POLICIES FOR FINANCIAL SECTOR DEVELOPMENT: WHEN AND HOW TO BUILD A PUBLIC-PRIVATE PARTNERSHIP?[2]

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The paper discusses the prospects of public-private partnership for fostering financial sector development in Armenia. It argues that the government's approach to regulating the financial sector recognizes that such partnership is driven by market participants. Development of financial services intrinsically requires close cooperation between financial authorities and market participants. This ensures that regulation matches the outcome expectations of market participants. The beneficial impact of such enhanced public-private dialogue would be the development of analytical capacities in financial economics, banking, finance, legal and regulatory matters within Armenian civil society which itself is an important contribution to sustainable economic and social development of the country.

I. IS PRIVATE SECTOR INVOLVEMENT IN FINANCIAL SECTOR POLICY DESIGN DESIRABLE?

The necessity for government intervention to control access to and conduct of financial intermediation, through the licensing, regulatory and supervision functions, obscures the fact that financial sector development depends essentially on private sector initiative. Regulations do not drive financial sector development. Market participants drive financial sector development—that is expansion of intermediation volumes, also with new products and to new clients. Of course, product and client-segment development is shaped by regulations. It is thus important that authorities assess the impact that regulations have on financial intermediation. It is also important that market participants help authorities assess this impact, particularly when it is inadvertently harmful. Market participants should also make proposals for lower-cost regulatory alternatives, if any.

II. LIMITS OF PUBLIC SECTOR INTERVENTION IN FINANCIAL SECTOR DEVELOPMENT

While development of financial services intrinsically requires close cooperation between financial authorities and market participants, this is not general practice in many developing

[2] Based on a presentation made at the "Armenia Financial Sector Development: Directions and Challenges" workshop held in Tsakhkadzor (Armenia) on May 29, 2005.

countries. In advanced countries, authorities have understood this interdependence. Sir Eddie George, the former Bank of England Governor, said:

> We recognized early on that where intervention was judged to be necessary – in the interest of market transparency or of prudential or behavioral conduct – it needed to be informed by those who properly understood the subtleties of the market if we were to reduce the risk of unforeseen consequences or unnecessarily obstruct market innovation.

Acknowledging the power of market incentives, authorities in sophisticated markets are publicly committed to facilitate the collective activities of market participants. The European Central Bank President regularly emphasizes this principle as follows:

> We at the ECB see the fostering of collective action on the part of the private sector to overcome possible coordination problems as a very important contribution by public authorities. The ECB plays this "catalyst" function.

One of the intellectual fathers of this enlightened role of authorities in enabling market development is Tommaso Padoa-Schioppa, former Member of the ECB Executive Board. To make the benefit of collective action more apparent to market participants, he argues for a catalytic public intervention:

> It is crucial to be aware that market-led progress does require co-operation among economic (public and private) agents. The driver of co-operation should be, as much as possible, moved by the private sector, i.e. by an enlightened perception of the private interest. The necessary co-operation among private market participants does not materialize unless public authorities play an important role in promoting it.

The next financial sector development frontier is indeed how best to marry market incentives and policy measures. This suggests a new role for international financial institutions as advisors to both authorities and market participants.

III. How Could the Private Sector Engage in Policy Dialogue?

Collaboration requires responsible engagement by market participants. They have to recognize the public policy dimension of their profit-making activities by understanding how the authorities look at the risks, both short-term and long-term, of their activities. They must learn to speak the same language and they must understand how they can become valuable development partners to the authorities.

All this requires a change in culture and approach. Market participants must equip themselves as "architects of growth". This means foregoing the temptation to seek quick remedies through individual "lobbying" and focusing instead on the strategic context of how can a country build itself up to expand the use of external finance in support of economic activities. The role of knowledge and analysis is essential for this upgraded role of market participants in policy dialogue. The example of the Italian Banking Association is interesting. It started being accredited as policy stakeholder after having shown, as Prof. Francesco Cesarini recently wrote:

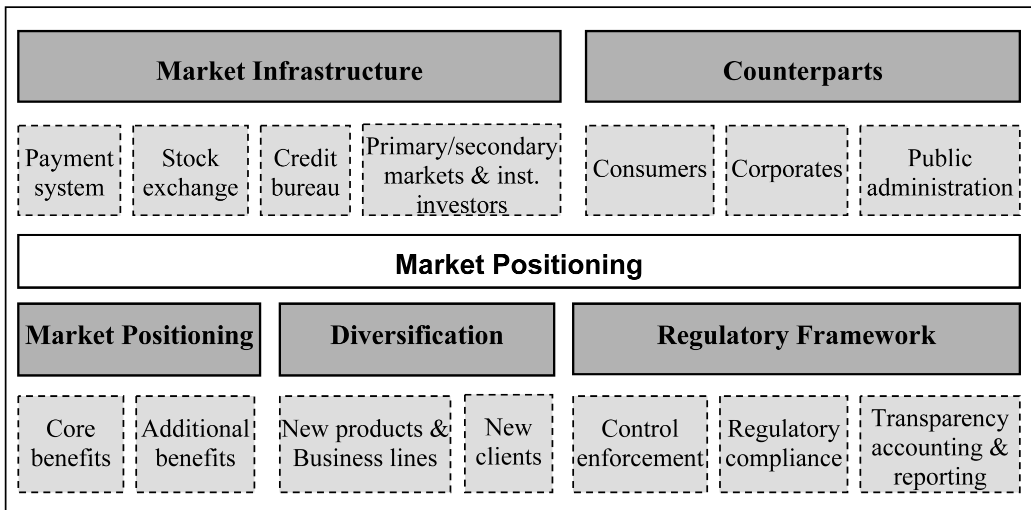
> …its readiness to engage in research projects on new and emerging issues. ABI drew not only on its members' intellectual resources but also on external counsel

and by linking itself with parallel studies conducted by regulatory authorities and independent research organizations.[3]

IV. Public-Private Dialogue: Where to Start?

Turning now from describing the concept of public-private partnership to the practicality of nurturing it, it is important to cement it on issues where a public-private "win-win" situation is possible. This means avoiding tackling issues where authorities may not feel ready to move such as, for instance, monetary policy targets or broad financial stability issues (*e.g.*, capital adequacy ratios). Looking at the experience of developed financial markets, one can readily note how many infrastructural issues have impacted the market positioning of banks. The following figure shows the very many elements of an efficient financial system: payment systems, inter-bank deposit activities, credit bureaus, capital market activities, financial products for the authorities, etc.

Figure 2.1. Financial System Efficiency



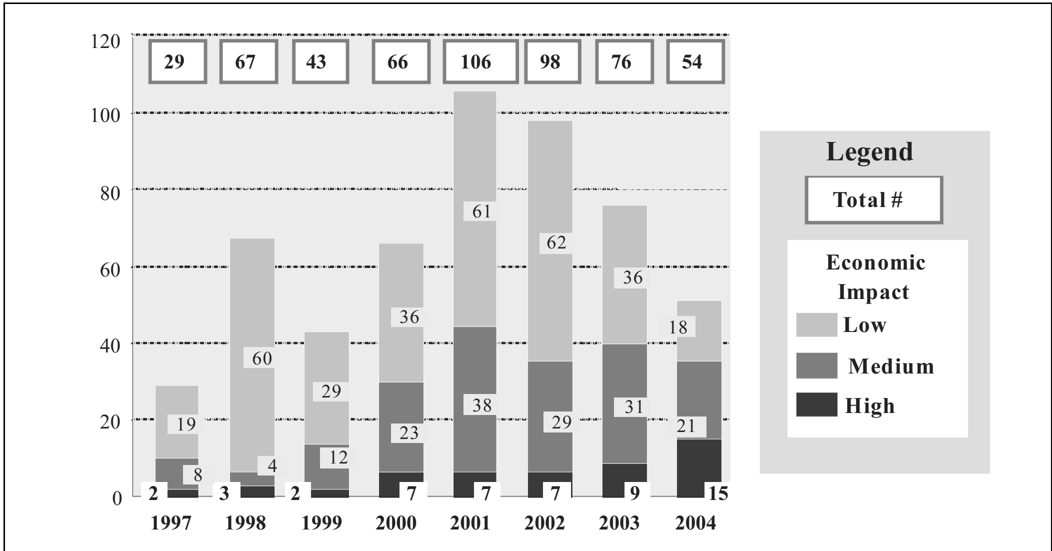
V. A Large Reform Platform Emerges With Adoption of a Win-Win Approach

Once the policy focus is placed on making the market work better to enable private sector initiative, it becomes readily observable how large an ongoing reform work is required to fine-tune the financial system infrastructure, even in advanced countries. In Italy, for instance, the Banking Association is actively involved in shaping about sixty policy changes every year—of which more than ten are now of systemic importance with

[3] Francesco Cesarini, "*Has the Italian Banking Association contributed to financial sector development in Italy? Review of its functions and structures and their recent development*", Convergence (World Bank) mimeo, December 2005.

significant economic impact on banking activity through either volume or profit & loss channels.

