Issues in Implementing Standards and Codes

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I. Introduction

'And I have become convinced that it is in the interests of stability – and of preventing crises in developing countries and emerging market economies – that we seek a new rule-based system: a reformed system of economic government under which each country, rich and poor, adopts agreed codes and standards for fiscal and monetary policy and for corporate governance. …over time – the implementation of the codes should be a condition of IMF and World Bank support…'

Gordon Brown, Chancellor of the Exchequer, UK in his speech to the Federal Reserve Board, New York, 16 November 2001.

The intention of the architects of the new global financial architecture is to maintain international financial stability. The international initiative consists of defining rules for transparency, financial supervision and regulation. The purpose is to ensure that only countries that accept these globally defined rules gain access to international support, for example in times of crisis. This process of defining rules has, for the most part, been undertaken by the industrialised world along with some of the 'emerging block' countries. Developing countries are expected to comply with the new rule-based system if they are to have access to international finance.

The idea of global rules is very appealing. For the first time, the linkages between national and international regulatory bodies, the market and international financial institutions are recognised explicitly. Common standards are being attempted to facilitate international comparisons and to avoid confused signals from an individual country. It is also believed that such rules will enhance the role of market discipline because countries that want to improve their access to international finance will have the incentive to enforce the standards.

Despite the intuitive appeal of a globally defined set of rules, there is a need for caution because there is a danger of producing a system that is too inflexible and that does not allow for the differences in institutional development, legislative framework, and the different stages of development. The generally accepted rules and principles, under which the financial and corporate sectors operate in the industrialised world, have evolved over time. Introducing rules that are imported from other parts of the world may not therefore have the desired outcomes. Research to investigate the likely implications is needed. Investigation into the impact of the proposed global rules on the efficiency of financial systems and domestic financial stability is particularly urgent. Other critical research areas include the limitations of the new initiatives, requirements for implementation, and structuring of transition periods. These issues should be discussed and researched from both a developed and a developing country perspective. Furthermore, the urgency of the subject arose against the backdrop of the East Asian crisis, yet problems with compliance to these rules are a global phenomenon, which often gets ignored in recent debate and is frequently regarded as a developing country or emerging market issue. What is more, rules alone will not help prevent a crisis or contagion. Rules of corporate governance in the United States did not help to avert the ENRON disaster, and Argentina has found itself in crisis despite substantial compliance with transparency codes.

This chapter aims to facilitate a discussion about the issues involved in defining universally accepted standards in areas crucial for the maintenance of international financial stability, whilst taking into consideration institutional and legal structures and the different stages of economic development across regions and countries. Although the implementation of standards is an issue that affects all countries, this chapter devotes more attention to developing country issues. It is organised as follows: Section II provides the background for the present discussion. Section III examines some of the general issues arising from the policy initiative from the perspective of developing countries. Two themes run through Section IV: the limitations intrinsic in the codes are outlined by using a few codes as an illustration, and selected examples are used to illustrate some limitations that also arise in that process and the limits of the implementation process. The final section throws open the debate with some issues for discussion.

II. Background

In the aftermath of the East Asian crisis the international community has been engaged in reforming the international financial architecture to deal with some of the dangers inherent in globalisation. The dynamic growth in capital markets following the liberalisation of financial markets in many countries occurred without domestic economic and financial weaknesses as well as the regulatory and supervisory frameworks being taken fully into account. A vital lesson which has been learnt is that the health of both internal *and* external balance sheets is important in all sectors of the economy, be it the central bank, the government or the private sector. Another important lesson concerns the role of information in the smooth functioning of international financial markets, a lack of which often leads to contagion and herding by international investors. The crisis also highlighted the lack of transparency on the part of international institutional investors and the inability of the international financial architecture to prevent and manage financial crises. The post-crisis international emphasis has been on strengthening players: through stronger risk management, more prudential standards and improved transparency.

The establishment of the Financial Stability Forum (FSF) in February 1999 by the G7 Finance Ministers and central bank governors[1] was a new initiative in direct response to the East Asian crisis and reflects the importance given to globally co-ordinated financial and regulatory aspects of domestic policy and the need to re-think those regulations grouped together under the heading of Standards and Codes (S and C). The Forum supports the belief that financial stability can be promoted by the improved exchange of information and co-operation with regard to financial supervision and surveillance. This is the first attempt to develop a single set of international rules and principles for crucial areas of domestic policy in the financial and monetary spheres.

Identifying standards is a complex task. Moreover, the dynamic nature of these markets and their increasing sophistication means that these standards will have to be flexible enough to incorporate this process of change. The FSF has identified over 60 standards, and 12 of these standards and codes (see Table 2.1), in the three areas of macro policy and data transparency,

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[1] Its membership consists of the national authorities responsible for financial stability in selected OECD countries, Hong Kong and Singapore, and major international financial institutions, international supervisory and regulatory bodies and central-bank expert groupings.

institutional market infrastructure and financial regulation and supervision, have been endorsed by the G-7 countries and the multilateral institutions as essential for financial stability. In practice, the classification of the standards and codes into three categories is not very distinct. For example, macroeconomic policy 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), as well as on the functioning of the payments and settlement system (which is at the heart of the infrastructure of financial markets). Effective financial regulation and supervision are inextricably related to accounting, auditing and insolvency procedures. 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 between markets. And even such an apparently self-contained issue as money laundering has on occasion threatened the stability of financial firms (UNCTAD, 2001).

The codes provide a body of 'best practices' pooled from different international standard-setting bodies and regulatory frameworks related to the legal, regulatory and institutional framework for any financial system. Many of them are intended to serve as guidelines but some, such as the standard on data dissemination, can be detailed and precise.

Table 1: 12 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)	IMF
Institutional and market infrastructure		
Insolvency	Principles and Guidelines on Effective Insolvency System	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards	International Accounting Standards Committee (IASC)
Auditing	International Standards on Auditing	International Federation of Accountants (IFAC)
Payment and settlement	Core Principles for Systematically Important Payment Systems	Committee on Payment and Settlement Systems (CPSS)
Money laundering	The Forty Recommendations	Financial Action Task Force (FATF)
Financial regulation and supervision		
Banking supervision	Core Principles for Effective Banking Supervision	Basle Committee on Banking Supervision (BCBS)
Securities regulation	Objectives and Principles of Securities Regulation	International Organisation of Securities Commissions (IOSCO)
Insurance supervision	Insurance Supervisory Principles	International Association of Insurance (IAIS)

Source: Financial Stability Forum

International standards are not a new concept. The international standard-setting bodies have existed for a long time but each developed its rules in isolation. Various international standard-setting bodies have raised awareness about standards of soundness and risk in financial systems.[2] The implementation of these has, until now, been voluntary and has differed across countries and firms.

In order to discuss implementation of international best practice relating to the legal, regulatory and institutional framework that underpins a financial system, a global overview of the present situation with regard to compliance is desirable but not readily available. There are three possible sources of information about the implementation of standards and codes: the Reports on the Observance of Standards and Codes (ROSCs) prepared by the IMF, countries' own self-assessments and the information provided by a specific private sector initiative. The preparation of ROSCs started in 1999 assessments and publication is voluntary. Some of the ROSCs are part of the Financial Sector Assessment Programme, run jointly by the IMF and the World Bank.

ROSCs are currently (as at June 2002) available for 53 countries, 19 of which are OECD member countries.[3] There are no modules for more than one-third of the OECD countries, and among them, for three of the G-7 countries (Germany, Italy and the USA[4]). Although ROSCs have been updated recently for some countries, most of the information still dates from 1999. The information available from ROSCs is very limited because of the heterogeneity of both the codes and the country coverage, as well as the uncertain timing of publication. The ROSC modules are not standardised: some contain only a short analysis, while others are very detailed, some take compliance with one standard into account, others with several.

Self-assessments are not systematically collected by any international organisation, and information about them is sometimes difficult to obtain. Private initiatives, such as the eStandardsForum website (http://www.estandardsforum.com), provide information on the

[2] Some examples are the Principles for the Supervision of Banks' Foreign Establishments agreed by the Basle Committee on Banking Supervision in 1983 and a Framework for International Convergence of Capital Measurement and Capital Standards published in 1988. Work on some standards, such as those for data dissemination and fiscal transparency, exists prior to the outbreak of the East Asian crisis. The Special Data Dissemination Standard (SDDS), for instance, was developed by the IMF in response to the deficiencies in major categories of economic data following the Mexican crisis in December 1994.
[3] See Annex Table 1 for a summary coverage of countries and codes by ROSCs.
[4] The US Treasury website provides a self-assessment of the US position on the 12 core standards as at 25 June 2001.

implementation of S and C for a large number of countries in a more user-friendly format but the information is under copyright and access to the website is not free. The information is in a simple format which can easily be quantified. Market participants prefer information that can be quantified or used in a classification system that can be incorporated in tick boxes. However, implementation of S&C is a process, and not designed to meet fixed target deadlines for compliance or provide pass/fail tests. Such a process necessarily requires qualitative assessments. Simplistic quantification and classification risk producing scoring systems capable of creating one-way expectations and bandwagon effects in the market. If market participants are left to make their own discretionary judgements on a country's level of compliance, there is a better chance of a more reasoned assessment.

