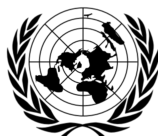
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# TRADE AND DEVELOPMENT REPORT, 2001

***Global trends and prospects***

***Financial architecture***



UNITED NATIONS

***Chapter IV***

# STANDARDS AND REGULATION

## A. Introduction

Many recent initiatives for international financial reform are directed at reaching agreement on, and implementation of, standards for major areas of economic policy. Most of these standards are ultimately intended to contribute to economic stability both at the national and international level. Their main proximate targets are the strengthening of domestic financial systems and the promotion of international financial stability "… by facilitating better-informed lending and investment decisions, improving market integrity, and reducing the risks of financial distress and contagion" (FSF, 2000a, para. 23). In pursuit of these objectives, the standards cover not only the financial sector, but also aspects of macroeconomic policy and policy on disclosure. Many features of these standards reflect concerns arising out of the experience of recent financial crises, though in a number of cases they also build on initiatives involving mainly industrial countries and originating from events of the more distant past. While the standards themselves are designed to promote stability, their development can also be viewed as part of a process of arriving at a set of globally accepted rules for policy in the financial and monetary spheres. Such rules could furnish one of the prerequisites for the provision of international financial support for countries experiencing currency crises. In this sense, they are an international analogue of the national rules for the financial sector, compliance with which is a condition for lender-of-last-resort financing.

The Financial Stability Forum (FSF)[1] has identified a number of standards which it considers particularly relevant to strengthening financial systems. These vary in the precise degree to which they have received international endorsement, but they have been broadly accepted, in principle, as representing basic requirements for good practice. As can be seen from table 4.1, the standards cover the areas of macroeconomic policy and data transparency, institutional and market infrastructure, and financial regulation and supervision – areas that are closely interrelated in many ways. Macroeconomic policy, for example, can crucially affect the more sectoral dimensions of financial stability through its impact on the values of financial firms' assets and liabilities (and thus on the context in which financial regulation and supervision are conducted). It can also affect the functioning of the system for payments and settlement, which is at the heart of the infrastructure of financial markets. Similarly, effective financial regulation and supervision are inextricably related to accounting, auditing and insolvency procedures.

***Table 4.1***

**KEY STANDARDS FOR FINANCIAL SYSTEMS**

| *Subject area* | *Key standard* | *Issuing body* |
|---|---|---|
| ***Macroeconomic policy and data transparency*** | | |
| Monetary and financial policy transparency | Code of Good Practices on Transparency in Monetary and Financial Policies | IMF |
| Fiscal policy transparency | Code of Good Practices in Fiscal Transparency | IMF |
| Data dissemination | Special Data Dissemination Standard (SDDS)<br>General Data Dissemination System (GDDS) [a] | IMF |
| ***Institutional and market infrastructure*** | | |
| Insolvency | Principles and Guidelines on Effective Insolvency Systems [b] | World Bank |
| Corporate governance | Principles of Corporate Governance | OECD |
| Accounting | International Accounting Standards (IAS) [c] | IASC [d] |
| Auditing | International Standards on Auditing (ISA) | IFAC [d] |
| Payment and settlement | Core Principles for Systemically Important Payment Systems | CPSS |
| Market integrity | The Forty Recommendations of the Financial Action Task Force on Money Laundering | FATF |
| ***Financial regulation and supervision*** | | |
| Banking supervision | Core Principles for Effective Banking Supervision | BCBS |
| Securities regulation | Objectives and Principles of Securities Regulation | IOSCO |
| Insurance supervision | Insurance Supervisory Principles | IAIS |

***Source:*** FSF (2000a: 19).

***a*** Economies that have, or might seek, access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.

***b*** The World Bank is coordinating a broad-based effort to develop these principles and guidelines. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the *Model Law on Cross-Border Insolvency* in 1997, will help facilitate implementation.

***c*** The BCBS has reviewed relevant IAS, and a joint BCBS-IASC group is further considering bank-related issues in specific IAS. IOSCO has reviewed and recommended use of 30 IAS in cross-border listings and offerings, supplemented, where necessary, to address issues at a national or regional level. The IAIS's review of relevant IAS is under way.

***d*** The International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.

Insurance products are frequently incorporated in, or sold in close conjunction with, investment products, thus increasing the channels through which disturbances affecting the market for one financial service can be transmitted to markets for another. And even such an apparently self-contained issue as money laundering has, on occasion, threatened the stability of financial firms.[2]

The list of organizations associated with the key standards in table 4.1 is not exhaustive, and the standards themselves give only a brief idea of

the many initiatives taking place under each heading. When the FSF reviewed the standards agenda in March 2000, the 12 subject areas were already only a subset of a larger group which eventually numbered 64 (FSF, 2000a, paras. 55–57 and Annex 8). The discussion in section B focuses on the main thrust and contents of the standards in table 4.1. It also aims to illustrate some omissions and some of the practical problems posed by implementation of the standards. Section C looks at the process of participation in the formulation and application of the standards initiatives. This leads naturally to the issue of bias in the official thinking which underlies the selection of the subjects covered by these initiatives and the asymmetrical way in which they are approached. To illustrate the strengths and weaknesses of this thinking, section C examines in some detail three major reports of FSF working groups. Section D deals more systematically with implementation issues and some of the problems already raised in the context of particular standards in section B. Various incentives and sanctions are discussed as well as the findings of a preliminary survey to review progress so far. As discussed in section E, the contribution of standards to the achievement of greater financial stability depends to a great extent on their incorporation into the rules and norms of business practice. This in turn is closely connected to the regulatory and supervisory regime within which these rules and norms are applied. However, improvements on this front have inherent limits, as illustrated by examples taken from the key area of banking supervision.

## B. Themes of the key standards

Each of the codes discussed here is intended to accomplish improvements at both macroeconomic and microeconomic levels. A significant part of the impetus behind the initiatives discussed in subsections B.1–B.3 was furnished by particular financial crises and systemic incidents of stress – mostly recent ones. Their major objectives are macroeconomic or systemic, though particular features of the behaviour of specific economic agents are also targeted. In the case of the codes discussed in subsections B.4–B.9, the balance between macroeconomic and microeconomic objectives is different, with much less explicit emphasis given to the former. Moreover, many of the latter codes are of long-standing origin and antedate the crises of the 1990s. It is their incorporation into a global programme of financial reform that is recent.

### 1. Macroeconomic policy and data transparency

The Code of Good Practices on Transparency in Monetary and Financial Policies (IMF, 2000c) identifies desirable transparency practices in the conduct of monetary policy and of policies towards the financial sector. These practices require: clarity with respect to the roles, responsibilities and objectives of central banks and financial agencies other than central banks with responsibility for overseeing and supervising different parts of the financial sector; open processes for the formulation and reporting of decisions on monetary and financial policy; public availability of information concerning policies in both spheres; and accountability and assurances of integrity for the

central bank, other financial agencies and their staff.

The Code of Good Practices on Fiscal Transparency (IMF, 1998a) is based on four principles: first, the roles and responsibilities of and within the government should be transparent, and for this purpose there should be a clear legal and administrative framework for fiscal management; secondly, governments should commit themselves to public disclosure of comprehensive, reliable information on fiscal activities; thirdly, the process of budget preparation, execution and reporting should be open; and, fourthly, fiscal information should be subject to public and independent scrutiny.

The new disclosure rules of the Special Data Dissemination Standard failed to serve as an effective early warning system in the case of the Asian crisis.

The Special Data Dissemination Standard was developed by the IMF in response to recognition, after the Mexican crisis, of widespread deficiencies in major categories of economic data available. It prescribes the data which countries intending to use the world's capital markets should be expected to make public concerning the real, fiscal, financial and external sectors of their economy. Moreover, it lays down minimum benchmarks to be met in terms of periodicity and timeliness in the provision of that information. Since its inception, the Special Data Dissemination Standard (SDDS) has been strengthened by the inclusion of a requirement to disclose not only reserve assets, but also reserve-related liabilities and other potential drains on reserves, such as short derivative positions and guarantees extended by the government for borrowing by the private sector in foreign currency. The SDDS is supplemented by the General Data Dissemination System (GDDS), which is designed to improve the quality of data disclosed by all member countries of the IMF.

A common characteristic of the countries affected by recent financial crises was their openness to capital flows, while there were substantial differences in many of their macroeconomic indicators and other features of their economies.

The rationale for these codes and standards has several facets. The effectiveness of monetary, financial and fiscal policies can be enhanced if the objectives and instruments of policy in these areas are known to the public and if the government's commitment to these objectives is credible. Good governance more generally requires that central banks, other financial agencies and fiscal authorities are accountable. But an important aspect of the Codes' rationale goes beyond their benefits at the domestic level and concerns international lenders and investors. Here, the idea is that transparency should help lenders and investors to evaluate and price risk more accurately, thus contributing to policy discipline in recipient countries. Moreover, the assessment of individual countries made possible by these Codes is expected to prevent the so-called contagion effect, whereby a loss of confidence in one country spreads to others simply because they belong to the same category or region.[3]

That transparency regarding major areas of macroeconomic policy can contribute to their credibility, and to good governance more generally, seems incontrovertible. Transparency is also capable of facilitating multilateral surveillance by organizations such as the IMF. Understandably, the Codes confine themselves to process rather than substance, since codes of rules for policy would be enormously complex if they were to cover the great variety of different situations and countries. In addition, it would be much more difficult to reach consensus on such rules than on those limited to process.

Regarding the expectation that either the Codes concerning macroeconomic policy or the SDDS will lead to much improved decisions by international lenders and investors, and thus to improved resource allocation and enhanced policy

discipline for the governments of the receiving countries, there are grounds for scepticism. The new disclosure rules of the SDDS failed to serve as an effective early warning system in the case of the Asian crisis. Indeed, information was widely available concerning the balance of payments of the countries involved, the external financial flows to them, their corporate governance, trends in their domestic lending and in their banks' exposure to overvalued property sectors, and major features of external assets and liabilities (though there were gaps in what was publicly disclosed concerning the last of these items, gaps which subsequent strengthening of the SDDS was designed to fill). And if the availability of pertinent data failed to deter capital flows associated with the build-up of eventually unsustainable external financial positions in certain Asian countries, the same applied, *a fortiori,* to the behaviour of international lenders and investors in the Russian Federation prior to the crisis of mid-1998.

