CONNECTING THE DOTS

EVIDENCE THAT DRIVES CHANGE

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EBRD Independent Evaluation Department

In this brief:

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European Bank for Reconstruction and Development | IEvD Independent Evaluation Department

Cultivating a Resilient Financial Ecosystem:

Selected Insights from Evaluation

Navigating Turbulence: Establishing a Robust Financial Sector in a Crisis-Prone and Fragile World

Global finance experiences ongoing changes as nations progress through different stages of economic development, influencing their financial structures and vulnerabilities. At the same time, multilateral development banks (MDBs) are under pressure to reform and expand their efforts following a recent review of their capital adequacy frameworks.[1] They are urged to enhance their monetary capacity and tailor their operating models for greater effectiveness. This challenge has intensified, particularly for MDBs operating in conflict-affected countries like Ukraine. For instance, EBRD has recently secured a capital increase to help bolster investments in Ukraine.[2] Despite the availability of funds, MDBs still grapple with the task of building a resilient financial sector in such fragile contexts.

A stark reality frames this edition of the Connecting the Dots series — **the profound impact of multiple crises on countries, erasing decades of growth and poverty reduction in short spans**. Though global banking stress has eased in recent months, some countries still grapple with weakened banks (International Monetary Fund (IMF), 2023). Furthermore, cracks in other sectors may emerge, potentially evolving into concerning fault lines. If financial conditions abruptly tighten, adverse feedback loops may be triggered, once more challenging the resilience of the global financial system. **The need for a resilient, diversified, and stable financial sector becomes evident as a shield against the disruptive forces that precipitate crises, even if it cannot entirely avert them.**

Since the global financial crisis of 2007-2008, International Financial Institutions (IFIs) launched multiple initiatives to strengthen the financial sector and to foster greater financial resilience in their regions of operations. This report takes a step back and collects the evaluation evidence with the goal of offering a panoramic view of challenges and opportunities that shape the IFIs' quest for financial stability in an ever-changing economic landscape.

Financial sector: some basic definitions

Financial sector	Financial sector is the set of institutions, instruments, markets, as well as the legal and regulatory framework that permit transactions to be made by extending credit.
Key functions of a financial system	The five key functions of a financial system are: (i) producing information ex ante about possible investments and allocating capital; (ii) monitoring investments and exerting corporate governance after providing finance; (iii) facilitating the trading, diversification, and management of risk; (iv) mobilizing and pooling savings; and (v) easing the exchange of goods and services.
Financial sector development	Financial sector development occurs when financial instruments, markets, and intermediaries ease the effects of information, enforcement, and transactions costs and therefore do a correspondingly better job at providing the key functions of the financial sector in the economy. (World Bank Group, 2021). Financial sector development plays an important role in economic development. It promotes economic growth through capital accumulation and technological progress by increasing the savings rate, mobilizing and pooling savings, producing information about investment, facilitating and encouraging the inflows of foreign capital, as well as optimizing the allocation of capital.

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1 See: Independent Expert Panel convened by the G20. 2022. Boosting MDBs' investing capacity. An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks
2 See: Financial Times, 2023. EBRD to double lending to Ukraine after agreeing €4bn capital increase. December 2023.

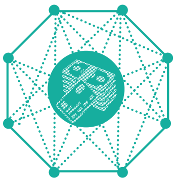
7 key evaluation insights
for cultivating a resilient financial ecosystem

Seven insights emerged from an extensive review of more than 100 independent evaluation reports published since 2007 by independent evaluation departments from nine IFIs[3], covering episodes from both crises and more stable periods.

These evaluation insights – strategic- and operational - shed some light on factors that could help IFIs unlock the full potential of supporting financial stability in their countries of operations (CoOs), particularly considering MDB's current spirit of reforms.

Strategic-level

1



Applying holistic approach in integrating financial sector development

2

Measuring progress and strategic responses to crises in the financial sector

3

Managing currency risks and avoiding the pitfalls of over-reliance on foreign currency

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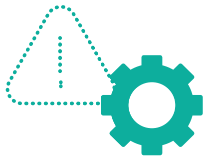
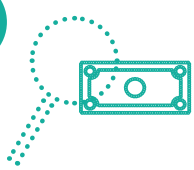


Building capacity for better risk management and non-performing loan (NPL) disposition

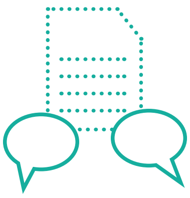
Operational-level

5



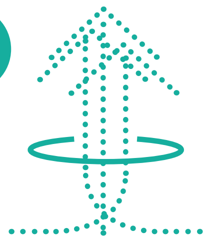
Enhancing country-level diagnostics

6



Tailoring policy dialogue and investment tools for financial stability restoration

7



Synergizing efforts among IFIs and collaborating on financial stability

3 This includes independent evaluation offices of: African Development Bank (AfDB), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Inter-American Development Bank (IADB), International Fund for Agricultural Development (IFAD), International Monetary Fund (IMF), Islamic Development Bank (IsDB) and World Bank Group (WBG).

