Key financial codes and standards: different views of their role in a new financial architecture

by

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An initiative which responds to the financial crises of the 1990s

The initiative on key financial codes and standards aims to achieve strengthened rules and institutions for the financial sector worldwide. This initiative evolved piecemeal as a major part of the policy response to the crises of the 1990s involving large-scale disruptions of both the banking system and the foreign exchange market which have been felicitously named "twin crises", the term which will be employed in the sequel. The origin of the initiative was the "early warning system" mandated by the Halifax Summit of the G-7 in 1995 after the Mexican financial crisis of 1994, one of whose elements was to be enhanced disclosure intended to enable avoidance in future of the Mexican government's failures in this area during the period preceding the crisis, particularly regarding the country's reserves of foreign currency. As a result the IMF undertook the development of standards for the prompt publication of specified financial and economic data, its vehicles for this purpose being a Special Data Dissemination Standard (SDDS) for countries wishing to raise money in international capital markets and a less stringent General Data Dissemination Standard (GDDS) for others.

A parallel initiative, endorsed by the Lyon Summit of the G-7 in 1996, was the encouragement of stronger prudential supervision for banks worldwide through the development of standards for this purpose, which were to materialise in the Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision (BCBS) in 1997. This period also witnessed the establishment of a number of official working groups to consider issues related to the stability of the international financial system, a subject whose urgency was increasingly underlined as first the Asian crisis and then the Russian crises unfolded in 1997-1998.

Interestingly the early stages of the policy response to the succession of twin crises were notable for the continuation of a campaign of major G-7 countries and the management of the IMF for an extension of the Fund's Articles of Agreement to include the obligation to liberalise capital transactions (current-account transactions already being covered by the obligations defined in Article VIII), a campaign which reflected pressures from the private financial sector as well as a long-standing ideological commitment to such liberalisation. This objective was endorsed by the Fund's Interim Committee at the 1997 meetings of the IMF and World Bank in Hong Kong only a short time after the beginning of the Asian crisis in Thailand. At this time official circles in major advanced economies appeared to view measures to prevent financial crises (of which the initiative on financial codes and standards was a major example) as not merely compatible with greater freedom of capital movements but as also rendering it safer and thus more acceptable. However, as the crises unfolded, the objective of capital-account liberalisation was increasingly put to one side, and a report of the G-7 finance ministers to the Köln Summit in 1999 actually endorsed recourse to capital controls for limited periods. By 2000 the major advanced economies had signalled their acceptance of controls over capital inflows as a "prudential measure" (i.e. as part of management of external assets and liabilities). The campaign for liberalisation of capital

transactions shifted to other fronts – in the case of the United States to bilateral agreements on trade and investment.

One of the reports of this period, prepared by the IMF, reviewed the key features of financial regulation and supervision and disclosure as well as the lender-of-last-resort and deposit-insurance arrangements required for financial stability, covering much of the agenda of the key financial codes and standards.\(^3\) Another produced by the Working Party on Financial Stability in Emerging Market Economies, which was composed of G-10 deputies and representatives of Argentina, Hong Kong, Indonesia, Mexico, Poland, Singapore, South Korea, and Thailand as well as of the multilateral financial institutions, produced in the spring of 1997 a wide-ranging review of sources of vulnerability involving corporate governance, market infrastructure and discipline, and financial regulation and supervision.\(^4\) In this report there was a ringing endorsement of the contribution a diverse array of markets and instruments makes to financial robustness. Yet only a little more than a year later the financial system of the United States, which had these features (and which, it is reasonable to assume, provided much of the inspiration for the report’s endorsement), was severely shaken in the aftermath of the Russian crisis during the autumn of 1998 with consequences which included a drastic reduction in issues of bonds for almost a month and a flight to liquidity leading to fears in the highest official circles of the severest credit crunch since World War Two.

By 1998 various other financial codes and standards were being developed, and the Birmingham Summit of the G-7 addressed what it perceived as the need for multilateral surveillance of the subjects which they covered, limiting itself, however, to the suggestion that one condition for granting access to the markets of advanced economies for foreign financial firms could be satisfactory quality of financial regulation and supervision in their home countries. Unsurprisingly in view of the tremors in financial markets during the two previous years, by 1999 the recommendations and actions of the governments of the major advanced economies reflected greater urgency as to ways of dealing with international financial instability.

Much of this programme concerned ways of resolving debt-related crises but there was also movement regarding financial codes and standards. The Financial Stability Forum (FSF) was established as a venue for promoting international cooperation and the exchange of information among bodies responsible for financial regulation and supervision with a membership that included representatives of selected OECD countries, Hong Kong, Singapore, the multilateral financial institutions and standard-setting bodies. One of the FSF’s tasks was to compile a compendium of work on financial codes and standards. The year also witnessed pilot studies by the IMF to assess countries' observation of standards for data dissemination, for transparency regarding fiscal, monetary and financial policy, and for banking supervision, which were eventually to be named Reports on Standards and Codes (ROSCs), followed by the establishment of of the IMF/World Bank Financial Sector Assessment Programme (FSAP) to monitor countries' financial sectors including their compliance with key financial codes and standards. Another action of interest in the context of financial codes and standards in 1999 was the establishment of a new IMF facility, the Contingent Credit Line (CCL), which would provide support to a country experiencing international financial contagion. A country could prequalify for financing under the CCL if it


had received a favourable assessment during Article IV surveillance consultations concerning a list of subjects which included its compliance with key financial standards.\(^5\)

In the autumn of 1999 ROSCs were given their current form, which involves collaborative assessments by different institutions in their areas of competence, the World bank, for example, taking responsibility for corporate governance, accounting and auditing, and insolvency. Each assessment of a standard (including those of the FSAP) is covered by a separate ROSC "module". A country's participation in a ROSC exercise is voluntary, and it can choose to be assessed only for those standards which it believes to be most relevant to its circumstances. ROSC modules serve as inputs into the IMF's Article IV country surveillance. And in July 2000 the IMF's work on financial sectors was extended to offshore financial centres (OFCs) under a programme involving three alternative possibilities: (1) self-assessment; (2) IMF assessment of financial supervision; or (3) more comprehensive assessment within an FSAP-type framework.

