

FINANCIAL AND SECURITIES MARKETS DEVELOPMENT PROGRAM

(TC-96-01-39-6-RG)

EXECUTIVE SUMMARY

REQUESTER: Bank initiative.

EXECUTING AGENCY: Bank initiative through the Infrastructure and Financial Markets Division of the Social Programs and Sustainable Development Department.

BENEFICIARIES: IDB borrowing member countries

FINANCING:

IDB foreign exchange:	US\$650.000 (SF)
Local foreign currency:	US\$200.000
Total:	US\$850.000

TERMS:

Execution period:	3 years
Disbursement period:	4 years

APPROVAL PROCEDURE: Pursuant to document AT-1046-4, approved by the Board of Executive Directors on November 21, 1995, this operation must be submitted for consideration by the Committee of the Whole.

ENVIRONMENTAL CLASSIFICATION: The Environmental Management Committee, at its meeting of April 16, 1996, classified this as a Category II operation.

OBJECTIVES: To strengthen the development of domestic financial and securities markets and support regional integration by assisting with financial sector reform and modernization in Bank borrowing member countries.

DESCRIPTION: The Program will finance studies and training programs on financial and securities markets in the Latin American and Caribbean region in response to the mandate received from the Finance Ministries of the Region. Topics include institutional requirements for financial development and innovation with a focus on the regulatory and supervisory aspects of the markets. The work will comply with the objectives of the Bank's lending strategy and will be communicated to persons with the strategic areas of interest for the Regional Finance and Infrastructure Divisions and for the relevant regional institutions (e.g. COSRA, ALACBS, IASC, CHFI, etc.) that have an interest in the Program's development and success.

The Technical Cooperation for Financial and Securities Markets Development Program will finance research on financial and securities markets in the Region. Research work will focus on the policy lessons for the Region, the frontiers of financial innovation, and prudential regulation. Topics will include the institutional requirements for financial development and innovation, with particular attention given to the regulatory and supervisory aspects of these markets. The results from the research will be disseminated to Bank borrowing member countries and other interested parties through conferences, workshops, roundtables, training programs, electronic media (i.e. Internet), working papers, and manuscripts.

This Technical Cooperation program is designed to support the institutions that efficiently allocate domestic and foreign capital within these markets, and develop some commonality among institutions and financial instruments within the Region. The Program will explore ways in which the Region's private market participants and regulatory authorities can create, strengthen, and integrate market institutions and instruments. Projects designed to achieve these objectives include the following: (a) a risk management program; and (b) a study focusing on asset-allocation decisions for pension funds and related annuity markets. The Program is also dedicated to the development of financial markets, promotion of information disclosure, and the strengthening of bank supervision and training. Projects developed to further these goals include: (a) a survey of financial systems; (b) an inventory of best practices in accounting and auditing standards and information disclosure for bankers and public listings; and, (c) a banking supervision and examination training seminar.

**BENEFITS TO
COUNTRIES:**

The Program will provide a focal point for the Bank's expertise in the area of financial and securities markets, and will serve as a clearinghouse for best practices and information in the Region. This central source of information and technical expertise will provide cohesion to the dialogue on the development and operation of these markets and related issues between the Bank and its members, contribute to the improved quality of Bank lending, as well as identify new areas for lending. Research findings from the Program studies and training programs will be disseminated to borrowing member countries to ensure knowledge/technology has been transferred to the Region. The Program's success will

be enhanced by collaborating with borrowing member countries and divisions within the Bank, without which the relevance of the research will be diminished.

RISKS:

To be effective, the Program must focus on a select set of topics. However, because of the nature of the subject, which is rapidly evolving as new and more complex markets and financial instruments are being introduced, flexibility will be needed in program execution to allow for changes in the topics covered through research for publication and/or conference/workshop presentation. Furthermore, an Advisory Committee comprised of Bank staff will be established in order to ensure a linkage with the operational concerns of the Bank and proper transfer benefits accrued from research work. Also, given the size and scope of the studies and training programs included in the Program, budgetary provisions have been made to cover administrative costs incurred at headquarters and in the field.

**THE BANK'S
COUNTRY STRATEGY:**

The Bank's Eighth Replenishment recognizes the importance of domestic savings and investment. The Program would promote these goals through the development of a capital markets and financial markets strategy for the Bank's lending and technical assistance operations. The Capital Markets Development Strategy reviewed by the Policy Committee of the Board of Directors (September 28, 1995, GN 1870-2) proposes the establishment of a capital markets program to provide analytical work, support for technical assistance, and dissemination of best practices in the area of capital market development. This Technical Cooperation proposal fulfills the objectives of the Capital Markets Development Strategy. Attention has also been placed on continuing efforts to address the special needs and conditions of the banking system throughout the Region, which will be part of the Financial Markets Development Strategy currently under preparation. This Program would effectively integrate both subjects in a complementary manner.

