FINANCIAL SECTOR STANDARDS AND CODES AND INSTITUTION BUILDING

A well-functioning financial sector is essential for economic development. A robust financial sector, however, depends importantly on effective institutional infrastructure. Sound institutions contribute not only to macroeconomic and financial stability, but also to financial deepening, and greater and more stable international capital flows.[1] Effective institutions and efficient markets also reduce the likelihood and magnitude of a financial crisis.

The IMF has a long history in assisting member countries in developing institutional capacity in the financial sector. Traditionally, such assistance has concentrated on central banking and development of markets to support effective conduct of monetary and exchange rate policies. The financial crises of the 1990s led the IMF to broaden these efforts to encompass other aspects of institution building. In particular, the joint IMF-World Bank Financial Sector Assessment Program (FSAP), introduced in May 1999, has been developed as an important diagnostic instrument for the identification of risks and vulnerabilities and development priorities in the financial sector. In many cases, these focus on the strengthening of markets and institutions and adoption of best practices that promote financial stability. The FSAP, therefore, is a key element in the efforts of the international community to prevent crises and strengthen the international financial architecture. The standards assessments in FSAPs are undertaken in cooperation with other institutions and rely on methodologies developed by standard setting bodies.

This note summarizes the Fund's experience with the assessments of financial standards and codes and their role in institution building.[2] While it is premature to judge the full impact of the standards assessments, experience and feedback from participating countries thus far point to positive contributions to crisis prevention and financial stability through strengthening supervisory and regulatory frameworks, enhancing transparency of monetary and financial policies, and boosting the capacity of supervisors and supervised institutions to assess and manage risk. These derive from the identification of institutional weaknesses in key areas and provision of follow-up technical assistance. At the same time, development of standards and codes and finding ways to enhance national authorities' ownership of needed reforms continue to be an important part of the ongoing agenda of institutional reform.

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[1]See Prasad, Rogoff, Wei, and Kose, 2003, "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence," forthcoming IMF Occasional Paper 220.

[2] This note mainly draws on the paper on "Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward," and supplements, Feb. 2003, IMF, SM/03/77.

I. The Role of Standards Assessments in FSAPs in Strengthening the Institutional Infrastructure in the Financial Sector

The institutional infrastructure needed to support financial development has been characterized as encompassing "software" and "hardware." The relevant body of laws, regulations and procedures constitute the essential institutional software, while the organizational arrangements and market structures may be viewed as the requisite hardware. The various standards and codes assessed in FSAPs embody widely accepted principles concerning these aspects of institutional development. They reflect a broad conception of institutional requirements, covering areas such as the legal, regulatory, and supervisory framework, the functioning of markets, organizational arrangements for the supervision of sub-sectors, transparency of policies and organizations, and the adequacy of related resources. The standards are based on widely accepted practices emerging from a broad range of experience which suggests that adherence to certain principles contributes to sound and stable institutions.

There is evidence that the quality of banking supervision is associated with financial strength of banking institutions. An analysis of broad measures of supervisory compliance with Basle Core Principles for Effective Banking Supervision (BCP) and indicators of institutions' financial strength points to a strong connection between the two. For the purposes of the analysis, a BCP Compliance Index was constructed by assigning numerical scores to each of the 25 BCPs drawing on 46 BCP assessments. A similarly constructed Financial Strength Index, based on financial strength ratios of banking institutions, was obtained from private sector sources. Statistical analysis yielded a correlation coefficient of 0.73 between the two indices, suggesting that supervisory systems that conform to international best practices tend to be associated with strong and healthy financial institutions.

Financial sector standards are designed to provide general guidance, while allowing sufficient flexibility to take into account individual country circumstances and needs. It is well understood that institutional design and reform are heavily influenced by country- and time-specific considerations. Indeed, high level of income and wealth have been achieved under a variety of institutional structures, reflecting different legal and regulatory approaches and degrees of state involvement in the economy. Internationally accepted practices therefore, are likely to be only a reference point or benchmark for specific institutional reforms.[3] It should be noted that standards assessments are aimed at identifying systemic weaknesses and should not be viewed as instruments for preventing failures of individual institutions.

Standards assessments are most helpful if undertaken in the proper context. The comprehensive scope of the FSAP provides a meaningful setting within which to assess financial sector standards. It takes into account the broader macroprudential environment and

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[3] See "Growth and Institutions," *World Economic Outlook*, April 2003, IMF, EBS/03/22.

related risks and draws inferences about the broader financial stability implications of the assessments. In many cases, FSAPs also evaluate other related standards and practices, such as corporate governance, insolvency regimes and accounting practices, that affect the quality and integrity of institutions. The usefulness of evaluating individual country practices against accepted international benchmarks derives importantly from the quality and consistency of assessments that are based on standardized methodologies and templates. This is facilitated, in addition, by an intensive review process, which seeks to ensure consistency and provides a cross-country perspective.

