, where ADB has been less active. In the recent 10 years, however, the performance of ADB's financial sector operations improved in all subsectors, and particularly in SME finance and leasing, banking systems, and housing finance, although the number of observations for SME finance and leasing is limited.

In terms of project and technical assistance success ratings, ADB has historically performed well in financial sector development, microfinance, and money and capital markets subsectors, but needed improvement in small and medium-sized enterprise finance and leasing, and housing finance, where ADB has been less active

Performance by Operational Modality

3.4 Loans. ADB's major operational modality in the financial sector has been sovereign lending. Since the 1980s, ADB has shifted the focus of its financial sector lending operations from intermediation loans to program loans to support policy reforms. It was accompanied by a

Table 2 Ratings of Technical Assistance and Loan Projects by Financial Sector Subsectors (number and share, 2001–2010)

Financial Sector	US		PS		GS		S		HS		Total
Banking Systems	1	2.2%	8	17.8%	13	28.9%	22	48.9%	1	2.2%	45
Money and Capital Markets	0	0.0%	5	18.5%	6	22.2%	15	55.6%	1	3.7%	27
Investment Funds	0	0.0%	1	50.0%	0	0.0%	1	50.0%	0	0.0%	2
Housing Finance	2	28.6%	0	0.0%	0	0.0%	5	71.4%	0	0.0%	7
Microfinance	2	4.9%	12	29.3%	2	4.9%	14	34.1%	11	26.8%	41
SME Finance and Leasing	0	0.0%	1	33.3%	0	0.0%	2	66.7%	0	0.0%	3
Trade Finance	0	0.0%	0	0.0%	0	0.0%	0	0.0%	0	0.0%	0
Insurance and Contractual Savings	0	0.0%	7	21.2%	15	45.5%	10	30.3%	1	3.0%	33
FSD	5	5.4%	14	15.1%	10	10.8%	53	57.0%	11	11.8%	93
Total	**10**	**4.0%**	**48**	**19.1%**	**46**	**18.3%**	**122**	**48.6%**	**25**	**10.0%**	**251**

FSD = financial sector development, GS = generally successful, HS = highly successful, PS = partially successful, S = successful, US = unsuccessful.

Source: Office of Regional Economic Integration consultant calculations based on project completion reports and technical assistance completion reports rating data from Central Operations Services Office.

6 ADB. 2009. *Staff Instructions for the Revised Project Classification System*. Manila.

change of rationale for program loans from enabling capacity utilization through support for import financing to supporting sector policy reforms and development plans.[7] This shift of focus has made ADB's financial sector interventions more efficient and effective (para 3.8). Program loans have now become a dominant operating instrument in the financial sector in particular. However, the share of total financial sector lending to ADB's total lending has decreased (Appendix, Figure 7B), especially if the emergency financial sector program loans made during the Asian financial crisis 1997–1998 are excluded.

3.5 Technical assistance. Financial sector TA operations have grown substantially, especially since 1987 with ADB's strategic shift of focus in the financial sector to policy reform support (Appendix, Figure 7E). With the growing complexity of the financial sectors of DMCs, the focus of ADB's financial sector TA operations has also diversified from the banking system to FSD, microfinance, and money and capital markets. However, financial sector TA operations show a decreasing trend in the share of total ADB TA operations in both number and amount since late 1990s as TA projects approved reach financing limits (Appendix, Figure 7F).[8] In response, several trust funds have been established to meet the DMCs' growing demand for TA to supplement the Technical Assistance Special Fund and the Japan Fund for Poverty Reduction (JFPR). However, the demand for TA is substantially higher than the available resources, which results in funding gaps for financial sector operations.

Private sector assistance has emerged as another catalytic axis of ADB's financial sector operations

3.6 Nonsovereign loans and equity.[9] Private sector assistance has emerged as another catalytic axis of ADB's financial sector operations (Appendix, Figures 7G and 7H). Under the Nonsovereign loans and equity category, the banking systems subsector accounted for 36% of private sector operations, followed by investment funds at 29% and SME finance at 17% (Appendix, Figure 7I). FSD projects constitute only a small portion because private sector operations tend to aim at making an impact on specific projects or subsectors rather than on the sector as a whole. An Independent Evaluation Department (IED) study on private equity funds[10] points to a need to more systematically combine nonsovereign and sovereign operations to design a programmatic approach to optimize sector-wide impacts. It also recommends that the Private Sector Operations Department (PSOD) make better use of resident missions and assign adequate budget and staff.

3.7 Grant-financed projects and regional activities. A small portion of ADB's financial sector operations—19 projects in total—have been financed by grants. More than half of those focused on the microfinance and FSD subsectors. The regional activities project category is mostly regional TA projects, research, conferences, and training programs at the regional level. Of the 1,690 regional activities implemented, 174 projects have made impacts on the financial sector, mostly in the money and capital markets and FSD subsectors.

Overall Evaluation of Past Financial Sector Operations by Instrument

3.8 In general, ADB's support for FSD is considered to have delivered positive impacts, although it is not always possible to distinguish ADB's contribution from other factors.[11] ADB's

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7 ADB. 2001. *Special Evaluation Study: Program Lending*. Manila.

8 ADB. 2007. *Special Evaluation Study: Performance of Technical Assistance*. Manila.

9 Nonsovereign loans and equity also includes underwriting and guarantee operations.

10 ADB. 2008. *Special Evaluation Study: Private Equity Fund Operations*. Manila.

11 For example, evaluation findings show that ADB support for financial sector reforms helped improve financial intermediation for private sector development. See ADB. 2009. *Annual Report 2008*. Manila, p. 97.

evaluation results show significant differences in performance ratings across different types of operations. While project loans in the financial sector have received lower success ratings than in other sectors, program loans in the financial sector were rated highly, outperforming those in other sectors (Appendix, Figure 8A).[12] In case of TA operations, advisory TA projects have been more successful than project preparatory TA projects (Appendix, Figure 8B).[13] These evaluations are robust with respect to different time periods chosen for comparison, whether or not the period includes a crisis.

3.9 Despite continued efforts to enhance the effectiveness of financial sector operations, some areas require improvements. For example, the evaluation study in 2008 on capital market development[14] pointed out that ADB needs to (i) develop a corporate level financial sector strategy (or operational plan), (ii) strengthen the coordination of various ADB entities that work in the sector, (iii) facilitate the availability of adequate staff and consultant resources to support sector operations, (iv) involve relevant stakeholders of the private sector as well as the government in the preparation of sector assistance strategies and programs, and (v) strengthen the delivery of ADB sector assistance by adhering to international standards and principles as indicators in design and monitoring frameworks. The study also emphasized that ADB needs to evaluate carefully the viability of capital markets in small economies, and more closely and systematically involve market participants in formulating policies and regulatory measures.

Capacity building support for participating intermediaries and end-borrowers in credit assessment needs to be strengthened

3.10 For ADB's financial intermediation loan operations, IED studies pointed out that the operations have decreased as the market-based pricing of credits was emphasized.[15] Capacity building support for participating intermediaries and end-borrowers in credit assessment needs to be strengthened. The most recent study on financial intermediation loans[16] also emphasized a need to (i) continue the shift from lending to more diversified operations with expanded non-lending services, policy advice, and capacity building TA; (ii) support the diversification of the financial sector to enhance SMEs' access to finance;[17] and (iii) explore other modalities such as partial risk guarantee, commercial cofinancing, underwriting, subordinated loans, and equity participation in financial institutions.

3.11 Some of the success factors in financial sector program loans outlined by IED studies include (i) openness of the recipient countries to reform, (ii) favorable investment and policy climate influencing a targeted sector, (iii) well-designed sequencing of reforms of the sector, (iv) strong political commitment of the recipient government, and (v) strategic focus of the program. ADB's program loan modality should continue to help stabilize macroeconomic conditions and strengthen the financial sector in the following areas: (i) autonomy of financial institutions; (ii) legal frameworks, prudential regulations, and their enforcement; (iii) good governance, transparency, and accountability; (iv) diversification of the financial sector with innovative savings and lending products; (v) financial sector deepening by enhancing access for the poor and SMEs; and (iv) institution, capacity, and human resource development.

12 ADB. 2008. *Annual Evaluation Review*. Manila.

13 ADB. 2007. *Special Evaluation Study: Performance of TA*. Manila.

14 ADB. 2008. *Special Evaluation Study: ADB's Assistance for Domestic Capital Market Development*. Manila.

15 ADB's *Operations Manual* (section D6), issued in 2003, formalized the requirement of market-based pricing of credit lines financed by ADB to avoid undermining the commercial incentive for banks to competitively mobilize funds.

16 ADB. 2008. *Evaluation Update: Support for Financial Intermediation in Developing Member Countries*. Manila.

17 For example, supporting leasing is often found more effective than providing additional liquidity to banks.

4 ADB's Financial Sector Operational Areas and Focus through 2020

The high level of substitutability among some financial instruments, products, and services also allows different priorities for different countries at different times

4.1 The Economics and Research Department recently completed a literature review on FSD,[18] which found two simple but powerful stylized facts: (i) FSD promotes growth and poverty reduction, and (ii) no consensus has emerged on the optimal pattern of FSD. In fact, the level and pattern of FSD differ widely among DMCs, influenced by factors such as per capita income, population size and density, resource endowment, industrial structure, savings propensity, demographics (population aging), planned economic legacy, conflict-affected situations, and even religion. The high level of substitutability among some financial instruments, products, and services also allows different priorities for different countries at different times. The situation requires ADB to take a country-specific approach and tailor its support to focus on the priority areas of each DMC individually, which will be identified through the country partnership strategy (CPS) process.

4.2 However, income level and population size are particularly important in underpinning the characteristics of DMCs' FSD needs. Box 1 presents a short analysis of typical FSD needs of different groups of DMCs categorized by the two factors. With this broad characteristic in mind, the following part of this section identifies themes and subsectors of the financial sector that ADB aims to focus on to support the diverse assistance needs of DMCs and the challenges of the region's financial sector identified in Section 2.

Foundation for Financial Sector Development and Banking Sector Development

4.3 **Public debt market, central banking,** and basic **financial infrastructure** (e.g., payments system, core financial laws, and accounting systems) are the foundation for building public confidence in the financial system. Government debt is considered the most creditworthy asset in an economy backed by taxing power. Public debt issuance also requires high operational competency and soundness in the financial institutions involved, including the central bank. The central bank needs to strengthen its capacity to carry out economic and financial surveillance, monetary operations and, in many cases, bank supervision. The effort includes capacity building in human resources and management information systems, as well as rationalization of the organization and business process. ADB will support government debt market development and central bank capacity building. The FSD CoP will seek coordination with the governance and public management CoP in the area of public debt and cash management to support the public debt market development.

[18] ADB. 2009. Financial Sector Development, Economic Growth, Poverty Reduction: A Literature Review. *Economics Working Paper Series.* No. 173. Manila.