**The key codes and standards\(^6\)**

The FSF identified 12 subjects and the associated development of codes and standards as especially relevant to its work. These so-called key standards can be categorised as directed towards three broad subjects: (1) transparency (regarding economic data important for the assessment of financial stability and the conduct of fiscal and monetary policies); (2) regulation and infrastructure of the financial sector proper (banking, securities, insurance, and payments and settlement); and (3) market integrity (accounting, auditing, corporate governance, insolvency and creditor rights, and money laundering and terrorist financing).

*Code of Good Practices on Monetary and financial policies.* Issued by the IMF, this code identifies desirable transparency practices in the conduct of monetary policy and of policies towards the financial sector. This code (like that on transparency in fiscal policy) is limited to process and does not cover the substance of policies.

*Code of Good Practices on Fiscal Transparency.* Issued by the IMF, this code covers four headings: (1) the roles and responsibilities of government and the legal and administrative framework; (2) government disclosure on its fiscal activities; (3) openness of the budgetary process; and (4) the scrutiny of fiscal information.

*Special Data Dissemination Standard (SDDS).* Issued by the IMF, the standard prescribes the data which countries expecting to make use of international capital markets should make public concerning economies' real, fiscal, financial and external sectors, laying down minimum benchmarks for periodicity and timeliness. It is supplemented by a less stringent *General Data Dissemination Standard (GDDS)* which is designed to improve the quality of data disclosed by other member countries of the IMF.

*Core Principles for Effective Banking Supervision.* Issued by the BCBS, these principles cover the major areas of banking supervision classified under seven headings: (1) preconditions; (2) the licensing and structure of banks; (3) prudential regulation; (4) supervisory methods; (5) information requirements; (6) supervisors' powers; and (7)

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5 No country borrowed under the CCL, which was recently discontinued.

6 This section draws freely on the more extended account in A.Comford, "Appendix: key financial standards-a guide", in B.Schneider (ed.), *The Road to International Financial Stability: Are Key Financial Standards the Answer?* (New York, etc. : Palgrave Macmillan, 2003).
cross-border banking. In response to feedback on problems of practical implementation the BCBS issued the Core Principles Methodology in 1999 to provide guidance on criteria for assessing compliance, a task entrusted to the IMF, the World Bank, regional supervisory groups, regional development banks and consulting firms but not to the BCBS itself.

Objectives and Principles of Securities Regulation. Issued by IOSCO (the International Organisation of Securities Commissions, a private, non-profit body with a membership of securities regulators and exchanges), this standard has three major objectives: (1) protection of investors; (2) ensuring that markets are fair, efficient and transparent; and (3) reduction of systemic risk. The 30 principles cover the regulatory framework, domestic and international regulatory cooperation, issuers' responsibilities, collective investment schemes, market intermediaries, and the secondary market.

Insurance Supervisory Principles. Issued by the IAIS (International Association of Insurance Supervisors), the standard covers the organisation and practice of insurance supervision, the corporate governance, internal controls, and prudential and conduct-of business rules of insurance companies, and supervision of cross-border business.

Core Principles for Systemically Important Payments Systems. Issued by the Committee on Payment and Settlement Systems of the BIS, the standard is directed at controlling the credit, liquidity, legal, and operational risks of payments and settlements systems, a vital part of what has been described as a financial system's "plumbing", where four key dimensions of an economy's flow-of-funds process interact, namely the activities of economic agents, the markets for financial assets and liabilities, supporting infrastructure (of which payments and settlements is an integral element), and the conditions binding markets together and ensuring that they clear. These interactions and their implications for financial stability are a frequent theme of the writings of the BIS economist, William R. White. See, for example, "International agreements in the area of banking and finance: accomplishments and outstanding issues", BIS Working Paper 38, October 1996.

The subjects of the standard include payment systems' legal basis, procedures to enable participants to have a clear understanding of systems' impact on financial risks, the management of credit and liquidity risks, prompt settlement, a settlement asset with low credit risk, multilateral netting systems, and the minimization of operational risks.

International Financial Reporting Standards (IFRS). IFRS cover requirements for recognition, measurement, presentation and disclosure for transactions and events that are important in general purpose financial statements. They may also set out such requirements for transactions and events that arise mainly in specific industries or sectors. This initiative is carried out under the auspices of the International Accounting Standards Committee Foundation (IASCF), an organisation established in 2000. Since 2001 the International Accounting Standards Board (IASB), whose members are appointed by the Trustees of the IASCF, has had the responsibility of developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements, cooperating for this purpose with national accounting standard-setters and also being advised and otherwise

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

9 Prior to 2001 and the reorganisation of the responsible international bodies this initiative went by the name of International Accounting Standards.
assisted in its work by other bodies operating under the auspices of the IASCF. On its
inception the IASB adopted the then existing body of International Accounting Standards
(IAS) issued by its predecessor, the Board of the International Accounting Standards
Committee (IASC).

**International Standards on Auditing.** Issued by the International Federation of
Accountants (IFAC), a body which was established in 1977 to promulgate international
standards in auditing and closely related subjects and which nominates 5 of the 19
Trustees of the IASCF, the standards of IFAC are directed at international harmonisation
of external auditing (in areas such as auditors' responsibilities, audit planning, assessment
of internal controls, audit evidence, using the work of other auditors or experts, and audit
conclusions and reporting). This task is complicated by variation in countries' company
law and other regulations with respect to such subjects as qualifications, the respective
authority of the profession and the government, and the degree of local control in
countries with federal systems.