A more fundamental limitation of the potential contribution of transparency to the prevention of financial instability is due to the considerable variation in accompanying macroeconomic conditions and other features of policy regimes – a variation evident during recent financial crises. A common characteristic of the countries affected by these crises was their openness to capital flows, but there were substantial differences in many of their macroeconomic indicators and other features of their economies. These differences involved external deficits, the extent of currency overvaluations, the size of budget deficits, the relative importance of consumption and investment in the booms preceding the crises, the relative size of countries' external debt owed by the public and private sectors, and the coverage and effectiveness of regimes of financial regulation and supervision.

Analysis of recent international financial crises also points to other difficulties as to the extent to which improved disclosure of macroeconomic variables can contribute to greater financial stability, in particular to the avoidance of the contagion effect. National balance sheets do not always reflect the pressures on external payments that can result from the adjustment of derivative positions which are off-balance-sheet and not always adequately covered by accounting rules. Moreover, derivative positions, even if covered under these rules, are capable of blurring distinctions between different categories of exposure, such as those between short and longer term. There is now a consensus that cross-border hedging and other practices make many of the international financial system's fault lines difficult to identify in advance. As a recent report of the Financial Stability Forum states:

> Certain commonly employed risk management techniques … can have the effect of adding to the volatility of both prices and flows in the international capital market … That is, investors acquire or dispose of claims whose risk characteristics and price history resemble those of the asset being proxied but where the market is deeper, more liquid, or subject to fewer restrictions and controls. Such behaviour was one of the factors behind the large fluctuations in capital flows to South Africa and several countries in Eastern Europe around the time of the Asian crisis. (FSF, 2000b, para. 28)

In the context of more recent events, attention has been drawn to the way in which Brazilian bonds have become an instrument widely used by investors in emerging markets to hedge positions in the debt of other countries such as the Russian Federation, Morocco and the Republic of Korea.

## 2. Banking supervision

Weaknesses in the banking sector and inadequate banking supervision[4] have played a central role in recent financial crises in developed as well as developing countries. Recognition of the increasing potential for destabilizing the cross-border effects of banking crises – owing to the internationalization of the banking business – has led to initiatives since the 1970s that aim to improve international cooperation in banking regulation and supervision. Initially, these initiatives were directed primarily at banks in industrial countries and offshore financial centres in response to a number of events that highlighted the inadequacies in their banking regulation and supervision. These events provided much of the inspiration for subsequent efforts to improve regulatory and supervisory cooperation. The standards which emerged from these initiatives eventually

also achieved widespread acceptance among developing and transition economies. The Basel Committee on Banking Supervision (BCBS) – the most important vehicle for most of these initiatives – has increasingly assumed the role of global standard-setter in this area.[5]

A major outcome of the BCBS's extension of the focus of its activities beyond the concerns of its member countries is the *Core Principles for Effective Banking Supervision* issued in late 1997. In the development of these Principles, the BCBS collaborated with supervisors of economies outside the Group of Ten (including several developing and transition economies). They cover seven major subject areas: (i) the preconditions for effective banking supervision; (ii) the licensing and structure of banks; (iii) prudential regulations and requirements; (iv) methods of ongoing supervision; (v) information requirements; (vi) the formal powers of supervisors; and (vii) cross-border banking. In April 1998, the BCBS undertook a survey of compliance with the Core Principles in 140 economies, an effort paralleled by IMF and World Bank reviews of compliance in selected countries.[6] Subsequently a Core Principles Liaison Group (CPLG) of 22 members[7] was set up to provide feedback to the BCBS on the practical implementation of these Principles. The reviews of compliance and feedback from the CPLG led to the development by the BCBS of the *Core Principles Methodology* issued in October 1999 (BCBS, 1999a).

This document on methodology is intended to provide guidance in the form of "essential" and "additional" criteria for the assessment of compliance by the different parties to which this task may be entrusted, such as the IMF, the World Bank, regional supervisory groups, regional development banks and consulting firms, but not the BCBS itself. In addition to the specific criteria relating to banking supervision, the assessors are also required to form a view as to the presence of certain more general preconditions regarding such subjects as: (i) sound, sustainable macroeconomic policies; (ii) a well developed public infrastructure, including an adequate body of law covering, for example, contracts, bankruptcy, collateral and loan recovery, as well as accounting standards approaching those of international best practices; (iii) market discipline based on financial transparency, effective corporate governance and the absence of government intervention in banks' commercial decisions except in accordance with disclosed policies and guidelines; (iv) adequate supervisory procedures for dealing with problems in banks; and (v) adequate mechanisms for systemic protection such as a lender-of-last-resort facility or deposit insurance (or both). The parts of the assessment directed more specifically at banking supervision comprise not only the procedures of supervision but also its subject matter (which, of course, includes the standards for prudential regulation and for banks' own internal controls and risk management covered in the BCBS's own documents over the years). With respect to subjects such as accounting and auditing standards and insolvency law, the Core Principles for Effective Banking Supervision clearly overlap to some degree other key standards mentioned in table 4.1.

> Internationally promulgated standards can help upgrade national rules and norms, but the objective should not be uniform rules for all countries.

Assessment of compliance with the Core Principles requires evaluation of several related requirements, including prudential regulation and other aspects of the legal framework, supervisory guidelines, on-site examinations and off-site analysis, supervisory reporting and other aspects of public disclosure, and enforcement or its absence. Assessment is also required of the supervisory authority's skills, resources and commitment, and of its actual implementation of the Core Principles. If evaluation of the preconditions for effective supervision (mentioned earlier) and assessment of the criteria relating to supervision itself are considered together, the exercise covers substantial parts of a country's commercial law, its accounting and auditing standards, and to some extent the quality of its government's macroeconomic management.

The assessment of relevant laws, regulations and supervisory procedures would appear to be

fairly straightforward, but that of supervisory capacity and the effectiveness of implementation more complex.[8] Thus, perhaps understandably, the annex to the *Core Principles Methodology,* which sets out the structure and methodology for assessment reports prepared by the IMF and the World Bank, focuses principally on the former set of subjects and not the latter. Assessment of supervisory capacity and the effectiveness of implementation is generally likely to be feasible only through extended in-depth scrutiny. This would require a lengthy presence of the assessor in the country undergoing assessment, either in the form of a permanent presence, or through a process involving several visits. If the latter option were selected for the purpose (and it seems rather more likely to be acceptable and more in accord with normal procedures for IMF surveillance), an authoritative assessment of compliance with the Core Principles may take years.

Assessment of the more general preconditions for effective supervision is not mentioned in the annex to the *Core Principles Methodology,* but here, too, a lengthy exercise is likely to be necessary. In particular, assessment of the many dimensions of a country's legal regime and of its accounting and auditing standards requires evaluation not only of laws, regulations and principles promulgated by professional bodies (such as those of accountants), but also of their implementation, and of the way in which they are incorporated into rules and norms in practice.[9] Many features of countries' legal regimes and business norms reflect differences in historical roots and in compromises among social groups. Internationally promulgated standards can help upgrade national rules and norms, but many aspects of the process will be gradual, and the objective should not be uniform rules for all countries.[10]

At the level of the countries being assessed, such exercises will often place an additional burden on a limited supply of supervisory capacity. In time, this capacity can be expanded, but the training of a bank supervisor typically requires a considerable period. And once trained, a supervisor may be faced with attractive alternative employment opportunities in the private sector, or even in the IMF or the World Bank themselves (which have recently been increasing the number of their staff with expertise in this area). There is, of course, awareness of the problem of human resources among bodies such as the BCBS, the IMF, the World Bank and the CPLG, and efforts are being made to coordinate initiatives and to ensure that scarce expert resources are used in the most efficient way. However, there remains a real danger that international assessment of countries' supervision will be at the expense of actual supervision on the ground.

### 3. Payments and settlement

Payment systems enable the transfer of funds between financial institutions on their own behalf and on behalf of their customers, a role which makes such systems a potential source of systemic risk. This role is evident from a consideration of four key dimensions of an economy's flow-of-funds process: (i) the activities of various economic agents; (ii) the markets for financial instruments, assets and liabilities; (iii) the supporting infrastructure, of which an integral component is the payments system; and (iv) economic conditions binding the markets together and ensuring that they clear. Failures in any of the first three dimensions are capable of disrupting links between the markets and between economic agents whose mutual interdependence is based on several different kinds of transaction and exposure. If large, such disruptions can easily take on a systemic character.[11] Moreover, payment systems also play an essential role in foreign exchange transactions, which are thus an interface between different countries' payment systems.[12] As a result of the links and similarities between systems of payment and settlement for fund transfers and for transactions in other financial assets, the main vehicle for international initiatives in this area, the BIS Committee on Payment and Settlement Systems (CPSS), has extended its purview beyond fund transfers to settlement systems for securities and foreign exchange and to clearing arrangements for exchange-traded derivatives (White, 1998:196–198). Moreover, the specific stability issues posed by securities settlement are currently the subject of a joint working group of the CPSS and the International Organization of Securities Commissions (IOSCO).[13] But the discussion here will be

limited to the key standard in the area of payment and settlement mentioned in table 4.1.

The initiative to develop an internationally agreed framework of core principles for the design, operation and oversight of payment and settlement systems reflects increased recognition of the risks associated with rapidly rising volumes of payments (CPSS, 2000a).[14] The main risks in these systems are: *credit risk*, when a counterparty is unable to meet obligations within the system currently or in future; *liquidity risk* (clearly closely related, but not identical, to credit risk), when a counterparty has insufficient funds to meet obligations within the system, though it may be able to do so at some future time; *legal risk*, when an inadequate legal framework or legal uncertainties cause or exacerbate credit or liquidity risks; and *operational risk*, when factors such as technical malfunctions or operational mistakes cause or exacerbate credit or liquidity risks. As discussed above, any of these risks can have systemic consequences, as the inability of a counterparty or counterparties to meet obligations within the system can have a domino effect on the ability of other counterparties to meet their obligations, and thus, ultimately, threaten the stability of the financial sector as a whole.[15] The task force established to develop the Core Principles was to limit itself to "systemically important payment systems", namely those capable of triggering or transmitting shocks across domestic and international financial markets.

The first Core Principle is directed at legal risk and specifies the need for a robust legal basis for the payment system, a requirement that links its rules and procedures to related areas of law such as those concerning banking, contract and insolvency. The second and third Principles concern rules and procedures for enabling participants to have a clear understanding of the system's impact on financial risks. They also recognize the need for defining how credit and liquidity risks are to be managed and for identifying responsibilities for this purpose. A system's risks can be exacerbated by the length of time required for final settlement or by the nature of the asset used to settle claims. Thus the fourth and sixth Principles specify the need for prompt settlement and for a settlement asset that is either a claim on the central bank or one carrying little or no credit risk (owing to the negligible risk of its issuer's failure). The fifth Principle requires a minimum standard of robustness for multilateral netting systems.[16] The seventh Principle is intended to minimize operational risk through ensuring a high degree of security and operational reliability. The eighth, ninth and tenth Principles address the more general issues of the system's efficiency and practicality (including the need for explicit recognition of any trade-off between safety and efficiency). They also address the need for objective and publicly disclosed criteria for participation in the system, permitting fair and open access, and effective, accountable and transparent governance arrangements. The Core Principles attribute to central banks key responsibility for ensuring that payment systems comply with the Principles.