Strategic-level evaluation insights to develop a healthy financial sector

1

A holistic approach applied when integrating financial sector development is most likely to set a solid foundation for a robust financial sector

Evaluation evidence suggests that **financial sector development is not a singular regulatory challenge but a dynamic interplay of policies.** For instance, the importance of designing comprehensive development strategies in building rapid adaptability against systemic economic shocks in the financial sector, was featured in *the Evaluation of WBG's Crisis Response and Resilience to Systemic Shocks (2017).*

The evaluation evidence shows that **embracing a holistic approach ensures that the tapestry of efforts to attract private sector participation in financial sector development is woven into the broader macroeconomic fabric.** This is particularly important in developing countries as evidenced in the *Evaluation of the Asian Development Bank (ADB) Support to the Indonesia Finance Sector (2019).*

However, **evaluation evidence across IFIs also sheds light on potential pitfalls. It cautions against a myopic focus on privatisation as an end in itself, urging a balanced perspective that emphasises well-managed banks with aligned incentives.** The cautionary tales from Mozambique, Georgia, and Uganda underscore the importance of discerning ownership and strategic decision-making in financial development initiatives, as shown in *a synthesis of the Independent Evaluation Group (IEG) review of WBG Assistance to the Financial Sector (2006).*

The literature points to a commendable systematic approach, addressing financial stability, inclusion and efficiency simultaneously. For instance, a testament to the effectiveness of a well-rounded financial sector growth strategy was shown in the Kyrgyz Republic that targeted the market simultaneously at the level of financial efficiency as well as inclusion, as detailed in *the WBG's Evaluation of Creating Markets to Leverage the Private Sector for Sustainable Development and Growth (2019).*

The evaluation evidence underscores the importance of strengthening financial inclusion as a channel for fostering inclusive growth and mitigating volatility in the financial sector. The conclusion is that a robust and inclusive financial sector not only propels economic development but also serves as a shock absorber in the face of external shocks, as noted in *the Evaluation of IMF Engagement with Small Developing States (2022).*

Finally, **the literature urges a proactive stance, where the financial sector's policy interactions are considered within a broader macroeconomic framework.** The cautionary tales of underregulated access to borrowing in foreign currencies, highlighted by historical crises, emphasises the need for prudence in financial regulations, as discussed in *the* Evaluation of *the IMF Advice on Unconventional Monetary Policies (2019).*

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2

To effectively respond to financial crises, evaluation evidence suggests a gradual approach that is built on early preparedness and anticipatory measures is the most viable route. This builds flexible safety nets that can most effectively respond to systemic shocks

In the realm of financial market development and crises response, evaluation evidence across IFIs contributes insights that coalesce into a central theme: the value of a gradual approach in navigating economic challenges.

Evaluation evidence calls for early preparedness to respond to crises by drawing from lessons of previous financial crises. For instance, the literature applauds the preparedness of Developing Asia during the global financial crisis of 2007-2008. Its resilience is attributed to how the region learned and applied lessons garnered from the 1997 Asian financial crisis, as presented in *the Evaluation Lessons of a Global Financial Crisis for Asia and the ADB (2012).*

The review highlights the inflexibility of social safety nets[4] in the face of global crises, emphasising the need for proactive engagement during stable times. Evaluation work underscores the importance of anticipatory measures in building flexible safety nets that can effectively respond to systemic shocks learning from the experience in many middle-income countries where poverty-targeted social safety nets failed, as evidenced in *the Evaluation of the WBG's Crisis Response and Resilience to Systemic Shocks (2017).*

The evaluation evidence calls for a proactive culture, urging a shift from primarily reactive responses. The importance of clear warnings and proactive measures are especially needed when externalities beyond a country's control pose significant risks, as illustrated in *the Evaluation of IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-2007 (2011).*

Crucially, the literature suggests that **crises can be catalysts for structural reforms, ultimately enhancing financial resilience.** However, it underscores the necessity for sustained political commitment, as reforms initiated during crises may falter without dedicated support, as explained most explicitly in *the Evaluation of the WBG's Crisis Response and Resilience to Systemic Shocks (2017).*

Finally, **evaluation evidence provides insights into the dynamic balance between financing and policy reform objectives during crises.** It advocates for a pragmatic approach, recognising that the predominance of one objective over the other can impact the design of policy-based lending. This perspective calls for adaptability and clarity in objectives, particularly in times of crisis, as most clearly illustrated in *the Evaluation of ADB Policy-Based Lending (2018).*

Evaluation evidence calls for early preparedness to respond to crises by drawing from lessons of previous financial crises.