I. BACKGROUND

- 1.1 The Latin American and Caribbean region has made tremendous progress over the past decade with economic policies that have restored growth and lowered inflation, expanded the role of the private sector, and reduced distortions in domestic markets. Although some of that agenda is still pending, there is a growing appreciation that another generation of reforms is needed to solidify the gains made from this economic transformation. This next period of change will likely require institutional and regulatory reforms that strengthen the market-based institutions which have been created by a growing reliance on markets and private capital to finance investment needed for development. The Technical Cooperation for Financial and Securities Markets Development Program is designed to address these necessary changes as well as concentrate on improving the quality of financial information (and enhancing market transparency) in borrowing member countries, and developing a set of "best practices," as adjusted for incomplete and immature markets, which can be applied to Bank-sponsored projects and policy.
- 1.2 A key to sustainable growth will be larger and more stable investment and savings. The low rates of domestic savings and investment in the Latin American and Caribbean region, as compared to East Asia, have led to weaker growth performance. At the same time, the Latin American and Caribbean economies are subject to additional shocks owing to the lack of depth in financial markets, and are more susceptible to volatile international capital flows than other regions. These factors make the promotion of higher domestic savings rates, adoption of appropriate investment policies, and a deepening of financial markets of major importance to the development of the Region. Raising savings and investment levels in the Region will require stable macroeconomic conditions, appropriate and credible fiscal and monetary policies, and non-distortionary tax regimes. Furthermore, steps are also needed in the reform process to improve the legal and institutional foundations of financial and securities markets within the Region.
- 1.3 Regulatory authorities in the Region increasingly are focused on "safety and soundness" issues in the regulation and supervision of banking, insurance and pension institutions, and stock and bond markets. Development of these institutions will continue to deepen financial and securities markets and enhance economic stability. By securing funds that match the currency of earnings, these institutions are able to support the country's investor base and extend the maturity of investment (especially with pension and insurance funds). New instruments will be developed as markets broaden, creating new choices for investors and issuers of securities in fixed-income and equity markets. However, this will also place new demands upon market participants and their regulators. For example, the use of derivatives such as forwards, futures, swaps, and options will require new regulatory and legal

structures, as well as appropriate monitoring and institution of modern risk management techniques by both investors and public authorities.

- 1.4 The rapid development of local financial and securities markets is accompanied by the growing integration of regional markets. Under the impetus of NAFTA, MERCOSUR, and similar agreements, trade and capital flows are increasing, as evidenced by the sizable amount of intra-regional investment in financial services and increased use of cross listings of stocks. Greater economic integration will also require harmonization and monitoring of policies affecting financial and securities markets since capital flows are sensitive to differences in regulatory treatment.
- 1.5 The IDB Bank Group has been active in financial market development through investment, financial and global multi-sector loans, Multilateral Investment Fund operations (since 1992), and Inter-American Investment Corporation's operations (since 1988). In these efforts, the Bank has pursued the creation of open, transparent and integrated markets by lending to support prudential and supervisory activities in securities markets, banking, pension institutions, and other areas. Given the pace of change owing to new information technology and the globalization of markets, the Bank has already indicated it is prepared to respond to these new developments (although no funds have been approved for such activity), as outlined in its statement of support for developing domestic capital markets throughout the Region (Report on the Eighth General Increase in Resources of the Inter-American Development Bank, August 1994 (AB-1704, Section 1.16)). In order to meet this challenge, the Bank's strategy for capital market development (Capital Market Development in Latin America and the Caribbean: A Strategy Proposal (GN 1870-2)) proposed the establishment of a program to prepare analytical work, support technical assistance, and disseminate information on best practices in order to support the Bank's guidance and lending in capital markets. (See Annex I-1). For that purpose, it is proposed that the Bank implement this Technical Cooperation program.

II. OBJECTIVE

- 2.1 The objective of the Technical Cooperation for a Financial and Securities Markets Development Program is to assist the reform and modernization process of the Region's financial and securities markets to mobilize capital for increased investment in the Region. The Program will support research activities that focus on the legal, institutional, and regulatory issues related to developing these markets, and will support the efforts of government officials, including banking and securities regulators, and interested regional institutions in the harmonization and integration of these markets.