It is generally assumed that OECD countries are largely compliant with the Codes. [5] However, although the information from the private sector initiative cannot be presented here for copyright reasons, the information obtained from the cross-checking of ROSCs, self-assessments and the eStandardsForum clearly indicates that, despite the fact that the impetus for an international set of codes came from the G-7 countries, compliance with the 12 codes in this group is not complete and there are varying degrees of compliance with the other standards. In the other OECD countries as well, compliance is weaker and deviations numerous. Although the East Asian crisis was the trigger in highlighting problems with transparency and central bank balance sheets, the banking system and the corporate sector, implementation of international financial codes is a global issue.

III. Issues in defining and implementing standards and codes: developing country perspectives

It was a challenge to define standards. It is an even greater challenge to gain global acceptance for the defined standards in order to ensure implementation. Standards and codes can only be effective as a tool of financial stability and crisis prevention if they are extensively implemented. Issues that arise in ensuring compliance with the codes in

[5] For example Acharya (2001) writes, 'As a rule of thumb, most OECD countries are in compliance (or are close to compliance) with most standards, while many developing countries are at varying distances from compliance with regard to most standards',p.38.

developing countries, such as ownership, appropriateness, incentives and voluntarity are examined in this section. Other issues discussed are those relating to resources and transition periods.

(i) The linkages between ownership, appropriateness, representation and incentives in implementing standards

The effectiveness of standards and codes as a tool of global financial stability depends on the number of countries adopting them and the extent to which they are implemented. The latter is closely related to the way in which S and C are incorporated into the norms of business practice. In order to achieve effective implementation, country 'ownership' of these policies is crucial. In the case of developing countries, 'ownership' is not possible without representation and positive incentives for implementation. The most constructive incentive for implementation is the appropriateness and meaningfulness of standards in the national interest.

'Ownership' of reforms in domestic financial architecture cannot be achieved whilst the present membership of the FSF[6] and other international organisations[7] involved in standard-setting is so heavily dominated by the industrialised nations. Although developing countries were well represented in the formulation of some of the codes such as those on transparency, their participation and representation have been limited with respect to others. The Financial Stability Forum is a very important initiative; including members from developing countries as full members and not just a few in working groups will enhance its legitimacy and increase commitment. It is important that their concerns and subject areas are represented; involvement brings commitment. 'Ownership' is meaningless without representation.

Appropriateness of the standards is another issue to ensure implementation. The 'ownership' principle cannot work if national governments are not convinced about the appropriateness of

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[6] Currently, the FSF has a total of 40 members, comprising 3 representatives from each G-7 country (1 each from the treasury, central bank and supervisory agency); 1 each from Australia, Hong Kong, Singapore and the Netherlands; 6 from international organisations (International Monetary Fund (2), World Bank (2), Bank for International Settlements (1) and OECD (1); 6 from international regulatory and supervisory groupings (Basle Committee on Banking Supervision (2), International Organisation of Securities Commissions (2) and International Association of Insurance Supervisors (2)) and 2 from Committees of Central Bank experts (Committee on the Global Financial System (1) and Committee on Payment and Settlement Systems (1) plus the chairman Mr Crockett.

[7] See Annex Table 2 for list of countries represented in the various standard-setting bodies and Table 3 for the countries represented in the various working groups..

some standards. This is the ‘one size fits all’ dilemma. In discussing the appropriateness of the selected standards, Rodrik (2000) points out that many rich countries have prospered by following different paths in corporate governance (where insiders and stakeholders have played a much more significant role) and in finance (where close links between governments have often been the rule rather than the exception). The Reserve Bank of India, perhaps the only country that evaluates the appropriateness and implementation issues and posts the information in the public domain, makes similar points.[8] Recognition by the standard-setters that different countries are at different stages of economic development with varying institutional capacities does not offer any clues as to how this difficulty will be resolved in practice. The resolution of the ‘one size fits all’ dilemma is complex but increasing developing country representation and participation and including subject areas of interest to them will be the first step forward. Appropriateness is a question of participation and involvement, and may not be achieved by providing economic proof alone[9].

In the absence of appropriate institutions, developing countries’ commitment to embracing standards and codes is not likely to lead to the desired goals. Pistor (2000) examines this aspect with regard to legal rules and argues that historical evidence supports the proposition that imported legal systems have in most cases not produced very efficient outcomes. The content of the rules is not as important as the existence of constituencies that demand these rules and the compatibility of the imported norms with pre-existing legal norms as well as pre-existing economic and political conditions. Voluntary compliance is important. Hence standardised rules are unlikely to be effective in countries where complementary laws exist only in part or not at all. For example, commercial law is a necessary prerequisite for the International Organisation of Securities Commissions (IOSCO) standards and an independent judiciary is a pre-requisite for defining and bringing into practice the code on insolvency.

The issue of "‘ownership’ is also closely related to the "‘incentives’" which a country has to implement standards. The FSF Task Force on the Implementation of Standards, established in September 1999, identified a blend of market and official incentives to encourage the implementation of standards and codes; these were examined in September 2000 bythe FSF follow-up group. Compliance thus rests either on countries being convinced of the usefulness of compliance and voluntary co-operation or on pressures from the markets for their

[8] The reports of the various committees are available on the RBI web site.
[9] Nor do studies carried out so far give enough economic proof.

observance. Compliance can therefore in principle be based either on positive incentives or negative ones (compulsions, sanctions). The present study catalogues market[10] and official incentives, and lays emphasis on the former.[11] If the market does not assimilate the information generated by a publicly led approach to ensure financial stability enabling market incentives to work, will some of the negative official incentives mentioned here (but for the most part not recommended) become the norm to be imposed by international organisations and by individual countries or some groups of countries?

The first item in the incentive list (see Box 1) from the official sector – making IMF funds contingent on compliance – is among the actions already taken[12]. In the case of the IMF's Contingency Credit Line, the conditions include a positive assessment during the most recent IMF Article IV consultation on the country's progress in adhering to internationally accepted standards. No country has yet made use of the CCL. It remains to be seen whether a public statement of the intent to comply or actual compliance will gain access to this facility.

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[10] The key requirements for this to be effective would be (i) market familiarity with international standards, (ii) their assessment of its relevance for assessments of market risk, (iii) market access to information on compliance and the degree of compliance and (iv4) use of information by the market in risk assessments.

[11] The period for assessing the effectiveness of market incentives is admittedly very short. Nevertheless, assessment of some codes in the literature points to the limited use of the market incentive. See for example Mosley (2001)

[12] For a further discussion on this issue see UNCTAD (2001)

Box 1 Incentives to Implement Standards and Codes

Positive incentives

National interest
Technical assistance
Policy advice

Incentives that could directly be applied by IFIs

Making the access to IMF funds contingent on compliance in standards and codes[a]
including implementation of certain S and Cs in the conditions of an IMF adjustment program. [b]
making implementation of S and Cs a condition for Membership in international groupings.[c]
Obligating countries that do not implement S and Cs to pay higher charges for the utilization of IMF funds is not under active consideration but remains one of the possible future steps.[d]

Incentives from the 'market side'

Disseminating information on compliance of S and Cs .
Encouraging private institutions to be concerned about compliance of S and Cs including this information in their risk assessment.[e]
Restricting market access either for selected foreign institutions to the domestic market or for domestic institutions to selected foreign markets.[f] Some examples of this may include: (i) banning the listing of a country's debt securities, or the shares and debt securities of companies resident there, on the sanctioning countries' stock exchange; or (ii) banning the sale of these debt securities to investors resident in the sanctioning country.

[a] Access to the CCL (contingent-credit lines) is subject to the adherence of, at least: '(1) subscription to and use of the IMF's Special Data Dissemination Standards, which guide countries making economic and financial data available to the public; (2) compliance with the Basle Core Principles for Banking Supervision; (3) use of the IMF-designed code on fiscal transparency; and (4) use of the IMF-designed code on transparency in monetary and financial policies. A more comprehensive analysis of adherence would be possible where a Report on Observance of Standards and Codes (ROSC) has been prepared. ROSCs include assessment of adherence to seven other sets of standards and codes.' IMF Executive Board Meeting 17 November, 2000
[b] Conditionality in Fund-Supported Programmes-Policy Issues. IMF 2001, p. 38
[c] FSF, Report of the follow-up group on incentives to foster implementation of standards, September 2000
[d] Ibid
[5e] 'The Group believes that, in addition to the continued encouragement to governments and congresses, implementation of standards could be promoted effectively by leveraging the private sector within EMEs, especially borrowers and recipients of foreign investment.' FSF(2001)
[f] (i) A *host* jurisdiction in deciding whether, and if so under what conditions, it will allow a foreign institution to operate in its markets, could take into account the degree to which that institution's home jurisdiction observes relevant standards. (ii) Where regulatory approval is required, a *home* jurisdiction could place restrictions on its domestic financial institutions' operations in foreign jurisdictions with material gaps in observance of relevant standards. (FSF, 2000)

IMF country programmes include specific steps to implement specific standards. Banking supervision in the home country is already a condition in several countries for market access to foreign financial firms. The disadvantage of this line of approach is that, despite implementation of S and C being a global issue, the pressures for implementation become restricted to countries that seek funds from the IMF. There is also the danger that moves towards conditionality may lead to negative retaliation by developing countries to restrict market access to countries that themselves have not achieved full compliance with international standards. Negative incentives may therefore have the undesirable consequence that issues of financial stability may be lost by such incentives working in the case of only a few countries (those that seek IMF funding and undertake negative retaliation against some of these pressures).