**OECD Principles of Corporate Governance.** These principles cover the following
subjects: protection of the rights and equitable treatment of shareholders; recognition and
protection of the rights of stakeholders other than shareholders (such as employees,
customers, suppliers and the community) and encouragement of cooperation between the
corporation and stakeholders; and a framework that ensures strategic guidance for the
corporation and effective monitoring of its management by the board of directors.
Promulgation as opposed to enunciation of the OECD Principles is also to involve other
organisations, a key role here being attributed to the World Bank. The World Bank and
the OECD have established a Global Corporate Governance Forum whose agenda
includes consensus building, technical assistance, the design and implementation of
projects, and the promotion of policy dialogue. For this purpose the Forum will include,
in addition to its two sponsors, regional development banks, other international
organisations, bodies working on the standards for financial reporting and securities
markets, and a Private Sector Advisory Group.

**Principles and Guidelines on Effective Insolvency Systems.** The leading role in
developing globally acceptable rules for insolvency drawing on existing best practices
has been attributed to the World Bank. A major outcome of this process so far is the
approval by the World Bank Board of a first set of **Principles and Guidelines for
Effective Insolvency and Creditor Rights Systems**, which cover the key areas of (1)
creditor rights and enforcement procedures, (2) the legal framework for corporate
insolvency, (3) the regulatory framework to implement the insolvency system, and (4) the
enabling framework for credit risk management and informal corporate workouts. Work
on more detailed guides to the implementation of these principles and guidelines as to
their inclusion in legislation is being carried out by the World Bank and by UNCITRAL
(United Nations Commission on International Trade Law). In parallel with its work on
insolvency in general the World Bank has also undertaken a joint project with the IMF on
bank insolvency, whose objective is to identify an appropriate legal, institutional and
regulatory framework for dealing with bank insolvencies, including those linked to
systemic crises.

**Money Laundering and Terrorist Financing.** The principal international body entrusted
with the task of combating money laundering is the Financial Action Task Force on
Money Laundering (FATF),\textsuperscript{10} Its current membership consists of a group of mainly developed countries and two international organizations, the European Commission and the Gulf Cooperation Council. In 1990 the FATF drew up a list of 40 recommendations which members were expected to adopt and which were revised in 1996.\textsuperscript{11} Amongst the obligations contained in the 40 recommendations are the following: criminalisation of the laundering of the proceeds of serious crimes, the identification of all customers and the keeping of appropriate records; a requirement that financial institutions report suspicious transactions to the competent national authority and that they develop programmes to counter money laundering including comprehensive internal controls and employee training; adequate supervision of money laundering and the sharing of expertise by supervisors with other domestic judicial and law enforcement authorities; and the strengthening of international co-operation through information exchange, mutual legal assistance, and bilateral and multilateral agreements. Implementation by member countries of these recommendations is monitored on the basis of a two-pronged approach: firstly, an annual self-assessment exercise and, secondly, periodic peer reviews of a member country by teams drawn from others.

At a meeting in Washington in October 2001 in the aftermath of the terrorist attacks of the previous month FATF agreed to an extension of its remit to cover terrorist financing. This extension is defined in eight special recommendations (so that the FATF recommendations are now often referred to as the 40 + 8). In June 2003 the FATF issued a revised version of its recommendations. These extend the recommendations to cover terrorist financing, require risk-based application of customer due diligence, extend the categories of person and institution covered by the recommendations, and comprise various additional institutional measures including the prohibition of shell banks.\textsuperscript{12}

In November 2001 the IMF’s International Monetary and Financing Committee (IMFC) endorsed an extension of FSAPs to include coverage of aspects of legal and institutional frameworks relevant to anti-money-laundering efforts and to countering terrorist financing (AML/CFT), acceleration of Offshore Financial Centre (OFC) assessments, and enhanced collaboration between the IMF and FATF to develop a global standard covering the FATF recommendations. This would include a comprehensive methodology (the AML/CFT methodology) to be used either on a stand-alone basis or in conjunction with FSAPs or OFC assessments. Revision of this methodology in the light of the changes to its recommendations of June 2003 has been undertaken by FATF.

Before reviewing the objectives of major promoters of the initiative on financial codes and standards and drawbacks and weaknesses pointed out by its critics some preliminary points which emerge from the preceding survey seem worth highlighting.

- There is a heavy emphasis in the standards on enhanced transparency linked to the prominence attributed to its absence or inadequacy in the Mexican and Asian crises by

\textsuperscript{10} Various other regional or international bodies either exclusively or as part of their work also participate in combating money laundering. These include the Asia/Pacific Group on Money Laundering (APG), the Caribbean Financial Action Task Force (CFATF), the PC-R-EV Committee of the Council of Europe, and the Offshore Group of Banking Supervisors.

\textsuperscript{11} FATF/GAFI, \textit{The Forty Recommendations}, including an up-to-date version of \textit{Interpretative Notes to the Forty Recommendations} (Paris: OECD, 1999).

\textsuperscript{12} Shell banks have no physical presence in the jurisdiction in which they are licensed and incorporated.
representatives of major advanced economies.

- Regarding monetary and fiscal policies this emphasis is arguably at the expense of more substantive issues. In defence of the limitation to enhanced transparency under these headings it could be argued that codification of rules for policies themselves would be a much more complex task because of the variety of situations and types of country that would have to be covered, and would confront more severe difficulties in obtaining a consensus. Fiscal and monetary policies are already covered under the IMF’s Article IV country surveillance (which reflects certain views as to what constitute good economic policies rather than codified standards). Macroeconomic policy is also among the preconditions for effective banking supervision whose assessment is prescribed in the Core Principles Methodology. Moreover, as discussed below, the recent development of the IMF’s work on macroprudential analysis is proceeding in parallel with that on codes and standards and could be seen as a logical extension of it.