- 2.2 The Program is designed to serve as a focal point for the Bank's know-how and technical expertise in this area, and provide a clearinghouse for best practices and information in the Region. Capitalizing on the Bank's unique position to facilitate discussion among government and private sector actors, disseminate information based on current research, and put into operation "best practices" through lending and technical assistance, the Program will be able to promote the development and integration of financial and securities markets throughout the Region.
- 2.3 The activities supported by the Financial and Securities Market Development Program are closely linked with the mandates the Bank has received from the Ministerial-level Committee on Hemispheric Financial Issues (CHFI), established following the 1994 Miami Summit of the Americas. These activities, aimed at strengthening and developing financial markets through the dissemination of information regarding best practices, will be closely coordinated with the CHFI and the regulatory institutions of member countries. The research program that will be addressed will draw upon prior work undertaken by other multilateral organizations, academic institutions, national and international regulatory bodies, and the private sector. The intent of this approach is to produce practical results that member countries can readily incorporate into their markets/institutions.
- 2.4 In addition to coordination with member countries of the Bank, the execution of the Program is designed to incorporate the expertise and specific knowledge of the Regional Operations Departments (especially the Finance and Basic Infrastructure (FI) Divisions and Representative Offices) as well as other units inside the Bank that maintain specialized skills and experience relevant to this Program. While the Infrastructure and Financial Markets (IFM) Division will be responsible for the coordination of activities, the members of the Advisory Committee (see Section 3.23) assigned to different projects will be drawn from a variety of units from within the Bank. It is also anticipated that the Program will incorporate experts from Bank member countries.
- 2.5 The Financial and Securities Markets Development Program is expected to deliver tangible benefits to Bank member countries. Functioning capital and financial markets, able to generate savings and allocate scarce resources, are critical to the development of the economy. The various components of the Program are designed to provide borrowing member countries with the tools and/or information they can use to undertake necessary legal and regulatory reform.
- 2.6 Results from the Program will be used to prioritize and coordinate the Bank's activities in the development of financial and securities markets. For the Bank, a conceptual framework will result from the Program that will enable it to immediately address the most urgent issues, and to act on those issues throughout the Region in a coordinated fashion. The Program's output is expected

to contribute to the formulation of loans and technical cooperations for financial and securities market development. For borrowing member countries, information and knowledge obtained from the Program's research and publications will be readily available and transferable to assist in the creation or strengthening of the appropriate institutions, laws, and policies required to develop these markets.

III. DESCRIPTION

A. Activities

- 3.1 The Technical Cooperation for a Financial and Securities Markets Development Program will finance research and training on financial and securities markets in the Region. Research work will focus on the policy lessons for the Region, the frontiers of financial innovation, and prudential regulation. Topics will include the institutional requirements for financial development and innovation, with particular attention, as noted by proposed training programs, given to the regulatory and supervisory aspects of these markets. The results from the research and training will be disseminated to IDB borrowing member countries and other interested parties through conferences, workshops, seminars, Round Tables, electronic media (i.e. Internet), working papers, and manuscripts.

Several activities are contemplated within this Program, including the following:

- 3.2 Financial and Securities Markets: Institutions and Instruments. The financial systems of the Region differ owing to the separate economic, political, and legal traditions of each country. At the same time, the comparatively small size of some markets makes it imperative that a "critical mass" is reached in order to achieve efficiency in financial intermediation. The Board of Governors, in the report on the Eighth General Increase in Bank Resources (AB-1704), endorsed the principles of open, transparent, and integrated financial and capital markets. This Technical Cooperation program is designed to support the institutions that efficiently allocate domestic and foreign capital within these markets, and develop some commonality among institutions and financial instruments within the Region.
- 3.3 This portion of the Program will explore ways in which the Region's private market participants and regulatory authorities can create, strengthen, and integrate market institutions and instruments. Methods for achieving these objectives include: improved financial management, including better mechanisms to control risk in financial and commodity transactions; analyses of the sources and uses of long-term savings; and better information on existing securities markets, which will promote openness and the trend towards greater integration. Projects designed to achieve these

objectives include the following: (a) a risk management program; and, (b) a study focusing on asset-allocation decisions for pension funds and related annuity markets.

1. Risk Management Program (\$144,000):

- 3.4 Risks are everywhere. In addition to normal business risks, corporate treasurers, commercial bankers, portfolio managers and commodity producers and users are exposed daily to changing commodity prices, currency values, interest rates and asset values. Derivatives are used to reduce or eliminate these risks by transferring them to others more capable or willing to manage financial risks. This is a valuable economic service, but the improper use of derivatives can be harmful, requiring proper supervision by securities regulators and management of their use by private institutions.
- 3.5 This program will introduce securities regulators, securities exchanges, commercial banks and corporate end-users of derivatives in Latin America and the Caribbean to risk management techniques and establish oversight capabilities to monitor and control derivatives activities. The objective of the program is to design a model derivatives risk management system suitable to the market conditions of Latin America and the Caribbean. Working with local institutions, a pilot study of this system will be conducted in two Latin American institutes, examining futures and options. A report outlining this model will be distributed to securities exchange commissions, central banks, bank supervisors, financial institutions and potential users in the region as examples of best practices in risk management techniques.
- 3.6 The model risk management system will be designed using the recommendations of the Group of Thirty, the Basel Committee, ISDA, the Derivatives Policy Group, and other regional institutions. It will involve the following activities: (a) identify and quantify the various types of market risks facing businesses and financial institutions such as commodity producers, exporters/importers, commercial banks and portfolio managers in the region; (b) design a model hedge program; and, (c) design a management-driven derivatives control system. The results of this work will be incorporated into a report outlining the risk management system, and will include: (i) example of a value-at-risk (VAR) and scenario analysis models; (ii) policy statements by boards of directors and senior management; (iii) sample procedure manuals for management, trading, accounting and auditing staff, and automated procedures and documentation systems; and, (iv) examples of training programs for management, traders, accounting and auditing staff of institutions using derivatives. Information gathered from this study may be used for technical assistance or lending projects to assist with capital market reforms carried out in the Region. (See Annex II-1, Terms of Reference A).