4 Social safety nets refer to a range of policies and programmes implemented by governments to provide financial assistance and support to individuals and families facing economic hardships or vulnerabilities. These safety nets are designed to alleviate poverty, ensure basic living standards and offer a social cushion by providing assistance such as cash transfers, food assistance, healthcare, and education subsidies. The goal is to protect vulnerable populations from falling into extreme poverty during times of crisis or economic instability.

3

Hedging and local currency loans are critical to managing currency risks and avoiding the pitfalls of over-reliance on foreign currency that can lead to financial sector fragility

Evaluation evidence across IFIs reveals **a series of insights that collectively underscore the importance of adopting strategic financial instruments, such as hedging instruments and local currency loans, to enhance financial stability and mitigate risks in various domains.** These insights contribute to a nuanced understanding of effective financial management and market development.

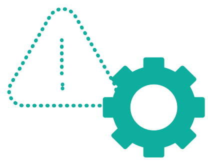
Firstly, **the recommendation to use hedging instruments to manage foreign exchange risks, as outlined by IFAD's exposure to multiple currencies, serves as a valuable lesson,** as taken from *the Corporate-Level Evaluation on IFAD's Financial Architecture (2018)*. Drawing parallels with other Development Finance Institutions (DFIs) that employ hedging instruments showcases a pragmatic approach towards risk management. This insight advocates for the adoption of best practices and knowledge-sharing within the international financial community.

Secondly, **the utilisation of longer-term local currency loans and capital expenditure (CapEx) loans is presented as an effective strategy to manage risks.** *The evaluation of the European Investment Bank (EIB) Intermediated Lending through the Investment Facility in the African, Caribbean and Pacific Group of States (ACP) (2017)* showed that endorsing Multi-Beneficiary Intermediated Loans (MBILs) allowed financial intermediaries to mitigate their maturity and currency mismatches. It also showed how CapEx loans supported intermediaries in their expansion and consolidation strategies.

The third element delves into the **consequences of having an over-reliance on foreign currency**, which was particularly evident during the global financial crisis of 2007-2008. Countries, such as Ukraine, Hungary, and Baltic nations, faced direct negative effects on their economies due to the excessive dependence of their banking systems on foreign currency. This cautionary tale points to the importance of diversification, as explained in the Evaluation of *the EBRD's Experience with Policy Dialogue in Ukraine (2014).*

4

In order to ensure financial stability, it is essential for IFIs to build capacity for better risk management, including that of NPLs



The evidence discerned from evaluation evidence highlights how pertinent IFIs' focus on building capacity is to improving risk management and non-performing loan (NPL) disposition. The insights drawn from the literature present a comprehensive picture of how such initiatives can be instrumental in preventing systemic crises, fostering economic growth and maintaining the health of financial systems.

The literature reveals a programmatic response to managing rising banking risks, emphasising the need to avert a systemic crisis that could impede economic growth. For instance, *the Evaluation of the ADB Banking Sector Rehabilitation and Financial Stability Strengthening Programme in Mongolia (2021)* revealed that the targeted key reforms aimed at NPL reduction and enhanced regulatory oversight of governance and risk management practices contributed to strengthening and stabilizing the banking industry. The multifaceted approach underscores the importance of a comprehensive strategy that addresses various facets of risk within the banking sector.

Furthermore, the International Finance Corporation's (IFC) Debt and Asset Recovery Program (DARP), which focuses on the creation and consolidation of platforms that specialise in the resolution of NPLs, was found to be an effective strategic response tool to address the escalating generation of NPLs and distressed assets in financial systems. This was highlighted in *the Evaluation of the WBG's Support to Capital Market Development (2016).*

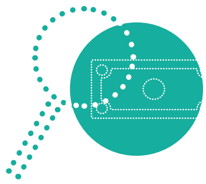
In addition, **evaluation evidence underscores the genuine gap in financial stability that IFC sought to address by building capacity for the implementation of improved risk management practices and NPL disposition in the aftermath of the global financial crisis of 2007-2008.** *The Evaluation of the WBG's Response to the Global Economic Crisis, Phase 2 (2012)* shows that the IFC was able to effectively build capacity and expand the scope and reach of its activities in partnerships with local institutions, financial intermediaries and other IFIs.