- The key codes and standards cover areas which are closely interrelated. Macroeconomic policy, for example, can crucially affect the sectoral dimensions of financial stability through its impact on firms' assets and liabilities and thus on the context in which financial supervision is conducted. It can also affect the functioning of the system for payments and settlement. Effective financial regulation and supervision are inextricably related to accountancy, auditing and insolvency procedures. Moreover money laundering has on occasion threatened the stability of financial firms.\(^\text{13}\)

- One may wonder why so central a role should be attributed to the IMF in the surveillance of implementation when the codes and standards themselves are issued by a diverse set of bodies from both the public and private sectors. The key factor here is the role already assumed by the IMF in global macroeconomic and financial surveillance under Article IV of its Articles of Agreement and the greater ease of extending this role to surveillance of implementation of the key financial codes and standards as compared to possible alternatives.\(^\text{14}\) The issuing bodies themselves focus on their areas of specialisation and much of their work antedates the initiative on key codes and standards, in many cases by several years. They promote implementation through agreements, consultation, and sometimes peer reviews carried out in accordance with their own procedures. Moreover they lack the resources required for the assessment exercises which produce the ROSCs.

- The rationale for the assignment of responsibility to the World Bank for ROSCs in the areas of corporate governance, accounting, auditing, and insolvency and creditor rights is usually given as its developmental experience in emerging financial markets. The legal department of the IMF has in fact worked on orderly and effective insolvency procedures. None the less a consequence of the multiple connections of these subjects to different systems of financial and company law is that their integration into ROSC

\(\text{13}\) An example of such dangers was furnished by the large-scale withdrawal of funds from, and subsequent bankruptcy of, two subsidiaries of Deak and Co. (Deak Perera Wall Street and Deak Perera International Banking Corporation) in response to information in a 1984 report of the United States Presidential Commission Crime concerning Deak Perera's involvement in money laundering.

\(\text{14}\) Assignment to the IMF of a key role in the surveillance of the implementation of the key financial codes and standards also left the organisation well placed to accommodate changes which might have followed from adoption of reforms in response to criticisms of its performance during the financial crises of the 1990s. For example, one widely discussed report issued in March 2000, Report of the International Advisory Committee (generally known as the Meltzer Report after its chairman, Allan Meltzer), suggested a substantial restriction of Fund lending, while attributing to the IMF the responsibility for providing the seals of approval as to whether countries wishing to borrow met standards regarding the financial sector and fiscal performance.
procedures and IMF Article IV surveillance is likely to be particularly complex and potentially politically controversial. Moreover regarding both corporate governance and more especially insolvency and creditor rights the process of identification and development is currently diffused among several bodies. These factors may have pointed to the World Bank with its traditionally structural and long-term focus as the more appropriate of the Bretton Woods Institutions to assume the key role in these areas. As might be expected, these subjects account for a low proportion of ROSCs completed and published.\(^{16}\)

**The role of codes and standards in the international financial system**

Concerning the role to be played by the key financial codes and standards there is a spectrum of views ranging from one where they are to be an integral part of a rules-based system to one where their potential for upgrading countries' financial systems is realised more gradually and their implementation and design take more account of countries' different levels of development and capacities. The following remarks of Gordon Brown, United Kingdom Chancellor of the Exchequer, in a speech at the Federal reserve in New York in November 2001 are representative of the first view:

"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."

Among officials in advanced economies more nuanced positions are also expressed with a greater emphasis on the relation between compliance with financial codes and standards and access to, and borrowing costs in, international financial markets than on the conditions associated with financing from the World Bank and the IMF. There is also more explicit acknowledgement of the need for a realistic and thus lengthy timetable for their implementation.\(^{17}\)

**Design and effectiveness**

Problems raised in discussion of the design of the key financial codes and standards concern

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\(^{16}\) ROSCs completed and published were initially given in IMF, *Quarterly Report on the Assessment of Standards and Codes*. Figures up-to-date as of the end of May 2003 show that 12 per cent of ROSCS completed and 11 per cent of those published concerned corporate governance, accounting and auditing, and insolvency. All the ROSCs on these subjects were for economies usually classified as developing or in transition.

\(^{17}\) This position can be exemplified in the following recent remarks of a senior official of the Bank of England: "...it is worth emphasising that the main rationale for the implementation of standards and codes is the contribution it can make to improved economic performance. In that sense, virtue is its own reward. As a corollary, however...it should also mean that countries can obtain access to finance in international markets on more favourable terms...Finally, it seems important to have a realistic timetable. The standards and codes programme is not something which can be delivered overnight, within a few months or even within a year or two. It is bound to require a sustained effort. The important thing is to keep going." See A.Clark, "Standards and codes: a G-7 perspective", p.151 in Schneider, *op.cit.* at note 6.
representation within bodies responsible for their design and the closely related dangers that they will reflect a one-size-fits-all approach, and that some widely expressed concerns concerning the functioning of the international financial system will not be addressed. Representatives of developing countries have also emphasised the obstacles to speedy implementation posed by limitations on the availability of the required human resources. Incentives and sanctions for implementation are widely regarded as asymmetric since in many cases they are clearly directed primarily towards, or are more likely mainly to affect, developing countries. To the extent that the incentives and sanctions are to operate through private financial markets, their effectiveness has been questioned. And to the extent that they are to operate through the conditions attached to borrowing from the multilateral financial institutions, the danger that these bodies will increasingly assume a role resembling credit rating agencies is a source of concern. Attention has also been drawn to the limitations on the contribution to financial stability not only of this initiative but also of any feasible upgrading of financial standards. Finally recent developments under the headings of banking regulation and supervision, on the one hand, and accounting, on the other, have pointed to difficulties of achieving consistency between different codes and standards which reflect differences in the perspectives of the actors involved.

The representativeness of the bodies responsible for the design of the key financial codes and standards varies. Partly this is an inevitable feature of an attempt to bring together under a single overall initiative work already taking place in fora with memberships reflecting an anterior history sometimes going back considerable periods of time. But it is also true that the membership of some key bodies in the formulation or oversight of the initiative is restricted to groups typically consisting mainly or exclusively of advanced economies. This is true, for example, of the FSF, the OECD, and the BCBS, and resulting concerns have been only partially addressed by the ad hoc incorporation of additional countries in some of the exercises.