- 3.7 The Bank's borrowing member countries will derive a number of benefits from the introduction of well-designed and well-managed risk management programs. Many firms in the Region are already exposed to risk that can be hedged, utilizing derivative instruments. This is especially true for agriculture and other producers of primary commodities. By not hedging risk, these firms or individuals are, in fact, bearing risks that may negatively impact their ability to finance their operations. As domestic financial markets develop and are integrated into international markets, market participants will naturally begin to use the risk transfer and risk mitigation instruments that are commonly used in more developed financial markets. Nevertheless, these instruments are two-edged swords. While they can be used to control risk, misuse or poorly designed or executed risk management programs can actually increase risk. If not controlled and monitored, these instruments can produce changes that not only affect an individual firm but can have systemic implications for the financial sector as a whole.
- 3.8 While the private sector is beginning to use derivative instruments and is obtaining some of the information and training needed to monitor and control risk, greater efforts are needed. Moreover, the public sector, in its role as market regulator, will need information and technical support on how these instruments are used, how to support the development of derivative markets, and how to monitor excessive risk taking. Currently, little information is reaching market regulators and the information reaching users needs to give greater emphasis on risk control mechanisms. This program will provide firms, financial institutions, exchanges, and regulators with the information they need to understand the operational and credit/counterparty risks associated with derivative instruments and markets, so that these risks can be properly included in their analysis and risk management strategies, programs, or regulatory activities. The results of these studies will also assist the Bank with the design and implementation of lending and technical assistance programs by incorporating specific risk management components and possible provision of future education programs for specific instrument users (especially firms in the agricultural sector).

2. Asset-Allocation Decisions for Pension Funds and Related Annuity Markets (\$100,600):

- 3.9 Several countries in the Latin American and Caribbean region have experimented with the use of privately managed, defined contribution pension systems as a way to provide retirement security while supporting the development of deeper (local) financial and capital markets. These programs have also resulted in the development of related life insurance and annuity markets. Many questions have been raised regarding the role of these private pension programs in the development of capital markets and whether one can expect benefits to accrue from these programs in smaller countries with limited capital markets and investment

opportunities. Many of the questions are related to the appropriate allocation of investment and the costs enjoined by government imposed constraints on investment allocation. This research program will provide part of the theoretical and empirical analysis needed to address and answer these questions.

- 3.10 A study will be conducted to assess the allocation decisions of investment funds in terms of risk/return, and local versus international investments. The study will highlight the critical differences between optimal investment allocations for a larger economy with developed financial markets compared to the optimal allocation of a smaller economy. Similarly, the study will examine the differences in allocation decisions for new and mature private pension programs. The results of the study will be presented at a one-day clearinghouse/workshop on asset allocation in pension and pension-related insurance markets.
- 3.11 The results of the asset-allocation study will provide valuable information to the countries that are in the process of pension and pension-related insurance market reform. The specific guidelines and best practices developed through the study will be disseminated to borrowing member countries, and may be used in the design of investment rules and policies. In particular, it is anticipated that a better understanding of the role of diversification (including international diversification), hedging, and asset-liability management (duration and convexity of the combination of investment portfolios, annuities, and other pension liabilities) in properly functioning domestic capital markets, with both domestic and international institutional investors, will allow for a more rational investment structure. This type of analysis is not taking place today, in either the public or private sector. The promoters of privately managed pension funds often neglect the importance of risk in potential investments, instead preferring to emphasize the private benefits accruing to the investment managers. This program will provide the careful research and analysis required by policy makers in the Region to develop and implement pension market reform.
- 3.12 The results of the asset-allocation studies will also be useful in the design of Bank lending programs and technical assistance programs that are aimed at restructuring pension systems and the sequencing of financial market reforms. The problems associated with asset-allocation are particularly acute for smaller countries, and the studies and dissemination activities are expected to especially aide the Bank in working with these countries. (See Annex II-1, Terms of Reference B).
- 3.13 Financial and Securities Markets: Regulatory Issues. Financial markets differ from many other markets because they deal extensively with information asymmetries. For example, the depositor does not usually know the quality of a bank's asset portfolio, nor do bond and equity holders have perfect knowledge of the value of their claims against a firm. Likewise, insurers do

not know the amount of caution taken by the insured (both before and after a policy has been written). Moreover, to the extent that the claims are traded in illiquid markets, information on the price or "intrinsic value" may not be available. These information problems have led to government intervention in financial markets in virtually all countries. Most often the intervention takes the form of regulation, including government oversight and the placement of limitations on the activities of financial institutions, disclosure requirements, and/or limited government guarantees (e.g. deposit insurance or minimum pension guarantees).