Box 1 Financial Sector Development Assistance Needs by Group of Developing Member Countries

Grouping of Developing Member Countries

In the Appendix, Table 1, developing member countries (DMCs) are broadly grouped into low- and middle-income categories, considering the importance of per capita income in financial sector development (FSD). It also categorizes DMCs based on population to account for the importance of scale economies. Population density is also indicated to show the feasibility of branching by financial institutions.

Large DMCs

Large DMCs such as Bangladesh, the People's Republic of China (PRC), India, Indonesia, and Pakistan need to develop a full-fledged financial sector—from microfinance to capital markets—as well as a banking sector that can meet the diverse needs of the economy. Large countries tend to require fiscal decentralization, calling for more autonomous subnational finance and therefore a subnational debt market. The need to develop their local and urban infrastructure particularly requires it. The PRC, India, and Indonesia have access to ordinary capital resources (OCR) only, and are increasingly integrated with the regional and global economies. They are of systemic importance, and their financial stability is critical for the region and the world. The PRC is also faced with the issue of an aging population that is in the long run likely to impact savings patterns and capital flows across the region. Bangladesh and Pakistan are blend countries with a sizable financial sector. Bangladesh, with its low per capita income, needs to emphasize strengthening the public debt market, central banking, financial infrastructure, and the banking sector.

Medium-Sized DMCs

Most of the medium-sized, middle-income DMCs have attained a significant level of FSD and now require focused assistance to address specific capacity building and reform issues. In particular, those with OCR-only status typically have access to international capital markets. This group of DMCs needs to attend closely to issues arising from the recent global financial crisis in the areas of financial regulation and supervision, as well as macro-prudential management, because their respective financial sectors are increasingly internationalized. They also need to continue to promote their domestic capital markets and institutional investors to finance infrastructure. On the other hand, medium-sized, low-income DMCs such as Afghanistan, Myanmar, and Nepal need to prioritize laying a foundation for FSD in the public debt market, building central banking capacity, developing financial infrastructure, and strengthening the banking sector.

Small DMCs

Small economies are faced with a special challenge because of the lack of scale economies in their financial industry and market. Most Pacific island countries are exceptionally small in population and economic scale. Seven of them are therefore classified as Asian Development Fund (ADF)-only countries despite their middle-income level. Regional approaches are needed to attain the minimum necessary scale economies. Eight of the 14 Pacific island states belong to three currency zones.[a] Small ADF-only countries such as Cambodia, Lao People's Democratic Republic, Kyrgyz Republic, Tajikistan, and Timor-Leste need to strengthen their public debt market, central banking, and the banking sector to build a solid foundation for FSD. They need to avoid duplication of financial infrastructure or regulatory arrangements, and accept a high degree of centralization and concentration within the financial industry while checking and balancing the resulting lack of competition with sound corporate governance.

continued on next page

Developing member countries are broadly grouped into low- and middle-income categories, considering the importance of per capita income in financial sector development

Box 1 *continued*

DMCs with Low Population Densities

Mongolia and Kazakhstan have the lowest population densities among DMCs, followed by Turkmenistan, Papua New Guinea, Bhutan, and Solomon Islands. Many of them also have small total populations. Thus, they need to explore ways to have financial services reach the population to overcome the difficulty of branching by financial institutions. Countries with high population densities but limited banking networks, such as Bangladesh, need to exploit their potential.

DMCs with Special Developmental Needs

Resource-rich countries (e.g., Kazakhstan, Papua New Guinea, and Timor-Leste) as well as high net savers (e.g., the PRC) are accumulating foreign exchange reserves and sovereign wealth funds and need to manage the national assets optimally. Agriculture-based economies, particularly those with long coastlines (e.g., Cambodia, Indonesia, Sri Lanka, Thailand, and Viet Nam) need to develop financial mechanisms to cope better with natural disasters and climate change. Cambodia, Kazakhstan, Lao People's Democratic Republic, Uzbekistan, and Viet Nam need to continue to reform their financial sectors which are still influenced by the legacy of planned economy with state-owned or controlled banks playing a dominant role. DMCs with fragile and conflict-affected situations (e.g., Afghanistan) need to strengthen the foundation for FSD to build public confidence in the financial system. Islamic finance is an important area of FSD for some DMCs with significant Muslim populations. However, all DMCs need to promote financial inclusion to address poverty and strengthen small and medium-sized enterprises.

[a] Marshall Islands, Federated States of Micronesia, Palau, and Timor-Leste use the US dollar. Tuvalu, Nauru, and Kiribati use the Australian dollar. Cook Islands uses the New Zealand dollar.

Payments systems are basic financial infrastructure and need to be built strategically from the early stages of financial sector development

4.4 **Payments systems** are basic financial infrastructure and need to be built strategically from the early stages of FSD. They can be divided into two types: large value interbank payments systems and bulk payments systems including card switching centers. The former is to be operated by the central bank and serves as key infrastructure for the banking sector, government treasury, and financial markets. The latter is typically jointly owned by commercial banks and operated by a private consortium. ADB will support them with sovereign and nonsovereign operations. ADB will assist the central banks to develop a vision for a national payment network and provide guidance for commercial banks to play their role. ADB will also support the development of core **financial laws** such as a central bank law, commercial banking law, securities law, and **accounting** and financial reporting systems in line with international accounting and financial reporting standards. ADB will provide policy advice and TA for drafting, linking those with program lending operations as appropriate.

4.5 These efforts of ADB will be focused on, though not limited to, **low-income DMCs** and **fragile and conflict-affected** ones that need to strengthen the foundation of their financial sector before, or in parallel with, tackling more sophisticated issues of FSD. Governments of low-income DMCs rely on concessional resources from the international development partners, including ADF, while having little or no access to international capital markets. However, as they move toward the ADF-ordinary capital resources (OCR) blend[19] status, they will be faced with increasing costs

[19] A DMC is categorized as ADF-OCR blend when it attains an adequate level of creditworthiness to borrow at commercial market rate (OCR) but is not fully graduated from ADF and still eligible to access it.

of external finances and, therefore, will need to develop the domestic financial sector and market as an alternative source of finance. ADB will support near and early blend countries in tackling this challenge.

4.6 The banking subsector forms the core of the financial sector in the region, and it is vital to ensure that this sector plays its role in the economy. Banks also provide essential services for nonbank financial institutions and money and capital markets to function and, therefore, are a priority. In under-banked, low-income DMCs, ADB will support governments in using banks for all public sector payments as a key step to promote the use of the banking system and the growth of the banking sector. To enhance **access to banking services**, ATM networks, which tend to develop on a bank-by-bank basis in the initial stage, need to be interconnected to enable an account holder of one bank to use an ATM of any other bank. ADB will support central banks as well as commercial banks to achieve such network integration, as it often does not voluntarily occur because of conflicting interests of the commercial banks.

4.7 It is crucial to ensure the **stability** and **efficiency** of this sector particularly as it provides increasing financial access for nontraditional customers. ADB will support DMCs to meet the challenge of upgrading the legal, regulatory, and supervisory framework for banks in response to the recent global financial crisis. Tasks should also include the restructuring of distressed banks; strengthening of capital adequacy, macro-prudential norms, and supervision; and promotion of sound bank governance and risk management. In particular, ADB will support the reform of state-owned banks with respect to their role, ownership, and governance, particularly in DMCs with a dominant state banking sector (e.g., Uzbekistan, Viet Nam). ADB will also explore opportunities to support the adoption of core banking systems at individual banks.

Inclusive Finance—Households and Small and Medium-Sized Enterprises

4.8 Promotion of financial inclusion is a common developmental theme for most DMCs and is key to **inclusive and balanced economic growth**. ADB will support DMCs' efforts to enhance the financial access for the traditionally underserved such as poor households, vulnerable groups (e.g., women, minorities), and SMEs to promote inclusive economic growth, which is one of the three strategic agendas under Strategy 2020. ADB will do so with both of its sovereign and nonsovereign operations. The FSD CoP will promote the inclusive finance agenda in coordination with other sector and thematic CoPs including social development and poverty, gender equity, health, education, and infrastructure-related CoPs.

Promotion of financial inclusion is a common developmental theme for most developing member countries and is key to inclusive and balanced economic growth

4.9 **Microfinance** should go beyond credits and include savings, payments and remittance services, insurance, and pensions. ADB will support mobile banking, particularly in DMCs where traditional bank branch networks have not proven practical or cost effective because of geographic conditions or low population density. ADB will also support development of efficient mechanisms for remittances. ADB will do so directly through nonsovereign operations, collective financing, or guarantee arrangements; or indirectly through policy support. At the same time, ADB will promote the financial literacy of and consumer protection for the user of microfinance services.

4.10 **Housing finance** is another special dimension of household access to finance. The development of better housing is essential for improving people's lives. Housing is the largest investment most households make in their lifetime, while housing construction is a downstream industry with a high multiplier effect and generates demand for a wide range of products and services, as well as employment. ADB will support DMCs in building a foundation for housing finance such as well-defined property ownership with balanced rights and obligations of mortgage debtors and creditors, and an efficient system of collateral and property registration. The real estate market is often subject to speculative investment and bubbles that could expose the financial system to major risks. ADB will support development of a balanced and sustainable system of housing finance. In particular, ADB will support the refinancing of housing loans and provision of mortgage guarantees for low-income households. The FSD CoP will work with the urban CoP on financial aspects of the themes identified in the Urban Operations Plan.[20]

4.11 **SMEs'** access to credit can be improved by enhancing the secured and nonsecured lending regime and infrastructure. ADB will continue to support improving the **insolvency** and **secured transaction regimes**, including well-balanced rights and obligations of the debtor and the creditor, efficient collateral registry, and a contract enforcement mechanism. In parallel, ADB will support the development of sound credit information bureaus to facilitate **nonsecured lending**. The FSD CoP will work with the social development and poverty CoP to support the sustainable development of social enterprises by connecting them with impact investors.

Access of small and medium-sized enterprises to finance can be improved not only through credit institutions, but also leasing, credit guarantees, factoring, insurance companies, and capital markets

4.12 SMEs' access to finance can be improved not only through credit institutions, but also **leasing, credit guarantees, factoring, insurance companies**, and **capital markets**. Medium-sized enterprises tend to have more assets to pledge to gain access to credit, while small ones lack them. Medium-sized enterprises are also more able to access capital markets. If they can access capital markets, it could induce banks to focus more on serving smaller enterprises, especially if it is backed by a sound secured and nonsecured lending framework. It is also often useful to have nonbanks not linked to a commercial bank to promote competition in providing financial access to SMEs. This kind of holistic view should not be lost in considering a policy to promote financial access for SMEs. ADB will help DMCs strengthen nonbank financial institutions that support SME access to finance, both directly by nonsovereign operations, including investment via **private equity funds**, and indirectly by policy support. ADB will also support DMCs to develop **equity markets for SMEs** as well as venture capital and private equity funds.