The second part of the Report on the *Core Principles for Systemically Important Payment Systems* provides details on issues such as the identification of systemically important payment systems, the modalities of their review and reform, structural, technical and institutional factors to be considered, and the kinds of cooperation necessary with participants in the system, user groups and other parties to the reform process (CPSS, 2000b).[17] The second part also takes up certain cross-border aspects of payment systems. The Core Principles are now included in the joint IMF-World Bank Financial Sector Assessment Programme (FSAP).[18] However, experience in industrial countries suggests that the upgrading of payment systems required by the Principles is likely to entail a lengthy process owing to the many different actions required and the many different parties involved.

### 4. Accounting and auditing

Improvements in financial reporting and transparency are essential to most of the initiatives on codes and principles, but in the area of accounting and auditing in table 4.1 there is an explicit aim to harmonize standards. Through their impact on disclosure, these standards have an obvious bearing on counterparties' ability to assess the financial risks of transactions. The need for international harmonization is also due to the

growth in cross-border business, especially in lending and investment. The principal body with responsibility for promulgating international accounting standards is the International Accounting Standards Committee (IASC).[19] Much of the recent work of the IASC has been directed at reaching a compromise on a set of standards acceptable both to the United States and to other member countries, and which satisfies disclosure requirements for the issuance and trading of securities in the world's major financial markets. A number of the difficult problems here concerns the reconciliation of the understandably pluralistic approach of the IASC with the more specific and constraining rules of the Generally Accepted Accounting Principles (GAAP) of the United States.[20]

There is also a question as to how far the greater transparency leads to greater financial stability.

While debate on the International Accounting Standards (IAS) is concerned mainly with highly specific subjects,[21] its impact on the international financial system is likely to depend more on its success in raising standards of accounting and financial reporting worldwide. And this will also be related to accompanying initiatives to raise auditing standards. The targets of such efforts include internal auditing (i.e. assessment of the extent and effectiveness of a firm's management and accounting controls and of the safeguarding and efficient use of its assets) as well as external auditing (i.e. auditing of financial statements and supporting evidence to determine the conformity of the former with applicable standards). Internal auditing is now a legal requirement in several countries, and auditing committees have frequently acquired greater importance in countries where shifts in corporate governance have resulted in increased power for boards of directors vis-à-vis senior operating executives. But it is external auditing which is the principal subject of international initiatives. Here the problems of harmonization relate partly to differences in the accounting standards underlying financial statements but also to divergences in audit standard-setting processes themselves. These divergences result, for example, from the fact that in some countries auditing standards are set by the accounting profession whereas in others they are based on requirements mandated in laws and regulations, or they result from a process involving the joint participation of both the accounting profession and the government. The institution specified in table 4.1 as having the lead responsibility for international harmonization of auditing standards is the International Federation of Accountants (IFAC),[22] which closely collaborates with other bodies also occupying key positions in this area such as IOSCO and relevant EU institutions.

If the information in good financial reporting has such a beneficial effect on decision-making, why were lenders and investors not more wary in its absence?

While improved standards of accounting and auditing have the potential for contributing to better decision-making by lenders and investors through enhanced transparency, recent experience cautions against exaggerated expectations in this regard, especially in the short run. There is also a question as to how far the greater transparency – which is the main ultimate objective under this heading – leads to greater financial stability. As the celebrated investment manager, Warren Buffett, warns, "the accountants' job is to record, not to evaluate", and "… the business world is simply too complex for a single set of rules to effectively describe reality for all enterprises" (Cunningham, 2000: 196, 202). In the case of financial firms, the difficulties are multiplied by the speed with which assets and liabilities can change, even in cases where high standards of reporting are observed. Moreover, as already noted, although financial reporting was poor in several of the countries involved in recent financial crises, there was no shortage of information available to lenders and investors about key macroeconomic variables and the general economic and legal environment in the countries concerned. And if the information in good financial reporting has such a beneficial ef-

fect on decision-making, why were lenders and investors not more wary in its absence, especially in view of weaknesses which should have been evident from the macroeconomic information which was available?

### 5. Corporate governance

Corporate governance involves the relationships between the management of a business and its board of directors, its shareholders and lenders, and its other stakeholders such as employees, customers, suppliers and the community of which it is a part. The subject thus concerns the framework in which the business objectives are set and how the means of attaining them and otherwise monitoring performance are determined. The *OECD Principles of Corporate Governance* (OECD, 1999) cover five basic subjects: (i) Protection of the rights of shareholders, a heading that includes allowing the market for corporate control to function efficiently, transparently and fairly for all shareholders; (ii) Equitable treatment of shareholders, including minority and foreign shareholders, with full disclosure of material information and the prohibition of abusive self-dealing and insider trading; (iii) Recognition and protection of the exercise of the rights of stakeholders as established by law, and encouragement of cooperation between corporations and stakeholders in creating wealth, jobs and financially sound enterprises; (iv) Timely and accurate disclosure and transparency with respect to matters relevant to company performance, ownership and governance, which should include an annual audit conducted by an independent auditor; and (v) A framework of corporate governance to ensure strategic guidance for the company and effective monitoring of its management by the board of directors, as well as the board's accountability to the company and shareholders (certain key functions of the board being specified under this heading).

Corporate governance sets rules on matters where variations of approach among countries are often rooted in societal differences – for example, with respect to the relative importance of family-owned firms as opposed to corporations, or to prevalent norms regarding the primacy of sometimes conflicting business objectives, such as long-term sustainability, on the one hand, and value for shareholders, on the other. These societal differences, in turn, generally reflect differences in national histories and in the political and social consensus which has grown out of them.[23] The preamble to the OECD Principles acknowledges that there is no single model of good corporate governance and the Principles themselves are fairly general. They avoid rules for the more contentious aspects of relations between companies and their lenders and investors, such as appropriate levels of leverage. They also avoid the more detailed rules for the market for corporate control. Nevertheless, there remains a danger that the technical assistance and assessment exercises associated with the promulgation of these Principles – which will also involve other organizations such as the World Bank – will contain features that reflect biases in favour of concepts linked to particular models of corporate governance, most notably those of the United Kingdom or the United States.

Corporate governance sets rules on matters where variations of approach among countries are often rooted in societal differences that generally reflect differences in national histories and in the political and social consensus which has grown out of them.

Regarding the potential of better corporate governance to contribute to financial stability, a conclusion similar to that for auditing and accounting seems in order. Improvements in this area can be expected to lead to better decision-making on several matters, but if they are based on principles similar to those enunciated by the OECD, they are likely to be gradual. Moreover, the better decision-making achieved in this way may have only limited effects on instability, which results from forces which corporate governance can mitigate but not eliminate. These forces include the pressures on loan officers to achieve target levels of profit in financial firms (a chronic problem, but one still not satisfactorily addressed in most firms' internal controls), weakness in even state-of-the-

art techniques for controlling credit, market and other financial risks, and psychological factors conducive to imitative and herd behaviour in the financial sector.

## 6. Insolvency

Insolvency rules are such a substantial part of corporate governance as defined above that they have generated a separate literature on the subject. There is general recognition that existing regimes for insolvency are characterized by widespread weaknesses, or indeed by their total absence in some situations and countries.[24] At the national level (particularly in many developing and transition economies), weakness is associated with problems regarding the enforcement of contracts, ineffective modalities for the netting, clearance and settlement of outstanding obligations, poorly functioning arrangements for the collateral and security of loans, and conflicts of law. All these features can pose serious problems for certain aspects of the valuation of firms and securities, and they can be a source of increased financial risk. Their presence in emerging markets can therefore be a significant deterrent to foreign investment.

The lead role in developing globally acceptable rules for insolvency has been attributed to the World Bank, whose objective is to develop an "integrated matrix" of components and criteria for such rules, highlighting existing best practices.[25] These elements are intended to be a complement of a country's legal and commercial system with guidance provided as to how they would interact with and affect the system. Consensus on them is to be developed through a series of assessment exercises and international insolvency symposia. The principal focus of the World Bank's initiative is national regimes in developing and transition economies.

The feedback from this process has led to a Consultation Draft organized into the following three parts: (i) legal, institutional, regulatory, and restructuring and rehabilitation building blocks; (ii) different categories of insolvency conditions such as systemic insolvency and that of banks and enterprises; and (iii) an international dimension concerned with encouraging developing and transition economies to take account of both international best practices and issues with a cross-border dimension in order to facilitate their access to international financial markets.

Improved insolvency rules have a more direct link to financial stability than many of the other subjects covered by the codes in table 4.1. Their main role under this heading is to help contain the problems due to the insolvencies of particular firms and to prevent broader contagion effects. The beneficial impact of this role obviously extends to cross-border lending and investment. However, as noted above, the focus of the initiative being led by the World Bank is on rules for developing and transition economies, even though cross-border insolvencies (i.e. insolvencies involving firms with business entities in more than one country) pose difficult problems of coordination and conflicts of law in developed countries as well. Here the danger is that the insolvency of a large firm with an extensive international network of entities could seriously disrupt cross-border transactions. A special threat is that posed by the possibility of the failure of a large multinational bank having a home jurisdiction in a developed country.[26] Most of the problems which would result from such a failure concern the cross-border dimensions of insolvency, and attempts to develop international rules are currently concentrated in other forums.[27]

The insolvency of a large firm with an extensive international network of entities could seriously disrupt cross-border transactions.

## 7. Securities regulation

The *Objectives and Principles of Securities Regulation*, published by IOSCO in September 1998, sets out three major objectives: the protection of investors; ensuring that markets are fair,

efficient and transparent; and the reduction of systemic risk. To achieve these objectives, it lists 30 principles covering responsibilities of the regulator, self-regulation, enforcement of securities regulation, cooperation in regulation domestically and internationally, the responsibilities of issuers, rules and standards for collective investment schemes, requirements for market intermediaries, and rules and standards for the secondary market. The principles explicitly related to systemic risk are covered mainly under the last two headings, and are concerned with capital and prudential standards for market intermediaries, procedures for dealing with the failure of a market intermediary, and systems for clearing and settling securities transactions which minimize such risk. In other words, the focus of the principles for reducing systemic risk is on measures directed at firms and market infrastructure.