- 3.14 This portion of the Program is dedicated to to the development of financial markets and the strengthening of information disclosure, bank supervision and training. The projects will include input from academic, regulatory, and financial market practitioners (utilizing both regional and international experiences) to lay the foundation for the modernization of efficient and effective financial markets. The projects developed to further these goals include: (a) a survey of financial systems; (b) an inventory of best practices in accounting and auditing standards and information disclosure for bankers and public listings; and, (c) a banking supervision and examination training seminar.

3. Survey of Financial Systems (\$200,000):

- 3.15 A survey of the institutional aspects, laws, and regulations related to financial markets, capital movements and the ownership of assets will be developed under this project. This undertaking is part of the Bank's mandate under the Summit of the Americas initiative and will be pursued with guidance from the Committee on Hemispheric Financial Issues (CHFI). The Survey, which is expected to be completed by the middle of 1997, will result in a comprehensive volume of information and knowledge regarding laws, regulations and institutional practices of financial markets, financial instruments, and participants in the financial system. (See Annex II-1, Terms of Reference C).

4. Best Practices in Accounting and Auditing Standards-Information Disclosure for Commercial Banks and Public Listings (\$105,400):

- 3.16 Given the characteristics of Latin American and Caribbean economies, building capital markets will take time. One of the principal factors inhibiting their development is the lack of transparency in financial markets. Institutional as well as individual investors need information on which to base their investment decisions. Without timely and trustworthy information, markets are unable to function effectively. Liquidity is reduced in secondary markets and firms find it far more difficult to obtain funds in primary markets. Indeed, the bank dominated financial systems that are the norm throughout Latin America and the Caribbean, are to some degree symptomatic of the severe information asymmetries associates with non-transparent markets. Banks may specialize in obtaining and interpreting financial information, but

the bank dominated systems can also result in: (a) distorted capital structures with a far higher cost of capital; (b) more costly financial intermediation; and (c) the absence of many capital market instruments that would provide a more efficient allocation of risk. To the extent that the banking system itself is not transparent, regulators have a harder time monitoring and controlling risk and the moral hazard associated with increased risk taking by marginally solvent or insolvent depository institutions increases; both leading to greater fragility in the financial system and the too often repeated cycles of systemic bank crises in the Region.

3.17 The accounting and auditing standards in place in most of Latin America and the Caribbean (and the enforcement of the same) are significantly below international standards. However, there is a significant effort underway, being promoted by the International Organization of Securities Commissions (IOSCO), to strengthen international accounting standards. Part of this effort is designed to deal with new financial instruments for which international accounting standards do not exist, but the more importantly, this effort is associated with the need for international standardization of disclosure requirements associated with the integration of the international financial markets. At the present time is little evidence of involvement of the Latin American and Caribbean accounting standard setting boards in this effort. This lack of conformity to international standards has the potential of becoming one more roadblock for the flow of capital from international markets to the Region. Policymakers can assist with the development of more transparent financial markets by developing and enforcing regulatory and accounting standards designed to promote information disclosure and build investor confidence

3.18 The project will survey problems in accounting and auditing procedures and provide recommendations for improved information disclosure for the Region. Input from local and international accounting firms, as well as national and international accounting standards boards, will be incorporated into the analysis. Dissemination of project recommendations will be made through Round Table discussions and published material. A two-day Round Table discussion on the importance of disclosure, transparency and consistency in financial reporting as related to development of capital markets will be held. Proceedings from the Round Table will be published. (See Annex II-1, Terms of Reference D).

5. Training Programs for Bank Supervision (\$200,000):

3.19 The regulation and supervision of depository institutions is a key element of most developed financial markets. Regulators provide the oversight needed to maintain market confidence and ensure that banks and other financial intermediaries are operated in a safe and sound manner. Strong regulation also increases market transparency and protects the interest of smaller depositors (given the

existence of severe information asymmetries). Due to the importance of the banking systems in Latin America and the Caribbean, a program designed to strengthen bank supervision is essential to financial market development. Without a prudentially managed banking system, it is difficult for other financial markets to develop.