There is a danger that the key financial codes and standards will reflect a one-size-fits-all approach. This danger is accentuated by the under-representation of certain categories of country in the design process which has just been mentioned. Initially this danger was especially emphasised in the case of corporate governance. The preamble of the OECD Principles of Corporate Governance acknowledges that there is no single model of good corporate governance and the Principles themselves are fairly general, in some cases amounting to little more than a check list of relevant subjects. However, there are indications that the technical assistance and assessment exercises associated with their promulgation have included features biased in favour of the models of corporate governance of the UK and the US, and it is not yet clear how far these exercises have incorporated lessons from the

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18 The reservations among developing countries concerning the initiative of key financial codes and standards are set out at greater length in A.A.Mohammed, "Implementing standards and codes through the BWIs: a developing-country perspective", and Y.V.Reddy, "International standards and codes – comments on emerging issues", in Schneider, op.cit. at note 6.

19 Membership of the OECD consists of 30 largely advanced economies. The membership of the FSF is taken from selected OECD countries, Hong Kong and Singapore. The working groups of the FSF, including those on the implementation of standards include other countries, amongst them some developing ones. The membership of the BCBS consists of 13 advanced economies of Europe and North America. In the development of the Core Principles for Effective Banking Supervision the BCBS collaborated with supervisors from several countries outside its membership. To provide feedback to the BCBS on implementation of these principles a Core Principles Liaison group with 21 countries (including several developing ones) and the Commission Bancaire de l'Union Monetaire Africain as members was set up in 1999.
The weaknesses of these models evident in recent corporate scandals.20

The Core Principles for Effective Banking Supervision are also a source of concern under the heading of a one-size-fits-all approach, as is the work on a New Basel Capital Accord (Basel II) which has links to the Core Principles.21 Some commentators, for example, have emphasised the inappropriateness of a banking model that emphasises the desirability of arms-length relations with borrowers in countries where connected lending is a reasonable response to conditions characterised by the still inadequate transparency of firms' reporting and by the weak enforceability of contracts.22 This is a thorny question which illustrates the difficulty of prescribing global standards for banks at different levels of development: abuses related to connected lending have been a frequent feature of banking history in different countries but it is also true that business groups which include banks among their constituent enterprises are widely regarded as having made a significant contribution to several countries' economic development, especially that of Japan and certain other Asian countries.23

The additional human resources required for implementing the key financial codes and standards are often large and capable of slowing the process.24 In the case of banking supervision there is a danger that the resources required for assessment exercises may be at the expense of banking supervision itself. Resource constraints are a recurring theme of comments of developing-country representatives in the IMF and elsewhere. This point is highlighted by various evidence on the resources needed for implementing Basel II.25

The initiative on key financial codes and standards is asymmetric in its incidence and design

21 See BCBS, International Convergence of Capital measurement and Capital Standards (Basel: BIS, June 2004). Core Principle 6 covers minimum capital requirements and specifies that at least for internationally active banks these should be not less than those of the Basel Capital Accord. Since its adoption in 1988 this Accord has progressively assumed the status of a regulatory standard applied much more widely and the principles of the New Basel Capital Accord are intended to be suitable for application to banks of varying levels of complexity and sophistication.
22 See, for example, Eichengreen, op. cit. at note 1, p. 50.
23 Under Core Principle 10 "banking supervisors must have in place requirements that banks lend to related companies and individuals on arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks". Lending to shareholders as much or more than they have committed to the bank in shareholder funds negates the very notion of prudential rules as to capital adequacy since these funds will not be available in the event of losses on such lending. However, insistence on a restrictive application of this rule to affiliated companies of the same business group could harm the pace of economic development in countries where such arrangements work well.
24 The considerable cost in human resources of implementation of the key financial codes and standards has featured in communiqués of the Intergovernmental Group of 24 on International Monetary Issues and Development (the G24). See Mohammed, op. cit. at note 16, p. 69, and IMF Policy Development and Review Department, "International standards: background paper on strengthening surveillance, domestic institutions, and international markets", 5 March 2003, p.14.
25 In Germany, for example, there are estimates that more than 500 extra supervisors will be needed to implement the New Basel Capital Accord. See the editorial in The Financial Regulator, 6(1), June 2001. Estimates in response to a questionnaire sent by the Financial Stability Institute (FSI) to countries which are not members of the BCBS indicate that training on Basel-II-related topics will be required by about 9,400 supervisors or about 25 per cent of the countries' supervisory staff. See FSI, "Implementation of the new capital adequacy framework in non-Basel Committee member countries", Occasional Paper No. 4 (Basel: BIS, July 2004). (The FSI was created by the BIS and the BCBS in 1999 to assist financial supervisors through the provision of the latest information on financial products, practices and techniques and through the organisation of seminars and workshops.)
as between developing and advanced economies. Two dimensions of this asymmetry are emphasised by representatives of developing countries. Firstly, ROSC modules are now inputs in to IMF Article IV surveillance but a "seal of good house-keeping" regarding compliance with the codes and standards can be expected to have a greater effect on the access to financing of developing than of advanced economies. There is still some question as to how far ROSCs are influencing countries' access to financial markets and the costs of borrowing from them (see below), but to the extent that there is an influence, the impact is on developing countries. Despite reticence among developing countries (which have been the only borrowers from the IMF in recent years), recommendations in ROSC reports are now sometimes included in the conditions associated with Fund loans. Secondly, the initiatives on transparency have not met the concerns of developing countries regarding the operations of financial firms from advanced economies, in particular regarding the reporting obligations of "highly leveraged institutions" (hedge funds and similar entities).