4.13 The recent global financial crisis caused a liquidity trap, which has decreased the effectiveness of monetary policy in mobilizing domestic demand. ADB provided timely support for **trade financing** when exporters and importers of the region were hit hard by the global crisis. The trade finance program also supports regional financial integration by creating and cementing correspondent banking links between local banks in DMCs and international banks. It also enables ADB to gain an understanding of the soundness and performance of banks in the region, which should facilitate ADB's further timely and effective interventions in the sector. ADB will continue to support DMCs to develop efficient and effective trade financing mechanisms and measures, in addition to providing emergency financing.

Infrastructure Finance and Access to Capital Markets

4.14 Except for a few DMCs, the region needs to invest heavily in infrastructure to continue to provide a favorable business environment and improve people's living standards. In low-income DMCs, infrastructure does not have adequate access even to public debt finance and instead relies on concessional funding from development partners including the ADF. As DMCs approach ADF-OCR blend status, however, their access to external concessional resources diminishes. To develop alternative financing channels, the **domestic public debt market** is a priority. ADB will support this effort, particularly in low-income DMCs. In middle-income DMCs that are already making progress in developing this market, ADB will support **subnational debt markets**, which are key to financing **urban infrastructure**. The FSD CoP will seek support from the governance and

[20] For example, integrated urban redevelopment, cluster city economic development, and green cities.

public management CoP to build the market based on a sound framework of fiscal decentralization. As analytical underpinnings for works related to public debt market development, ADB will make systematic use of the debt sustainability assessment, which is led by the International Monetary Fund (IMF) and in which ADB participates when it is conducted in a DMC.

4.15 Because public sector resources are far from sufficient, infrastructure needs to access commercial finances, thus calling for public–private partnerships (PPPs). The region needs to enable infrastructure to access risk capital and long-term commercial finances without relying excessively on banking systems with systemic risks and short-term savings (Appendix, Figure 9). In cooperation with infrastructure-related CoPs, the FSD CoP will explore opportunities to support innovative financing mechanisms such as (i) a bond bank or pooled financing for a group of small subnational bodies or agencies, (ii) viability gap financing by use of a special purpose vehicle, and (iii) **credit guarantees** or enhancement to securitize project cash flows. The FSD CoP will also support other internal initiatives such as Energy for All and Water for All, which focus on providing enhanced access to infrastructure services for the poor.

ADB will continue to support debt, equity, and derivatives market development to help developing member countries diversify the financial sector.

4.16 Such financing will be possible only if the capital markets are generally well developed beyond the public debt market. ADB will continue to support debt, equity, and derivatives market development to help DMCs diversify the financial sector. ADB will support infrastructure projects' access to long-term finances of **contractual savings institutions** through the **corporate bond market**. ADB is uniquely positioned to support DMCs' efforts to develop bond markets because of its role as the secretariat for the ABMI of ASEAN+3. The Office of Regional Economic Integration (OREI) and regional departments will work more closely and systematically to synergize support for the ABMI and domestic market development. ADB's support will be extended beyond ASEAN+3. ADB will also make use of its own local currency issues to contribute to the market development as well as to support its own financing.

4.17 ADB will assist DMCs to enhance the efficiency and transparency of **equity markets**. ADB will (i) assist DMCs to encourage companies to go public, list on exchanges, and disclose information consistently with international accounting and financial reporting standards; (ii) support the capacity building of market intermediaries, introduction of new instruments, and regional integration of domestic markets; and (iii) support the adoption of international standards in reforming legal, regulatory, and supervisory frameworks such as the International Organization of Securities Commissions (IOSCO) principles; upgrading market infrastructure (e.g., Committee on Payment and Settlement Systems–IOSCO recommendations); and promoting sound corporate governance (e.g., OECD corporate governance principles, Basel financial institutions governance principles). ADB will assist DMCs to adopt these standards in partnership with international standard-setters and in coordination with the IMF and World Bank, which conduct the review of observance of standards and codes. ADB will also explore opportunities to invest in market infrastructure such as central depositories, exchanges, and credit rating agencies.

4.18 To support capital market development via a reform program, ADB will closely consult with market participants as well as policy makers to ensure that reform measures contained in the program suit market needs. **Small, low-income economies** naturally face difficulties in developing money and capital markets because of their lack of scale. ADB will help such DMCs examine the feasibility of creating a viable market by analyzing costs and benefits.

4.19 ADB will support the development of contractual savings institutions such as **pension funds** and insurance companies, which are small but are expected to become an important source of long-term finance. The region has a mixture of young and aging DMCs. The aging ones need to reform their social security system and develop funded pension schemes. However, private pension funds are only in an embryonic stage even in middle-income DMCs and are nonexistent in low-income ones. The introduction of the so-called second pillar schemes[21] requires careful consideration and coordination with domestic capital market development policies (e.g., Kazakhstan). Although many low-income DMCs, such as Cambodia and Lao People's Democratic Republic, have young populations, their pay-as-you-go public pension schemes, where they exist, need to enhance coverage in terms of both benefits and type of workers. The management of reserves of public schemes also needs to be improved. ADB will support enhancement of pension schemes to help DMCs reduce the need for precautionary savings, smooth consumption, and mobilize long-term savings to finance infrastructure needs.

4.20 **Insurance** industries also need to be strengthened as they are key participants of the broader social security system. The region's high savings rates help life insurers dominate its small insurance sector. They are well equipped to provide annuities. Non-life insurers are also growing steadily from a small base with premium incomes from compulsory insurance such as auto and housing insurance. Contractual savings institutions need an appropriate prudential policy and regulatory framework to grow in a healthy manner. ADB will support DMCs in developing legal, regulatory, and supervisory frameworks, as well as investment and risk management policies, for pensions and insurance. The insurance industry can grow only along with the growth of underlying business activities or social services. ADB will assist DMCs to coordinate policies to promote their growth and stability in parallel with capital market development. The FSD CoP will coordinate with the health CoP and social development and poverty CoP to ensure consistency in promoting the insurance sector along with social policies.

In response to the recent global financial crisis, prudential rules for financial institutions were revisited, including those for systemically important institutions, while procyclicality is being addressed

Financial Stability and Integrity

4.21 As the region's financial sector diversifies, introduces new instruments, reaches out to new clients, and integrates regionally and globally, it is essential to ensure the soundness and stability of the sector. In response to the recent global financial crisis, prudential rules for financial institutions were revisited, including those for systemically important institutions, while procyclicality is being addressed. A need for macro-prudential regulation and supervision was highlighted, while that to balance executive pay was emphasized. DMCs need to review and adopt these measures as appropriate. ADB will support the enhancement of the **regulatory framework** and **supervisory capacity**. ADB will (i) promote adoption of international standards and best practices such as those set by the Basel Committee, IOSCO, and International Association of Insurance Supervisors (IAIS); and (ii) provide TA on risk management by and promote sound corporate governance of both banks and nonbank financial institutions. ADB will seek systematic access to results of the Financial Sector Assessment Program (FSAP) of the IMF and the World Bank and, to the extent possible, take part in its process in the concerned DMCs. This is necessary for ADB to design its assistance without critical inconsistencies with FSAP findings and recommendations.

4.22 ADB will support DMCs to examine the need and design of **deposit insurance** (e.g., pay box versus risk minimizer) and develop it when appropriate. In doing so, ADB will support DMCs to (i) develop approaches to ensure the stability of systemically important financial institutions, and (ii) develop a state contingency plan to manage a crisis among financial authorities and put in place a resolution capacity for systemically important financial institutions. ADB will also support the enhancement of integrity of the financial system by promoting transparency and accountability, and supporting **anti-money-laundering measures**.

[21] Privately and competitively managed funded schemes with compulsory participation for all wage earners.

Regional Monetary and Financial Cooperation and Integration

4.23 With widely different savings levels across the region, gains can be realized by integrating domestic financial sectors and markets, and recycling the surplus savings of net saving DMCs to net borrowers. Integration can also help small DMCs and their financial institutions take advantage of scale economies. Consistent with Strategy 2020 and the Regional Cooperation and Integration Strategy, ADB will support DMCs' regional initiatives in liberalizing capital accounts and foreign direct investment in the financial sector, adopting common standards for financial transactions and services across the region, and establishing financial infrastructure that supports cross-border transactions. Yet, the resulting freer capital flows and systemically important regional financial institutions create challenges for financial supervisors and monetary authorities. DMCs pursuing financial integration need to strengthen their ability to monitor and manage capital flows and the prudential regulation and supervision of financial institutions and their risk management. ADB will support DMCs to manage risks of the integration process and ensure the soundness of the financial sector.

Regional cooperation and integration requires member countries' strong commitment to regionalism

4.24 Regional cooperation and integration requires member countries' strong commitment to regionalism. While there are several subregional groups of countries pursuing regionalism, ASEAN and ASEAN+3 have so far shown the strongest drive for it. ADB has been supporting ASEAN and ASEAN+3 in their efforts for regional financial cooperation and integration. ADB will continue to support ASEAN's effort to integrate their domestic capital markets and banking and nonbanking sectors, while gradually liberalizing the capital accounts to achieve an ASEAN Economic Community by 2015. ADB will also continue to support the Chiang Mai Initiative Multilateralization and ABMI of ASEAN+3, and the establishment of an Asian Financial Stability Dialogue. ADB will explore possibilities to support other subregional groups or extend the ASEAN or ASEAN+3 frameworks.

Financial Sector Development Outcomes

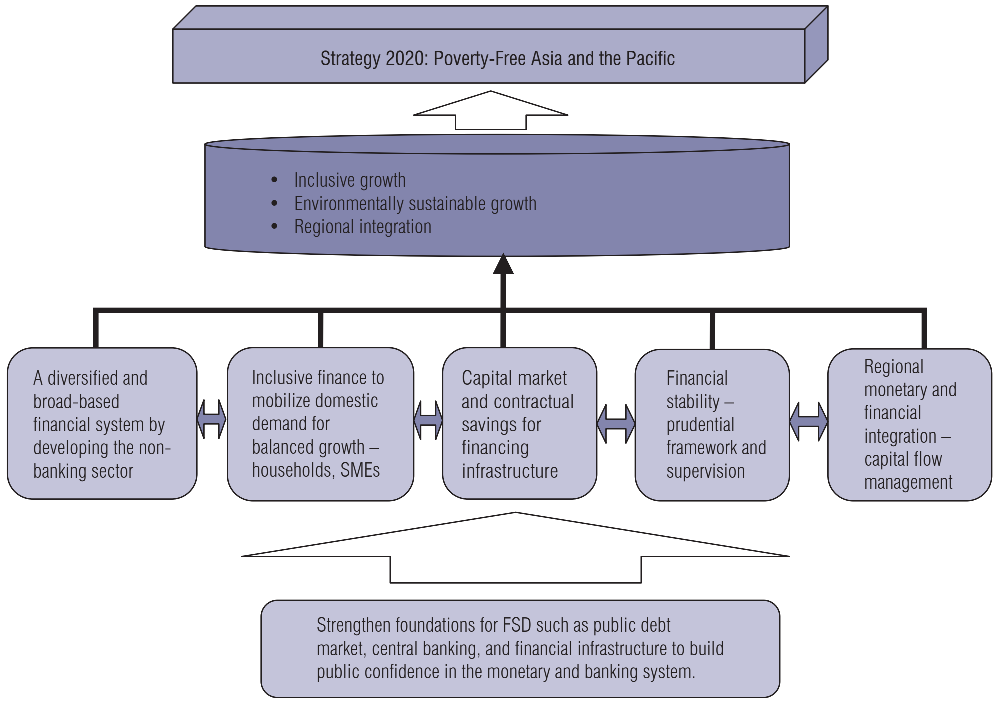
4.25 Figure 1 summarizes the FSD agendas discussed above. By working with DMCs on those, ADB aims to support achieving the following **FSD outcomes** with an ultimate objective of promoting balanced, inclusive, and sustainable growth, and poverty reduction:

(i) stronger foundation;
(ii) more diversified and broad-based;
(iii) more accessible and inclusive;
(iv) more able to mobilize long-term savings;
(v) more stable; and
(vi) more regionally integrated.

