Executive Summary

The *Financial Development Report 2012* is based on the Financial Development Index ("the Index"), which provides a score and rank for the breadth, depth, and efficiency of 62 of the world's leading financial systems and capital markets. The Index analyzes drivers of financial system development that support economic growth, and thus compares the overall competitiveness of financial systems. Ultimately, the *Report* aims to serve as a tool for both advanced and emerging economies to benchmark themselves, thereby allowing them to identify and prioritize areas for reform.

The *Report* defines *financial development* as *the factors, policies, and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital and financial services*. In accordance with this definition, measures of financial development are captured across the seven pillars of the Index:

1. *Institutional environment*: encompasses financial sector liberalization, corporate governance, legal and regulatory issues, and contract enforcement
2. *Business environment*: considers human capital, taxes, infrastructure, and costs of doing business
3. *Financial stability:* captures the risk of currency crises, systemic banking crises, and sovereign debt crises
4. *Banking financial services*: measures size, efficiency, and financial information disclosure
5. *Non-banking financial services*: includes IPO and M&A activity, insurance, and securitization
6. *Financial markets*: encompasses foreign exchange and derivatives markets, and equity and bond market development
7. *Financial access*: evaluates commercial and retail access

The Index takes a comprehensive view in assessing the factors that contribute to the long-term development of financial systems. Such an approach will allow decision-makers to develop a balanced perspective when determining which aspects of their country's financial system are most important, and to calibrate this view empirically relative to other countries.

An important finding of this year's Index results is that financial systems across the world appear to have stalled. One can observe this in the minimal movement across ranks among the top 10 economies (see Table A). This is in line with the fact that the aggregate Index experienced less year-over-year rank movements than at any time since this *Report* was first published in 2008. An analysis of the seven pillars and corresponding subpillars allows for additional insights. Among the countries covered in the sample, there was little rank movement across three of the seven pillars: the institutional and business environments, as well as non-banking financial services. Movement in the remaining pillars and corresponding subpillars was driven either by individual variables, such as improvement in Tier 1 capital ratios and non-performing loans to total loans, or by enhancements to this year's methodology.

Table A: Top 10 in overall Index rankings, 2012 vs. 2011

COUNTRY/ECONOMY	2012 RANK	2011 RANK	2012 SCORE (1-7)	CHANGE IN SCORE
Hong Kong SAR	1	1	5.31	+0.15
United States	2	2	5.27	+0.12
United Kingdom	3	3	5.21	+0.21
Singapore	4	4	5.10	+0.14
Australia	5	5	5.01	+0.08
Canada	6	6	5.00	+0.14
Japan	7	8	4.90	+0.19
Switzerland	8	9	4.78	+0.15
Netherlands	9	7	4.73	+0.02
Sweden	10	11	4.71	+0.20

Only two subpillars, IPO activity and equity market development, experienced considerable year-over-year change in the underlying data for the majority of the indicators. Results show that:

- Over the past year, median IPO market share in proceeds decreased 11 percent, while median share of world IPOs in number of offerings declined 14 percent. This suggests that the markets in which corporations list are getting slightly more concentrated.
- From 2010 to 2011, three out of the four indicators in the equity market development subpillar moved significantly, by a median of nearly 20 percent. Over the same time frame, more than two-thirds of countries experienced a year-over-year decline in stock market turnover ratio and number of listed companies per 10,000 people, while three-quarters of countries saw a drop in stock market value traded to GDP.

Although most subpillars experienced negligible movement, IPO activity and equity market development appeared to experience significant volatility. Therefore, a closer look at the underlying variables in each of these subpillars over a multi-year period proves informative. Looking at changes in the individual variables from a general and regional perspective sheds light on how individual economies and regions fared throughout the crisis. The *Report* pays particular attention to the top five countries hosting the world's largest exchanges, since they account for more than 50 percent of the world's stock market capitalization, and thus provide an additional perspective on the effects of the recent crisis on equity markets. Some of the key points from this analysis include the following:

- Across the country sample, the most significant change occurred within the domestic market capitalization to GDP indicator. The variable's largest year-on-year decline took place from 2007 to 2008, and 2011 levels are still substantially lower than in 2006. Nevertheless, liquidity appears to be stabilizing, as highlighted by the fact that turnover velocity rebounded in 2011, moving closer to 2006 levels.
- Regional results are in line with the above-mentioned trends, as domestic market capitalization to GDP decreased for most regions, with the exception of Asia/Pacific. In contrast, while the overall picture suggests that liquidity is stabilizing, Europe and Latin America see a decrease, indicating that lingering liquidity issues may be region-specific.
- Across the top five economies that host the largest exchanges, liquidity appears to be stabilizing in line with the overall trend, with the exception of the United Kingdom. Nevertheless, domestic market capitalization to GDP is still declining in three of the five countries examined. Among the factors that influence this drop are declines in value of shares trading to GDP, the number of listed companies per 10,000 people, and IPO activity.

While one can observe pockets of improvement across some indicators related to the banking system, this signifies only a small step in what will be a long road to recovery. Volatility across the equity markets also suggests that many actors feel a degree of uncertainty. In order to realize much-needed growth opportunities, decision-makers need to recognize that financial systems must progress. At the same time, leaders should keep a watchful eye on those indicators that have shown declines and take action should conditions continue to deteriorate.