Unsurprisingly for a code produced by a global organization of specialist regulators, these principles are concerned mainly with the fairness and efficient functioning of markets themselves. Connections to broader issues of macroeconomic policy and to policy towards the financial sector, both of which have been associated with systemic instability in developing and transition economies, are ignored. A more comprehensive and representative set of principles for securities markets – including issues highlighted by recent crises in developing and transition economies – should arguably address some aspects of policy towards the capital account of the balance of payments (such as appropriate conditions for the access of foreign portfolio investors) and the commercial presence of foreign investment institutions.

## 8. Insurance

Traditionally, insurance is not regarded as a source of systemic risk. Consequently, the principal objectives of its regulation and supervision are client protection and the closely related subjects of the safety and soundness of insurance companies and their proper conduct of business. This involves such matters as disclosure, honesty, integrity and competence of firms and employees, marketing practices, and the objectivity of advice to customers. The principal grounds for downplaying the systemic risks of the insurance sector are that companies' liabilities are long term and not prone to runs, while their assets are typically liquid. Moreover, mutual linkages among insurance companies and linkages between such companies and other financial firms are limited owing to the lack of a role for the former in clearing and payments and to the extent and depth of the markets where their assets are traded (Goodhart et al., 1998:14).

However, recently questions have been raised as to the adequacy of this characterization. This is partly due to the expanding role of the insurance sector in savings and investment products stemming from the close links between many kinds of life insurance policy and personal saving or investment instruments. The recent expansion in its turn is due partly to trends in the conglomeration of financial firms that have witnessed more widespread involvement of insurance companies in the sale and management of investment funds, on the one hand, and of banks in the insurance business, on the other. These trends have increased the possibility of contagion between insurance and other forms of financial business and, where large firms are involved, the scale of the possible adverse consequences of such contagion. In the case of developing and transition economies, an additional danger should be taken into account, namely, that the failure of one or more financial firms – including those with substantial insurance interests – may trigger a run on the currency. The resulting depreciation can have adverse consequences extending well beyond the sector where the problems originate.

The focus of the *Insurance Core Principles*[28] is the organization and practice of the sector's supervision, as well as the following sector-specific subjects: the corporate governance of insurance companies, their internal controls, prudential rules, conduct-of-business issues and the supervision of cross-border business. The prudential rules cover the management of an insurance company's assets, the identification and classification of liabilities, rules for capital requirements and for the use, disclosure and monitoring of derivatives and other off-balance-sheet items, and reinsurance as an instrument for risk containment. The principle covering the supervision of cross-

border business operations is designed to ensure that no cross-border insurance entity escapes supervision, and that adequate arrangements are in place for consultations and information exchange between such an entity's home-country and host-country supervisors. Thus the focus of the *Insurance Core Principles* is functional, while issues explicitly relating to the supervision of financial conglomerates are left to other forums (IAIS, 2000a).[29]

## 9. Market integrity and money laundering

Money laundering is one of the most politically sensitive subjects covered by the codes and principles listed in table 4.1. It is an area where financial supervision interfaces directly with law enforcement – including some of the latter's tougher manifestations – since the activities financed with laundered money include drug dealing and terrorism. Indeed, the attention given to money laundering reflects, to a significant extent, the political difficulties in major developed countries in dealing with the problem of drug consumption. The policies adopted here have focused mainly on repression of production and consumption as opposed to alternative approaches, with the result that profits from illegal supply remain high. Money laundering is also closely connected to corrupt activities in developed and developing countries since it is used for concealing the size, sources and recipients of the money involved in such activities. Generally accepted estimates of the global scale of money laundering do not yet exist, but there is no doubt that it is very large. Money laundering has long been an important issue in relations between OECD countries and offshore financial centres. However, some recent scandals indicate that it also remains a problem for countries with traditional financial centres.[30]

Money laundering has long been an important issue in relations between OECD countries and offshore financial centres. However, some recent scandals indicate that it also remains a problem for countries with traditional financial centres.

The principal international body entrusted with the task of combating money laundering is the Financial Action Task Force on Money Laundering (FATF),[31] established after the Group of Seven summit in 1989. Its current membership consists of 29 (mainly developed) countries and two international organizations – the European Commission and the Gulf Cooperation Council. In 1990, the FATF drew up a list of 40 recommendations which members are expected to adopt. These were revised in 1996 to take account of experience gained in the meantime and of changes in money laundering practices (FATF, 1999). Implementation by member countries of these recommendations is monitored on the basis of a two-pronged approach – an annual self-assessment exercise and periodic peer reviews of a member country by teams drawn from other members. More recently, the FATF has also conducted an exercise to identify jurisdictions deemed to be non-cooperative in the combat against money laundering (FATF, 2000). It clearly hopes that identification and the attendant publicity will prompt improvements in the 15 countries it has identified so far. In addition, its members have agreed to issue advisories to regulated financial institutions within their jurisdictions, requiring them to take extra care in business undertaken with counterparties in the 15 countries – an action that is likely to impose extra costs on such business.

The FATF's 40 recommendations include the following obligations: criminalization of the laundering of the proceeds of serious crimes; the identification of all customers and the keeping of appropriate records; a requirement that financial institutions report suspicious transactions to the competent national authority and that they develop programmes to counter money laundering, including comprehensive internal controls and employee training; adequate supervision of money laundering and the sharing of expertise by supervisors with other domestic judicial and law enforcement authorities; and the strengthening of international cooperation through information exchange, mutual legal assistance and bilateral and multilateral agreements. There are relations between the FATF's initiatives and others directed at offshore financial centres.[32]

For example, the harmful tax competition techniques for evading tax through recourse to offshore financial centres that are the subject of the OECD initiative (OECD, 2000d) are often the same as or similar to those used in money laundering. Likewise, "know your client" rules – a standard part of an effective regime for financial regulation – generally cover much the same ground as the FATF's requirements concerning customer identification. However, as in the case of other codes and principles discussed in this section, the contributions of the FATF's recommendations to international financial stability are mostly indirect.

Disclosures about involvement in money laundering have sometimes been associated with the failure of financial firms. However, money laundering – like the facilities offered by offshore centres – has played, at most, a marginal role in recent financial crises. Nevertheless, by making certain types of capital flight more difficult or costly, better control of money laundering can help restrain certain potentially destabilizing capital flows and accumulation of external debt not linked to legitimate economic activity. But the effectiveness of such restraint will depend on the degree of active cooperation between countries which are sources and recipients of laundered money. Rules on money laundering are therefore an essential component of regulatory regimes for financial firms; without them such regimes could scarcely be characterized as effective or comprehensive.

## C. Influence and participation in the formulation and implementation of standards

Since standards became an integral component of international financial reform, much emphasis has been placed on the importance of "ownership" of their adoption and implementation by the countries affected. Extensive consultation has taken place as part of the assessment of implementation now under way and the results can eventually be expected to affect the future development of the standards themselves. However, not all of the exercises under this heading have been free of asymmetries among the different parties involved. This has led, on occasion, to questions about fairness. Lack of symmetry, particularly in the degree to which developing countries' concerns are taken into account, is also evident in the selection of subjects to which some of the standards are to apply. This would appear, at least partly, to reflect divergences in viewpoints concerning the functioning of the international financial system and the issues appropriate for policy action.

"Ownership" is related to countries' perceptions of their national interest in the adoption and implementation of standards. Such perceptions can be assisted by the exchange of experiences in forums such as the multilateral financial institutions and the standards-setting bodies, providing the opportunity to contribute to standards setting, alignment of programmes for standards implementation with domestic agendas for financial reform, and encouraging and aiding self-assessment (FSF, 2000a: 2). The promotion of country ownership is an objective of outreach programmes on standards implementation (IMF, 2000e), which operate through vehicles such as technical assistance, workshops and regional meetings. These activities have also involved the IMF and the World Bank, institutions with relevant expertise such as supervisors from major industrial countries, and others participating in processes of peer review.

The asymmetries mentioned above are not omnipresent and are not always easily identified, since they are often woven into basic assumptions or categories underlying the standards in table 4.1. The bias in some of the Codes towards subjects likely to be of greater concern to developed countries often reflects the historical origins of the initiatives in question. Much of the cross-border business affecting the subjects covered was traditionally between parties in industrial countries, with developing countries' involvement being only fairly recent. Yet despite their increasing prominence in this context, certain concerns of developing countries appear to have been set aside during standards formulation and their interests ignored or downplayed during the follow-up. Moreover, parts of policy documents, the issuance of which has coincided with the standards initiatives – and which treat important parts of their rationale – in some cases substantially reflect official viewpoints in major developed countries, as evident from recent reports of the FSF.

Certain concerns of developing countries appear to have been set aside during standards formulation and their interests ignored or downplayed during the follow-up.

For example, the report of the FSF's Working Group on Capital Flows (FSF, 2000b) focuses mainly on improved risk-management practices and enhanced transparency on the part of private and public sectors in countries receiving international lending and investment as the principal means of countering the instability of these flows.[33] The report also identifies various biases or incentives in the policies of recipient countries that are likely to lead to excessive dependence on short-term (and thus potentially volatile) inflows. But it downplays the impact of the behaviour of lenders and investors in developed countries as well as the effects of macroeconomic policies in these countries on capital flows to developing and transition economies. The report gives considerable attention to improvements in the provision and use of official statistics and of information in financial reporting by the private sector in recipient countries. However, it shies away from endorsing a requirement for frequent disclosure of data on the large short-term positions in assets denominated in a country's currency held by foreign firms other than banks (a category that includes hedge funds), which several developing (and some developed) countries perceive as threats to the stability of their exchange rates and financial markets.

Similarly, the report of the FSF Working Group on Highly Leveraged Institutions (HLIs)[34] has tended to play down widely expressed concerns of certain countries in some of its policy recommendations (FSF, 2000c). This Working Group distinguished between two broad groups of issues posed by HLIs: systemic risks (of the kind exemplified by the collapse of Long Term Capital Management (LTCM)), on the one hand, and "market dynamics issues" (i.e. the amplification of instability and the threats to market integrity which may result from HLIs' operations in "small- and medium-sized open" economies), on the other. The systemic risks which may be caused by HLIs are naturally of concern to developing and transition economies. Like other participants in international financial markets, for example, they were affected by the increases in risk premiums and the sharply reduced availability of financing in late 1998, to which the collapse of LTCM contributed. Nevertheless, their special concerns are related more to the "market dynamics issues".