Agreement on official incentives and sanctions for implementation of the key financial codes and sanctions has proven difficult. A number of proposals for official incentives and sanctions other than linking compliance to access to IMF credit or to the conditions associated with such credit have been put forward. These include making countries' membership of international bodies conditional on progress in standards implementation, the differentiation of capital requirements on cross-border bank loans according to such implementation in borrowing countries, and tying the grant of market access to foreign banks and the tightness of regulation and supervision of foreign banks already accorded access to the observance of standards. The first two of these proposals were considered by the FSF follow-up group on standards implementation to have costs outweighing their benefits: exclusion of non-compliant countries from bodies concerned with financial regulation and supervision could have the perverse effect of removing a source of peer pressure; and assignment of higher risk weights in setting capital requirements for non-compliant countries' borrowing from banks presupposed a level of effectiveness in assessing compliance which had not yet been attained. Only the last proposal (already endorsed by the 1998 G-7 Summit, as mentioned above) was accepted.

The private sector now makes greater use of ROSCs in their risk assessment and management but their influence will continue to reflect limitations due to their periodicity and information content. Market-based incentives and sanctions for the implementation of codes and standards depend on market participants' use of information on an economy's observance and the incorporation of such information in differentiated credit ratings, yield spreads of international bond issues, banks' exposure limits and other lending and investment decisions. Requirements for the effectiveness of such incentives and sanctions are thus familiarity with the codes and standards, information on progress as to implementation, and the judgement that they are relevant to risk assessments.

26 Cases cited in a recent IMF document include benchmarks and performance criteria in IMF programmes for Uruguay, Ghana and Brazil. See IMF, op. cit. at note 24, Appendix IV.

27 The Working Group on Aggregate Positions (the Patat Group), which was set up in 1998 by the G-10 body, the Committee on the Global Financial System, to examine the scope for collecting aggregate firm data for financial markets, argued for greater transparency concerning such firms positions, a step which would probably have gone some way towards meeting developing countries' concerns. However, the G-10 central bank governors, led by the Federal Reserve, decided against accepting this recommendation in 1999. See G. de Brouwer, Hedge Funds in Emerging Markets (Cambridge: Cambridge University Press, 2001), pp. 202-203.

28 For more details on the pros and cons of different incentives and sanctions see FSF, "Issues Paper of the Task Force on Implementation of Standards", paper prepared for the meeing of the FSF, Singapore 25-26 March 2000, section III.
Early feedback to the FSF indicated only limited awareness among market participants of the key financial codes and standards and a correspondingly limited use in ratings of creditworthiness and decision making. Skepticism among market participants was reinforced by generally favourable, albeit experimental, 1999 ROSCs for Argentina covering data dissemination, fiscal transparency, monetary and financial transparency, and banking supervision (assessment here being limited to disclosure aspects of the BCBS's Core Principles). The country's subsequent default was regarded as pointing to the inadequacy of a favourable evaluation of compliance with the key financial codes and standards as an indicator of low vulnerability to twin crises in the absence of a broader assessment of the appropriateness and sustainability of its macroeconomic policy. None the less econometric research suggests the existence of favourable effects of compliance with key financial codes and standards on the yield spreads of countries' bonds denominated in foreign currencies and on their credit spreads.  

This would appear to reflect the impact of active promotion by the IMF, World Bank, FSF and other official and private bodies through seminars and conferences, fuller incorporation of information on compliance on codes and standards in the ratings of major credit rating agencies, and the impact of a variety of private-sector initiatives. Amongst the latter are a subscription-based internet data base on compliance by the e-Standards forum, a private partnership including Oxford Analytica, the Wharton Financial Institutions Center, the Reinventing Bretton Woods Committee and a former banker, George Vojta, and the use by the pension fund, CalPERS, of measures of transparency, corporate governance and financial regulation among criteria for determining countries eligible for its investments.

The IMF also appears to exploring ways of exploring areas in which its own work on fiscal transparency and on fiscal ROSCs can be made increasingly complementary with initiatives of civil society organisations (CSOs) to analyse budget policies, processes and institutions. CSOs may be concerned with more detailed issues at the level of particular sectors, regions, and programmes, while the IMF's focus involves a view across fiscal activities as a whole and at a more macroeconomic level. As an IMF paper puts it, "There appears to be considerable scope, as the number of both CSO budget transparency studies and fiscal ROSCs expands, for civil society to lever off fiscal ROSCs, both in terms of anaytical and advocacy activities. This will require a greater level of awareness of the availability and usefulness of fiscal ROSCs amongst civil society...Finally, civil society budget transparency studies could, in turn, prove to be a very useful complement to, and cross-check on the quality of fiscal ROSCs".

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29 See C.Christofides, C.Mulder and A.Tiffin, "The link between adherence to international standards of good practice, foreign exchange spreads, and ratings", IMF Working Paper WP/03/74, which contains a lucid account of the methodological problems of assessing the effects of compliance with the key financial codes and standards including controlling for macroeconomic variables. The measures of compliance with the different codes and standards consist of scoring systems which involve a degree of subjectivity and which are based on a still limited period of experience. The estimates should thus be considered preliminary. Two other papers look at the effects on borrowing costs of enhanced transparency: those on yield spreads in secondary markets for international bonds of the publication of certain IMF country documents and of compliance with SDDS are analysed in R.Glennaerster and Y.Shin, "Is transparency good for you, and can the IMF help ?", IMF Working Paper, June 2003; and those on yield spreads in the markets for new issues of SDDS compliance in J.Cady, "Does SDDS subscription reduce borrowing costs for emerging market economies ?", IMF Working Paper, April 2004.


31 See IMF, op. cit. at note 24, pp. 29-30.

32 See Petrie, op. cit. at note 30, p. 21.
However, owing to the relatively low frequency of ROSCs and their updates as well as the omission from them of information on key subjects, they are likely to serve as part of background information about countries rather than a major determinant of changes in perceived creditworthiness in financial markets. Moreover the IMF itself appears unwilling to accord ROSCs the whole authority of the organisation.