Implementation of codes is of self-interest to a country only if it intends to borrow from the private financial market or from bilateral or multilateral official sources. (See box 2.2) The official incentives are not valid for the G-7/G-10 countries, as they no longer borrow from multi-lateral institutions. The market incentive also works asymmetrically in the case of industrialised and emerging market economies. Although industrialised countries do borrow from private capital markets, these markets do not necessarily take the degree of their adherence to international standards into account. For instance, Germany presently does not comply with fiscal transparency, but its credit rating and ability to borrow are not seriously affected, as an emerging market's economy would be. Furthermore, the incentive for industrialised countries to comply with many standards may not be very strong because, unlike emerging market economies, it is possible for them to borrow capital in their own currency. Ricardo Hausmann refers to this as the 'original sin.' Developing countries are faced with the exchange-risk impact on their balance sheets because they almost always borrow in a foreign currency; industrialised countries can avoid this risk, and there is therefore less incentive for them to implement standards. This is presumably because domestic financial crisis have been combined with external payments crises only in developing and transition economies.

Box 2. Why identified Incentive structures may not work in the case of industrialised countries?

Positive incentives

Self-interest is muted because the recent crises have been domestic financial crises combined with external payments only in developing and transition economies.
Reduced exchange risk compared to developing countries, as it is possible for them to borrow in their own currencies**.**
Do not need technical assistance as an incentive.

Official incentives

Inapplicable as the industrialised countries no longer borrow from multilateral institutions**.**

Market incentives

There is asymmetry in the way the market assesses the same information for industrialised, emerging markets and developing countries. For example, one of the G-7 countries presently does not comply with fiscal transparency but this does not seriously affect its credit rating or ability to borrow from private markets.
Thus the idea that the market can punish for non-compliance through higher costs or drying up funds may not be valid for the industrial countries.

Another approach, adopted with some success both by the OECD's Financial Action Task Force (FATF) with regard to countries that do not combat money laundering actively enough and by the OECD in dealing with tax havens (Speyer, 2001), is ‘Name and Shame’. Key sanctions under ‘naming and shaming’ are advisories that raise transaction costs in dealings between non-co-operating and co-operating countries.

Research on the relationship between the implementation of standards and the development of the macroeconomy and of financial stability is scanty. A better case for 'ownership' can be made if countries can be persuaded that implementation of standards and codes is in their national interest in order to maintain domestic financial stability and hedge against external shocks. A crisis is a costly affair, and it is in a country's interest to avoid it. Moreover, a healthy, strong financial sector is essential for the efficient allocation of resources and improved growth performance. Thus, self-interest is the best incentive.

(ii) How voluntary is voluntary?

Adoption of standards and participation in external assessments should be voluntary. (FSF, 2000: 10).

The Executive Board of the International Monetary Fund (29 January 2001) has voiced similar sentiments. The Directors agreed that the adoption and assessment of internationally recognised standards will remain voluntary. They recognised that priorities for implementing standards would differ by country and through time, and that assessments would need to take into account differences in members' economic circumstances and stages of development (IMF, 2001a).

Although the initial public statements concentrated on the voluntary principle, a shift in focus is perceptible. For example, Eichengreen (2001: 43) makes a case for conditionality. In his view ‘upgrading practices in such areas as macroeconomic policy and transparency, financial market infrastructure, and financial regulation and supervision is essential in a financially integrated world. And international standards, with pressure to comply to be applied by multilateral surveillance, IMF conditionality, regulation and market discipline, are the only available means to this end in a world of sovereign states’. (p.43) He sees the Asian model as needing to be reformed to comply with international best practice. The argument contains a certain amount of 'idealism', a 'wish list' of what lenders would ideally like to have without any reciprocal arrangements.[13] Eichengreen does not take account of the practical aspects of applying a universal rule in diverse conditions. The idea of conditionality, as evidenced by the quotation at the beginning of this chapter, has support from high-ranking individuals in the industrialised world.

Developing countries have expressed concern that compliance with standards and codes should not become a part of conditionality; they believe that compliance should be voluntary (see, for example, Reddy, 2001). Many, including Brazil (Gottschalk, 2001: 16) and Russia (Granville, 2001: 7) have also expressed the view that capacity-building is more important than conditionality. While developing countries have been supportive of the need to observe certain minimum standards in areas relevant to the maintenance of the international monetary system, including greater transparency, there is less agreement on the design of some codes as relevant and applicable in economies with different legal institutional set-ups and at different stages of development.[14]

How is 'ownership' of polices ensured if compliance with standards becomes a part of IMF conditionality? Furthermore, conditionality can take the form of formal or informal conditionality. If the view put forward by Bretton Woods Institutions and statements from high-ranking individuals in the industrialised countries leads to the perception that a universal rule ensures financial stability, the market participants will respond accordingly, and even if adherence to S and C is not a part of formal conditionality, the market mechanism will in practice work to achieve the same end through different means.[15]

[13] The wish-list is an intrusion in the affairs of emerging markets and developing countries. The destabilising activities of Highly Leveraged Institutions have been ignored in the discussion. The Report of the Working Group on HLIs (April 2000) identified the capacity of HLIs to establish large and concentrated positions in small and medium-sized markets and with this capacity the potential to exert destabilising influence. Some aggressive practices of HLIs include heavy selling of currencies in illiquid markets, selective disclosures, rumours about future developments, and correlated position-taking in the markets for different assets within a country and also across countries with the objective of achieving profitable movements in relative prices.

[14] Mr. Jin Liquin, Deputy Finance Minister of China, for example, voiced this at a conference organised by the IMF. 'Developing countries are given to understand that they can pre-empt a financial crisis and achieve economic stability, providing they follow rigorously the international Standards and Codes. But there are two questions to answer: first, are the Standards and Codes suitable to developing countries at their stage of development; and second, do they have a minimum institutional capacity to apply these standards and codes at the same level as developed countries?' IMF Survey, Vol. 30, No. 7, 2 April, 2001, p.103.

[15] See Axel Nawrath (Chairman of the Follow-Up Group on Incentives to Foster Implementation of Standards), to William McDonough (chairman of the BCBS) (4 April 2001): 'I am of the view that the new [Basel] Accord can provide incentives, albeit indirectly, to banks and other market practitioners to pay attention to Standards.

Developing countries are already overburdened with conditionality. How will the IMF streamline conditionality if a new raft of conditions is added? Moreover, one cannot discus conditionality when there is no economic proof that S and C are effective in developing countries. ENRON, World Com etc. failures have demonstrated the possible problems with effectiveness in the industrialised countries as well.

It is premature to be discussing S and C as a condition for finance.[16] Even informal conditionality through the market incentive is problematic. If credit-rating agencies are assimilating information from ROSCs on the credit ratings of individual developing countries, this confirms their concerns voiced on outreach activities. ROSCs are considered by developing countries to be a useful benchmark, as shown, for example, by the responses of Armenia (IMF, 2000: 7) and Russia (Granville, 2001: 7). But there is concern that the judgments expressed may become a way of giving a simple score to a country facing a complex process. (Gottschalk, 2001: 13)

The complexity of the S and C process and the problems in global monitoring make it difficult to set up binary yes/no judgments or a scale of the degree of implementation. Market incentives incur the danger of being based on partial and subjective information on compliance or on a lack of judgement about the usefulness of a particular code in a developing country setting. The international debate needs to focus greater attention on the possibilities of bad judgments. To reiterate, in order to fully understand the issues involved, research is necessary on the usefulness and effectiveness of codes and country experiences with their implementation. Market incentives have been brought into uncharted territory too early for single rules to be applied globally.

(iii) Resources

The resources required for the implementation of standards and codes are expected to be enormous, and many countries face serious practical constraints. Some developing countries

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This should in turn raise awareness among economies to the need to upgrade the implementation of Standards in their jurisdictions.'

[16] Conditionality is a highly contentious issue. We do not go into this discussion here. For a discussion on effectiveness see, for example, Kapur and Webb, (2000). Killick, (1995),

have expressed the view that these efforts may be made at the expense of socially vulnerable groups. In a DFID outreach activity on Standards and Codes, the response of many countries was that implementation of would be costly in terms of time and resources and the need for effective technical assistance was stressed (Gottschalk, 2001: 13; Granville, 2001: 26; Charpentier, 2001: ii)). In some cases it is doubtful if implementing S and C ought to be a priority for countries with very limited resources and deep poverty problems(Charpentier, 2001: ii).