- 3.20 The Bank has supported the improvement of bank supervision in a large number of financial sector loans and global multi-sectoral lending facilities. Recently, the Bank was asked by the Finance Ministers of the Region to prepare a program for training bank inspectors. The activities included in this program are designed to initiate a single, Bank-sponsored training program. This includes hiring consultants for developing a comprehensive three week training program for thirty five bank and its execution in Washington, D.C. The consultants will examine the training programs currently used in several countries, and to the greatest extent possible, will incorporate the structure and content of these programs into the training seminar. Funds will be available, as needed, for the preparation and/or translation of course material, for hiring instructors, and for the simultaneous interpretation of the training seminar. Funds will be made available to cover the travel and per diem expenses of a portion of the participants, particularly those individuals from group C or D countries. The seminar will maximize its utilization of training staff of the bank supervisors of non-borrowing member countries on a pro bono or cost-shared basis.
- 3.21 The consultants will also be responsible for evaluating and refining the training programs for future replication in the Region. It is anticipated that four additional regional training seminars will be proposed in a second phase (in the Caribbean, Mexico/Central America, Spanish-speaking South America and Brazil), though funding for these regional seminars will be requested in a separate regional technical cooperation proposal. Due to uncertainty regarding the amount of pro bono training that will be provided by non-borrowing member countries, it is proposed that any funds remaining after the first seminar has been completed be allocated to cover the costs of preparing the regional seminars and sponsorship of individual inspectors attending training programs conducted by non-borrowing member countries. (See Annex II-1, Terms of Reference E).

B. Organization and Execution

- 3.22 The Technical Cooperation program has been organized to achieve several goals: (a) ensure that the research and training is consistent with the Bank's objectives in the Region and is relevant to the policy decisions facing borrowing member governments; (b) secure efficient program operations, incorporating key stakeholders in the decision-making process; and, (c) produce high quality output in a cost-effective manner. To meet these goals, the following administrative structure is proposed.

- 3.23 An Advisory Committee of Bank staff will be established and will monitor all projects that are established under the Program. The Advisory Committee will be managed by SDS/IFM, with representatives of FI Divisions, INT/RTC, Legal Department, OCE, and Country Office technical staff kept informed of developments and requested to participate in the Group, as needed. The Advisory Committee will review the design, terms of reference, and output of all projects. In addition to providing quality control, the Advisory Committee will contribute to the dissemination and application of information resulting from program-sponsored research and training through the design of loan operations, technical assistance projects, and conference presentations, and through other fora.
- 3.24 To ensure the policy relevance of the Program's work, activities will be designed to support MIF, Regional, and FI Division lending programs, and will include the participation of existing regional institutions with particular interests in the development of financial and securities markets in the Region. SDS/IFM has already established contact with many of these groups and will expand the Bank's working relationship with other organizations through this Program. (See Annex II-2 for a description of potential participating institutions).
- 3.25 When support from the Field Offices is required for preparation of seminars, conferences and/or coordination of work by consultants, funding will be made available in local currency for a limited period of time. It is hoped that by participating in the Advisory Committee, the technical staff of the Field Offices will be able to offer analytical contributions, and to a lesser degree, administrative input, to the Advisory Committee.
- 3.26 The results of the research carried out in the topics previously mentioned will be reviewed and prepared for dissemination by the Advisory Committee. Research findings and other related information will be dispersed through a variety of fora, including conferences, workshops, training programs, surveys, electronic media (e.g. Internet), books/manuscripts, and working papers.

C. Monitoring

- 3.27 SDS/IFM will carefully monitor the Program's progress and provide a written evaluation of all activities carried out under the Program. These reports will be prepared following final disbursement of funds and will be distributed to all members of the Advisory Committee and others as appropriate. Interim reports will be prepared if the duration or size of the projects warrant periodic review.

D. Cost and Financing

- 3.28 The total cost of the Program is the equivalent of US\$850,000 and will be charged to the net income of the FSO, of which the

equivalent of US\$650,000 will be disbursed in foreign exchange, and the equivalent of US\$200,000 in local currencies.

- 3.29 A summary of the budget for the Program is listed below (in US dollars). Annex II-3 contains a detailed breakdown of the budget by expenditure category, although they represent tentative estimates. Budgetary figures outlined below include expenses, totaling US\$70,000 already incurred by the Bank from work performed to prepare the Survey of Financial Systems since inception of the Program, which will be reimbursed upon approval of this operation.

Activity	US Dollars	Local Currency	Total US\$
Institutions and Instruments	154,600	90,000	244,600
Regulatory Issues	445,400 ^{a/}	60,000	505,400
Administration and Evaluation	50,000	50,000	100,000
Total amount	650,000	200,000	850,000
Total %	76.5	23.5	100

^{a/} Expenses already incurred for the Survey of Financial Systems total US\$70,000. See Annex II-3 for detailed budget.