Prioritization

4.26 Although priorities differ among DMCs and between subregions, **financial inclusion** is emphasized in all subregions. Given the massive investment requirement in infrastructure in the region, **capital markets for infrastructure finance** are also expected to be a major area of ADB operations. Operations in the two areas also support the three key pillars of the real economy: households, SMEs, and infrastructure. In fact, ADB's preliminary project pipeline for 2011–2013 reflects the concentration in these two areas. Therefore, ADB will prioritize financial inclusion and capital markets and aim to build a particular strength in the two areas. At the same time, ADB plans to gradually phase out from areas where a growing majority of DMCs build a significant capacity over time. Those are expected to be areas belonging to the foundation for FSD. Banking

Figure 1 Key Financial Sector Development Agendas and Strategy 2020



FSD = financial sector development, SMEs = small and medium-sized enterprises.

Source: ADB.

ADB first aims to strengthen its operations in the established areas—particularly in quality—while improving its business models and building a knowledge base in the areas of limited experience

and financial stability are areas where multiple development partners provide support, while regional integration requires mostly TA. The FSD agendas identified above can also be categorized as follows: (i) established areas where ADB has a track record; and (ii) areas where ADB had only occasional operations or limited experience. ADB first aims to strengthen its operations in the established areas—particularly in quality—while improving its business models and building a knowledge base in the areas of limited experience.

Established areas

(i) Foundation for FSD – public debt market, financial infrastructure (except payments system) and banking sector development
(ii) Financial inclusion – microfinance, SME finance, and trade finance
(iii) Capital markets for infrastructure finance, and contractual savings
(iv) Financial stability and integrity
(v) Regional monetary and financial integration.

Areas of limited experience

(i) Foundation for FSD – central bank capacity building (including payments system)
(ii) Financial inclusion – housing finance
(iii) Contractual savings – insurance
(iv) Regional monetary and financial integration – capital flows monitoring and management.

5 Business Model, Modalities, and Product Lines

Financial Sector Development in Project Classification

There is A fair volume of cross-sector projects that cut across the financial sector but are not classified as financial sector projects

5.1 ADB's financial sector lending has been modest in terms of its share in total lending volume. It stands historically at 12% but declined in recent years to 9% (Table 1), while the modality shifted from intermediation loans to program lending. It also varies widely year to year with a spike in crisis years. The financial sector lending volume and share also depend significantly on how financial sector projects are defined. There is a fair volume of **cross-sector projects** that cut across the financial sector but are not classified as financial sector projects. Examples are credit lines for rural development or SMEs, wholesale financing of small-scale infrastructure, public financial management reform, municipal or urban development finance, and agricultural development projects with disaster insurance. On the other hand, there is a question of whether the total amount of program loans should be counted as financial sector lending, although it has become an important modality to support policy reforms in the sector. Therefore, the effort to measure ADB's operational volume in the financial sector needs to start with properly defining FSD projects and capturing them effectively. The Strategy and Policy Department (SPD) and FSD CoP will work together to do so.

5.2 In particular, projects involving a credit line need to be properly accounted for. Any ADB-financed project involving a credit line intermediated through formal financial institutions should be vetted in accordance with the *Operations Manual* (D6), which requires market-based pricing of the credit.[22] To accurately capture ADB's activities in the sector and understand their scope, all operations subjected to the *Operations Manual* (D6) should be counted at least partially as financial sector operations. When a management decision is made not to subject such a project to the *Operations Manual* (D6), the deliberation and justification for the decision should be recorded for reference.

Sovereign and Nonsovereign Operations

5.3 Although sovereign lending in FSD has room to increase, a fundamental aspect of FSD work is about helping DMCs build their own financial sector and market to mobilize and allocate domestic financial resources. In the long run, it could reduce the DMCs' dependence on external resources, including those from ADB. Therefore, it is not realistic to expect a sustained large increase in ADB's sovereign lending volume and share in FSD. To ensure the continued usefulness of ADB's sovereign lending in FSD, it should be fortified with enhanced knowledge support, such as high-quality advisory services and TA to support policy reforms and capacity building. The delivery of such knowledge-intensive products and services should be built on a platform of effective policy dialogue and strong analytical underpinnings.

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[22] Some are grant-funded and intermediated by a nongovernment organization, which may not need to be vetted with the *Operations Manual* (section D6).

5.4 On the other hand, **nonsovereign operations** and **equity investments** in the sector have a greater upside potential, albeit from a small base. Those include private equity fund operations by PSOD to participate directly or indirectly in financial institutions and infrastructure. However, they need to be synergized more effectively with sovereign operations to catalyze private sector–led development. Regional departments can strengthen the impact of their operations by incorporating PSOD transactions in a programmatic approach. PSOD, for its part, can learn more closely and in a timely fashion the nature and characteristics of individual sovereign interventions by regional departments and enhance the design of its nonsovereign operations for better developmental effectiveness.

5.5 Regional departments and PSOD have been trying to do so by working jointly on the CPS process. However, PSOD's nonsovereign operations are carried out on shorter planning horizons than sovereign operations and are subject more to the needs of an individual market than CPS or the government's approval. Thus, the coordination requires closer, more frequent and systematic communication between regional departments and PSOD beyond the CPS process and cycle. ADB will further strengthen this top–down and bottom–up cooperation and integrate the mutually supplementing strengths of regional departments and PSOD. The FSD CoP will offer a platform for regional departments and PSOD to coordinate and work more closely and systematically together in financial sectors.

ADB needs to continue to strengthen knowledge elements of its lending and investment products in the financial sector to enhance their value and relevance

Modalities and Products

5.6 ADB needs to continue to strengthen knowledge elements of its lending and investment products in the financial sector to enhance their value and relevance. The financial sector functions in a highly complex and dynamic manner, and its subsectors and instruments compete with and substitute for them concurrently or intertemporally. Interventions in narrow subsectors or themes without understanding the big picture can risk causing unintended consequences. ADB needs to take a holistic approach to the sector development for which a program loan, sector wide approach, or programmatic approach is useful. As a starting point, ADB will conduct a comprehensive review of the financial sector in a CPS or as a separate sector study as appropriate. Depending on country context, ADB's experience, and coordination with other development partners, the following modalities and products—or a combination of them—could be considered for ADB's assistance program.

5.7 **Program loans.** Program loans are lent to the fiscal budget of a DMC and provide a platform for continuous policy dialogue to support policy reforms. As such, they serve as the backbone of a programmatic approach required to address a set of issues and capacity building needs simultaneously or sequentially. Financial sector program loans now account for 26% in number and 67% in amount of total financial sector loans,[23] although it could reach as high as 100% in crisis years. Given the modest base of total financial sector lending, this level of program lending in the financial sector may be accommodated within ADB's ceiling on program lending (20% of the entire ADB portfolio and 22.5% of ADF). However, ADB needs to add greater knowledge value to continue to make program loans useful for DMCs. Such knowledge value addition is particularly necessary when ADB lends to a middle-income DMC that has access to the international capital market.

[23] This figure includes emergency lending to DMCs during the Asian financial crisis 1997–1998.

5.8 IED studies on program lending[24] have identified areas requiring improvements, including strong country ownership and results chains, as well as a flexible tranche release and capacity building support for implementing agencies. A **program cluster approach** with strong TA and advisory support now enables such operations. To enhance the quality of program lending, ADB will carry out analytical work in advance of the formulation of a program. In doing so, ADB will closely consult with development partners active in the financial sector of a given DMC and, as appropriate, solicit cofinancing for some of its subprograms. It will strengthen the support for implementation of policies and reforms with policy advice and TA enhanced in both quality and quantity.

5.9 The program lending modality can be strengthened by including an **earmarked** component to finance financial infrastructure. A financial market and sector needs to be supported by sound infrastructure such as a payments system, securities depository, credit information system, and collateral registry. A challenge for ADB is that many such infrastructures individually require only a modest amount of money[25] and are, therefore, not suitable for financing by a dedicated ADB project loan. The client government and ADB can instead agree on earmarking a portion of a program loan to finance such infrastructure as part of the program. ADB has done such earmarking in the past, but this approach could be systematized and developed into a recognized operational modality. It may be particularly useful when built into subprograms under the program cluster approach. ADB will support DMCs to carry out a feasibility study and the procurement and implementation of the infrastructure. Earmarking can also be used to finance capacity building among financial supervisors, public financial institutions, or government bodies. ADB will work with DMCs, particularly those near graduation from ADF, to use ADF resources to finance capacity building.

5.10 **Financial intermediation.** Credit line operations have given way to program lending apparently because of the emphasis on market-based pricing of credits, which is now required by the *Operations Manual* (D6). Sufficient liquidity in the banking systems of DMCs is another reason. If they are combined with effective capacity building and reform support for banks and credit institutions, they could add value and be demanded by DMCs. The *Operations Manual* requires such capacity building because intermediaries participating in the credit lines will need to strengthen their credit assessment and risk management. ADB's past credit line operations were combined with capacity building TA. However, ADB needs to enhance both the quality and the quantity of such TA operations for both sustainable capacity building and policy reforms.

Credit line operations have given way to program lending apparently because of the emphasis on market-based pricing of credits, which is now required by the *Operations Manual* (D6)

5.11 Cross-sector projects involving credit lines need to be designed to strengthen the capacity of financial institutions intermediating the credits. Such a project should comply with the *Operations Manual* (D6) to avoid undermining the commercial incentive for the participating financial institutions to competitively mobilize finances and distorting the credit and interbank market. ADB will examine whether the project design is in compliance with the *Operations Manual* (D6). Such an examination is necessary because market-based pricing benchmarks are often not readily available particularly in lower-income DMCs where the local money and capital markets are underdeveloped.