It is for this reason that capacity-building efforts are seen as crucial to strengthening financial systems. The resource constraint has been identified as the major problem in implementing standards and codes, and therefore the Bretton Woods Institutions, the Bank International Settlements and the standard-setting bodies are all supporting implementation through technical assistance. The UK Government has taken a lead by announcing the Financial Sector Reform and Strengthening (FIRST) Initiative, a technical assistance programme for implementation. A global directory of training opportunities has been sponsored by the FSF (see www.fsforum.org/training/home.htm). The initial focus is on banking supervision. It is planned to expand the training to other areas of financial activities including insurance supervision and payment and settlement systems.

The number of countries with zero or incomplete compliance is large. The demands for resources are likely to be large. There is likely to be a resource constraint at both domestic and international levels. So far, no estimation of the costs of implementation is available. The task of estimating costs is complex as different countries are at different stages of compliance. Some case-study analysis needs to be carried out to gauge what the resource constraints are likely to be. Technical assistance efforts will need to identify the countries to be targeted and how much assistance over a considerable period of time is required, as implementation is going to be a long process. Resources are also needed for the assessment exercise to gauge where developed and developing countries are in the spectrum.

(iv) Transition period

If one accepts that globalisation is here to stay, then the challenge is to prepare developing countries for a highly integrated world. The risk inherent in opening up capital markets requires a well-thought-out preparatory stage. In referring to transition periods for fulfilling the pre-conditions for opening up the capital account, the principles behind the standards and codes exercise form part of those pre-conditions. Capital account liberalisation requires that central banks have effective regulatory, supervisory, enforcement and informational structures in place. Liberalisation must not be seen to require authorities to retreat from these essential functions. Priority setting and sequencing of the implementation exercise for standards and codes therefore need to be linked to the timing and sequencing of capital account liberalisation.

As stressed earlier, research on country experiences needs to be collated in order fully to understand the implications of applying internationally defined codes to countries with divergent systems. The risks inherent in introducing codes without an understanding of the outcomes justify a gradual approach to implementation. The experiences with a 'big-bang' approach to capital account liberalisation are well documented in the literature (see, for example, Schneider, 2001). Gradualism also allows time for the inevitable learning curve in developing countries.

The transition period needs to be carefully considered to take account of the institutional framework, such as the legal framework, administrative and human capacity and financial resources. Technical assistance can play a very important role in the transition period. Priorities need to be established for countries at different stages of development and also with regard to the degree of openness of their financial systems. For official and financial incentives, an understanding of the transition period is crucial for the initiative to work in ensuring financial stability.

The IMF and the World Bank can play an important role in helping member countries in this regard. The ROSC exercise may not provide information with respect to compliance in the form desired by the private sector, but it can be useful in identifying constraints in member countries and in working out transition periods.

IV. Some Examples of Limitations to Standards and Codes

Despite the progress made in formulating an international set of standards and codes, the goals of financial stability are better served if some of the limitations in defining the codes themselves and in the process of their implementation are recognised. Moreover, countries implementing these standards need to recognise that these are not static rules or principles but will need constant improvements and adjustments to keep pace with the dynamic process of change and the increasing sophistication in financial markets . Flexibility is important and governments need to take care not to waste resources on standards that may already be outdated. This section takes account of some of the limitations of S and Cs. Implementing of codes is a very recent exercise and discussion of their effectiveness and limitations is therefore limited to a few specific codes which have been the subject of recent research.

It is important to recognise that financial stability depends on macroeconomic fundamentals, and sometimes on endogenous consequences of rapid expansion of lending and that this poses a limitation on the regulation and supervision of a country's financial system. For instance, most bank assets are subject to changes in their quality resulting from broader changes in economic conditions that are often characterised by boom and bust cycles. Moreover, cross-border financing and herd behaviour on the part of investors along with macroeconomic fluctuations can further intensify problems in the financial system (UNCTAD, 2001). Thus macro stability is a pre-requisite for the success of the present exercise in new financial architecture.

(i) Transparency codes

International organisations have put increasing emphasis on transparency in macroeconomic policy and data in order to ensure financial stability.[17] The rationale for greater transparency is based on the argument that (i) it forces public and private institutions to be accountable; (ii) it helps lenders and investors to evaluate risk; and (iii) it prevents herding and contagion. Support for this view was voiced early on after the Mexican crisis and reinforced after the outbreak of the East Asia crisis. The G-7 Finance Ministers reported to the Cologne Summit that 'the availability of accurate and timely information is an essential ingredient for well-functioning financial markets and market economies' (G-7, 1999).

Although the benefits of transparency have been recognised, views from both the market and governments in developing countries have also indicated that too much of a good thing may not necessarily be good. The G-22 report on transparency points out that 'confidentiality may be warranted in some circumstances: for example, to encourage frank internal policy deliberations. In determining the optimum degree of transparency, the benefits must be balanced against the costs' (Group of 22, 1998). For example, many IMF members have been concerned about releasing data on foreign-exchange reserves as they may reduce the effectiveness of market interventions. These data are therefore now provided following a one-month lag. Thus, although transparency is necessary, there is a question mark over how transparent developing countries should become Similar points were made at an Overseas Development Institute conference in June 2000.[18]

The case for transparency rests on the belief that information and transparency are central to successful policy in developing countries. Precise, regular information is essential in attracting investors. For instance, a case can be made that the marginal product of information in Africa is still very high, given the poor record of disclosure there and investor ignorance of the region. Many have also argued that the vulnerability of developing countries to self-fulfilling crises is due to their lack of transparency which leads to herd-like behaviour in the financial markets. However, the private sector also acknowledges that the provision of information could backfire since it could highlight faults that are shared by many countries

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[17] See the Code of Good Practices on Transparency in Monetary and Financial Policies at http://www.imf.org/external/np/mae/mft and fiscal transparency at http://www.imf.org/external/np/fad/trans

[18] See Development Policy Review, Vol. 19, No 1, March 2001 and Conference Report (2000) on www.odi.org.uk

but publicised by only a few. Another view from the market is that of Persaud (2001), which argues that, while transparency is a good thing, too much transparency may be self-defeating. This market research makes a convincing case for not making information available on reserves etc. on a daily basis.

Persaud's study bases its argument on the following:

- In the short run, there is compelling evidence to indicate that the markets cannot distinguish between the good and the sustainable.
- In a herding environment, tighter market-sensitive risk-management systems and more data transparency actually make markets more prone to a crisis.
- The growing fashion in risk-management is to move away from discretionary judgements about risk to more quantitative and market-sensitive approaches. Analysis is based on the daily earnings at risk. A rise in market volatility hits the daily earnings ratio (DEAR) limits of some banks, causing a hit in the DEAR limits of other banks. Several banks sell the same asset at the same time, leading to an increase in market volatility and higher correlations.

Banks or investors like to buy what others are buying and sell what others are selling. Their performance is rated relative to each other. Employees are more likely to be dismissed for being wrong and alone than for being wrong and in company

Transparency alone cannot avert a crisis or contagion. Moreover, in a contagion situation there is a distinction between fully informed traders who follow fundamentals and less informed 'noise traders'. In the Keynesian 'beauty contest' world, informed traders anticipate irrational trading by noise traders since it is not a question of what one's own beliefs or knowledge are regarding fundamentals but rather that of the common perception. Information may help ameliorate this situation but it is unlikely to eliminate it entirely.[19] For instance, while the Special Data Dissemination Standard (SDDS) was implemented before the crises in Turkey and Argentina, the new disclosure rules failed to serve as an effective warning

[19] Ibid.

system.[20] Availability of information on the differences in macroeconomic scenarios in the countries hit by contagion failed to act as a warning signal and prevent contagion.

The approach to transparency is also asymmetric. 'Ownership' of regulatory policies will be greatly facilitated if there is symmetrical treatment between borrowers and lenders. One of the FSF working group reports on capital flows, for instance, focuses attention on improved risk-management practices and enhanced transparency on the part of the public and private sectors in borrowing countries (Cornford, 2000). It also identifies the factors which may lead to short-term volatile capital inflows into developing countries. The burden of providing information is asymmetric; transparency rules are adhered to by the developing world, but not necessarily by the lenders. Information on the portfolio share allocated to a particular country and the time horizon in which this share would be reached would enable developing countries to plan for their resource gaps in a more effective manner and to finance development from alternative sources. Stability would be enhanced if high frequency data on the largely short-term position of assets denominated in a country's currency held by foreign firms other than banks were endorsed by international action to enable timely action by the national authorities in their foreign-exchange and other financial markets.

The positive and negative incentives discussed in this chapter are valid largely in the case of emerging markets and developing countries. Transparency can enhance financial stability only if all countries participating in international financial markets implement transparency procedures.