There are intrinsic limits to the contribution to financial stability of not only the existing initiative on key financial codes and standards but also of any other which can be reasonably be envisaged. The existing initiative puts great emphasis on improved transparency, while also avoiding substantive guidelines regarding subjects such as fiscal and monetary policies and other areas of macroeconomic policy. These are important limits on its scope. The availability of pertinent country data (for, example, the scale and maturity of external borrowing and its relation to foreign currency reserves and the balance of payments) did not prevent the eventual build-up of eventually unsustainable financial positions in certain Asian countries prior to the crisis of 1997 and thus exemplify the limitation of transparency's potential contribution to the prevention of financial instability. The twin crises of recent years have typically involved the interaction of macroeconomic conditions and policy responses, on the one hand, and the balance sheets and practices of the financial sector, on the other. More generally, quite apart from the connections between systemic financial risks and macroeconomic dynamics, only so much should be expected of standards embodied in financial regulation and supervision and in the infrastructure of financial markets. Their design is rooted in past experience, a feature which makes them less than perfect for dealing with the consequences of novelty. Moreover supervision has oft-demonstrated difficulties in identifying certain kinds of malpractice and fraud.

As part of a 2004 study carried out by PricewaterhouseCoopers for the European Commission of the macroeconomic and financial consequences of new rules for the capital of banks in the EU the National Institute of Economic and Social Research (NIESR) of the United Kingdom developed a taxonomy of characteristic features of financial crises, which can serve as a useful benchmark for reviewing the effectiveness of the key financial codes and standards in the prevention and management of such crises. Not all these features were of equal weight in all the historical instances studied.

- Crises followed financial liberalisation where both banks and regulators were unfamiliar with the risk assessment now required. Since crises were events with at
most limited precedents, they would not be detected by time series of loan losses used for credit risk assessment.

- There was generally a lack of diversification across types of borrowers and collateral which left banks vulnerable to shocks affecting a particular type of borrowing, real estate being a prime example.
- There was often disintermediation which lowered the dispersion of risk among economic agents.
- The crises often involved unregulated institutions which were new entrants to the financial system and competed with established banks.
- There were failures of regulation of banks' risk taking.
- Accounting figures for earnings and valuations often gave misleading indications as to banks' robustness, capital adequacy sometimes appearing to be satisfactory until the occurrence of crisis.
- An important role was often played by the interbank market where the bank runs triggering the crisis generally took place.
- The crises accompanied asset price bubbles.
- The crises generally followed a macroeconomic shock but vulnerability was evident before the shock.
- Inappropriately loose monetary or fiscal policy often contributed to the run-up to crises, while a tightening of policy often accompanied its onset.

In the case of the twin crises in developing economies these features were typically accompanied by a number of others.

- Exchange-rate pressures, resisted by the government through increases in interest rates, often triggered or aggravated financial instability.
- Financing of the banking, other private or public sector in foreign currency, which left balance-sheet positions sensitive to exchange rates and led to a link from depreciation to market and credit risk, was often a source of generalised financial instability.
- Capital flight from weakened domestic banks put downward pressure on the exchange rate.
- The increasing role of institutional investors as a conduit for international capital flows led to herding into rising markets and rapid withdrawal from falling ones.
- Cross-country similarities in trade patterns sometimes served as a source of cross-border contagion of crises.

Many but not all these features of financial crises are covered by the subject-matter of the different key financial codes and standards. However, even when they are covered, guidelines for policy making at both national and international levels are often missing or only at an early stage of development. In this context a look at the Core Principles for Effective Banking Supervision and Basel II in relation to these features of financial crises is of special interest, not least because the rules of Basel II as eventually translated into new rules for capital adequacy in the EU were the concern of the NIESR contribution.

Most of the characteristics of crises directly involving weaknesses in banks could be alleviated by good supervision under appropriate rules framed under the different major headings of the Core Principles, but the supervisory guidelines for many of the situations encountered are still being developed or have not yet been widely incorporated into practice.
This can be illustrated more concretely from Basel II, whose rules have as a major objective the control of financial risks capable of contributing to generalised financial instability. The following points (mostly ones to which the NIESR draw attention) are worth noting here.37

- During regime shifts, of which financial liberalisation is an example, adequate bank capital is a useful in backing up other policies but no more. The stress testing prescribed by Basel II is likely to provide inadequate guidance concerning the dangers of such shifts which have little or no precedent.
- Inadequate diversification and concentration risks will be alleviated but not eliminated by the improved pricing and control of risk of Basel II. The modelling of credit risk underlying the risk weights of Basel II takes account of correlations in a still circumscribed way and the supervisory guidance concerning concentration risks is of a general nature.
- If the more finely calibrated risk weighting of Basel II leads to increased volatility in borrowers' ratings (a point on which there is not agreement amongst commentators), instability in interbank markets may sometimes increase.
- The capital rules of Basel II will hopefully reduce the incidence of illiquidity and insolvency but in themselves do not ensure sound liquidity management of assets and liabilities.
- By its very nature Basel II is limited in its capacity for dealing other than responsively to macroprudential risks due to fluctuations in asset prices, overall credit expansion, the state of balance sheets in the non-financial sector, and other sources of macroeconomic vulnerability.

The Basel II process has interestingly pointed to the difficulties of achieving consensus on consistency concerning issues with a bearing on financial instability between different initiatives under the heading of the key financial codes and standards. Perhaps most importantly from the point of view of achieving improvements in risk management which will contribute to increasing financial stability bank regulators need to apply a forward-looking perspective to financial information that may sometimes be difficult to reconcile with the accounting rules of IFRS.38 This is perhaps especially evident in the area of provisions for loan losses, which not only play a central role in the setting of Basel II's risk weights but in the view of many may also be used as a complementary instrument for increasing the stability of bank lending through such practices as dynamic provisioning39 (and thus for helping to offset any contribution to procyclicality in lending of Basel II itself). Here the problem is that the occurrence of loss events is stressed in setting allowances for losses under IFRS rather than information on historical trends as might be preferred under the heading of forward-looking regulation and supervision. More narrowly, the required use of measurement of fair

