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PUBLIC POLICY FOR THE PRIVATE SECTOR

Bank Governance

Lessons from the Financial Crisis

Principles of good governance have been a major component of international financial standards and are seen as essential to the stability and integrity of financial systems. Over the past 10 years much energy and attention have gone to improving the ability of company boards, managers, and owners to prudently navigate rapidly changing and volatile market conditions. So, how to explain the events of 2007–08? Many of the recent problems can be traced to flawed implementation of good principles and to behavior prompted by increasingly short-term performance horizons.

Corporate governance refers to the set of rules and incentives through which the management of a company is directed and controlled.¹ Corporate governance frames the distribution of rights and responsibilities among management, the board of directors, controlling shareholders, minority shareholders, and other stakeholders and provides the structure for setting, implementing, and monitoring company objectives. A firm committed to good corporate governance has an empowered board, a solid internal control environment, high levels of transparency and disclosure, and shareholder rights that are well defined and protected.²

Banks have some specific corporate governance issues. Their stakeholders vary more widely than those of other private companies, including not only shareholders but also, and perhaps more significantly, depositors and the general public. Banks deliberately take and

intermediate financial risk to generate revenue and serve their clients, leading to an asymmetry of information, less transparency, and a greater ability to obscure existing and developing problems. They can also quickly change their risk profile, so weak internal controls can rapidly cause instability. As a result, sound internal governance for banks is essential, requiring boards to focus even more on assessing, managing, and mitigating risk. Good governance also complements financial supervision and is an integral part of effective risk-based oversight.³

Governance failures in the crisis

The central irony of the governance failures that became apparent in the crisis is that many took place in some of the most sophisticated banks operating in some of the most developed governance environments in the world, such as the United States and the United Kingdom. A

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This is the 13th in a
series of policy briefs on
the crisis—assessing the
policy responses, shedding
light on financial reforms
currently under debate,
and providing insights
for emerging-market
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variety of studies have analyzed the contribution of weak governance to bank failure and, more broadly, to the financial crisis. Most of their conclusions can be grouped into four broad areas:

- Risk governance
- Remuneration and alignment of incentive structures
- Board independence, qualifications, and composition⁴
- Shareholder engagement

Risk governance

A lack of effective risk governance tops the list of governance failures leading to the crisis (OECD 2009; UBS 2008; U.K. Treasury 2009). Risk governance is generally defined as board and management oversight of risk and the attendant configuration of internal systems for identifying, measuring, managing, and reporting risk.

Board-level weaknesses. While effective risk governance has many elements, it is the board that is ultimately responsible for ensuring that all risks to the bank are identified, evaluated, and suitably managed. Many boards lacked a comprehensive understanding of their institution's risk profile and were unable to judge its appropriateness, in part for the following reasons:

- Incomplete risk information was transmitted to boards, leading to a false sense of security.
- There was a fundamental lack of expertise among nonexecutive directors.
- Executives used boards as a “group think” function rather than as a forum for vetting strategic risk issues.
- There was an overreliance on regulatory and compliance mechanisms to “catch” and report new or inappropriate sources of risk. This created a sort of “autopilot” risk mentality (U.K. Treasury 2009).

Lack of timely information for the board due to failures in risk management systems was evidently a problem at several major financial institutions, including UBS (UBS 2008). At Northern Rock, by contrast, the board appeared to know the funding risks but decided not to hedge them with backup credit lines. Ladipo and Nestor (2009) report important differences in the amount and type of information reaching the boards of European banks.

Management-level weaknesses. In institutions with weak risk governance systems, senior management failed to adopt and integrate the necessary systems to identify, manage, and report risk. The level and nature of aggregate risk arising in rapidly evolving balance sheets were not captured by systems and reports. Risk was not priced properly, either internally or by the market. Return on risk was not accurately reflected or analyzed, and as a result, capital was not properly allocated on the basis of the actual level of business risk. Moreover, funding and liquidity were not properly structured and planned.

- In some cases risk measurement systems narrowly focused on readily identifiable or already recognized risks and did not conduct adequate surveillance for other, less obvious and higher-level risks (U.K. Treasury 2009).
- Risk management was generally confined to “silo” arrangements and therefore isolated along product and organizational lines (Senior Supervisors Group 2008).
- Risk management units lacked the visibility, stature, or independence to consolidate institution-wide risks and elevate concerns to a level sufficient to prompt a response from management and the board.