Example 1: Some limits in implementing transparency

Achieving transparency through the SDDS is still a problem, although it has been in operation since the Asian crisis in 1997. As of June 2002, only 49 out of the 183 IMF member countries have subscribed to the SDDS. Thus incomplete information remains a problem for world financial markets. A study by Mosley (2002) identifies two constraints with respect to poor implementation: a weak market response, and a weak response from countries

The study investigates a government's incentives to subscribe to the SDSS. On the basis of surveys, Mosley argues that the benefits of SDSS compliance are quite low, while the

[20] The SDDS was launched in April 1996 and became operational in September 1998.

potential costs are high. She also points to lack of market awareness and use as the disincentive for governments to subscribe to the SDDS. The results of a survey of mutual fund managers show their reliance on private agents such as brokerage houses and credit-rating agencies for information.[21] Credit-rating agencies apparently make more use of the SDDS than other market participants, which implies that the SDDS is utilised indirectly. This survey result is consistent with the outreach exercise performed by the FSF which also found that few participants in the market took account of an economy's observance of standards in their lending and investment decisions, though observance of the SDDS was found to influence credit ratings (FSF, 2000: Section III).[22] Nonetheless, the use by credit-rating agencies and the possible indirect use by the market do not appear to be sufficient to induce governments to subscribe to the procedure.

Secondly, the costs of implementation or transition costs can be a reason for the under-subscription of the SDDS. This is particularly a problem for developing countries that are generally not accustomed to disclosing and providing information in a systematic way. Implementation of the SDDS requires not only changes in national practices but also an increase in resources. Mosley (2002) surveyed the government officials of subscribing countries and found that, though there were some transition costs, most subscribers to the SDDS were not required to overhaul their national systems completely. From a cost-benefit analysis point of view, one can deduce from this, as Mosley does, that a country is less likely to join the system if the cost is prohibitively high.

The third potential reason for under-subscription of the SDDS is concern about 'too much' transparency as mentioned in the previous section.[23] To sum up Mosley's findings, the perceived costs from signing on to the SDDS outweigh the benefits, which are limited because of lack of use by market participants. The SDDS can be effective in achieving its

[21] The subjects of the survey were specifically managers of internationally-oriented US mutual funds and managers of UK funds which invest at least 5% of assets in emerging markets regions. For more details, see Mosley, 2002: 13.

[22] The report was based on an informal dialogue with participants from 100 financial firms in 11 jurisdictions, mostly developed countries. Overall the FSF found limited awareness of the 12 key standards. Observance of the standards was considered less important than the adequacy of a country's legal and judicial framework; political risk and economic and financial fundamentals were more important factors.

[23] 'For a variety of reasons, ranging from legitimate economic policy-making concerns to pure political opportunism, governments may prefer not to be completely transparent in their dissemination of economic information.' (Mosley 2002: 26)

goals if the private sector actively embraces it; this, in turn, would induce governments to accept the standard.

Under-subscription to the SDDS limits the information available in markets. Although transparency is a desirable quality, unless the codes on transparency are implemented globally, its usefulness is limited. Research similar to Mosley's work or the outreach activities by the FSF is not available with regard to the other transparency procedures.

Example 2: Some limits in implementing transparency in banking supervision and regulation

Even with the best intentions, transparency in the field of banking supervision and regulation can be blurred. Difficulties arise because of off-balance sheet items in national accounts and corporate balance-sheets. Accounting rules cannot adequately cover these items and thus, in spite of transparency, it may be difficult to assess exposure and its distinction between the short and long term. Cross-border hedging makes it difficult to give advance warnings of financial-system weaknesses and pressures (Basle Committee on Banking Supervision, 2000: para 28). Also, financial innovation affects the transparency required for regulation and supervision. The balance sheets of many financial firms have an increasingly chameleon-like quality that reduces the value of their financial returns to regulators. The tensions between financial innovation and effective regulation in modern financial markets are unlikely to disappear and pose a challenge for financial regulators. The limits of financial regulation have been exemplified in the recent period by the fall of Enron, WorldCom and Global Crossing for example. These failures highlight the need for better and innovative supervision and regulation in the industrialised economies too.

(ii) Codes on banking supervision

Example 1: Licensing

Another illustration of the limitations of standards can be demonstrated from the vital field of banking supervision. Take licensing of banks, for instance. In some countries the criteria were designed primarily to ensure the distinction between the owners and those controlling a bank. But licensing is often also used to serve 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 cannot prevent serious banking instability or banking crises (UNCTAD, 2001).[24]

Example 2: Banking Capital Adequacy Standard

The capital adequacy standard has been widely implemented and serves as a useful illustration of the limited applicability of a rule-based system. This standard has gained importance in a world of open capital accounts in the industrialised as well as many emerging and developing countries. It was first applied to the initial twelve members of the Basle Committee on Banking Supervision but has now grown to more than 100 countries encompassing banks that operate in domestic markets. The information arising from the implementation of these principles is intended to reduce the occurrence of the contagion effect by providing improved information on the level of risk in the banking system, and thus early warning of an impending crisis. In fact, Argentina had complied with this standard above the required minimum of 8 per cent.

Rojas-Suarez (2002) discusses the appropriateness and effectiveness of the banking capital adequacy standard. Sufficient banking capital is considered to be a good indicator of bank soundness, as it acts as a buffer to absorb unexpected adverse shocks. However, there is evidence that banks' capital requirements had very little usefulness as a supervisory tool in recent experiences of banking crisis in developing countries, compared with industrialised countries. Rojas-Suarez shows that for the developing countries that faced banking crises during the 1990s, growth in net equity capital was high and positive while for industrial countries the growth rate was negative.[25] The capital standard did not prove to be an appropriate indicator of bank soundness in developing countries and instead could have been misleading.

The reason why the capital standard has not been an effective tool for developing countries is because there are some pre-conditions that need to be met first, Rojas-Suarez argues. 'Effective banking supervision may, therefore, need to take into account particular features of

[25] Furthermore, in a related study (2001) where Rojas-Suarez compares various early warning indicators of banking problems in developing countries, capital ratio performed the worst. The same indicator is found to be much more efficient in analysing the soundness of the banking system of developed countries.

developing countries that are different from those of industrialised countries' (Rojas-Suarez, 2002: 14). The first condition for the appropriate performance of the capital requirement is compliance with adequate infrastructure; an appropriate legal, judicial and accounting framework must first be in place. The second condition relates to the depth and efficiency of capital markets. Liquid markets for bank shares, subordinated debt, and other bank liabilities and assets are needed to validate the 'real' value of bank capital as distinct from its accounting value. However, when a capital market lacks liquidity and depth, as is the case for many developing countries, changes in the market value of bank capital do not provide much useful information regarding the quality of reported capital. In addition, the market for capital tends to be small and uncompetitive due to highly concentrated asset ownership. This concentration of wealth provides incentives for bank owners to undertake higher risks than in industrialised countries, as it becomes easy to raise low-quality bank capital relative to the bank's capital base. This feature can explain why emerging-market countries have had high and positive net capital growth when on the brink of banking crisis. In sum, the degree of financial development is an important factor for the effectiveness of capital adequacy standards.

The conditions point to the importance of sequencing and capacity for implementing of the capital standard. The nature of sequencing differs according to the level of overall economic and financial development. Moreover, Rojas-Suarez argues that a strict application of the capital standard can have unintended consequences in emerging markets, such as weakening the banking systems. For example, the regulatory treatment of banks' claims on government tends to reduce the soundness of banking systems in emerging markets (see Rojas-Suarez, 2002: 18-20 for explanation on this point).

The new Basle Accord (Basle II) presents some new characteristics that could potentially worsen the condition of emerging markets and developing countries (Griffith-Jones and Spratt, 2001). The proposed reform to the Basle code sets out two different systems of measuring credit risk: the standardised approach based on the ratings of external independent agencies and the Internal Risk Based approach (IRB), a complex mechanism based on the bank's own internal rating system. Both have been criticised in the literature because they may increase the volatility of private debt flows to developing countries, intensify pro-cyclical lending and enforce short-term rather than long-term inter-bank lending; they can thus cause a further weakening of the financial markets in developing countries (Griffith-Jones and Spratt, 2001; Cornford, 2001; Reisen, 2001). Moreover, the IRB approach is unlikely to be adopted by newer banks that may suffer a competitive disadvantage in international markets.

A disadvantage of these model-based approaches to risk assessment is that there is very little role left for discretionary judgements. All the information has to be in a simple format to feed into mathematical models. It is likely that they generate similar assessments about countries, so that there will be only one-way expectations in markets. One of the challenges for the international financial architecture is how to generate two-way expectations in the market to avoid herding.

Reisen (2001) simulated the effects of applying the standardised approach and the IRB to the financial markets and found that 'the potential impact of changing risk weights in Basel II can be dramatic.' The countries with a rating of BB (the majority of non-OECD sovereign states) or inferior would face an exponential increase in their weights of risk; the possible result being an increase in the capital cost for speculative grade developing countries and an increase in volatility. Other aspects, such as the incentives for short-term lending and the rigidity of the 8 per cent capital ratio, may further increase the volatility of the system.[26] Under these terms Basle II is unlikely to protect the international financial system from instability and, moreover, 'will not be of help to widen the range of countries likely to benefit from private capital inflows' (Reisen 2001).

[26] Under the new Accord, the short term is considered to be a maximum of three months instead of one year. See also Conford, (2000b).

(iii) Some limits of codes on securities regulation: securities listing standards

Market incentives are explored in Saar (2001) by examining the benefits of compliance with securities listing standards, with special reference to the depository receipt market.[27] The study analyses the importance of reporting and disclosing standards for the amounts of equity capital raised in international markets. The analysis used the American Deposit Receipt (ADR) market because the differences in types of ADRs are based on the differences in compliance procedures. Since both developing and industrialised countries issue different types of ADRs, the analysis also uncovered differences explainable by the stage of development.