Finally, **the literature details a case where a Technical Assistance (TA) project's work on NPL management directly led to a policy-based loan with a strong governmental commitment to NPL management, showcasing the practical outcomes of capacity-building efforts.** In Mongolia, for example, the urgency and importance of the country's needs for financial stability prompted a follow-on loan. This underscored the real-world impact of initiatives focused on better risk management and NPL disposition, according to *the ADB's Mongolia Technical Assistance Completion Validation Report – Supporting Financial Sector Development and Stability (2021).*

Operational-level evaluation insights on tools and pathways to ensure stability within the financial sector

5

Enhanced country-level diagnostics are pivotal in discerning financial vulnerabilities and mitigating the risk of financial instability



Evaluation evidence emphasises the critical importance of IFIs enhancing country-level diagnostics as a proactive measure to identify financial vulnerabilities that can trigger financial instability. The evidence drawn from various sources underscores the need for rigorous and frequent assessments, accentuating the pivotal role of in-depth financial sector surveillance and diagnostic tools. For instance, the joint WBG-IMF's Financial Sector Assessment Programme (FSAP) has proven to be an effective tool in identifying and resolving financial sector vulnerabilities with macroeconomic stability implications, as shown in *the Evaluation of FSAP: Independent Evaluation Group (IEG) Review of a Joint World Bank and IMF Initiative (2006).* These diagnostics play an essential role in fostering financial sector development and contributing to economic growth. However, it is acknowledged that even comprehensive diagnostics, including stress tests, cannot guarantee financial crises will be avoided every time.

Country-level diagnostics conducted by MDBs can be powerful tools in spotting financial vulnerabilities that could potentially lead to economic instability. Examples from WBG, such as Systematic Country Diagnostics (SCDs) and Country Economic Memorandums (CEMs), are cornerstones of country-level analysis that are proven to provide timely and relevant insights into fiscal and financial vulnerabilities as evidenced in *the Evaluation entitled Addressing Country-Level Fiscal and Financial Vulnerabilities (2021).* The case of the Ukraine Country Economic Memorandum (2010) is specifically cited, where the diagnostic correctly identified mounting vulnerabilities in the banking sector due to lax credit analysis and regulatory shortcomings.

Secondly, **the literature advocates for more frequent and in-depth financial sector surveillance, particularly focusing on the largest systemic financial sectors, as a critical measure in preventing global crises.** *The evaluation of the IMF Response to the Financial and Economic Crisis (2014)*, for instance, recognised the decision to make the IMF's Financial Sector Stability Assessments (FSSAs) mandatory every five years as a positive step. However, the evaluation evidence also suggests that a five-year interval might be too long to detect emerging vulnerabilities in a timely manner.

Finally, **evaluation evidence across IFIs also highlights a case where IMF's insufficient analytical depth, rigour, and alignment with European officials led to an underestimation of risks, undermining financial stability in the Euro area.** *The Evaluation of the IMF and the Crises in Greece, Ireland, and Portugal (2016)* attributed those shortcomings in pre-crisis surveillance to a lack of IMF's independence and a close alignment with the official line of European officials. However, post-crisis surveillance was more effective in identifying vulnerabilities and advocating for remedial actions.

6

Evaluation evidence underscores the effectiveness of tailored policy dialogue and investment tools created by IFIs to help restore financial stability in context of crises.

Evaluation work highlights the diverse ways in which IFIs can contribute to crisis response, resilience building, and financial stability through targeted policies and instruments. For instance, evidence shows that ADB's Trade Finance Programme (TFP) is a valuable tool for addressing market gaps, especially during financial crises, helping restore financial stability. TFP's countercyclical response during the 2008-2009 global financial crisis is cited as timely and pertinent, as described in *the Evaluation of the ADB Trade Finance Programme (2015).*

The safe and efficient settlement of government securities has also been recognized as a key contributor to financial stability in the WBG's work. Settlement systems can play a crucial role in money market operations, providing collateral for transactions among financial institutions and supporting liquidity management. In turn, this indirectly promotes financial stability and aids capital market development, as explained in *the Evaluation of the WBG's Support to Capital Market Development (2016).*

Furthermore, the utility of policy-based guarantees (PBGs) in overcoming credit constraints during financial fragility episodes is evidenced in *the Findings from Evaluations of Policy-Based Guarantees – an IEG Learning Product (2016)*. This provides examples from Montenegro and the Former Yugoslav Republic (FYR) of Macedonia.