The Working Group conducted an examination of "market dynamics issues" in the experiences of six economies during 1998.[35] Its conclusions amounted to a qualified endorsement of concerns which had been expressed regarding HLIs. Thus the capacity of HLIs to establish large and concentrated positions in small- and medium-sized markets was acknowledged, and with this, their potential to exert a destabilizing influence. But there was less consensus as to the importance of their influence in comparison with other factors during particular instances of instability in the different economies during 1998. Similar conclusions were reached regarding the threat to market integrity posed by some aggressive practices attributed to HLIs, such as heavy selling of currencies in illiquid markets, dissemination of rumours about future developments, selective dis-

closure of information about firms' positions and strategies, and correlated position-taking in the markets for different assets within a country and also across currencies with the objective of achieving profitable movements in relative prices.[36] Here, too, the capacity of HLIs to engage in such practices was recognized, but there was less agreement as to its significance at different times and in different countries.

The major thrust of the Working Group's recommendations is directed at reducing the systemic risk HLIs are capable of causing rather than at "market dynamics issues". The recommendations, directed primarily at systemic risk, have many connections to those of official bodies and industry groups of major industrial countries surveyed at some length in an annex to the report. These include: stronger risk management by both HLIs and their counterparties; enhanced regulatory oversight of HLIs' credit providers; further progress in industry practices with regard to such aspects as the measurement of exposures and of liquidity risk, stress testing, collateral management and external valuation, as well as in building market infrastructure in areas such as the harmonization of documentation, valuation and bankruptcy practices. In addition, the Working Group recommended fuller public disclosures by HLIs in the context of a movement towards improved and more comparable risk-based public disclosure by financial institutions more generally.

Most of these recommendations are capable of having beneficial effects on "market dynamics issues" and of reducing systemic risk. However, the Working Group limited itself to two recommendations of particular relevance to the former subject. The first recommendation aims at strengthening some kinds of surveillance of activity in financial markets at the national level with a view to identifying rising leverage and other concerns relating to market dynamics that may require preventive measures. The second aims to promote guidelines of good practice for currency trading with the support of leading market participants who would review and, as necessary, revise existing codes and guidelines in this area in the light of concerns recently expressed about trading behaviour.

Underlying the second of these two recommendations is a recognition of the absence in most emerging financial markets of guidelines and codes of conduct for trading practices, such as are issued in most major financial centres by trade associations, industry groups and committees of market participants. The recommendation is that major financial institutions should take the initiative in preparing and promoting codes and guidelines for jurisdictions where they currently do not exist. If this recommendation is to be effective, it must not only lead to industry initiatives of the kind envisaged, but also to changes in actual behaviour, even though such guidelines and codes lack legal weight.

Regarding surveillance and transparency concerning market positions, the report on HLIs is more forthcoming than that on capital flows, though the somewhat veiled character of the exposition renders the nature of the different options considered, and the Group's view on their associated pros and cons, hard to grasp precisely. The collection of aggregate high-frequency information on positions in key markets is not accepted on the grounds of feasibility, cost and difficulties in obtaining compliance.[37] National initiatives involving proactive surveillance between monetary authorities, supervisors and market participants receive greater support from the Working Group, but subject to reservations and doubts concerning such matters as the costs and benefits of, and international participation needed for, disclosure of information on positions in major emerging-market currencies. Some surveillance of this kind (but possibly mainly of an informal nature) presumably already exists in several countries, since it would appear to have been the source of part of the information contained in the report's survey of the experience of HLIs' operations in six jurisdictions. The strongest reservations of the Report in this area concern enhanced oversight by national authorities of the provision of local currency, which is necessary for the settlement of the great majority of speculative positions against a currency. These reservations are due primarily to the Working Group's view that formal procedures for this purpose constitute capital controls.

The unavoidable conclusion regarding the Working Group's recommendations on "market dynamics issues" is that they fall well short of symmetry. Although they recognize the concerns recently expressed about HLIs' practices in this

area as legitimate, they devote much more attention to the obligations for transparency sought from economic actors in developing and transition economies as part of international financial reform.

Asymmetries in the assessment procedures associated with the standards initiatives are also exemplified in another report of the FSF (2000d), that of its Working Group on Offshore Centres (OFCs).[38] In the context of international financial reform, there is concern that, although OFCs do not seem to have been a major cause of systemic problems so far, they might become so in the future. This is because of the growth in the assets, liabilities and off-balance-sheet activities of institutions based in OFCs, as well as growing interbank relations. In particular, the fear is that OFCs could prove an important source of contagion. The terms of reference of the Working Group included a general stock-taking of the use made of OFCs, and, more particularly, a review of their progress in enforcing international prudential and disclosure standards, and in complying with international agreements on the exchange of supervisory information and other information relevant to combating financial fraud and money laundering.

Smooth progress in global initiatives on standards requires a perception of even-handedness regarding different aspects of their application among all the parties involved.

For this purpose, the Working Group organized a survey of OFCs that aimed at assessing compliance with the international standards of supervision established by the BCBS, the IAIS and IOSCO (i.e. with standards for the banking, insurance and securities business). The survey was conducted through two questionnaires – one for onshore supervisors in 30 major financial centres and the other for 37 OFCs. The first questionnaire was designed to elicit views on the quality of regulation and supervision in those OFCs with which the onshore supervisors had some degree of familiarity, and on the quality of cooperation they had experienced with OFC supervisors. The second questionnaire was intended to provide information on how these OFCs interacted with the home supervisors of suppliers of financial services operating in or from their jurisdictions (i.e. branches, subsidiaries or affiliates of suppliers incorporated in an onshore jurisdiction). The survey was the basis of a classification of OFCs into three groups: (i) those generally viewed as cooperative, with a high quality of supervision, which largely adhered to international standards; (ii) those generally seen as having procedures for supervision and cooperation in place, but where actual performance fell below international standards and there was substantial room for improvement; (iii) those generally seen as having a low quality of supervision and being non-cooperative with onshore supervisors (or both), and as making little or no attempt to adhere to international standards. However, several supervisors in OFCs considered that the procedures followed in this exercise had provided them with an inadequate opportunity for self-assessment of their regulatory regimes and of the quality of their supervision. Providing OFCs with such an opportunity would have been in better accord with the spirit of the report's proposals concerning the future programme for assessment of standards implementation on the part of OFCs. One of the stages specified is self-assessment assisted by external supervisory expertise (FSF, 2000d: 56–60). As a class, OFCs do not arouse much sympathy within the international community. However, smooth progress in global initiatives on standards requires a perception of even-handedness regarding different aspects of their application among all the parties involved.[39]

## D. Implementation, sanctions and incentives

Implementation of standards is a process with several dimensions and stages. The first step specified in the strategy of the FSF Task Force (FSF, 2000a, sect. III) is to identify and achieve international consensus on standards. This is followed by a prioritization exercise so that the process of implementation becomes manageable – an exercise which has led to the list of key standards in table 4.1. Action plans at the national level then need to be drawn up. The primary agents involved here are national governments, which consult multilateral financial institutions and standard-setting bodies as necessary and can receive technical assistance of various kinds. Once implementation of plans is under way, it is subject to assessment, partly by the relevant national authorities themselves, but also by multilateral financial institutions, standard-setting bodies, and possibly other parties; technical assistance is also provided under this heading. Another integral part of the process of implementation is the dissemination of information on progress, in particular, to market participants such as lenders and investors.

Implementation is also to be promoted by official and market sanctions and incentives, which have many mutual links.[40] One important example on the official side is the technical assistance already mentioned. Others might involve the inclusion of standards implementation in policy surveillance (closely linked to assessment exercises), conditions attached to official financing (especially that of multilateral financial institutions), and taking into account the observance of standards in decisions on eligibility for membership of international bodies and in regulatory and supervisory decisions in host countries with respect to a country's financial firms abroad. In some of these cases the FSF Task Force is endorsing actions already taken or is advocating further steps in the direction of such actions. But in others the sanctions and incentives put forward have not yet been the subject of official decisions and the Task Force itself has expressed its awareness of possible drawbacks.

One of the conditions for a country's eligibility for financing through the IMF's Contingency Credit Line is a positive assessment of its progress in adhering to internationally accepted standards.

In terms of actions already taken, implementation of financial standards is now included in the IMF's policy surveillance under Article IV (which takes account of the conclusions of the FSAP mentioned in subsection B.2). One of the conditions for a country's eligibility for financing through the IMF's Contingency Credit Line (CCL)[41] is a positive assessment during the most recent Article IV consultations of its progress in adhering to internationally accepted standards. There are also indications of pressure to link standards implementation to the conditions associated with other IMF facilities. In particular, steps to implement and observe specific standards have been included in some IMF country programmes. Finally, the granting of market access to a foreign financial firm in several countries is already conditional on the standard of supervision in its home country, and the incentive put forward by the Task

Force would presumably reinforce such conditions.

Possible official sanctions and incentives which are not currently in place and would not represent extension or reinforcement of existing policies include various measures. Membership of bodies such as IOSCO, the Basel-based bodies concerned with financial regulation and supervision, or the OECD might be linked to progress in standards implementation. But this, as the FSF Task Force notes, could actually have the perverse effect of removing a source of peer pressure. Risk weights in setting prudential capital requirements for borrowing counterparties could be differentiated in accordance with the observance of standards in the jurisdictions where they operate. This presupposes effective assessment of compliance, which is not yet in place and may prove difficult to achieve in some cases. Nonetheless, steps in this direction are part of some proposals currently under consideration (see box 4.1).[42] Supervision could be tightened and other regulatory actions taken regarding the subsidiaries or branches of foreign financial firms whose home supervisors are in countries where implementation of standards is weak. Such actions might include restricting inter-affiliate transactions and increasing scrutiny of customer identification, for example. As the FSF notes, this would require disclosure to supervisors in host countries of all pertinent information concerning compliance with the standards in question. Another challenge would be to achieve a level of coordination sufficient to avoid regulatory arbitrage among financial centres.

Assessment of the effectiveness and appropriateness of official and market sanctions and incentives in standards implementation has now commenced. The FSAP[43] and IMF Article IV surveillance will inevitably play a key role in the former. Among the subjects of surveillance would be progress in standards implementation under the heading of the strength of the financial sector more generally. The extensive – and thus resource-consuming – process of assessment should itself be subject to continuing evaluation by a body which needs to keep a certain distance from the assessors. This may prove to be one of the key roles for the FSF, though one possibly complicated by membership in it of important institutions responsible for this assessment.