IV. BENEFITS AND RISKS

- 4.1 The principal benefit of the Program will be its assistance with financial and securities markets reform and modernization in the Region. The Program is intended to contribute to the quality of Bank lending and identify new areas for Bank action in the field of financial and securities market development. The Program will also expand the dialogue on these topics between Regional member countries, related institutions, and the Bank in order to contribute to the integration of the Region's capital markets.
- 4.2 The Technical Cooperation program will enable the Bank to develop and strengthen its important relationships with several of the Regional Institutions that are expected to cooperate with, and benefit from, the various sub-components of the Program (see Annex II-2 for a description of these organizations). For example, as a first step towards a more extensive program of future cooperation with the Association of Latin American and Caribbean Bank Supervisors, the Bank is co-sponsoring a Conference on the role of external auditors in bank supervision to improve disclosure, market transparency, and consistency in reporting the condition of the Region's financial institutions to external agents. The Bank is also acting as the de facto secretariat to the Committee on Hemispheric Financial Issues (CHFI), a Ministerial-level committee

established during the 1994 Miami Summit of the Americas, with a focus on capital market, banking supervision, and related institutional issues throughout the Region. Likewise, the Bank has actively supported the Council of Securities Regulators of the Americas (COSRA) in its efforts to harmonize capital market regulations and promote better information exchange among supervisors.

- 4.3 The projects listed in Section III.A. are representative of the topics to be pursued under the Program. Due to the nature of the subject, and in an effort to be responsive to the strategic interests of the Bank, flexibility in program execution is necessary so that topics may be substituted as needed.
- 4.4 If the Program fails to provide analysis that is relevant to the concerns of the borrowing members and the lending operations of the Bank, its usefulness will be diminished. In order to ensure a linkage with the operational concerns of the Bank, and to transfer the benefits of the research work, the Advisory Committee will include the participation of Bank staff, as identified in Sections 2.4 and 3.23.
- 4.5 Given the size and scope of the studies included in the Program, and the need to coordinate activities with the Regional Divisions and Field Offices of the Bank, administrative delays may arise in the execution of the Program. In order to avoid such delays, the program budget includes provisions to cover administrative costs incurred at headquarters and locally.

V. EVALUATION OF THE PROGRAM

- 5.1 At the conclusion of three years from the Program's approval date, the Advisory Committee and other Bank staff will evaluate the impact and results of the Technical Cooperation for Financial and Securities Markets Development Program, including the publications and interim reports it produces, as well as other activities designed to transfer information to borrowing member countries (e.g. conferences, seminars, training programs, informal consultations, etc.). The results of the final evaluation will be made available to Bank staff.

LOGICAL FRAMEWORK

<u>OBJECTIVE</u>	<u>INDICATORS</u>	<u>MEANS OF VERIFICATION</u>	<u>ASSUMPTIONS</u>
<p><u>GOAL</u></p> <p>To improve the level of savings and investment in the Latin American and Caribbean region as a means to support economic growth throughout the Region.</p>	<p>Changes in savings and investment levels, and investment flows revealed through macroeconomic indicators, national savings rates, and capital formation rates.</p>	<p>Quarterly/annual country progress reports, containing current measures of domestic saving and investment performance.</p>	<p>Macroeconomic stability.</p> <p>Appropriate and credible fiscal and monetary policies.</p> <p>Non-discriminatory tax regimes.</p> <p>Economic growth.</p> <p>Liberalization of the financial sector.</p>
<p><u>PURPOSE</u></p> <p>To strengthen the development of domestic financial and securities markets, institutions, and regulations, and support regional integration by assisting with financial sector reform and modernization in Bank borrowing member countries. Research work will focus on the policy lessons for the Region, the frontiers of financial innovation, and prudential regulation.</p>	<p>Improved level of financial management, derived by better mechanisms to control risk in financial and commodity transactions; analyses of the sources and uses of long-term savings; and better information on existing securities markets.</p> <p>Development and application of best practices in market regulation and legislation, as related to accounting/auditing, pensions, and bank supervision.</p> <p>Strengthening of market institutions and greater financial integration through harmonization of standards and regulations governing cross-border investments and capital movements.</p>	<p>Survey of Financial Systems.</p> <p>Creation or enhancement of financial instruments and institutions.</p> <p>Examination of local/regional regulatory apparatus for the financial sector.</p> <p>Adoption, change in, or enforcement of regulations and laws effecting the financial sector.</p>	<p>Government policy - priority to modernize/reform the financial sector.</p> <p>Macroeconomic stability.</p> <p>Institutional capacity to make changes in the financial sector, where necessary, on a local or region-wide basis.</p>