The WBG's comprehensive analyses on resilience, which builds upon its work in the programmes it supported over the years extends to innovative insurance tools against natural and climate shocks, as shown in *the Evaluation of the Crisis Response to Resilience and Systemic Shocks (2017).* **This showcases the importance of developing and implementing cutting-edge financial instruments to address specific challenges that are related to crisis response.**

IFIs' cross-border support to foreign banks during crises has also been found by evaluation work as a strategy in helping maintain financial stability. For example, the Multilateral Investment Guarantee Agency's (MIGA)'s cross-border support to foreign banks in countries facing banking crises and currency devaluation is deemed strategically relevant, as disclosed in *the Evaluation of the WBG's Response to the Global Economic Crisis – Phase II (2012).*

A key takeaway from the literature is the importance of adapting financial products to evolving circumstances and crises. *The Corporate-Level Evaluation on IFAD's Financial Architecture (2018),* for instance, advised enhancing the flexibility of its financial products and considering new ones to respond to diverse needs, including natural disasters and economic fragility. The Evaluation of the EBRD's Credit Lines (2018) shows that the EBRD's response to the 2007-2008 global financial crisis boosted the use of credit lines as a means of simultaneously supporting the liquidity of financial institutions (FIs) with the Bank's client portfolio, thus contributing to restoring of financial stability.

A key takeaway from the literature is the importance of adapting financial products to evolving circumstances and crises.

7 MDBs can expedite the achievement of their individual financial stability goals by synergising efforts and collaborating on common objectives

The evaluative evidence derived from diverse sources reinforces the view that collaborative initiatives amongst IFIs paves the way for more efficient responses to global challenges and crises. The literature suggests various avenues for collaborative action. The exploration of innovations in disaster risk financing, for instance, is identified as an opportunity for collaboration between IFIs in *the Evaluation of Asian Development Fund X and XA Operations (2015)*. The evaluation identified the ADB and the WBG as good partners when collaborating on catastrophe bonds and other financial instruments that underscore the potential for shared solutions in reinforcing fiscal and financial adjustability and strength amidst disasters.

Strengthening multilateral cooperation on policy issues affecting capital flows and enhancing the impact of the IMF's multilateral surveillance through increased rigour and transparency are two areas where IFIs' collaborative efforts can particularly yield positive outcomes. *The Evaluation of the IMF Advice on Capital Flows (2020)* illustrated that the work of IMF with the Financial Stability Board (FSB) and the Bank for International Settlements (BIS) can promote regulation to address systemic concerns arising from securities markets that are related to cross-border flows.

During the global economic crisis of 2007-2008, the WBG's financial support and technical assistance - complemented in the most affected countries by an IMF programme - contributed to restoring confidence in the banking system's soundness, as noted in *the Evaluation of Crisis Response and Resilience to Systemic Shocks (2017).*

Furthermore, the joint World Bank-IMF Financial Sector Assessment Programme (FSAP), developed in response to the 1997 Asian crisis, is highlighted as a collaborative tool that has the power to enhance the likelihood of both institutions being aware of client countries' vulnerabilities and ultimately avoiding financial fragility. This is evidenced in *the Evaluation of the World Bank Assistance to the Financial Sector: A Synthesis of IEG Evaluations (2006)*. However, it acknowledges that the boundary between the two institutions can be unclear, and collaboration remains a challenge.

Regular consultations and meetings between IFIs are key to successful coordination mechanisms, as exemplified by the EBRD's close cooperation with other IFIs in Romania. *The Evaluation of the Financial Intermediation Sector in Romania (2010)* finds that EBRD, the EU Delegation, EIB, IMF and WBG demonstrated good cooperation towards common objectives to assist with the development of Romania's financial sector and ensure financial stability.

The literature also points to the importance of balancing short-term crisis mitigation and long-term resilience building, particularly in social protection mechanisms. *The Evaluation of the WBG's Crisis Response and Resilience to Systemic Shocks (2017)* calls for more international attention to assess trade-offs and contribute to building social protection mechanisms that can be scaled up in response to systemic shocks.

Finally, **transparent reporting frameworks and harmonised monitoring across IFIs are encouraged to ensure adequate funding and tailored support during a crisis, thus potentially having a healing effect on financial stability.** The lack of cooperation among multilaterals at the start of the COVID-19 pandemic, for instance, is cited as a potential risk area that could arise again during future crises. Accordingly, the literature calls for comprehensive reporting frameworks to enhance efficiency and tailored support as noted in *the Evaluation of the IMF's Response to the Pandemic (2023).*

The harmonization of information sharing among IFIs facilitates the understanding of country needs, boosts the efficiency of financial allocations, and increases additionality by building more tailored responses.

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