Figure 2.2. ABI: Number of Regulatory Changes Completed



VI. A Valuable Permanent Issue-Identification Structure Also Emerges

The extensive involvement of the banking association in policy analysis and dialogue is rooted in a large participatory effort by the banking community to screen the impact of existing regulations on various facets of the banking activity. To use again Italy's example, the industry has organized itself in ten permanent Technical Commissions, which in turn preside over the work of some 150 specific working groups.

Table 2.3. Technical Commissions and Working Groups of A.B.I. as of July 2005

Commissions	*Number of Working Groups*
Taxation	18
Legal	27
Financial system legislation	7
Lending activities	9
Finance	23
Payment system	20
Research and statistical analysis	21
Technology and security	23
Trade union relationships	1
Labor legislation	3
	152 (1)

This is a formidable market reality "intelligence" taskforce that supplements and expands the issue identification efforts that the Central Bank and the various Ministries can undertake. It is fairly obvious that authorities cannot match the fact-gathering resources of the industry. This simple observation lies at the center of the rationale for a public-private alliance for financial sector development.

VII. The Benefit of the User's Perspective: Outcome Orientation

It is important to note that the industry looks at regulations from the user's angle. The industry is interested in assessing how existing regulations affect the production and distribution of specific banking activities or products, such as trading, depository functions, debt origination, off-premise promotion of financial products, placement of investment funds, etc. This business perspective complements the regulatory-based approach typically followed by authorities.

It is important, as the EU Commission says, that regulation-making become as much outcome-oriented as possible:

> The Commission will deploy the most open, transparent, evidence-based policy-making, based on a dual commitment to open consultations and impact assessments, so as to ensure sound rules are drawn up, adding value to EU's financial services sector and consumers.[4]

VIII. Outcome Orientation Assessed Through Regulatory Impact Analysis

Regulatory Impact Analysis (RIA) is an important tool to keep the focus on the purpose of regulations. It allows for a systematic assessment of the potential cost and benefit of a specific regulation on banking activity and on economic activity more generally.[5]

Table 2.4. Key Analytical Steps in Impact Assessment

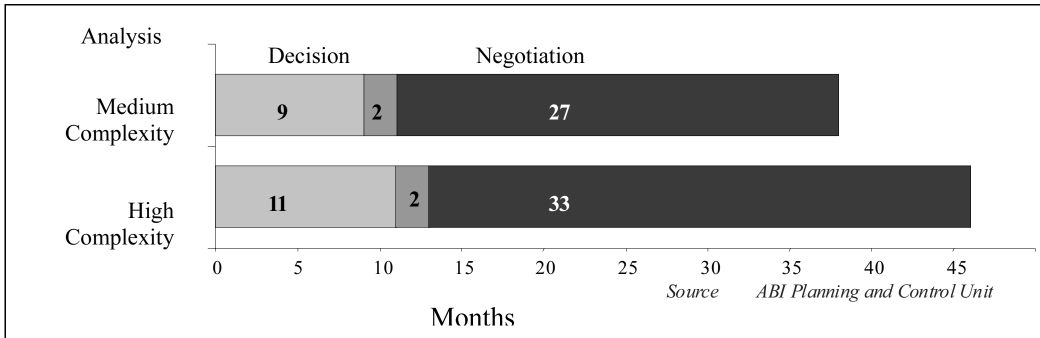
1. Identify the problem
2. Define the objective
3. Develop the main policy options
4. Analyze their impacts
5. Compare the options
6. Outline policy monitoring and evaluation

RIA is also a management tool for banking associations to direct their efforts to study those regulatory aspects that, if changed, are going to yield the highest economic benefits to the banking system. This tool helps with the resource allocation of banking sector representatives (and their experts) to work with authorities on implementing financial sector reforms which, as the figure here below shows, is a time-consuming activity.

[4] EU Commission, "*White paper: Financial Services Policy 2005-2010*", Brussels, December 2005.