5.12 The need to comply with the *Operations Manual* (D6) applies even to projects funded by ADF with highly concessional terms. In this case, the government makes significant interest income by onlending it to participating financial institutions at a market rate. ADB will explore

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[24] ADB. 2007. *Evaluation on Policy-Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries*. Manila. Also see ADB. 2001. *Special Evaluation Study: Program Lending*. Manila.

[25] Exceptions are interbank payments systems and central bank management information systems, which tend to require a significant amount of financing.

ways to encourage the government to use the income to fund capacity building TA projects for the financial institutions or their client borrowers. At the same time, grant-funded TA may be arranged to provide policy advice on reforms and support designing the intermediation project.

5.13 ADB could also cautiously increase **project lending** to finance financial infrastructure. Because most financial infrastructure requires only a modest amount of financing, ADB needs to be selective in developing a dedicated project for them. As a stand-alone project, ADB will focus on central bank management information systems (for financial and economic surveillance) and interbank payments system, as they require a significant amount of financing. The FSD CoP and the governance and public management CoP will work together as needed to support operations in the area of government treasury management systems.

An additional challenge for ADB is that such financial infrastructure projects tend to be technically demanding despite the small amount of financing required

5.14 For other systems such as financial trading systems or clearance and settlement systems, which individually tend to require a modest amount, ADB will try to finance them with earmarking of program loans. To finance systems for web-based credit information and collateral registry, which require an even smaller amount, ADB will explore with donors possibilities for using the **Financial Sector Development Partnership Fund/Facility (FSDPF)**, which is discussed below, particularly for lower-income DMCs. The FSDPF may also be used to provide TA to support their implementation.

5.15 An additional challenge for ADB is that such financial infrastructure projects tend to be technically demanding despite the small amount of financing required. It requires specialized expertise, particularly in information technology project management, and is costly to prepare. Although appropriate consultants can be hired to assist the project team, ADB staff need to have significant knowledge of financial infrastructure to help DMCs design a sensible project and supervise consultants. ADB needs to develop such staff expertise in selected areas of the financial infrastructure. ADB will invest in staff training, seek secondees from appropriate partners, or selectively hire experts to design such projects and supervise their implementation.

5.16 ADB will use **guarantees** and **cofinancing** to mobilize private sector resources as well as development partner funds to participate in FSD projects and facilitate overcoming a constraint arising from ADB's capital adequacy. With an enhanced sense of corporate social responsibility, private sector firms are increasingly interested in promoting social goods. For example, ADB's guarantees or cofinancing can facilitate support for the green growth or microfinance agenda from private financial institutions, which would otherwise be hesitant to enter such a new business with unknown risks. ADB will try to meet the cofinancing target set under Strategy 2020 by collaboration with other development partners and private financial institutions.[26]

5.17 **Regional projects** in the financial sector are an emerging new business for ADB. Beyond the TAs ADB has been providing on regional financial integration, a trade facilitation project for Central Asia Regional Economic Cooperation, and the Credit Guarantee and Investment Facility of ASEAN+3 are examples of regional projects. SPD is working on developing a horizontal multitranche financing facility modality for this type of project. Similar regional projects could be developed in the financial sector, and ADB will explore such opportunities.

5.18 More **knowledge works, policy advice,** and **TA** not directly linked to ADB-financed projects will also be necessary to support FSD. Many DMCs are eager to adopt sound practices and global regulatory and supervisory standards set by the Basel Committee, IOSCO, IAIS, OECD,

[26] Under Strategy 2020, ADB aims to provide 20% direct value-added cofinancing by 2012 and 100% by 2020, targeting 50% of that at the private sector.

and the Consultative Group to Assist the Poor (CGAP). ADB will support the efforts jointly with these standard-setters by strengthening the partnerships with them. ADB will also seek to have systematic access to results of an FSAP of the IMF and World Bank whenever one is conducted in a DMC.[27] In coordination with the Financial Sector Reform and Strengthening Initiative administered by the World Bank, ADB will support TA required to implement FSAP recommendations. ADB will also support TA required for regional cooperation and integration in the financial sector in accordance with Strategy 2020 and the Regional Cooperation and Integration Strategy. ADB will work with donors to develop the FSDPF into a multi-donor facility that allows financing of these activities.

5.19 ADB will provide **timely advice** and **small-scale technical or knowledge support** for DMCs since some critical and urgent issues in FSD cannot wait for a full project preparation cycle. ADB is increasingly called upon to advise on issues requiring urgent attention such as capital flows, asset bubbles, rapid inflationary development, stock market volatility or speculation, and foreign exchange pressure. To respond in a timely fashion to calls for advice and TA from DMCs on such matters, ADB will work with donors to mobilize resources to finance rapid deployment of consultants, possibly as part of the FSDPF.

5.20 Knowledge works and TA should also be used strategically to build new business in the financial sector. The FSD CoP will seek to develop new lines of cross-sector operations with other CoPs in environment, infrastructure, education, social development, and health. Those will also be used to conduct research to provide analytical underpinnings based on which program lending operations can be developed.

Project Performance and Developmental Effectiveness

5.21 One challenge ADB is facing is how to monitor the performance of ADB-wide financial sector operations—level 2 indicators for the *Development Effectiveness Review* (DEfR). ADB uses two indicators that measure the growth of microfinance and SME finance. ADB recently added the size and growth of banking sector assets as a measure for region-wide FSD—level 1 indicator. However, they are too narrow in scope as a measure for ADB-wide financial sector operations that cover the banking sector, capital markets, and other important subsectors. They also do not measure consumer protection and credit quality, which are increasingly focused on in microfinance. Some aid agencies now consider overly rapid microcredit growth as a negative sign in this regard. Unlike the infrastructure sector, the financial sector is highly diverse and complex. While it is possible to identify appropriate performance or effectiveness indicators for each project or intervention, their aggregation does not lead to a sensible measure of ADB-wide performance. Even if developing certain indicators may be conceptually possible, the cost of doing so and monitoring them could be prohibitive. The FSD CoP will continue to work with SPD to identify or develop appropriate indicators.

One challenge ADB is facing is how to monitor the performance of ADB-wide financial sector operations—level 2 indicators for the *Development Effectiveness Review* (DEfR)

5.22 Meanwhile, ADB introduced and is strengthening a sector **peer review** process. The FSD CoP has developed a procedure to compile projects identified by operational departments into an ADB-wide financial sector project pipeline and assign a peer reviewer to each project. Guidance from the Budget, Personnel, and Management Systems Department (BPMSD) regarding the work plan and Performance and Development Plan process to recognize staff contributions to high-quality reviews will continue to be followed. Peer review is done from the concept stage as it is important to polish a project concept from an early stage. Although the *Operations Manual*

27 Through the Report on the Observance of Standards and Codes.

(D12) does not require peer review for all types of TA works, departments and project leaders are encouraged to adopt peer review for all TA works.

Guiding Principles for Developmental Effectiveness

5.23 In light of the findings of the IED reports, as well as lessons learned from past operations, ADB will observe the following principles to promote the developmental effectiveness of its FSD operations:

ADB will strengthen its support for the adoption of international best practices while considering the country context

(i) ADB will ensure that FSD will serve needs of the real sector development and fit into the overall development agenda of the economy, based on the CPS.
(ii) In designing program operations, ADB will first gain a comprehensive picture of the financial sector and in-depth understanding of its issues in a given DMC either through a CPS process or a dedicated sector review. ADB will also explore programmatic approaches, coordinating sovereign and nonsovereign operations.
(iii) ADB will support sustainable capacity building as appropriate for the duration of the operation, while ensuring the client's absorption capacity and commitment to reforms.
(iv) With financial intermediation projects, ADB will strengthen its support for consumer protection and education as well as the market-based pricing of the credits and sustainable capacity building for participating intermediaries.
(v) When supporting the financial market, ADB will take into account the size of the market and closely consult market participants as well as the regulatory and supervisory authorities to ensure the appropriateness and effectiveness of reform measures.
(vi) ADB will strengthen its support for the adoption of international best practices while considering the country context.
(vii) ADB will work with middle-income DMCs to assist human resource development in small, low-income DMCs, to promote cooperation among developing countries.
(viii) ADB will continue to coordinate with other development partners to avoid overlaps and remain consistent with the Paris Declaration on Aid Effectiveness. This includes CPS coordination with the World Bank.

6 Skill Needs and Resource Arrangements

6.1 The enhancement of the quality of policy advice and TA, and the increase in their volume, will require additional staff time and resources. It will also require high-quality and specialized expertise. Of 194 staff members currently registered with the FSD CoP, only 80 belong to operational departments, including the financial sector team of OREI (Appendix, Figure 10). Staff in resident missions, headquarter operations departments, and OREI financial sector team need to be strengthened in both quality and quantity. Greater staff capacity will enable ADB to leverage consultant resources more effectively. Some staff have expertise in certain areas of finance and the financial sector. ADB has occasionally mobilized them across departments to support operations in the past. Regional departments, BPMSD, and the FSD CoP will work together to systematize this practice, including the use of expertise existing in the non-operations departments for operational purposes as appropriate.

6.2 ADB also needs to shift its modus operandi to enable its FSD staff to spend more time delivering knowledge works, including TA operations, instead of managing consultants to deliver them. A number of ADB staff are potentially capable of doing so but are currently unable because they lack the time. As ADB moves toward more knowledge-focused operations as committed under Strategy 2020, it will need staff with a more specialized skill mix.

6.3 However, the type of expertise required of staff is not the same as that of consultants. ADB staff need to have working knowledge of the financial sector in addition to that of finance. The expertise to analyze and advise on financial sector issues is less readily available from the commercial market place than that on finance. Further, while consultants are expected to contribute highly specialized or technical knowledge, ADB staff need to be able to connect it to broader development policies and dynamics of policy making and implementation. This expertise is highly scarce and can be hardly found in the commercial world. Therefore, ADB needs to develop a significant part of necessary expertise in-house.

6.4 From 2009, ADB started developing and delivering a tailor-made staff training program on FSD. The FSD CoP will continue to work with BPMSD to design and deliver it. In 2010, three training events were delivered. Beginning in 2011, the CoP aims to run the program quarterly. ADB will continue to examine whether the level of intensity and frequency is adequate, based on demand and feedback from CoP members. The CoP will also consult BPMSD to enhance career opportunities for specialists.

6.5 For ADB to work in areas identified in section 4, its staff need to have skills and knowledge in certain disciplines, such as banking, capital markets, and financial inclusion. The FSD CoP may designate leading experts, with the concurrence of their departments, to lead each discipline and form **working groups** to promote mutual learning and information sharing. Tasks of the working groups include partnerships with international organizations in their respective disciplines.