Market participants considered observance of the standards less important than the adequacy of a country's legal and judicial framework, political risk, and economic and financial fundamentals.

Market sanctions and incentives are to depend most importantly on market participants' use of information on an economy's observance of standards in their risk assessment. Such information is then reflected in differentiated credit ratings, spreads for borrowers, exposure limits and other lending and investment decisions. If these sanctions and incentives are to work, the key requirements are: (i) that market participants be familiar with international standards; (ii) that they judge them to be relevant to their risk assessments; (iii) that they have access to information on their observance; and (iv) that this information be deployed as an input in their risk assessments (FSF, 2000a). Official assistance to the operation of market sanctions and incentives can take the form of promoting disclosure of relevant information as well as pressures on, and encouragement to, market participants to take account of standards observance in their decisions.

The effectiveness of market sanctions and incentives depends on their incorporation into market practices. Although experience so far has been of a short duration, the FSF has sought feedback from market participants to enable preliminary conclusions on the effectiveness of such sanctions and incentives, most importantly in the form of an informal dialogue with participants from 100 financial firms in 11 jurisdictions (FSF, 2000e, sect. III).[44] This outreach exercise revealed only limited awareness of the 12 key standards in table 4.1, though the degree of awareness varied, being greatest for the Special Data Dissemination Standard (SDDS) and International Accounting Standards (IAS). Few market participants took account of an economy's observance of the standards in their lending and investment decisions, although observance of the SDDS was found to

**Box 4.1**

**BASEL CAPITAL STANDARDS**

The Basel Capital Accord of 1988 was the result of an initiative to develop more internationally uniform prudential standards for the capital required for banks' credit risks. The objectives of the Accord were to strengthen the international banking system and to promote convergence of national capital standards, thus removing competitive inequalities among banks resulting from differences on this front. The key features of this Accord were a common measure of qualifying capital, a common framework for the valuation of bank assets in accordance with their associated credit risks (including those classified as off-balance-sheet), and a minimum level of capital determined by a ratio of 8 per cent of qualifying capital to aggregate risk-weighted assets. In subsequent years, a series of amendments and interpretations were issued concerning various parts of the Accord. These extended the definition and purview of qualifying capital, recognized the reductions in risk exposure which could be achieved by bilateral netting meeting certain conditions, interpreted the Accord's application to multilateral netting schemes, allowed for the effects on risk exposure of collateralization with securities issued by selected OECD public-sector entities, and reduced the risk weights for exposures to regulated securities firms. Simultaneously, the Basel Committee continued its work on other banking risks, of which the main practical outcome so far has been the amendment of the 1988 Accord to cover market risk, which was adopted in 1996. The 1988 Basel Accord was designed to apply to the internationally active banks of member countries of the Basel Committee on Banking Supervision, but its impact was rapidly felt more widely; by 1999 it formed part of the regime of prudential regulation not only for international, but also for strictly domestic banks, in more than 100 countries.

From its inception, the 1988 Basel Accord was the subject of criticism directed at such features as its failure to make adequate allowance for the degree of reduction in risk exposure achievable through diversification, the possibility that it would lead banks to restrict their lending, and its arbitrary and undifferentiated calibration of certain credit risks. In the case of country risk, with very limited exceptions this calibration distinguished only between OECD and non-OECD countries – a feature of the Accord which some developing countries considered unjustifiably discriminatory. In the aftermath of the financial crises of the 1990s, the Accord's contribution to financial stability more generally became a focus of attention. There was special concern here with regard to the incentives which the Accord's risk weighting was capable of providing to short-term interbank lending – a significant element of the volatile capital movements during these crises.

The Basel Committee responded by initiating a comprehensive overhaul of the 1988 Accord. Its first proposal for this purpose (*A New Capital Adequacy Framework* – henceforth New Framework), published in June 1999 (BCBS, 1999b), incorporates three main elements or "pillars": (i) minimum capital rules based on weights that are intended to be more closely connected to credit risk than those of the 1988 Accord; (ii) supervisory review of capital adequacy in accordance with specified qualitative principles; and (iii) market discipline based on the provision of reliable and timely information. In early 2001 (as this *TDR* was completed), a revised set of proposals was issued that is designed to take account of comments by the banking industry and supervisors around the world.

The New Framework contains two basic approaches to the numerical standards for capital adequacy: the standardized and the internal-ratings-based approaches. A major feature of the standardized approach is the proposal for recourse to the ratings of credit rating agencies in setting weights for credit risk. The New Framework's proposal regarding the internal-ratings-based approach is still tentative and will require adequate safeguards concerning such matters as the calibration of risk and comparability. However, the approach is likely to be an option in the revised proposals for banks with sufficiently sophisticated systems for handling credit risk.

The New Framework's proposal for recourse to the ratings of credit rating agencies in setting weights for credit risk has proved highly contentious. Perhaps most importantly, there is a widespread view that the track record of the major agencies, especially with respect to identifying the probability of serious threats to the debt-service capacity of, or defaults by, sovereign borrowers,

***Box 4.1 (concluded)***

is not good enough to justify reliance on them for setting weights for credit risk. Much recent criticism has focused on the agencies' performance during the Asian debt crisis. A notable feature of this crisis was the large and swift downgrading of some of the countries affected. Thus a major concern here is that, if credit rating agencies' announcements simply parallel changes in market sentiment or, still worse, actually follow such changes, they are capable of exacerbating fluctuations in the conditions in credit markets and thus financial crises. Recourse to agencies' ratings for credit-risk weighting might result in the new capital standards, on occasion, actually exacerbating the instability of bank lending.

Statistical studies[1] of the effects of rating agencies' announcements concerning creditworthiness on countries' borrowing costs show a strong correlation between such announcements and the spreads on dollar-denominated bonds above the yields of United States Treasury bonds of the same maturity. But mere correlation does not settle questions regarding the nature of the role of agencies during fluctuations in credit conditions. Only if the announcements of credit agencies concerning changes in creditworthiness preceded changes in market conditions would it seem reasonable to attribute to them an effective *ex-ante* capacity to rate credit risk. However, the results of research on the subject provide weak support for this proposition. Indeed, the findings of this research help to explain widespread opposition in official circles to major agencies' ratings for setting banks' minimum capital levels (and not only those in developing and transition economies), an opposition which, it should be noted, is apparently matched by some reluctance among the agencies themselves to assume such a responsibility.

There is also concern about the expansion in the use of agencies' ratings for the purposes of economic policy. The ratings of major rating agencies already have a role in the regulatory framework of a number of countries. In the United States, for example, they are used to distinguish investment grade from speculative securities for various purposes such as rules governing the securities holdings of banks and insurance companies. Nonetheless, the proposals of the New Framework would substantially extend the influence of major rating agencies and could easily lead to increased official regulation and oversight.

Other questions have focused on the coverage of major agencies' ratings in the context of their use of credit-risk weighting. Even in the European Union, according to provisional estimates of the European Commission, coverage of the major credit rating agencies is limited to less than 1,000 corporates. In India, to take a developing-country example, in early 1999, out of 9,640 borrowers enjoying fund-based working capital facilities from banks, only 300 had been rated by any of the major agencies (Reserve Bank of India, 2000: 13–14). Of course, as noted above, the New Framework envisages internal-ratings-based approaches to the setting of banks' credit-risk weights as an alternative to recourse to the ratings of credit rating agencies for sufficiently sophisticated banks. But other banks might still need to make extensive use of the New Framework's proposed risk weightings for unrated exposures. In view of the unsatisfactory character of this alternative, there have been calls for greater emphasis in the Basel Committee's revised proposals on recourse to the ratings of domestic (as opposed to major international) rating agencies – a proposal not in fact excluded from the New Framework so long as the agencies in question meet certain minimum criteria.

As for the promotion of greater stability in international bank lending through incentives to tighter control over short-term interbank exposures, the proposals of the New Framework are widely regarded as still inadequate. This is because, under one of the options for credit-risk weighting, exposures with an original maturity of up to six months to banks within a broad range of credit ratings would be attributed a weighting more favourable than those with longer maturities (subject to a floor). In the light of recent experience, a more restrictive approach to short-term interbank claims may indeed be required.

---

[1] These studies are summarized in Cornford (2000b, sect. VI.A).

influence economies' credit ratings. Generally, market participants considered observance of the standards less important than the adequacy of a country's legal and judicial framework, political risk (often rated as more important than regulatory or supervisory risk), and economic and financial fundamentals. Rating agencies, which tend to be better acquainted with both the standards and the assessment exercises undertaken so far, nonetheless considered that their direct access to national authorities provided them with a better understanding of the quality of regulation and supervision, of policy and data transparency, and of market infrastructure.[45]

It is too early to make more than a highly preliminary evaluation of standards implementation and of the effectiveness of incentives. The large potential costs of the administrative burden associated with implementation and assessment are widely acknowledged. But the effectiveness of measures proposed to alleviate this burden has yet to be proved. In the case of the official sanctions and incentives mentioned above, many are still only being considered and not all will necessarily be adopted. The inclusion of standards implementation in IMF conditionality is still at an early stage, and its extension in this area remains highly contentious. The impact of market sanctions and incentives on standards is likely to take time. This is indeed reflected in the feedback from market participants concerning factors that override standards observance in their decisions. For example, market participants' reference to the overriding significance of the quality of the legal and judicial framework – one of the targets of the standards – should be viewed in the light of the length of time required for the standards to have an impact. Similar considerations apply in varying degrees to political risk (where market participants cited the threat of nationalization and policy reversals) and economic and financial fundamentals. Regarding incorporation of standards observance as a factor in the decision-making processes of market participants, there is a chicken-and-egg problem, at least in the medium term. By taking account of standards observance in their lending and investment decisions, market participants are supposed to make an important contribution to such observance. However, during the early stage of standards observance, its impact on the determinants of creditworthiness and the investment climate is at most still superficial. This means that market participants will continue to rate this subject as being of limited importance, and it will, therefore, have a correspondingly low weight in their lending and investment decisions.