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37 PricewaterhouseCoopers, op. cit. at note 35, Appendix 6, section 3.3.
38 For a useful summary of issues here see A.Schilder, "Dynamics in accounting and auditing in relation to banking supervision", speech of the chairman of the BCBS Accounting Task Force at the Plenary Session of the International Conference of Banking Supervisors, Madrid, 23 September 2004 (reprinted in BIS Review 56/2004).
39 The idea underlying dynamic provisioning is that a protective cushion of loss reserves should be built up in good times so that it is available to be drawn down during bad times, thus mitigating procyclical pressures on bank lending from the negative correlation currently observed between banks' provisions and the business cycle. There has been much interest recently in rules embodying dynamic provisioning adopted in Spain in July 2000. See J.Caruana, "Banking provisions and asset price bubbles", p. 49 in J.Caruana, A.Crockett, D.Flint, T.Harris and T.Jones, Enron et al.: Market Forces in Disarray, Group of Thirty Occasional Paper No. 66 (Washington, D.C.: Group of Thirty, 2002), and S.Fernández de Lis, J.Martinez Pagés and Jesús Saurina, "Credit growth, problem loans and credit risk provisioning in Spain", BIS Papers No. 1 (BIS, 2001).
values\textsuperscript{40} of assets and liabilities in several circumstances under IFRS has consequences for the gains and losses recorded as part of a bank's earnings which are a potential source of changes in its capital and, when incorporated in information provided to investors, may render more volatile its valuation in financial markets. Both consequences are evidently subjects of concern under bank regulation.

**Further development**

The extent and pace of work on the subjects covered by the key codes and standards responds to events on the ground. Unsurprisingly, therefore, much recent work in the major advanced economies has involved corporate governance, the legal framework for the securities business, and auditing, all of which have been in the limelight owing to recent scandals and malpractice.\textsuperscript{41}

Concerning the most inclusive of the international standards here, the *OECD Principles of Corporate of Governance*, the OECD has committed itself to a drive to strengthen corporate governance worldwide which goes beyond the Principles themselves. Thus the focus of a meeting in Paris in November 2002 on initiatives addressing weaknesses in market foundations and improving market integrity also included the OECD Guidelines for Multinational Enterprises and the Anti-Bribery Convention\textsuperscript{42}. OECD ministers have brought forward to 2004 a comprehensive review of the OECD Principles and expressed the hope that the revision would embody more specific guidance than the existing Principles. The work on accounting and auditing is taking place at the level of the EU as well as at a national level and within the international bodies mentioned above.

Work deserving special attention owing to possible implications for an extension of the IMF's remit on macroeconomic and related financial policy under key financial codes and standards to substance as opposed to transparency is the development of Financial Soundness Indicators (FSIs) to improve monitoring of financial vulnerabilities.\textsuperscript{43} This is an important component of the IMF's work on macroprudential analysis, namely the assessment and monitoring of strengths and vulnerabilities of financial systems on the basis of quantitative information and indicators which include not only FSIs but also macroeconomic indicators, information on systems' structures, and other quantitative information on the institutional and regulatory framework (including that on compliance with key financial standards). Such work can of course be seen as a logical extension of inclusion of FSAPs and ROSCs in this area and of Article IV surveillance. But the work also has a potentially more controversial dimension in that macroprudential analysis bears a close resemblance to types of analysis carried out by credit rating agencies. Thus the IMF's current efforts raise the question whether willy-nilly the

\textsuperscript{40} Fair value is defined in the IFRS as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair value accounting involves the recognition of gains and losses on the fair value of specified assets and liabilities in the period in which they occur even when this precedes their actual sale, repurchase or settlement.

\textsuperscript{41} For a compendium of ongoing national and international work on these subjects see the compendium of the FSF, "Addressing weaknesses in market foundations: selected domestic and international initiatives", 18 September 2003 (www.fsforum.org).


\textsuperscript{43} FSIs are indicators designed to monitor the health and soundness of the financial sector and of financial firms' counterparties. They include aggregated information on institutions and markets as well as selected relevant macroeconomic indicators. Concerning the IMF's work on FSIs and macroprudential analysis see V. Sundarajan, C. Enoch, A. San José, P. Hilbers, R. Krueger, M. Moretti and G. Slack, *Financial Soundness Indicators: Analytical Aspects and Country Practices*, IMF Occasional Paper No. 212 (Washington, D.C.: IMF, 2002).
institution is moving in the direction of assuming an increasing number of the functions of a global rating agency and thus exposing itself to increased risks of moral hazard vis-à-vis international lenders and investors.

As of mid-2003 410 ROSC modules had been completed for 91 economies, and of these 292 had been published. To give an approximate idea of what this pace of completion implies, completion of all ROSC modules for the entire membership of the IMF and World Bank would take between 15 and 20 years. As of the autumn of 2003 40 of the 44 OFCs contacted had undergone assessments as part of the programme on this subject initiated in mid-2000. As of September 2004 71 assessments under FSAP had been completed, as had 7 updates.

In the discussions of the IMF's Executive Board support is expressed for focusing future efforts in the light of two not necessarily consistent objectives. On the one hand, owing to the costs of ROSC exercises, there is emphasis on the need for prioritisation which would target countries of systemic importance. On the other hand, support is expressed for balanced coverage of countries and greater participation of advanced economies. At the same time the commitments made regarding AML/CFT are leading to an extension of the coverage of subjects covered by ROSCs. In October 2002 a 12-month pilot programme of AML/CFT assessments based on the methodology endorsed by the FATF was initiated with participation of the IMF, World Bank, FATF and FATF-style regional bodies. Under this programme as of February 2004 19 assessments had been completed by the IMF and the World Bank or both and another 14 reports were in the pipeline, while 8 assessments had been completed by FATF and FATF-Style Regional Bodies (FSRBs) and another 12 were under way.

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46 See, for example, IMF, "IMF Executive Board reviews international standards: strengthening surveillance, domestic institutions, and international markets" Public Information Notice No. 03/43, 3 April 2003, p.2, and IMF, Annual Report 2003, p.23.