Of 194 staff members currently registered with the financial sector development community of practice, only 80 belong to operational departments, including the financial sector team of Office of Regional Economic Integration

6.6 Because of the high demand for knowledge and advisory support for the financial sector, ADB's financial sector operations could not financially rely only on revenues from financial sector lending. Substantial donor resources will be required to fund consultants to work on a significant part of financial sector knowledge works, advisory services, and capacity building TA, as discussed in section 5. The FSD CoP is working with the Office of Cofinancing Operations (OCO) to mobilize such donor resources and transform the **FSDPF** into a multi-donor facility. It is also working with SPD, the Treasury Department, and OCO to explore possibilities of allocating ADB's revenue to the FSDPF.

6.7 The FSD CoP will perform the following functions aside from the operations discussed above:

The financial sector team of OREI will continue to serve as the secretariat for the FSD CoP

(i) monitor the implementation of the Financial Sector Operational Plan and the performance of ADB projects on FSD, and provide guidance for ADB's future operational direction;
(ii) guide partnership works with international organizations such as the Financial Stability Board, Basel Committee, IOSCO, IAIS, CGAP, OECD, United Nations Conference on Trade and Development, IMF, and the World Bank to promote best practices in the financial sector;
(iii) guide research and other knowledge works in the financial sector and in disseminating them by working with the Department of External Relations;
(iv) identify human resource needs and plan staff training programs on FSD, working with BPMSD as well as member departments;
(v) cooperate with OCO to mobilize and administer FSD-related donor resources; and
(vi) maintain and update the financial sector project database, the financial sector staff directory, and the consultants' roster; and facilitate their use by staff via the intranet.

6.8 The financial sector team of OREI will continue to serve as the secretariat for the FSD CoP. Its primary role will be to support regional departments and PSOD in operational and knowledge works, aside from conducting its own knowledge and TA works as part of the OREI work plan. The support will include participation in operational missions and contribution to project or program preparation and supervision. The team will house specialists in areas where expert support is needed but not necessarily required full time by any single operations department. As such, the team will consult operations departments and the FSD CoP in considering its staffing.

7 Timetable for Implementation

7.1 The implementation of this Operational Plan is divided into two phases. In the first phase, lasting 2 years, ADB aims to strengthen its operations in the **established areas** identified at the end of section 4. ADB plans to build staff and skill capacity; mobilize the FSDPF to fund TA operations; and strengthen partnerships, the business process, and practice groups. In consultation with SPD, the FSD CoP aims to develop measures for the six outcomes identified in section 4 and improve the indicators for the DEfR framework. In the second phase, ADB aims to enhance business models in the **areas of limited experience**, while carrying out knowledge works to further build expertise in the areas.

ADB plans to build staff and skill capacity; mobilize the Financial Sector Development Partnership Fund/Facility to fund technical assistance operations; and strengthen partnerships, the business process, and practice groups

7.2 As ADB implements the plan through 2020, the share of financial sector operations in its total operations should increase from that of the past 10 years,[28] although the volume in the immediate future needs to be guided by the existing CPSs. The FSD CoP will periodically review the implementation of the plan and consider needs of amendments to the plan.

Phase One: 2011–2012

(i) Launch the Operational Plan.
(ii) Identify core skill areas and leading experts, and build staff capacity by training and hiring.
(iii) Develop a cross-support mechanism to systematically use experts mapped across ADB, monitor its implementation, and evaluate the performance.
(iv) Mobilize donor funds and transform the existing FSDPF into a multi-donor facility and finance TA operations (not project preparatory TA).
(v) Develop or strengthen partnerships with international financial standard-setters such as the Financial Stability Board, Basel Committee, IOSCO, IAIS, and CGAP.
(vi) Continue to strengthen the peer review process and evaluate the quality enhancement ADB is achieving.
(vii) Develop or improve indicators for the DEfR and outcomes identified in section 4, and monitor and evaluate performance.
(viii) Establish targets for financial sector lending operations in the **established areas**.
(ix) Carry out knowledge works in **areas of limited experience** and enhance the knowledge base.

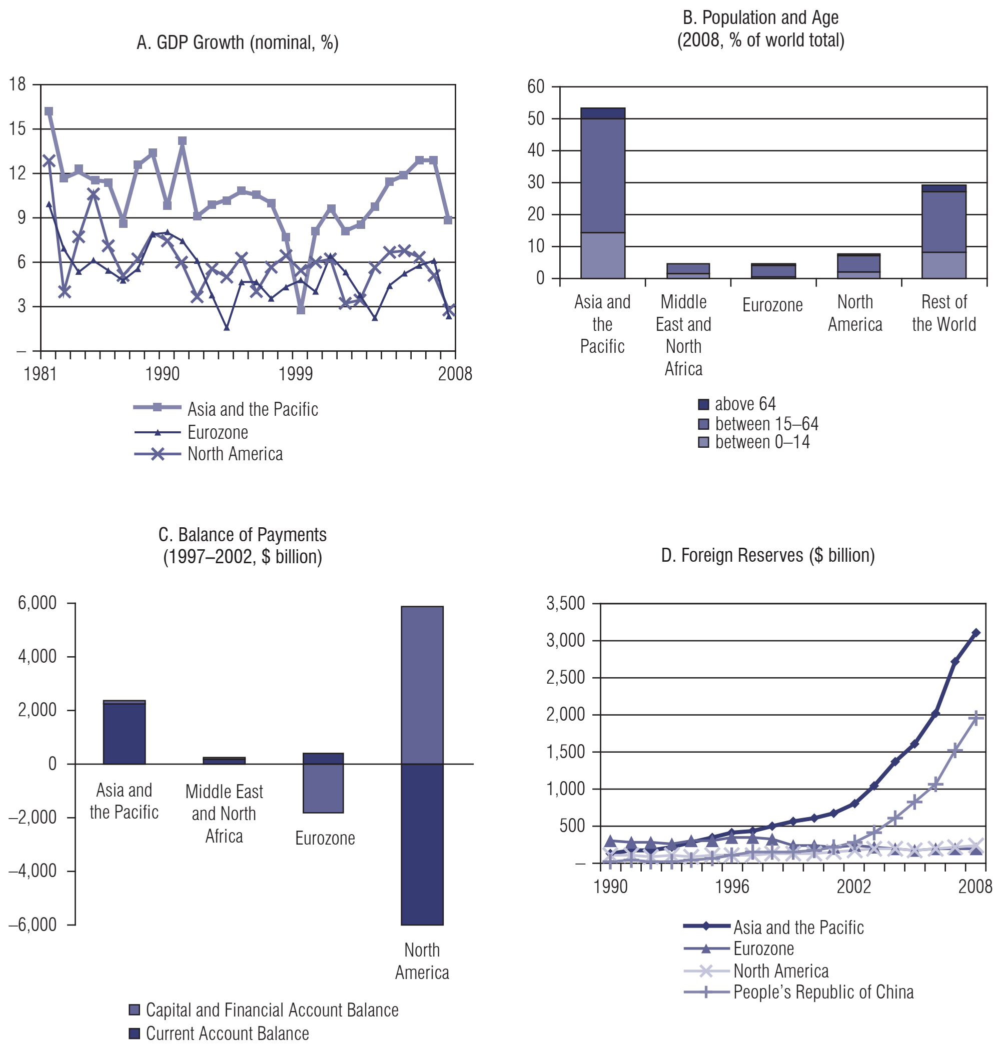
Phase Two: 2013–2014

(i) Improve business models for areas of limited operations or experience, and monitor and evaluate ADB's performance.
(ii) Review ADB's performance in building the human resource capacity.
(iii) Review the Operational Plan and revise it as necessary.
(iv) Execute the revised plan.

[28] 9.55% in number and 9.11% in amount (Table 1).

Figures and Table on Economic and Financial Sector Landscape in Developing Member Countries and ADB Operations in the Sector

Figure A1 Key Developments in Asia and the Pacific

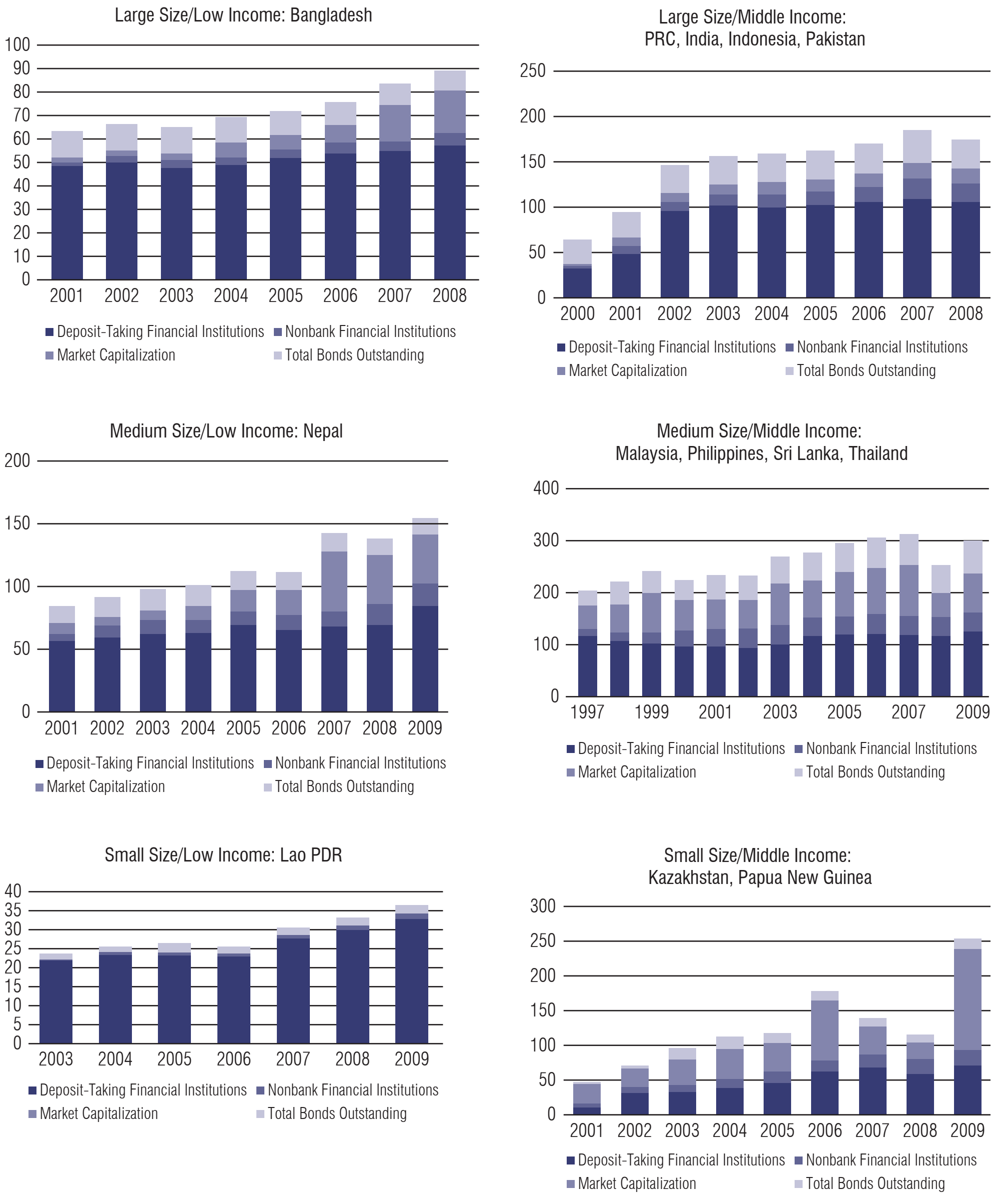


GDP = gross domestic product.