## E. Standards, financial regimes and financial stability

As already mentioned, the improvements described in previous sections will entail extensive changes for many countries, and their implementation could be lengthy. This is particularly true of the required reforms in the legal and regulatory framework and of their incorporation into the norms of business practice, which is a prerequisite for receiving the full benefit of these reforms. The gradual and difficult nature of this process for developing and transition economies should not be taken as a reflection on their legislative and administrative competence or their political will. For example, the process of deregulating financial sectors in OECD countries or of putting in place a single-market regime in the European Union for the banking and securities business – both processes involving obstacles and constraints similar to those confronting the global regimes of financial standards – took decades.[46]

The limits on the efficacy of enhanced standards and associated legal and regulatory reforms reflect various factors. One of these is the rootedness of standards in past experience, which makes them less than perfect for dealing with the consequences of innovation. Moreover, many of the standards covered by recent initiatives are directed at the behaviour of economic agents and the functioning of firms and markets. Stronger foundations at this level can reduce – but not eliminate – the likelihood and magnitude of systemic instability. Malpractice and fraud may become easier to detect as standards are enhanced, but they will not disappear. The collapse of Barings in early 1995 is an example of the broader destabilizing potential of events originating in malpractice within a single firm. More importantly, systemic crises in the financial sector are often closely linked to macroeconomic dynamics and to developments at the international level – or regional level within a country – which transcend particular national financial sectors. A Utopian vision of standards might include standards for macroeconomic policy designed to put an end to phenomena such as boom-bust cycles, which historically have frequently proved to be the financial sector's nemesis. But, as already noted in subsection B.1, the codes of good practices regarding various aspects of macroeconomic policy in table 4.1 concern transparency and procedural issues, and not the contents of such policy itself.

The crucial field of banking supervision illustrates the limitations of standards. A natural starting-point here is the licensing of banks. In some countries the relevant criteria were long designed primarily to ensure adequate levels of competence and integrity among those owning and controlling a bank. But licensing is often also used to serve less limited objectives, such as the avoidance of "overbanking", limitation of financial conglomeration, and (in the case of foreign entities) restricting foreign ownership of the banking sector, or ensuring that the parent institution is adequately supervised in its home country. The objectives of licensing may have (usually proximate) relations to banking stability, but they cannot prevent serious banking instability or banking crises. Another major subject of banking supervision is implementation of prudential regulation, much of which is concerned with ensuring adequate management and internal controls, but which also includes prudential capital requirements.[47] A key purpose of capital here is to pro-

vide a stable resource to absorb any losses incurred by an institution, and thus protect the interests of its depositors. Capital requirements for credit and market risks are also clearly intended to contribute to financial risk management of assets and liabilities, as well as to appropriate pricing of the different products and services which a bank offers. Prudential capital, by strengthening financial firms, reduces the likelihood of major financial instability originating in the failure of a single firm. It also increases such firms' defences against instability originating elsewhere. However, its contribution to restraining financial instability stops here. Other prudential guidelines or rules are directed at subjects such as exposure to foreign-exchange risks, risks due to large exposures to single counterparties or groups of related counterparties, adequate liquidity, loan-loss provisions, consolidated financial reporting and country exposures. These guidelines and rules serve the same objectives as prudential capital, and their efficacy is subject to the same limitations.

These limitations are explicable, at least in part, in terms of the considerations raised above concerning standards more generally. Financial regulation is constantly struggling to keep up with financial innovation, and in this struggle it is not always successful. There is thus a continuing danger that new practices or transactions, not yet adequately covered by the regulatory framework, may prove a source of financial instability. Closely related in many ways to financial innovation, are difficulties – which have become more important in recent years – regarding the transparency required for regulation and supervision. The balance sheets of many financial firms have an increasingly chameleon-like quality which reduces the value of their financial returns to regulators. Consequently, the tensions between financial innovation and effective regulation in modern financial markets are unlikely to disappear. In principle, one can envisage a tightening of regulation sufficiently drastic as to come close to eliminating the dangers due to innovation. However, the tightening would be too stifling to be politically acceptable in any country that values dynamism in its financial sector.

Financial regulation is constantly struggling to keep up with financial innovation, and in this struggle it is not always successful.

Probably the most important determinant of the intrinsic limitations of regulation and supervision is the unavoidable dependence of financial stability on macroeconomic stability more generally.[48] Most assets of banks are susceptible to changes in their quality resulting from broader changes in economic conditions. So long as cycles of financial boom and bust are features of the economic system, so also will be unforeseeable deteriorations in the status of many bank assets.[49] Where banking crises are combined with currency crises, and cross-border as well as domestic financing contributes to the boom (as in many recent instances involving developing economies), the process is fuelled by forces similar to those that characterize purely domestic credit cycles. These include herd behaviour of lenders and investors, driven partly by the very conditions their lending and investment have helped to create, but also by competition within the financial sector. Other forces include the all too ready acceptance, for example, of benchmarks resulting from collective behaviour, poor credit evaluation (often exacerbated in the case of cross-border financing by less familiarity with the borrowers and their economies), and the pressures on loan officers resulting from target returns on capital. An important distinctive feature of boom-bust cycles with a cross-border dimension is another macroeconomic factor – the exchange rate. Capital inflows generally come in the first place in response to exchange-rate adjusted returns, and thus on assumptions about the stability of the exchange rate. The outflows are in most cases associated with movements in contradiction with these assumptions, in the form of a large depreciation of the currency. This often has devastating effects on the net indebtedness and income of many domestic economic actors.

In thinking about the interaction between broader types of financial instability and difficulty in controlling financial risks, as experienced in the internal controls of banks as well as in their supervision, the concept of "latent concentration risk" (used in some recent literature on credit risk to denote problems due to unpredictable correla-

tions between defaults) can be an illuminating one. This concept also serves to pinpoint relations between uncertainty, on the one hand, and the limitations of banking supervision, on the other.[50] Concentration risk is traditionally handled in the context of banking regulation and supervision through limits on the size of exposures to particular borrowers. For this purpose, "borrower" is typically defined to include groups of counterparties characterized by links due to common ownership, common directors, cross-guarantees, or forms of short-term commercial interdependency. But boom-bust cycles bring into focus risks due to latent concentration, as they lead to deterioration in the economic positions of counterparties apparently unconnected in other, more normal, times. Indeed, a common feature of the boom-bust cycle would appear to be exacerbation of the risk of latent concentration as lenders move into an area or sector *en masse* prior to attempts to exit similarly. To some extent, the risks of latent concentration can be handled through prudential measures, such as banks' general loan-loss reserves and capital requirements for credit risk, but there are limits to the efficiency of such measures. ■

## Notes

1 The Financial Stability Forum was established by the finance ministers and central bank governors of the Group of Seven in February 1999 to promote international financial stability through improved exchange of information and cooperation with respect to financial supervision and surveillance. Its membership consists of the national authorities responsible for financial stability in selected OECD countries, Hong Kong (China) and Singapore, and major international financial institutions, international supervisory and regulatory bodies and central-bank expert groupings.

2 An example of such dangers was furnished by the large-scale withdrawal of funds from and subsequent bankruptcy of two Deak and Co. subsidiaries (Deak Perera Wall Street and Deak Perera International Banking Corporation) in response to information in a 1984 report of the United States Presidential Commission on Organized Crime concerning Deak Perera's involvement in money laundering.

3 This part of the rationale for standards is particularly emphasized in Drage, Mann and Michael (1998:77–78).

4 The distinction between banking regulation and supervision in the literature is not particularly clearcut. But regulation can be taken roughly to refer to rules, both those set out in banking legislation and those referring to the instruments and procedures of the competent authorities. Supervision refers to implementation including licensing, ongoing off-site and on-site supervision of institutions, enforcement and sanctioning, crisis management, the operation of deposit insurance, and procedures for handling bank insolvencies. These distinctions follow closely those in Lastra (1996: 108).

5 The BCBS comprises representatives of the central banks and supervisory authorities of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and United States. For an account of the acceptance of the BCBS's standards beyond its membership, primarily in relation to prudential standards for bank capital, see Cornford (2000b, sect. III).

6 For a discussion of these assessments of compliance, see IMF (2000d).

7 The members of the CPLG are from Argentina, Australia, Brazil, Chile, China, Czech Republic, Commission Bancaire de l'Union Monétaire Ouest Africain, France, Germany, Hong Kong (China), India, Italy, Japan, Mexico, Netherlands, Republic of Korea, Russian Federation, Saudi Arabia, Singa-

pore, South Africa, United Kingdom and United States. In addition, the CPLG has representatives from the European Commission, the Financial Stability Institute, the IMF and the World Bank.

8 This is recognized in the IMF paper cited above concerning the experience of the early assessment exercises as follows: "Due to lack of manpower and time, the assessments are not always as in-depth as warranted to identify all the underlying weaknesses. It is also difficult to obtain a thorough understanding of the adequacy of supervisory staff numbers and skills, as well as the skills of commercial bankers. A genuine assessment of bank supervision requires in-depth on-site review – including interviews with supervisors and bankers – resulting in well-researched judgements on institutional capacity and supervisors' concrete achievements" (IMF, 2000d, para. 57).

9 In 1996, for example, before the outbreak of the East Asian financial crisis, the ratio of capital to risk-weighted assets in the Republic of Korea, according to official estimates, was above 9 per cent. However, if accounting rules closer to international norms had been used, non-performing loans for the sector as a whole would have exceeded its combined capital funds (Delhaise, 1998: 115). By the mid-1990s, in a number of countries affected by the crisis, the capital standards of the 1988 Basel Accord were part of the legal regime for banks (*TDR 1998*, Part One, chap. III, box 3). But in the absence of proper rules for the valuation of banks' assets, this standard had little meaning for many of the institutions to which it was supposed to apply.

10 For a survey of banks' accounting practices and other financial reporting under regulatory regimes in 23 mainly industrial countries that highlights the prevalence and extent of shortfalls from international best practice in the first half of the 1990s, see Cornford (1999, sect. III).

11 This framework for analysing policies aimed at the stability of the financial sector is frequently deployed by William White of the BIS (White, 1996: 23).

12 Traditionally, such transactions have depended on national payment systems for the transfer of funds between correspondent banks of the countries whose currencies are involved. For example, in the case of a cross-border payments order transmitted between banks through SWIFT (Society for Worldwide Interbank Financial Telecommunication – a private company which transmits financial messages for the benefit of its shareholding member banks and of other approved categories of financial institutions in 88 countries), the banks must arrange the clearing and settlement themselves, either relying on mutual bilateral correspondent relationships or forwarding the orders to domestic systems for interbank fund transfers. Many major banks have introduced "straight-through processing", in which there is an automated linkage between their SWIFT connection and their computers linked to the domestic payments system (BIS, 1997: 482–485). More recently there has been growth in the direct settlement of foreign exchange transactions between parties in different jurisdictions through systems processing payments in more than one currency.

13 IOSCO is a grouping of securities regulators (both governmental and self-regulatory bodies) from more than 90 countries. Created in 1984, it is a private, non-profit organization whose main objectives are cooperation for better market regulation, information exchange, standard setting, and mutual assistance in the interest of protecting market integrity.