Saar finds that the costs of implementing stringent securities listing standards may exceed the benefits. For lower levels of compliance, the results show that factors associated with the stage of development of the issuing firm's country account for the lower levels of capital raised. Thus investing resources in complying with higher standards may not be efficient. The main policy conclusion is that compliance with securities listing standards is not cost-efficient and should remain voluntary. The results indicate that a cost-effective strategy would be to let developing countries decide when implementation is needed, and that official incentives to foster implementation would also not be cost-effective.

(iv) Monitoring and administrative capacity: a limiting factor in ensuring implementation

The task of assessing of standards implementation began with the IMF and World Bank co-operating in the job of monitoring. The work is carried out by the Financial Sector Assessment Program (FSAP) and IMF Article IV surveillance which includes progress in standards implementation among the subjects of surveillance under the heading of the strength of the financial sector more generally.

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[27] Depository Receipts are negotiable certificates that certify ownership of a company's publicly traded equity or debt; they differ exclusively by the degree of compliance with transparency codes. There are different types of DRs. The American Depository Receipt (ADR) of Level I, II, III, and the rule 144A ADR issued and traded in the US Global Depository Receipts (GDRs) issued to US and non-US are traded outside the US. Level III ADRs can be traded at Nasdaq and NYSE and require full compliance with the SEC disclosure standards. Level II can be also traded at NYSE and Nasdaq but require less stringent requirements. Level I ADRs are the ones that need less compliance with the standard.

The administrative capacity of the IMF is likely to be stretched by the Reports on Observance of Standards and Codes (ROSCs) that have been conducted for a limited number of codes for some countries. If the administrative capacity were to be supported by other organisations, the issue of their judgement would arise. And, in the case of the IMF, it would be fair to make the evaluation of monitoring ROSCs independent of its other functions such as lending.

At the country level, the assessment exercises will often place an additional burden on a limited supply of supervisory capacity. Expanding this capacity takes a considerable time. And countries are then faced with the prospect of the flight of human capital. A well-trained supervisor may be tempted by attractive alternative employment opportunities in the private sector or even in the IMF or the World Bank themselves (they have recently been increasing the number of their staff with expertise in this area). These organisations are, of course, aware of the problem of human resources, as are the Basle Committee for Banking Supervision (BCBS) and the Core Principles Liaison Group (CPLG), and efforts are being made to co-ordinate 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.

A serious limitation of the monitoring process is that there is no public schedule with regard to the timing of future publications and no information on the criteria followed prioritising one country or one code over another. It is therefore impossible to discover whehter a ROSC has not been updated because no substantial changes took place in the country or because there were no resources or time for further analysis. At this stage it is uncertain how this exercise will prove to be a reliable source of information for investors and credit-rating agencies for market incentives to work. Currently ROSCs are available for only 53 out of the 183 members of the IMF. Although improvement in information is likely to contribute to financial stability, on an operational level information is scanty. The IMF has indicated that work is in progress with standardising ROSCS. Thus both human and financial resources and capacity constraints are identifiable on the BWIs serving as global monitors. One alternative would be greater use of self-assessment combined with a peer review process. The FATF model is a useful example. The BWIs could then be assigned an important role in co-ordinating the process and providing technical assistance to assist some countries in self-assessments and implementation. The BWIs could also play a useful role as providers of links to sources of information at country level on self-assessments, thus facilitating use of this information by market participants. The first step forward may be country self-assessment available on the treasury website. The US has set an example with self-assessment; the format is simple and may serve as one example for simplifying information. Amongst emerging markets, India has undertaken an exercise with the technical details of 10 standards and posted their assessment on the Reserve Bank of India web site. Technical assistance for self-assessment of the kind India has undertaken may be a better way forward than the use of negative incentives for compliance. Moreover, identification of where different countries are with respect to their institutional, legal and regulatory framework vis-à-vis the codes will also help to identify the real problems in applying a uniform rule across countries. The exercise will also be useful in defining the transition period needed for implementation. Another result of such an exercise will be in defining which areas a rule can be applied and in which one can best work with voluntary principles.

V. Open questions

The issues that have been raised and discussed in this chapter lead us to surmise the following:

- Compliance with standards and codes is a global issue although the incentive structure, monitoring mechanism and resources needed for assessment and implementation do not guarantee this.
- The arguments for making it a voluntary process and not a part of conditionality for developing countries lie in the advantages to be found in embedding the whole process in countries' self-interest in order to ensure 'ownership'. 'Conditionality' and 'ownership' do not go together.
- Research on the effectiveness and appropriateness of the codes in a diverse set of country situations produces arguments in favour of operating with principles rather than rules and working out transition periods for implementing them.

The following questions reiterate some of the issues raised and open up the discussion with a few more issues.

1. Can we ensure global participation of countries in the implementation of standards and codes? Are standards and codes meaningful for all countries?

Financial stability is a global concern. Crises emerging in any part of the world can have a contagion effect and can threaten the financial stability of other countries around the globe. The incentive structures prioritised in the present discussion make the implementation of standards and codes of self-interest to a country only if it proposes to borrow from the commercial financial markets or from bilateral or multilateral official sources. Since the G-7/G-10 countries no longer borrow from multi-lateral institutions, only the market incentives would be operative. But markets do not necessarily take the standards into account in the context of the industrial countries, and the latter's ability to borrow in their own currency is another factor operating to reduce the incentives. These asymmetries are not dealt with in the FSF reports on the subject. This is presumably because domestic financial crisis have been combined with external payments crises only in developing and transition economies. But the past is not necessarily a good guide to the future. Imagine for a moment the problems that might be spawned by the failure of one of the few global banks or by a meltdown in the US financial market which was less successfully contained that that of 1987.[28] How far is the emphasis on emerging markets and developing countries in the discussion of S and C implementation justified? Can a future crisis only arise in this part of the world? Is implementation the first priority for countries that are not financially integrated into global markets?

2. How do we ensure global monitoring of compliance with standards and codes?

The preceding paragraph raises the issue of monitoring. Are all countries covered by the monitoring activity of ROSCs and the FSAP? The answer is probably no. Is it possible to cover at least all countries participating in international financial markets? The answer lies in the fact that only some of the codes are covered for all countries under the current arrangement, but for others, surveillance is an issue. The chapter by Aziz Ali Mohammed will discuss this issue further. The results of ROSCs and FSAP exercises may prove to be of limited use as an early warning indicator of crisis because of the lack of universal coverage. How far does the progress made in the international financial architecture ensure that the goals of financial stability will be met by compliance on the part of countries not borrowing from multilateral institutions?

3. Is there a case for separating the monitoring of standards and codes from lending operations in order to ensure global stability?

If there is such a case, how do we ensure that monitoring is kept distinct from lending operations so that each exercise can be carried out more effectively? Currently, monitoring is carried out mainly under Article IV consultations, and there is a tension between the two operations. Will financial stability be better served if monitoring of standards is global and not linked to the lending function?

4. Who is responsible for providing information? Is the private sector the answer?

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[28] Another example of threats of a global meltdown is the crisis in Long-Term Capital Management. In September 1998, Russia's default on its sovereign debt, created losses for many large financial institutions, a widening of credit spreads and pressure on highly leveraged institutions like the LTCM. The consequences of a bankruptcy of the LTCM would have been enormous for the entire world economy. The LTCM was saved by the intervention of the US Federal Reserve and the principal international banks which, after 23 September 1998, owned 90 per cent of the fund (what fund??) and established a board to supervise its activities.

Information on compliance is vital for surveillance activity and assessment of risk by the private sector. The information generated by ROSCs and the FSAP is limited in its country coverage and is not a continuous data stream across the globe. The IMF has announced its intention to provide updates but will still not produce a continuous data stream.

Oxford Analytica and the Global Financial Services Forum have started a service to provide information on compliance with the core standards and codes for subscribers on the Internet. What are the advantages of the private sector supplying such information? What kind of peer review process would ensure that it functions better than credit-rating agencies in assessing information on standards and codes? Is self-assessment with a peer review process another alternative to global monitoring, since global monitoring faces a resource constraint? Should information not be a global public good?

5. *What measures can the international community take to ensure that there is reciprocity in transparency?*

At present the degree of transparency varies across countries and this incongruity can undermine its effectiveness. Transparency can effectively enhance financial stability only when it takes place across countries and markets.

6. *Do principles work better than rules?*

The research available on some of the codes indicates that there are limits to their effectiveness in predicting or preventing a crisis. The example of ENRON illustrates that even in a rule-based system crises are possible.

Too much time may be spent in adhering to the letter of the law rather than the spirit. It is not easy to monitor compliance by the letter of the law; judging by the ENRON experience, it is a good idea to move away from legislative (rule-based) operations. The UK provides an example of financial reporting procedures being based on broad principles.

7. Do we need the same model of corporate structure globally?

Financial stability is of interest to all countries. Some codes such as the corporate governance code require structural changes in the way economies function. Such changes are a political process and carry the exercise on standards and codes way beyond its initial objective.