<p><u>OUTPUTS</u></p> <p><u>I. Financial and Securities Markets: Institutions and Instruments.</u></p> <p>A. Development of a model risk management system, including examples of value-at-risk and scenario analysis models, policy proposals by market users, sample procedure manuals, and examples of training programs.</p> <p>B. Investigation and workshop on asset allocation in pensions and pension-related insurance markets.</p> <p><u>II. Financial and Securities Markets: Regulatory Issues.</u></p> <p>A. Dissemination of information regarding laws, regulations, and institutional practices of financial markets, financial instruments, and participants in the financial system Region-wide.</p> <p>B. Investigation, Round table session, and publication of information pertaining to best practices for accounting and auditing in the Region.</p> <p>C. Investigation and training in bank supervision and examination on regional and international basis.</p>	<p>I.A. Report outlining a model risk management system, distributed to securities exchange commissions in the Region. Pilot study carried out in two Latin American institutes, examining futures and options.</p> <p>I.B. Workshop and related studies addressing constraints in asset allocation in pension and related annuity markets.</p> <p>II.A. Survey of Financial Systems published and reported to the CHFI, distributed throughout the Region. Training workshop for finance ministry technicians. Region-wide conference to disseminate Survey information to ministerial-level government officials.</p> <p>II.B. Round table discussion on accounting and auditing procedures and standards. Publication of Round table proceedings, including recommendations on best practices in standards and information disclosure procedures and requirements, disseminated to borrowing member countries.</p> <p>II.C. Training seminar prepared and conducted to address bank supervision and examination. Report prepared containing information on the design, course curriculum, and evaluation of training program.</p>	<p>Monitoring activity by the Advisory Committee, including periodic evaluation of research and dissemination methods.</p> <p>Feedback from conference/workshop/round table/training seminar participants, relevant staff in headquarters and country offices, institutional partners, and other key stakeholders to information and policy recommendations, resulting from Program research and analysis.</p> <p>Data and legal/regulatory information for program analysis supplied by local, regional and/or international financial sector institutions.</p> <p>Final evaluation of the Program by the Advisory Committee at the end of the disbursement period.</p>	<p>Change in government policies as related to financial and capital markets reform.</p> <p>Institutional support by key stakeholders, including ability to supply required data and exchange information.</p>
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<p>ACTIVITIES</p> <p>I. Projects designed to create, strengthen, and/or integrate market institutions and instruments include the following:</p> <p>A. Research and design a model risk management program. Collaborate with consultants and local/regional/international institutions to assess market risks, design model hedge program and design management-driven derivatives control system.</p> <p>B. A study focusing on asset-allocation decisions for pension funds and related annuity markets. The study will make an assessment of the benefits of international diversification, evaluation of appropriate risk/return characteristics, and offer strategies for borrowing member countries.</p> <p>II. Projects developed to support effective and appropriate regulation of financial markets include:</p> <p>A. Design, produce and disseminate Survey of Financial Systems and its results.</p> <p>B. Survey of problems in accounting and auditing standards and an assessment of methods for improving information disclosure for bankers and public listings.</p> <p>C. A training program designed to support effective regulation and supervision of depository institutions in the Region.</p>	<p>I.A. Six consultants with specialized consulting expertise with derivatives instruments, margin valuation and custody issues, and securities law. Consultation with COSRA, stock exchanges of the Region, and regional and international institutions involved in derivatives management issues. Budget is \$144,000.</p> <p>I.B. Eight consultants with strong background in investment allocation models and data analysis will be required to prepare reports and workshop presentations. Budget is \$100,600.</p> <p>II.A. Three consultants and one research assistant to design, administer and analyze results of the Survey and prepare workshops, etc. to train users in Survey methodology and to disseminate results. Budget is \$200,000.</p> <p>II.B. In cooperation with local and regional financial institutions, nine consultants will research and prepare reports/presentations on current accounting and auditing practices on a regional and global basis and provide recommendations for improving the quality of publicly available information. Budget is \$105,400.</p> <p>II.C. Two lead consultants will research and design a three week long bank supervision training seminar, conducted by fifteen instructors. Thirty-five bank examiners from the Region will participate, twenty of whom will receive scholarships (directed at Group C and D countries). Budget is \$200,000.</p> <ul style="list-style-type: none"> • Project management. Budget is \$100,000. recommendations 	<p>Accounting records of Program budget.</p> <p>Terms of reference.</p> <p>Periodical progress and evaluation reports by the Advisory Committee.</p>	<p>Flexible program schedule in order to work with the appropriate individuals and local/regional institutions.</p> <p>Flexibility in project execution, enabling substitution of program topics, will be required in order to be responsive to the Bank's strategic interests.</p> <p>Continued interest in Program's objectives, as expressed by potential participating institutions.</p> <p>Local country support required for supplying information to consultants, and/or Advisory Committee members.</p>
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PROPOSED RESOLUTION

REGIONAL. NONREIMBURSABLE TECHNICAL COOPERATION FOR THE
FINANCIAL AND SECURITIES MARKETS DEVELOPMENT PROGRAM

The Board of Executive Directors

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank to take such additional measures as may be pertinent for the execution of the plan of operations referred to in Document AT- with respect to a nonreimbursable technical cooperation for the execution of the Financial and Securities Markets Development Program.

2. That up to the sum of US\$850,000 or its equivalent, is authorized for the purpose of this resolution, of which up to the sum of US\$650,000 may be disbursed in foreign exchange and the rest in local currency of the beneficiary countries, chargeable to the net income of the Fund for Special Operations.

3. That the above-mentioned sum is to be provided on a nonreimbursable basis.