14 For a commentary on the Core Principles and discussion of the initiative's background, see Sawyer and Trundle (2000). (John Trundle of the Bank of England was chairman of the Task Force which drew up the Core Principles.)

15 More specifically, the initiative was a response to the conclusion in the report of an ad hoc working party on financial stability in emerging market economies, set up after the 1996 summit of the Group of Seven, concerning the essential role of sound payment systems in the smooth operation of market economies, as well as to growing concern regarding the subject among emerging market economies themselves. See mimeograph document of the Working Party on Financial Stability in Emerging Market Economies*, Financial stability in emerging market economies: A strategy for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems* (April 1997, chap. II).

16 In a multilateral netting arrangement a participant nets obligations vis-à-vis other participants as a group throughout a specified period (typically a day), and then settles the debit or credit balance outstanding at the end of this period through the arrangement's common agent.

17 Part 2 was a response to widespread comments elicited by Part 1 that more detail on interpretation and implementation was needed.

18 This Programme is aimed at assessing the vulnerabilities of countries' financial sectors and identifying priorities for action, partly in the light of internationally agreed standards for these sectors.

19 The IASC was created in 1973 by major professional accounting bodies and now includes more than 130 such bodies from more than 100 countries. The entities concerned with international accounting standards include not only professional accounting bodies, international accounting firms, transnational corporations and other international lenders and investors, but also other bodies such as international

trade unions concerned with cross-border business activities.

20 A 1997 study of the United States Financial Accounting Standards Board (FASB) identified 255 variations between United States and international standards, many of which were judged as significant. See Scott and Wellons (2000: 67). For a more extended discussion of the *IASC-US Comparison Project*, which was the source of this finding, see Grossfeld (2000).

21 Specific topics identified as the most difficult for the achievement of reconciliation and understanding among countries in a survey of institutional investors, firms, underwriters and regulators in the first half of the 1990s (quoted in Iqbal, Melcher and Elmallah, 1997: 34) were the following: accounting for goodwill, deferred taxes, inventory valuation, depreciation methods, discretionary reserves, fixed-asset valuation, pensions, foreign currency transactions, leases, financial statement consolidation and financial disclosure requirements.

22 IFAC was established in 1977 to promulgate international standards in auditing and closely related subjects. IFAC and IASC have an agreement of "mutual commitments" for close cooperation and mutual consultations, and membership in one automatically entails membership in the other.

23 This point is forcefully made with the support of a wealth of case studies from the business history of the United States in Kennedy (2000, part 1).

24 The arrangements proposed below, in chap. VI, sect. B, for orderly workouts in the case of cross-border debt depend, for their functioning, on adequate national insolvency regimes.

25 The account which follows relies heavily on the Group of Thirty (2000, chap. 2, sect. 1).

26 This point was made recently in an OECD publication: "The incidence of banking crises, and the costs these have imposed on countries, is quite large and the systemic consequences of the failure of a large institution are of a different order of magnitude from those associated with the failure of smaller institutions. In particular, the costs of bailing out a very big institution might be large relative to the resources of the country in which the institution resides. … it is not clear that an increase in size and perhaps geographic scope of an institution makes the risk of its failure any greater than before. Accidents do happen, however, and it is likely that the systemic consequences of bank failures grow as institutions become larger and larger. The situation is also more complex in the case of internationally operating banks" (OECD, 2000c: 138–139).

27 See Group of Thirty (2000, especially chaps. 4–6). The policy issues are surveyed in Group of Thirty (1998).

28 For more detailed guidelines for the Principles' application, see International Association of Insurance Supervisors (IAIS, 2000b). The IAIS is an association of insurance supervisors established in 1994 and now includes supervisors from more than 100 countries.

29 The main forum dealing explicitly with these issues is the Joint Forum on Financial Conglomerates, which was founded in 1996 and brings together developed-country representatives from the BCBS, IOSCO and IAIS. The Joint Forum has reviewed various means of facilitating the exchange of information among supervisors within their own sectors and among supervisors in different sectors, and has investigated legal and other barriers that impede the exchange of information among supervisors within their own sectors and between supervisors in different sectors. It has also examined other ways to enhance supervisory coordination, and is working on developing principles for the more effective supervision of regulated firms within financial conglomerates.

30 See, for example, the coverage of recent events of money laundering in London in the *Financial Times*, 20 October 2000, and of a report of the subcommittee of the United States Senate concerning use of correspondent services provided by the country's banks for the purpose of money laundering in the *International Herald Tribune*, 6 February 2001. A *New York Times* editorial reproduced in the latter commented as follows: "Banks are undoubtedly wary of legal restrictions that raise costs and discourage depositors, particularly in their lucrative private banking divisions. But America cannot condemn corruption abroad while allowing its own banks to make fortunes off it."

31 Various other regional or international bodies, either exclusively or as part of their work, also participate in combating money laundering. These include the Asia/Pacific Group on Money Laundering (APG), the Caribbean Financial Action Task Force (CFATF), the PC-R-EV Committee of the Council of Europe, and the Offshore Group of Banking Supervisors.

32 Attention is drawn to such connections between different international initiatives concerning offshore financial centres by José Roldan, President of the FATF during the period July 2000–2001, in an interview (Roldan, 2000: 21–22).

33 For a more detailed commentary on this report, see Cornford (2000a).

34 This FSF report focuses mainly on large, substantially unregulated institutions characterized by low transparency, primarily hedge funds. But, as the report notes, a clear distinction cannot always be drawn between the practices of these institutions and others subjected to greater regulation.

35 The six economies were Australia, Hong Kong (China), Malaysia, New Zealand, Singapore and South Africa.

36 One instance of such activity, which attracted much attention in 1998, was the "double play" in which some financial institutions are believed to have engaged in Hong Kong (China). This operation is described as follows in the Working Group's report (FSF, 2000c: 117): "Some market participants suggested that there were attempts to carry out a 'double play' involving the equity and currency markets, whereby short positions would be first established in the equity (or equity futures) market, and sales of Hong Kong dollars would then be used to drive up interest rates and thereby depress equity prices. Some other market participants questioned whether such a strategy was pursued. Any double play would have been facilitated at that time by institutional factors in the linked exchange rate arrangement which made short-term interest rates very sensitive to changes in the monetary base, and also by reduced market liquidity as a result of the Asian crisis. Among those taking short positions in the equity market were four large hedge funds, whose futures and options positions were equivalent to around 40 percent of all outstanding equity futures contracts as of early August, prior to the HKMA [Hong Kong Monetary Authority] intervention (there were no limits or reporting requirements on large equity futures positions at this time). Position data suggest a correlation, albeit far from perfect, in the timing of the establishment of the short positions." See also Yam (1998).

37 A working group of the Committee on the Global Financial System on Transparence Regarding Aggregate Positions (the Patat Group), whose mandate was to look at what aggregate data on financial markets could be collected to enhance their efficient operation, was abolished because of its finding that "it would not be possible to obtain adequately comprehensive and timely information on a voluntary basis, and legislative solutions were deemed impractical" (see White, 2000: 22).

38 As the report notes (FSF, 2000d: 9), OFCs are not easily defined, but can be characterized as jurisdictions that attract a high level of non-resident activity. Traditionally, the term has implied some or all of the following: low or no taxes on business or investment income; no withholding taxes; light and flexible incorporation and licensing regimes; light and flexible supervisory regimes; flexible use of trusts and other special corporate vehicles; no requirement for financial institutions and/or corporate structures to have a physical presence; an inappropriately high level of client confidentiality based on impenetrable secrecy laws; and unavailability of similar incentives to residents. Since OFCs generally target non-residents, their business substantially exceeds domestic business. The funds on the books of most OFC are invested in the major international money-centre markets.

39 The point was eloquently expressed in a recent editorial in the periodical, *The Financial Regulator,* as follows: " The interconnection of the world financial system has created … problematic externalities, with … small countries now able to do a lot of damage. With world government some way off, these externalities are likely to prove tricky to manage. For the foreseeable future there is no better solution than international cooperation. When big countries push little countries around, even for the best of reasons, they give this crucial cooperation a bad name. The challenge for those interested in global financial stability is to find some way of negotiating better regulation while avoiding … the heavy-handedness characterizing the current drive against offshore centres." See "Justice for offshore centres", *The Financial Regulator*, September 2000.

40 The term "incentive" is used by the FSF in this context to cover measures which include sanctions as well as incentives.

41 For a description of the CCL, see chap. VI, box 6.3.

42 BCBS has proposed in its *A New Capital Adequacy Framework* (see box 4.1) the following incentives with regard to observance of standards: (i) to be eligible for claims on it to receive a risk weighting below 100 per cent, a country would have to subscribe to the SDDS; (ii) claims on a bank will only receive a risk weighting of less than 100 per cent if the banking supervisor in that country has implemented – or has endorsed and is in the process of implementing – the BCBS' *Core Principles for Effective Banking Supervision*; and (iii) claims on a securities firm will only receive a risk weighting of less than 100 per cent if that firm's supervisor has endorsed – and is in the process of implementing – IOSCO's *Objectives and Principles of Securities Regulation* (1998).

43 See note 18 (sect. B.3) above.

44 The jurisdictions covered by the outreach exercise were Argentina, Australia, Canada, France, Germany, Hong Kong (China), Italy, Japan, Sweden, United Kingdom and United States.

45 Nevertheless, as discussed in box 4.1 (on proposals for reform of the Basel Capital Accord), how effectively the agencies have used this understanding is still open to question.

46 Deregulation of interest rates in major OECD countries, for example, has taken from seven to more than 20 years in all but a small minority of cases. The establishment of a single market for financial services in the EU took more than 30 years (see Cornford and Brandon, 1999: 11–13).

47 Capital requirements are attributed a central role in countries' regimes of prudential regulation and supervision. They have also been the subject of major international initiatives, of which the most important is the Basel Capital Accord that is currently

undergoing a major revision . See box 4.1 on Basel Capital Standards.

48 This dependence, of course, provides the link between sectoral policies aimed at financial stability and macroeconomic policies, including those directed at the balance of payments (amongst which, especially for developing and transition economies, should be counted controls on capital transactions).

49 The argument here follows closely that of Akyüz and Cornford (1999: 30–31). See also *TDR 1998* (Part One, chap. IV, sect. C.3).

50 See, for example, Caouette, Altman and Narayanan (1998: 91, 240). The limitations of credit risk models in handling correlations among defaults are reviewed in BCBS (1999c, Part II, sect. 6, and Part III, sect. 3).