Changes in structures which are not supported by participants in the market can lead to more instability rather than stability.

Can the objective of financial stability be secured by accepting the codes in principle, i.e. by ensuring that the balance sheets of the corporate sector are healthy and do not subject the economy to risk? Is it necessary to impose the Anglo-Saxon model on countries with different structures and institutions? One argument may be that information coming out of similar structures is easily standardised and usable by the markets in risk assessments. Is it justifiable to expect countries to change their structures and adopt imposed models of corporate structure for which there is no evidence that they can work efficiently simply to attract international finance which is a small fraction of their GDP?

8. Is it not a good idea to encourage self-assessments on compliance?

This brings up the issue of whether national as opposed to international assessments of S and C compliance might be preferable. The process will need to be a voluntary one, with technical assistance in areas where there are gaps in skills. It is more practical to have national assessments of the risks to balance sheets. Common principles providing best practices would be very useful for bench-marking, and would also provide the opportunity to take country-specific factors into account. It is also conceivable that the market has resident consultants who can provide information in countries as here it is investing and in many spheres of market information this is already the case. Moreover, the argument that there is too little information is not a convincing one. The market has also failed to use existing information in past crises.

9. Are suggestions that S and C become a part of conditionality a good idea,

given that it is difficult to standardise different structures and systems across the world under a single rule? Attempts to do so may lead to more instability as the implementation process is a political one, and opposition to changing structures is to be expected. Is it possible that the debate is moving beyond the remit of international financial architecture into intrusion into the politics of sovereign countries? Is not access to finance from multilateral institutions already burdened with over-conditionality? How will the IMF streamline conditionality if at the same time a whole raft of new conditions is added?

10. In view of these difficulties, what is the way forward?

Self-assessments and voluntary principles can be supported by a background process, which would provide the necessary support for such an initiative. This could probably take the form of a major research programme possibly co-ordinated by the IMF and World Bank in a sample of countries representative of the different structures and systems across the globe on the appropriateness of different standards and their effectiveness, along with issues of defining transition periods, priorities and sequencing? How are 'ownership' and 'appropriateness' to be ensured? It is noteworthy that the few existing research studies do point to the limited usefulness of some codes in the developing country context.

11. How do we resolve the resource constraints for implementation?

Issues of administration are immense both at the surveillance and the country level. There are issues of capacity and resources. While technical assistance will undoubtedly play a very important role in helping countries to strengthen their financial sectors, is the scale of the resources required sufficient to support implementation in all countries participating in international financial markets? Have the agencies offering technical assistance any estimate of the scale of resources required?

12. How do we improve ownership and self-interest?

Standards and Codes have been found to be more effective in terms of intrinsic use and implementation when countries have the right incentives and when it is in their interest to adopt them. This can occur when countries feel that they 'own' the policies. A conscious effort to increase the involvement of under-represented countries in the design and development of standards is necessary to break the cycle of lack of incentives leading to limited effectiveness of the S and C. The appropriateness of standards is also essential

13. Should the emphasis not be on sound balance-sheet management?

Healthy balance sheets in both the macro, and corporate financial sectors are crucial in averting disaster. The World Bank is already working on indicators of financial soundness. Technical assistance can play a role in ensuring the quality of financial sector balance sheets. Wide encompassing rules, whether formal or informal, take the form of conditionality and can detract attention from this vital area. In terms of prioritisation, is this not the first priority?

14. What are the other priorities?

In terms of the 12 codes is there any basis for demarcating some codes as of higher priority? Which code do fund managers and credit rating agencies take into account? Is it right to have a market-driven process in deciding codes?

15. Is the initiative enough to ensure global financial stability? How do we ensure stability in the transition period?

The prioritised 12 standards will take years to implement. How is financial stability to be ensured in the transition period? Moreover, we do not know enough to be sure that even at the end of the transition period, the 12 codes will encourage financial stability. Financial crises have many causes and the danger is that too much emphasis on standards can detract attention from other policy measures.

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Annex Table 1 ROSC Modules published by 13 June 2002

OECD countries									
Data Dissemination	**Fiscal Transparency**	**Monetary and Financial Policy Transparency**	**Banking Supervision**	**Insurance Supervision**	**Securities Market Regulation**	**Payments Systems**	**Corporate Governance**	**Insolvency and Creditor Rights**	**Accounting and Auditing**
Australia, 1999	Australia, 1999	Australia, 1999	Australia, 1999	Canada*, 2000	Canada*, 2000	Canada*, 2000	Czech Republic*, 2001		
Czech Republic, 2001, 2000	Czech Republic, 2001, 2000	Canada*, 2000	Canada*, 2000	Czech Republic*, 2001	Czech Republic*, 2001, 2000	Czech Republic*, 2001			
France, 2001, 2000	Greece, 2002, 2001, 1999	Czech Republic*, 2001	Czech Republic*, 2001, 2000	Finland*, 2001	Finland*, 2001	Euro Area*, 2001			
Sweden, 2001	Hungary, 2001	Euro Area, 2001	Hungary*, 2001	Ireland*, 2001	Hungary*, 2001	Finland*, 2001			
Turkey, 2002	Finland*, 2001	Finland*, 2001	Iceland*, 2001	Mexico*, 2001	Iceland*, 2001	Hungary*, 2001			
United Kingdom, 1999	France, 2001	Iceland*, 2001	Iceland*, 2001	Poland*, 2001	Ireland*, 2001	Mexico*, 2001			
	Japan, 2001	Ireland*, 2001	Ireland*, 2001	Switzerland*, 2002	Mexico*, 2001	Poland**, 2000			
	Poland, 2001	Mexico*, 2001	Mexico*, 2001		Poland*, 2001	Poland*, 2001			
	Sweden, 2000	Poland*, 2001	Poland*, 2001		Switzerland*, 2002	Switzerland*, 2002			
	Turkey, 2000	United Kingdom, 1999	Switzerland, 2002			Turkey**, 2000			
	United Kingdom, 1999		United Kingdom, 1999						

Non-OECD countries									
Data Dissemination	**Fiscal Transparency**	**Monetary and Financial Policy Transparency**	**Banking Supervision**	**Insurance Supervision**	**Securities Market Regulation**	**Payments Systems**	**Corporate Governance**	**Insolvency and Creditor Rights**	**Accounting and Auditing**
Albania, 2000	Argentina, 1999	Argentina, 1999	Algeria, 2000	Bulgaria*, 2001, 2000	Bulgaria, 2001, 2000	Cameroon*, 2000	Croatia**, 2001	Bulgaria, 2001, 2000	
Argentina, 1999	Armenia, 2002	Bulgaria, 2001, 2000	Argentina, 1999	Cameroon*, 2000	Estonia*, 2000	Estonia*, 2000	Egypt**, 2001		
Armenia, 2002	Azerbaijan, 2000	Cameroon*, 2000	Bulgaria, 2001	Estonia*, 2000	Senegal*, 2001	Georgia*, 2001	Georgia*, 2001		
Botwana, 2002	Brazil, 2001	Estonia*, 2000	Cameroon*, 2000	Gabon, 2002	Slovenia*, 2001	Israel*, 2001	India**, 2000		
Bulgaria, 2001, 2000	Bulgaria, 2001, 2000	Gabon, 2002	Estonia*, 2000	Georgia*, 2001		Slovenia*, 2001	Latvia, 2002		
Cameroon, 2001	Cameroon, 2000	Georgia*, 2001	Georgia*, 2001	Israel*, 2001			Malaysia**, 2000		
Chile, 2001	Honduras, 2002	Hong Kong SAR of China, 1999	Hong Kong SAR of China, 1999	Israel*, 2001			Philipines**, 2001		
Estonia, 2001	Hong Kong SAR of China, 1999	Hungary*, 2001	Israel*, 2001	Latvia, Republic of*, 2002			Zimbabwe**, 2000		
Estonia, 2001	India, 2001	Israel*, 2001	Latvia, 2002	Lithuania, 2002					
Hong Kong SAR of China, 1999	Korea, Republic of, 2001	Senegal*, 2001	Lithuania, 2002	Senegal*, 2001					
Hungary, 2001	Kyrgyz Republic, 2002	Tunisia, 2001, 1999	Senegal*, 2001	Slovenia*, 2001					
Mauritius, 2002	Latvia, 2001	Uganda, 1999	Slovenia*, 2001						
Mongolia, 2001	Mali, 2002		Tunisia, 2001, 1999						
Romania, 2001	Mongolia, 2001		Uganda, 1999						
South Africa, 2001	Mozambique, 2001								
Sri Lanka, 2002	Nicaragua, 2002								
Tunisia, 2001, 1999	Pakistan, 2000								
Uganda, 1999	Papua New Guinea, 2000								
Uruguay, 2001	Tunisia, 2001								
	Uganda, 1999								
	Ukraine, 1999								
	Uruguay, 1999								

* Indicates the module was derived from an FSAP.