By contrast, banks with good risk governance systems were able to respond with more flexibility (Senior Supervisors Group 2008). While no financial institution appears to have fully anticipated the magnitude of the crisis, the way in which institutions were able to respond—and to influence their outcomes—depended in large part on the strength and configuration of their internal risk governance structure. The boards of the institutions better able to weather the storm generally received timelier, more complete, and enterprise-wide risk information, enabling them to make critical decisions to curtail risk earlier—before asset values plummeted and market-based sources of funding became inaccessible.

Remuneration and incentive alignment

Good practice suggests that boards should strive to align executive and board remuneration with the longer-term interests of the company and its shareholders (OECD 2004). Over the past 10–20 years this general goal was interpreted in the United States and elsewhere to mean greatly

increased use of equity-based, variable compensation, including stock options (Bebchuk and Fried 2004).

But the financial crisis has led to greater skepticism about the structure and use of incentive-based compensation. Executives of banks (particularly failed ones) were seen as reaching for short-term yield at the expense of their firm's long-term stability and value. This problem was compounded by the short-term nature of incentive structures, particularly those designed for the traders and business lines dealing with the offending products. In some cases the relatively high proportion of variable pay (bonuses), and thus low fixed salaries, required companies to issue bonuses even when the business was not profitable.

Board professionalism

One key to aligning the interests of the company with those of its shareholders is to ensure board objectivity with the goal of preserving a balance of power—or a certain level of “productive tension”—among directors. This requires ensuring effective leadership by the board chairman and the chief executive officer (CEO), appointing experienced nonexecutive directors, and assigning key tasks to board committees that include a majority of nonexecutive directors. When productive tension is lost, the ability of the board to respond to arising risks, address management issues, and maintain an objective perspective can be threatened. A closer look at the boards of six distressed investment banks revealed several common characteristics (di Benedetta 2009; Nestor Advisors 2009).

First, the positions of chairman and CEO were combined. While this violates good practice in many countries, the “imperial CEO” is typical among many large, publicly listed U.S. financial institutions.

Second, there may have been too few executives on the boards. Nestor Advisors cites the relatively small number of executives serving on the boards as a factor compounding the concentration of power in the CEO/chairman. Technical and institutional expertise may have been shallow, concentrated in the hands of a few, or lacking voice in boardroom dynamics. Some of the highly troubled banks, such as Northern Rock, did have banking experience on the board. But

given the strength of the CEO/chairman, having just one or two board members with technical expertise is reason for caution. One or two lone voices in a boardroom may not be enough to preserve “independence of mind.”

Third, boards were less independent than they appeared. On the basis of New York Stock Exchange rules, more than 74 percent of the board members were considered to be independent. But a closer look points to asymmetrical power exercised by the CEO/chairman, a lack of independence of mind and spirit, and therefore a clear lack of productive tension. For example, while many of the nonexecutive directors met the technical requirements for being considered independent, most had been in place for a long time, from an average of 4 years at Merrill Lynch to 10 at Bear Stearns. In three noteworthy cases (Bear Stearns, Lehman Brothers, and Merrill Lynch) the term of the CEO/chairman substantially exceeded that of the nonexecutive directors, indicating an imbalance of authority and potentially excessive sway over the appointment and turnover of board members.

Shareholder engagement

According to good corporate governance practice, shareholders have a number of basic rights and obligations. These include the right to appoint directors, the right to make key corporate decisions, and the right to obtain information about the company to inform their decision making and prevent management from making decisions contrary to their interests. At the same time, institutional investors (which own most of the shares traded in many markets) should play an active and informed role. They should participate in the governance process, engage with company management, and vote their shares responsibly.

Basic shareholder rights can be frequently violated, however, and institutional investors often fail to live up to good-practice expectations. In the United States dissident shareholders who put forward slates of directors for election are “confronted by substantial obstacles” and often cannot get a nonbinding resolution on compensation passed (Bebchuk and Fried 2004, p. 25). And institutional investors in many countries are passive, fail to vote, or have conflicts of interest with the companies in their portfolio.

As a result, boards can become insulated from investors in these countries, and shareholders are forced to rely on independent board members to oversee management and mitigate conflicts of interest. As suggested, however, board independence alone does not appear to have been able to control excessive risk taking by banks, the growth of executive compensation, and, ultimately, the riskiness of the banking sector during the crisis.

Yet evidence for the overall value of shareholder engagement has been mixed, and active shareholder engagement remains somewhat controversial. In fact, some accuse shareholders of behaving badly during the crisis. For example, Acharya, Gujral, and Shin (2009) consider the continuing payout of dividends during the crisis, including by several of the banks that subsequently received public assistance, as the “quintessential reflection of a failure of governance of banks.”

Policy responses

Policy responses to bank governance issues range from direct government interventions to revisions in international standards and regulatory reforms by national authorities.