Note: Asia and the Pacific includes ADB developing member countries as indicated in Appendix, Table 1.

Source: Office of Regional Economic Integration consultant calculations.

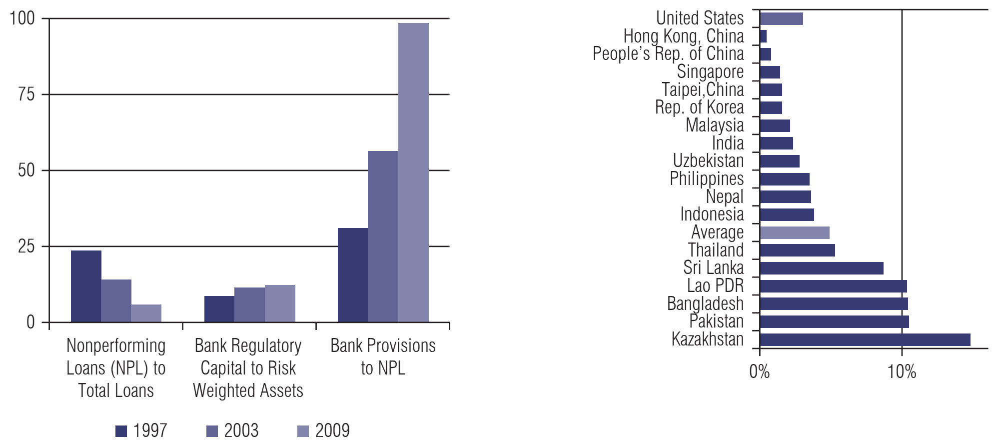
Figure A2 Comparison of Financial Sector Development by Size and Income Levels (% of GDP)



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.

Source: Office of Regional Economic Integration consultant calculations using data from national sources (accessed through CEIC Data and websites), Asian Bonds Online, World Bank, World Economic Outlook Database, Bank for International Settlements, Economist Intelligence Unit, and International Financial Statistics.

Figure A3 Banking Sector Soundness Indicators of Selected Asia and Pacific Developing Member Countries (%)

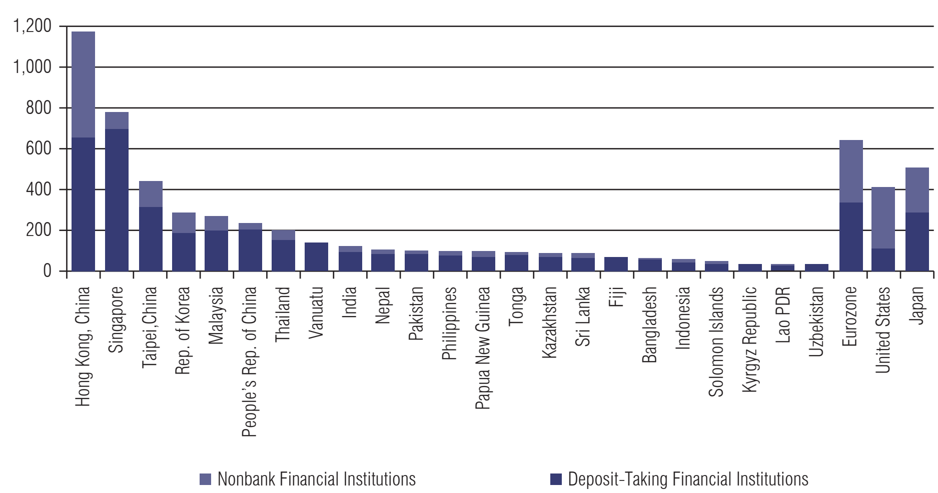


DMCs = developing member countries, Lao PDR = Lao People's Democratic Republic, NPL = nonperforming loans.

Note: The Asia and Pacific developing member countries include Bangladesh, the People's Republic of China (PRC), India, Indonesia, Kazakhstan, Lao PDR, Malaysia, Nepal, Pakistan, Papua New Guinea, Pakistan, Philippines, Solomon Islands, Sri Lanka, Thailand, and Tonga.

Source: Office of Regional Economic Integration consultant calculations.

Figure A4 Financial Sector Assets of Selected Developing Member Countries (2009, % of GDP)

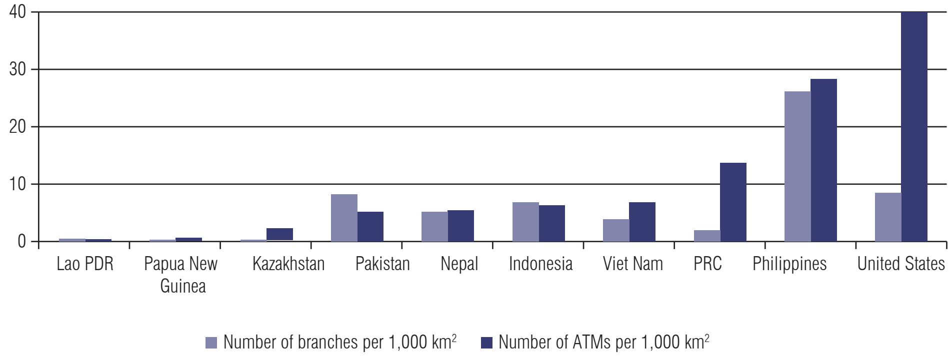


GDP = gross domestic product, Lao PDR = Lao People's Democratic Republic.

Note: Assets in nonbanks are not included in Fiji, Kyrgyz Republic, Uzbekistan, and Vanuatu due to lack of data. Figures for Fiji, Solomon Islands, Tonga, and Vanuatu are for 2008.

Source: Office of Regional Economic Integration consultant calculations.

Figure A5 Comparison of Access Points to Banking Systems (2009)

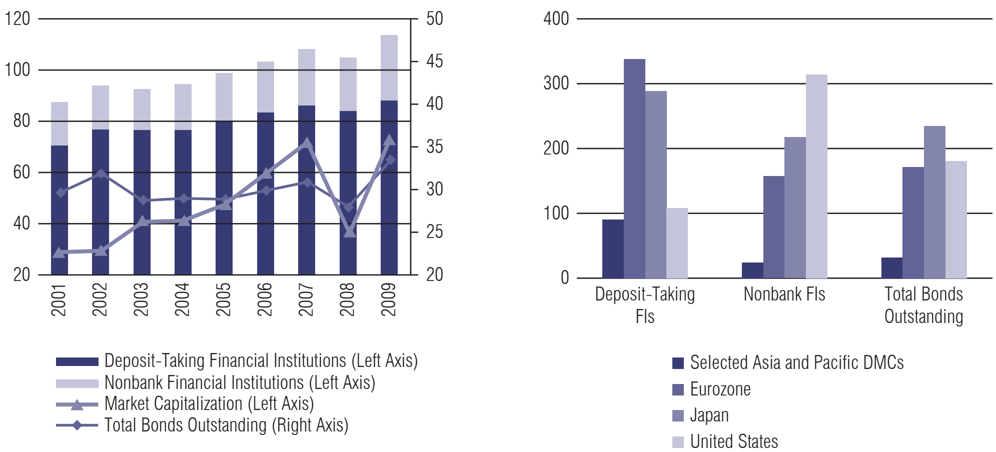


Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China, km² = square kilometer.

Note: Lao PDR for 2007; Indonesia ATM for 2007; Hong Kong, China for 2008; Malaysia for 2008; Papua New Guinea for 2008.

Sources: Bank for International Settlements, Retail Banking Research 2007, national sources, CIA World Factbook (2009), World Bank.

Figure A6 Development of Financial Systems of Selected Asia and Pacific Developing Member Countries (% of GDP)

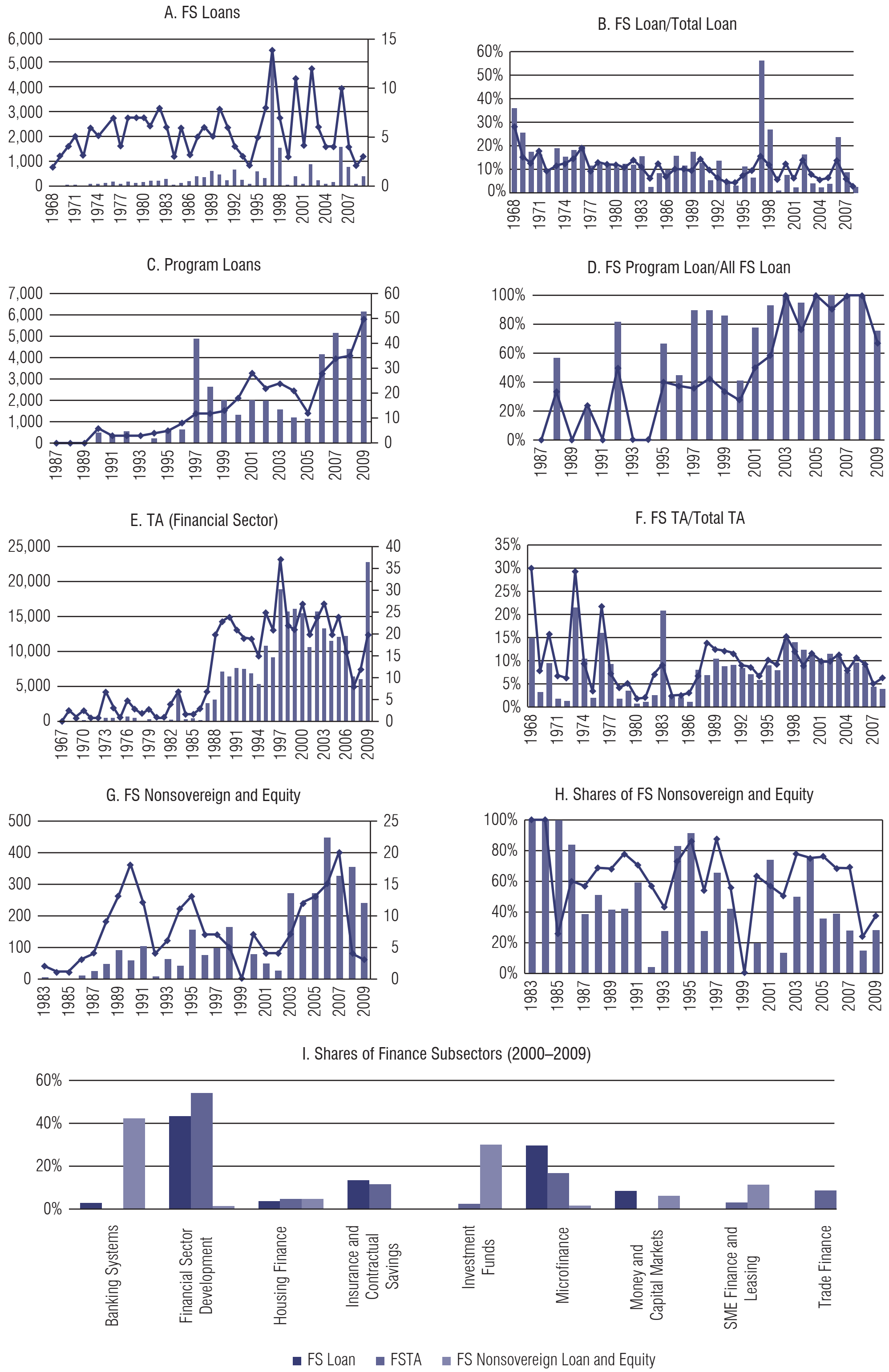


DMC = developing member country, FI = financial institution, GDP = gross domestic product.