[5] EU Commission, "*Impact Assessment Guidelines*", Brussels, June 15, 2005

Figure 2.5. Average Length of the Main Steps to Carry Out Policy Changes by "Business Line"



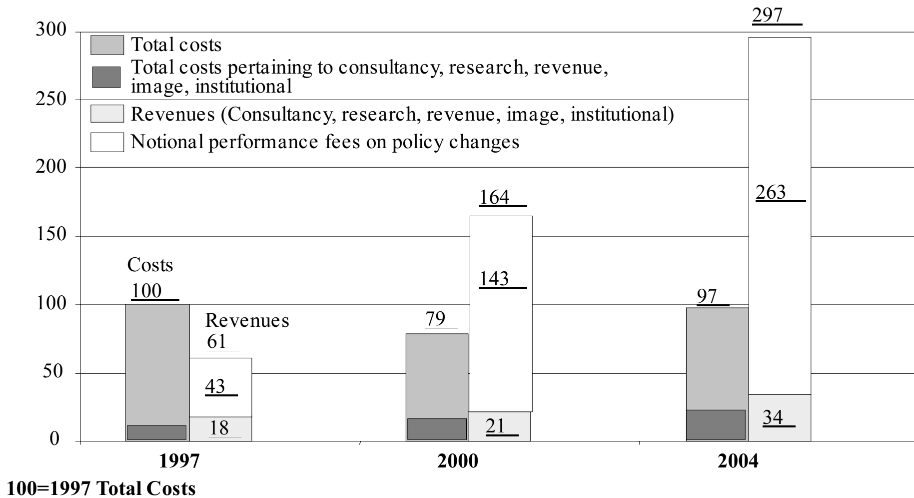
IX. THE NEXT "CONDITIONALITY" FRONTIER: MARKET INCENTIVES?

In most developing countries, financial or political conditionalities have eased the adoption of large financial sector structural reforms involving regulatory overhaul and large-scale ownership transfer from the public to the private sphere. When financial intermediation takes place mostly in private hands and there is a large degree of regulatory compliance with international supervisory standards, it is understandable that a sense of comfort of "mission accomplished" sets in. But this is the time when the real work starts: financial deepening (higher credit/GDP ratio) and broadening (higher non-bank financing/total financing flows) hinge on the effective interplay of a myriad of micro-regulations that should be made to work as a clock. What drives this regulatory fine-tuning to wring the maximum efficiencies out of the financial infrastructure in place and to allow for its further expansion? The answer is simple: interplay between public action and market incentives. How do market incentives work?

Market incentives identify the pursuit of increased profits as a driver for action. This also happens in the regulatory business. In this case the incentive is to increase shareholder value through regulatory fine-tuning. Each and every regulatory change can in fact be assigned a monetary value to the financial institution that will benefit from it. This estimate is done with RIA techniques.

Banking associations are uniquely positioned to assess the shareholder value generated from regulatory changes for the entire banking system. Playing the role of "arranger" of these changes for the banking system, they "earn" a fee based on the value created for their member banks. Comparing this notional revenue to their operating costs, banking associations can thus establish their own "profit and loss" account. If given proper incentives from their members, the management team of banking associations could become a powerful player in driving the micro-regulatory reform agenda. The following figure shows the synthetic profit and loss statement of the Italian Banking Association. The notional remuneration it draws from having arranged policy changes for its member banks is a three-fold multiple of its operating costs.

Figure 2.6. The Profit and Loss Statement of the Italian Banking Association



X. HOW TO CATALYZE PUBLIC-PRIVATE FINANCIAL SECTOR DIALOGUE IN ARMENIA?

"Convergence", the public-private financial sector development program sponsored by the World Bank for South-East Europe, is available to catalyze financial sector dialogue in Armenia and other countries in the South Caucasus.

Consistent with its mission to promote the build-up of analytical capabilities in financial economics, banking, finance, legal and regulatory matters within the civil society of its initial target market, "Convergence" could help the local financial community undertake analytical studies of micro-structural issues that, if properly regulated, could stimulate the growth of financial sector intermediation. It could also bring the results of these studies and those sponsored by other institutions, supported by a specific "Convergence" opinion, to the attention of authorities for decision-making after open public consultations.

A beneficial impact of an enhanced public-private dialogue will be the development of analytical capacities in financial economics, banking, finance, legal and regulatory matters within Armenian civil society. This, by itself, could be a very important contribution to sustainable economic and social development of the country. This will be the beginning of "country ownership", also in the financial sector.