Direct government interventions

The most obvious governance-related policy responses have accompanied government support to troubled financial institutions. For example, on June 10, 2009, the U.S. government appointed a new official with the power to approve the compensation packages of executives at any major firms receiving “exceptional assistance” from the government, including AIG, Citigroup, and Bank of America. In Germany banks participating in the support fund for capital injection and troubled asset purchases were required to cap executive compensation and ban dividends and bonuses. Other European governments have added board representation, assumed the authority to change selected management appointments, or done both. But these measures address only troubled financial institutions, not the system as a whole. They also run the risk of being perceived as short-term political gestures if there is no policy or institutional framework in place to support the government’s role as owner.

International responses

International organizations and standard setters, including the Organisation for Economic Co-operation and Development (OECD), Financial Stability Board, and Basel Committee on Banking Supervision, have launched several reviews on the role of corporate governance in the crisis and are updating their principles and guidelines accordingly. The OECD’s analysis of corporate governance and the financial crisis will feed into an eventual review of its assessment methodology and a possible review of its corporate governance principles (OECD 2009). The Financial Stability Board’s work on strengthening the global financial architecture includes recently issued principles and implementation standards for sound compensation practices that address the governance framework surrounding public disclosure, supervisory oversight, the determination of compensation systems, and the compensation structure needed to ensure risk alignment (FSB 2009a, 2009b). The Basel Committee will revise its bank governance principles by 2010, with a key focus on board practices, risk governance, transparency, and “know your structure.” The revised principles will also incorporate aspects addressing compensation from related work of the Basel Committee and of the Financial Stability Board.⁵

These reviews and revised guidelines generally focus more on effective implementation of existing principles, laws, rules, and codes than on radically different or additional standards. Many fear that more rigid, prescriptive regulation would result in “form over substance” compliance while failing to achieve better risk governance and more effective board and oversight structures.

Regulatory reforms

Regulators are pursuing reforms through mandatory rules applicable to financial institutions and through enhancements to corporate governance codes applicable to all listed companies. The postcrisis regulatory changes are focusing mainly on remuneration, board composition and independence, shareholder rights and obligations, and risk management.

Remuneration. The debate continues over the design of executive compensation packages,

including the optimal split between the fixed component (salary) and the variable component (stock options, bonuses, and other forms of remuneration) as well as the relationship with risk, long-term performance, and shareholder interests. The experience with varying allocations of fixed and variable compensation is mixed. Banks with both small and large proportions of variable compensation took significant risks and incurred substantial losses in the crisis. Moreover, there is much variation among countries and institutions in the proportion of equity-based compensation; according to a study by Nestor Advisors (2009), in the six U.S. investment banks under analysis the salaries of top executives averaged 2 percent of their total annual compensation, compared with the European salary average of 20–35 percent. In two of the more spectacular investment bank failures, Bear Stearns and Lehman Brothers, the CEOs had substantial “total at-risk wealth” and suffered the consequences of their bad decisions along with every other significant shareholder, suggesting that alignment of incentives alone was not the problem.

Several European countries have recently adapted their corporate governance framework in response to concerns about remuneration. The debate has centered largely on executive compensation packages, with relatively little focus on the remuneration of some of the more pivotal players in the financial crisis—the business line managers who crafted the products that later blew up and the traders who took aggressively risky positions. Good practice, as reflected in such reports as the Walker Review in the United Kingdom, therefore extends “the terms of reference of the remuneration committee to accordingly include responsibility for setting the over-arching principles and parameters of remuneration policy on a firm-wide basis” (U.K. Treasury 2009, Recommendation 28, p. 20).

The concept of capping executive pay has also received wide attention. However, this proposal has generated a groundswell of concern among bankers and corporate constituents given the attendant issues of an uneven international playing field and government interference.

Board professionalism. The crisis has reignited the debate on board effectiveness on several fronts,

although in many countries related reforms have not yet advanced:

- *Separation of the positions of CEO and chairman.* Distressed banks had a mix of both models, and success or failure seemed to depend more on the balance of power and board dynamics. Requirements for separation of the positions of chairman and chief executives have become increasingly common.
- *Board independence.* The emphasis on independent directors has begun to moderate as it becomes increasingly accepted that independence of mind and quality of judgment and character are more important than compliance with a legal definition. Moreover, growing emphasis is being placed on the overall composition of the board and on the dynamics established through the mix of skills and experience.
- *Industry experience.* There appears to be a consensus that having more nonexecutive directors with industry experience is essential and that all directors must dedicate more time to their duties. Board performance evaluations are likely to become more formal and public.