Annex Table 2. Countries' participation in standard-setting bodies

	Monetary Policy and Financial Policies	**Fiscal Transparency**	**Data Dissemination**	**Insolvency and Creditor Rights Systems**	**Corporate Governance**	**International Accounting Standards**	**International Auditing Standards**	**Systemically Important Payment Systems**	**Banking Supervision**	**Securities Regulation**	**Insurance Core Principles**
Organisation	IMF	IMF	IMF	WB	OECD	IASB	IFAC	CPSS	BCBS	IOSCO	IAIS
Participation	International Monetary Fund 183	International Monetary Fund 183	International Monetary Fund 183	World Bank 183	Organization for Economic Co-operation and Development 30	International Accounting Standards Board 106	International Federation of Accountants 122	Committee on Payment and Settlement Systems G-10	Basle Committee 13	International Organisation of Securities Commissions 99	International Association of Insurance Supervisors 66
					Australia				Belgium		
					Austria				Canada		
					Belgium				France		
					Canada				Germany		
					Czech Republic				Italy		
					Denmark				Japan		
					Finland				Luxembourg		
					France				Netherlands		
					Germany				Spain		
					Greece				Sweden		
					Hungary				Switzerland		
					Iceland				United Kingdom		
					Ireland				United States		
					Italy						
					Japan						
					Korea						
					Luxembourg						
					Mexico						
					Netherlands						
					New Zealand						
					Norway						
					Poland						
					Portugal						
					Slovak Republic						
					Spain						
					Sweden						
					Switzerland						
					Turkey						
					United Kingdom						
					United States						

Source: Organisations web sites – hyperlinked at: http://www.fsforum.org/Standards/keystds.html

Annex Table 3: Membership in FSF working groups

	Task Force on Implementation of Standards	Incentives to Foster Implementation of Standards	Working Group on Capital Flows	Working Group on Offshore Centres	Working Group on Enhanced Disclosure	Working Group on highly leveraged institutions	Working Group on Deposit Insurance
Established	Sep-1999	Apr-2000	Apr-1999	Apr-1999	Jun-1999	Apr-19	Apr-2000
Ended	Mar-2000	Sep-2001	Apr-2000	Apr-2000	Apr-2001	Apr-2000	Apr-2001
ToR	To explore issues related to and consider a strategy for fostering the implementation of international standards for strengthening financial systems.	To monitor progress in implementing core standards and further raise market awareness of standards.	To evaluate measures in borrower and creditor countries that could reduce the volatility of capital flows and the risks to financial systems of excessive short-term external indebtedness.	To consider the significance of offshore financial centres for global financial stability.	To assess the feasibility and utility of enhanced public disclosure by financial intermediaries	To recommend actions to reduce the destabilising potential of institutions employing a high degree of Leverage (HLIs) in the financial markets of developed and developing countries.	To review recent experience with deposit insurance schemes and consider the desirability and feasibility of setting out international guidance for such arrangements.
Final report	Issues of the task force on implementation of standards	Final Report of the Follow-Up Group on Incentives to Foster Implementation of standards	Report of the Working Group on Capital Flows	Report of the Working Group on Offshore Centres	Multidisciplinary Working Group on Enhanced Disclosure Final Report	Report of the Working Group on Highly leveraged Institutions	Guidance for Developing Effective Deposit Insurance Systems
Member Countries	Australia Canada China France Germany Hong Kong (Chair) India Italy Japan Mexico Netherlands South Africa Sweden UK US	Argentina Australia Canada France Germany (Chair) Hong Kong India Italy Japan Sweden UK US	Brazil Canada Chile France Germany Italy (Chair) Japan Malaysia South Africa UK US	Canada (chair) France Germany Italy Japan Singapore Switzerland Thailand UK US	Australia Canada France Germany Japan Mexico Sweden UK US	Australia Canada France Germany Hong Kong Italy Japan Netherlands UK (chair) US	Argentina Canada (chair) Chile France Germany Hungary Italy Jamaica Japan Mexico Philippines US

Source: Financial Stability Forum; www.fsforum.org

Annex 4: A summary of Reports on the Observance of Standards and Codes for selected countries

Argentina

Report dated 15 April 1999

General comments	Argentina made important improvements in its transparency practices. Although some aspects could be further improved, the compliance with the standards is very high. The report also includes a self-assessment of the country in Securities and Market Regulation, Accounting Practices and Auditing Practices.
Data dissemination	Argentina subscribes to SDDS since 1996 and the compliance with the standard is in progress
Fiscal transparency	Argentina achieved a high degree of fiscal transparency but in some areas it was required to: • simplify the rules relating to intergovernmental fiscal relations, strengthen tax regulation and administration, improve information on general government, finalise the draft legislation on fiscal responsibility
Monetary and financial transparency	The central bank's policies are transparent and the financial framework is clear. Argentina has a very high compliance with this standard. The report stress the importance of continuing the policy of independency of the Bank Supervising Agency.
Banking supervision	Argentina's practices appear consistent with the disclosure aspects of the Basle core principles. " Increasing public awareness of riskier institutions can be expected to impose market discipline on their management and promote (healthier forms of) competition among banks"

Greece

Report dated December 1999, updated on February 2001 and on March 2002.

General comments	The code was already implemented before the ROSC review in 1999 and the report of 1999 suggest several areas where improvement were necessary: Clarity of roles and responsibilities, Public availability of information, Open budget preparation, execution and reporting, Independent assurances of integrity.

Japan

Report dated August 2001

Fiscal transparency	Japan meets high standards of fiscal transparency and recent initiatives have improved the adoption of the standard. Nevertheless there is still room for major progress in key areas: more attention in providing timely information on the overall stance of fiscal policy, preparation of medium term budget plans, the role and consequence of public financial intermediation through the FILP (Fiscal Investment and Loan Program) should be clarified.

United Kingdom

Report dated 15 March, 1999

General comments	'United Kingdom has achieved high levels of transparency in the four areas assessed here'. The report also contains UK self-assessments of Securities Market Regulation, Insurance Industry Regulation, Accounting Practices and Auditing Practices.
Data dissemination	At the time of the report the UK was implementing SDDS and was still not disseminating the data on central and general government operations. The ROSC also stressed the importance of revising metadata.
Fiscal transparency	'The United Kingdom has achieved a very high level of fiscal transparency'
Transparency of monetary and financial policies	'The new monetary policy framework is highly transparent with respect to all four principles underlying the draft Code' With respect to financial policy the report asks for more transparency in the mechanism that may lead to the dismissal of the FSA (Financial Services Authority) board
Banking supervision	'While existing supervisory practices in the areas outlined above already appear consistent with the disclosure aspects of the Basle Core Principles, the picture can be expected to become somewhat sharper once the current period of regulatory transition is resolved, in particular with the passage of legislation underpinning the FSA'.

India

Report dated February 2001

General comments	The ROSC on fiscal transparency has been prepared by the IMF and the ROSC on corporate governance by the World Bank.
Fiscal transparency	'India has achieved a reasonably high standard of fiscal transparency'. Nevertheless lists issues that need to be improved: Enact the Fiscal Responsibility and Budget Management Bill (the report also stress the opportunity to revise some of its aspects). Further simplification and clarification in the area of intergovernmental fiscal relations The role of the central government in enforcing fiscal discipline on the states should be more clearly established The current nine-month lag in producing reliable and detailed general government accounts is too long. The budget documents should provide more background information and analysis (for example, there is a lack of long-term projections and assessment of fiscal risks) The expenditure framework needs to be strengthened Clarify the principles governing RBI (Reserve Bank of India) financing of the central government (the report suggests granting legal autonomy to the RBI) Continued efforts also are needed to stem the scope for corruption among tax and other officials The recently established National Statistical Commission ought to address the issue of the technical independence of the Central Statistical Organisation
Corporate Governance	India adheres only in part to the OECD principles of corporate governance. Compliance is not complete in all the areas taken into account: Basic shareholders' rights Equitable treatment of shareholders Role of stakeholders in corporate governance Disclosure and transparency Responsibilities of the Board

Cameroon

Report dated May 2000

General Comments	Report prepared in the context of a FSAP
Banking supervision	'The assessment of observance of each of the 25 Core Principles (30 after subdividing the first Core Principle into six sub-principles) has revealed a number of weaknesses (…) the legal and regulatory framework appear to be compliant or largely compliant with 18 of the 26 Core Principles that are relevant' Principles with which Cameroon is non-compliant (or broadly non-compliant) are: human resources (that are insufficient) capital requirements (the current minimum solvency ratio is too low and should be raised to 8%) loan policies connected lending (legal provisions are insufficient,) other material risks (many important risks have not been considered in the regulations) money laundering accounting and disclosure The report stresses the importance of the lack of human resources within the regional banking commission (COBAC) and 'recommends that COBAC be given a specific budget consistent with its need and that the latter be ranked top priority'.

Korea

Report dated January 2001

Fiscal transparency	'Korea meets international best practices in fiscal transparency in many areas'. For further improvements IMF staff suggested that the government should: take the opportunity, now that the effects of the financial crisis are waning, to reassess and more clearly define its fiscal role affirm the universality of the budget as the principal instrument of fiscal control improve the annual budget documents improve the quality of information on local governments, on its financial assets and on the working methods and assumptions underlying the fiscal forecasts significantly simplify the tax system continue to expand on its initiatives to improve taxpayer services