Note: The coverage of selected Asia and Pacific DMCs is the same as in Appendix, Figure 3.

Source: Office of Regional Economic Integration consultant calculations.

Figure A7 Financial Sector Projects and Operations, 1966–2009

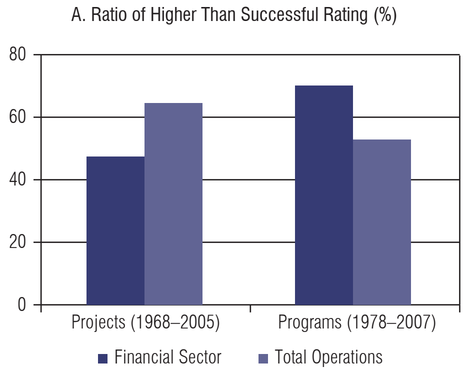


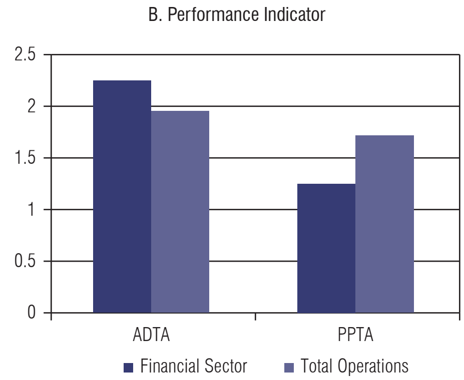
FS = financial sector, TA = technical assistance.

Note: For graphs of A, C, and E, bars represent amounts ($ million in A and C, $ '000 in E on left axis) and lines represent numbers on right axis. For graphs of B, D, and F, bar and lines represent an amount and number, respectively.

Sources: ADB Database (as of 31 December 2009), Office of Regional Economic Integration consultant calculations.

Figure A8 Performance of Financial Sector Operations





ADTA = advisory technical assistance, PPTA = project preparatory technical assistance.

Source: Asian Development Bank.

Table A1 Developing Member Countries Grouped by Size and Income Level (2009, $)

Size[a]/ Income[b]	Economy	Population (million)	Per Capita GDP	GDP (billion)	Land (1,000 km^2)	Population Density (per km^2)	Country Classification[c]
Large/Low	Bangladesh	164.71	573.8	94.5	144.0	1,143.8	B
Large/ Middle	PRC	1,334.74	3,677.9	4,909.0	9,597.0	139.1	C
	India	1,199.06	1,030.8	1,236.0	3,287.3	364.8	B
	Indonesia	231.55	2,329.4	539.4	1,904.6	121.6	C
	Pakistan	163.77	1,016.7	166.5	796.1	205.7	B
Medium/ Low	Afghanistan	28.89	486.1	14.0	652.2	44.3	A
	Myanmar	59.98	459.4	27.6	676.6	88.7	A
	Nepal	27.91	451.9	12.6	147.2	189.7	A
Medium/ Middle	Malaysia	27.76	6,896.7	191.5	329.8	84.2	C
	Philippines	92.23	1,745.6	161.0	300.0	307.4	C
	Sri Lanka	20.24	2,041.4	41.3	65.6	308.5	B
	Thailand	66.98	3,939.6	263.9	513.1	130.5	C
	Uzbekistan	27.91	1,175.7	32.8	447.4	62.4	B
	Viet Nam	87.21	1,059.9	92.4	331.2	263.3	B
Small/Low	Cambodia	13.94	775.0	10.8	181.0	77.0	A
	Timor-Leste	1.09	542.7	0.6	14.9	73.1	A
	Kyrgyz Republic	5.37	851.0	4.6	200.0	26.9	A
	Lao PDR	6.38	878.0	5.6	236.8	26.9	A
	Tajikistan	6.50	766.8	5.0	143.1	45.4	A

continued on next page

Table A1 *continued*

Size[a]/ Income[b]	Economy	Population (million)	Per Capita GDP	GDP (billion)	Land (1,000 km²)	Population Density (per km²)	Country Classification[c]
Small/ Middle	Armenia	3.27	2,667.6	8.7	29.7	109.8	B
	Azerbaijan	8.97	4,807.1	43.1	86.6	103.6	B
	Bhutan	0.68	1,880.6	1.3	38.4	17.6	A
	Cook Islands	0.02	18,555.3	0.4	0.2	95.0	C
	Fiji	0.88	3,464.4	3.1	18.3	48.3	C
	FSM	0.11	2,497.8	0.3	0.7	154.0	B
	Georgia	4.39	2,448.4	10.7	69.7	62.9	B
	Kazakhstan	15.57	7,019.0	109.3	2,724.9	5.7	C
	Kiribati	0.10	1,304.3	0.1	0.8	122.0	A
	Maldives	0.35	3,932.1	1.4	0.3	1,157.7	A
	Marshall Islands	0.05	2,890.1	0.2	0.2	300.0	B
	Mongolia	2.69	1,560.2	4.2	1,564.1	1.7	A
	Nauru	0.01	7,935.3	0.1	0.0	465.0	A
	Palau	0.02	8,807.0	0.2	0.5	44.0	B
	PNG	6.34	1,247.3	7.9	462.8	13.7	B
	Samoa	0.18	3,077.6	0.6	2.8	64.0	A
	Solomon Islands	0.54	1,223.0	0.7	28.9	19.0	A
	Tonga	0.10	3,032.1	0.3	0.7	137.0	A
	Turkmenistan	5.35	3,242.1	17.4	488.1	11.0	C
	Tuvalu	0.01	3,738.5	0.04	0.03	427.0	A
	Vanuatu	0.24	2,635.7	0.6	12.2	1,143.8	A

FSM = Federated States of Micronesia, GDP = gross domestic product, Lao PDR = Lao People's Democratic Republic, PNG = Papua New Guinea; PRC = People's Republic of China, km² = square kilometer.

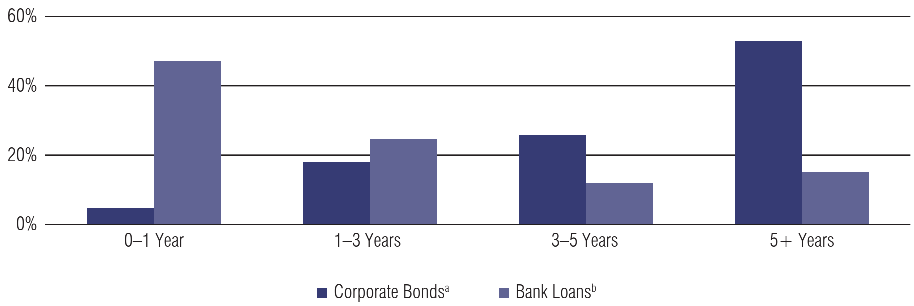
[a] Population under 20 million for small country, over 150 million for large country, and in between for medium country.

[b] Per capita GDP under $1,000 for low-income country and over $1,000 for middle-income country.

[c] Group A for Asian Development Fund-only countries, Group B for blend countries, Group C for ordinary capital resources-only countries.

Sources: ADB, IMF, and CIA World Factbook.

Figure A9 Maturity Profiles of Bank Loans and Corporate Bonds

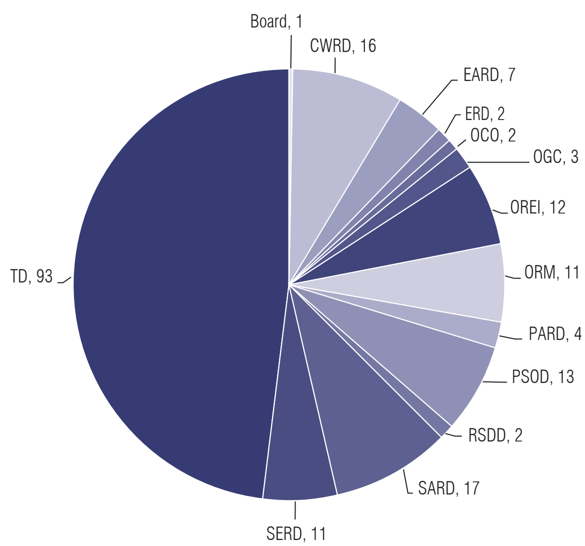


[a] Data from top 30 issues in Hong Kong, China; People's Republic of China; India; Indonesia; Malaysia; Republic of Korea; Philippines; Singapore; Thailand; and Viet Nam.

[b] Data from India, Philippines, and the Republic of Korea.

Source: Office of Regional Economic Integration consultant calculations and estimates based on Bloomberg and national sources as of June 2010 except for Hong Kong, China (as of September 2010) and India (bank loan maturity profile as of March 2010 and corporate bond issuance as of October 2010).

Figure A10 Staff Distribution of Financial Sector Development Community of Practice Members by Department (as of 4 January 2011)



Board = Board of Directors, CWRD = Central and West Asia Department, EARD = East Asia Department, ERD = Economics and Research Department, OCO = Office of Cofinancing Operations, OGC = Office of the General Counsel, OREI = Office of Regional Economic Integration, ORM = Office of Risk Management, PARD = Pacific Department, PSOD = Private Sector Operations Department, RSDD = Regional and Sustainable Development Department, SARD = South Asia Department, SERD = Southeast Asia Department, TD = Treasury Department.

Source: Asian Development Bank.

Financial Sector Operational Plan

The Asian Development Bank (ADB) issued its long-term strategic framework, Strategy 2020, in April 2008 to guide its operations to meet the changing assistance needs of its developing members. The strategy identified financial sector development as one of the five focal areas of ADB's operations through 2020. This Financial Sector Operational Plan aims to articulate the financial sector agendas of Strategy 2020 and guide its implementation by ADB.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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