Shareholder rights and obligations. While the failure of shareholders to actively engage has been broadly recognized, the solution to such passivity is more elusive and complex. In the United Kingdom the Walker Review (U.K. Treasury 2009) focuses on the major institutional shareholders of banks, encouraging them to discharge their assigned role more responsibly and to engage more productively with their investees rather than automatically resorting to divestment given certain circumstances. The review further encourages fund managers to confirm their commitment to a stewardship obligation or, if they are unwilling to do so, to explain their investment approach. It also recommends that fund managers commit to the ISC Principles of Stewardship.⁶ Other commentators go further by advocating that institutional investors be required to disclose their voting records from investee company shareholder meetings.

In the United States legislation has been proposed that gives company shareholders a non-binding vote on executive compensation (“say on pay”). A separate bill introduced in the U.S.

Senate proposes a variety of new shareholder powers, many of which are already standard in other countries, although the topic of shareholder engagement remains controversial.

Risk management. Given the importance of risk management issues in the crisis, it is surprising that the recent reforms have not given more attention to risk governance. Some of the newer codes in the European Union (such as those of Belgium, France, and the Netherlands) give increased responsibility for risk to the board's audit committee, but in most cases these changes are merely implementing past EU directives. There is also a concern that audit committees, if assigned responsibility for risk oversight as well, will become overburdened. The international

standard setters expect risk management functions to become more formalized and expect risk management and control functions to be independent of profit centers, operate increasingly on an enterprise-wide basis, and have more accountability to the board.

In the United Kingdom the Walker Review calls—for the first time in that country—for a board-level risk committee and for the creation of the position of chief risk officer to support board-level risk governance and “participate in the risk management and oversight process at the highest level on an enterprise-wide basis” (U.K. Treasury 2009, Recommendation 24, p. 19). These proposals are likely to establish good practice and may well be emulated in other jurisdictions.

Table Bank governance policy issues in developed countries and emerging economies

	Developed countries (crisis-related findings)	Emerging economies
Risk governance	<ul style="list-style-type: none"> ■ Risk management systems were often deficient. ■ Boards did not understand their bank's risk profile. ■ Strategies were not accompanied by a sufficient consideration of the risks involved. ■ Risk management functions in several banks lacked adequate visibility or stature. 	<ul style="list-style-type: none"> ■ Major area of concern in emerging economies. ■ Boards may not understand their role or set appropriate risk-taking strategies. ■ Rapid growth in many institutions, and resulting increases in risk, are not matched by improvements in risk governance. ■ Risk management systems are only now evolving.
Remuneration and alignment of incentive structures	<ul style="list-style-type: none"> ■ Increased skepticism about the use of incentive-based compensation. ■ Executives seen as reaching for short-term yield at the expense of the firm's long-term stability and value. ■ Weak design of compensation packages, including the optimal split between the fixed and variable components and the relationship with risk, long-term performance, and shareholders' interests. 	<ul style="list-style-type: none"> ■ Direct remuneration is less of a policy concern. ■ The opposite problem (low-paid executives and boards) is sometimes identified. ■ Lack of adequate disclosure is a major issue. ■ Indirect forms of compensation (benefits and privileges) may be a larger problem.
Board professionalism	<ul style="list-style-type: none"> ■ Studies of failed institutions suggest erosion in the independent and objective oversight role of boards. ■ In the United States the positions of chairman and CEO were combined; the “imperial CEO” remains common practice. ■ Boards were less independent than they appeared. ■ There may have been too few executives on boards. ■ Technical expertise may have been inadequate. 	<ul style="list-style-type: none"> ■ Large problem in emerging economies, but with different characteristics. ■ Boards tend to be passive and insular. ■ Board and executive capacity is a key concern. ■ Family ownership is prevalent, leading to lack of separation of roles of ownership, board representation, and management. ■ Putting independent boards in place is a particular challenge.
Disclosure and transparency	<ul style="list-style-type: none"> ■ Significant financial and nonfinancial disclosure. ■ Variety of problems in, and debates over, accounting standards (such as fair-value and consolidation accounting). ■ Concerns over sufficient disclosure of risks. 	<ul style="list-style-type: none"> ■ Major concern and a key problem. ■ Many countries are moving toward adopting International Financial Reporting Standards. ■ Enforcement mechanisms are weak. ■ Ownership is often opaque.
Shareholder roles and rights	<ul style="list-style-type: none"> ■ Debates over shareholder engagement and passivity during run-up to crisis. ■ In the United States shareholders are rarely able to veto board members or propose new ones in annual meetings. 	<ul style="list-style-type: none"> ■ Shareholder rights have improved, but problems remain with the application of rules designed to protect small shareholders against expropriation. ■ The state (a major owner of banks in many countries) is typically a poor owner that often plays by its own rules.

Relevance for emerging economies

These corporate governance issues are not limited to developed countries. Similar issues have been highlighted by World Bank work on corporate governance in a range of countries⁷ as well as by specialized reviews of the corporate governance framework for financial institutions carried out in response to client demand (table 1).⁸ The same general topics—risk governance, remuneration, board professionalism, and shareholder roles and rights—are important in every country, although the details and their relative importance may differ.

Yet many of the issues that drove the financial crisis are specific to the peculiarities of corporate governance in countries like the United States and the United Kingdom. These peculiarities stem from the relatively dispersed ownership structure of large companies and financial institutions in these countries, which gives rise to unique corporate governance problems and concerns relating to the conflict of interest between managers and shareholders. In most other countries, including emerging economies, such ownership is concentrated. This means that some of the problems raised by the crisis (especially issues of executive pay) are less prominent in emerging economies.

Conclusion

If there is one lesson from the current crisis—a lesson consistent with the Asian financial crisis—it is that corporate governance matters. The central irony of the governance failures in this crisis is that many took place in some of the most sophisticated banks operating in some of the most developed governance environments in the world. But different financial institutions in those countries have fared differently during the crisis, depending in part on the strength of their overall governance framework and culture.

While studies and reviews document several governance failures, one common conclusion is that much of the existing governance framework is generally adequate and should remain intact. But the devil is in the details of implementation. A key priority is to increase the capacity of boards to oversee strategic risk taking and to accurately judge institutional performance. Improving board capacity will require

upgrading the skills, experience, and leadership of nonexecutive directors and rebalancing the productive tension that should come with a high-performing board. Shareholders, particularly longer-term institutional investors, can play a role in this respect through more responsible interaction with the boards and a focus beyond short-term returns that might compromise longer-term safety and soundness.

The most obvious governance-related policy responses have accompanied government support to troubled financial institutions. In addition, international organizations and standard setters are updating their principles and guidelines, focusing more on the effective implementation of existing rules than on radically different or additional standards. Governments and regulators are also pursuing reforms, both through mandatory rules applicable to financial institutions and through enhancements to corporate governance codes applicable to all listed companies. Reforms are expected in executive remuneration, board independence and composition, and risk governance structures.

The issues are not solely developed-country issues. Some problems present in developed markets during the financial crisis, such as issues of executive pay, are less prominent elsewhere, while others, such as opaque and concentrated ownership, feature more prominently in emerging economies. There are lessons to be learned on corporate governance failures for all countries.

Notes

The authors would like to thank Constantinos Stephanou, Katia D'Hulster, Neil Gregory, and Damodaran Krishnamurti for their valuable comments and suggestions.

1. While this brief focuses on bank governance, most if not all of the issues discussed apply to all financial institutions. The *OECD Principles of Corporate Governance*, first drafted in 1999 and revised in 2004, are the basic standard for good practice in corporate governance and focus on “publicly traded companies, both financial and non-financial.” Governance elements are also embedded in principles and other guidance issued by international standard setters.
2. For more on the governance of financial institutions, see World Bank, “Strengthening Financial Sector

Governance,” <http://go.worldbank.org/M0IQDL2UB0>.

3. The Basel II framework requires that banks maintain strong internal governance procedures and processes. Pillar 2 (supervisory review) in particular requires that banks maintain well-functioning systems of internal controls and risk measurement, management, and mitigation—and adequate processes of review by management and directors.

4. Following standard practice, this brief uses *board* to refer to both the board of directors in a one-tier system and the supervisory board in a two-tier system. Similarly, it uses *CEO* (chief executive officer) to refer to the senior manager of a company (managing director and the like).

5. The Basel Committee on Banking Supervision (2009) has recently issued supplemental guidance for Pillar 2 of the Basel II capital accord, which addresses, among other things, firmwide governance, risk management, and incentives for managing risk and return over the long term.

6. The Institutional Shareholders’ Committee (ISC) in the United Kingdom set out basic responsibilities and principles for shareholder engagement in its 2007 Statement of Principles (annex 8 of the Walker Review).

7. Corporate governance is among the 12 core international standards for sound financial systems assessed under the Report on the Observance of Codes and Standards (ROSC) program. Since 2000, 72 assessments have been completed in 52 countries.

8. Reviews of bank governance are conducted according to the World Bank’s established methodology, which is based on the principles set forth by the Basel Committee. Ten such reviews have been conducted to date.

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