As of end-December 2002, over 283 assessments of standards and codes had been conducted under the FSAP, which typically consist of the Basel Core Principles for Effective Banking Supervision (BCP), the IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP), the IAIS Insurance Core Principle, the Core Principles for Systemically Important Payment Systems (CPSIPS), and the IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles). [4] The 12-month pilot program of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) assessments using the comprehensive methodology document, initiated in October 2002, is successfully underway. Between 46 and 56 assessments in total are expected to be completed during the pilot period.[5]

Standards assessments completed in the context of the FSAP have been most useful in identifying gaps and prioritizing institutional reforms.[6] The assessments also provide a context for judging relative importance of the various institutional deficiencies highlighted. For instance, FSAP missions have attempted to differentiate between appropriate legal frameworks (laws and regulations) and implementation. As a result, closing the gap between "laws on the books" and implementation is a developmental priority in many cases, and follow-up work would focus on enhancing the competence, efficiency, and independence of courts.

By setting the diagnosis in broader macro-prudential context, the assessments also help to sequence institutional reform. Measures to reinforce stability are given immediate attention,

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[4] Also, more than half of G-20 member countries and a number of other major economies and financial centers either have completed an FSAP, are in the process of completing one, or plan to do so the near future.

[5] AML/CFT issues will now have been assessed in all countries participating in the FSAP, with the scope and modalities of the assessment depending to some extent on the specific circumstances of each country.

[6] Financial sector standards assessments by the Bank and the Fund are also undertaken on a stand-alone basis as part of technical support in implementation of standards by member countries and as part of the preparatory work for a future FSAP assessment.

while developmental needs are addressed over the medium-term. In an outreach meeting held in 2002 with officials from countries that participated in FSAPs, participants identified a number of benefits of the FSAP assessments, including the application of a comprehensive approach to analyzing financial sector issues, an independent and objective review by outsiders; and an interactive dialogue with experts from other countries, which allowed for comparison of practices.

In many instances, standard assessments provided an impetus to the authorities' reform efforts and helped to sharpen or redirect the focus of reforms. Some countries have established a special committee to allow for a proper follow-up on FSAP recommendations and to ensure national ownership in their implementation. The experience highlights the role of assessments in promoting internal dialogue and mobilizing political support for the reform process.

Standards assessments have also helped country authorities to evaluate the transparency of their policies and practices against international benchmarks. The dissemination of transparency standards worldwide has raised countries' interest in enhancing observance of these standards. In this context, the publication of the IMF's Financial System Stability Assessments and other FSAP related documents, such as the Reports on Observance of Standards and Codes (ROSCs), detailed standards assessments, and analysis of selected issues, increases transparency and allows economic agents to be better informed about countries' financial sectors, especially with respect to the conduct of their monetary and financial policies and regulatory and supervisory frameworks. This, in turn, should help exert greater policy discipline, thereby promoting better policy decision making and more efficient markets and institutions.

II. Main Findings from Standards and Codes Assessments

The FSAPs are selective in terms of the standards that are assessed, and the diagnosis of weaknesses across countries has varied accordingly. In many developing countries, a range of concerns were identified that needed to be addressed over the medium-term, including those relating to banking supervision, legal and regulatory frameworks for banks and nonbanks, payment systems, systemic liquidity management, and arrangements for bank restructuring. At the same time, several emerging economies, having recovered from financial crisis, have achieved a good degree of compliance in banking supervision and regulation, and deficiencies in these cases relate to the ability of supervisory authorities to keep up with the proliferation of financial services, undertake risk-based supervision, take prompt corrective actions, deal with consolidated supervision, and cooperate with other domestic and foreign supervisory agencies. While the assessments undertaken for some industrialized countries indicate a higher degree of compliance with international standards and codes, they also face a number of challenges stemming from regulatory gaps in areas related to the trend toward global conglomeration of their financial institutions, electronic banking, the role of state banks, reinsurance, and loan classification systems.

The assessments of compliance with the ***Basel Core Principles*** have identified a number of areas where better compliance could contribute to sounder institutions. In particular, compliance with best practices regarding credit policies and connected lending is weak, and poor lending practices remain a serious threat to banking stability in many developing countries. The assessments also find that loan evaluation and provisioning practices tend to be weaker in practice than they are on paper, and exchange rate, interest rate and other market and country risks tend to be underestimated. In addition, in cases where the supervisory authority does not have full independence, mechanisms for actual enforcement of remedial measures against weak banks have limited effectiveness, notwithstanding relevant provisions in regulations. Another area requiring attention is the effective supervision of large and complex financial institutions, particularly as regards consolidated supervision and consolidation of accounts.

The assessments of the ***CPSIPS*** point to a high degree of observance in advanced economies and, to a large extent, also in transition economies. In developing countries, a significant majority of the payment systems have various design and operational limitations that expose them to certain risks. In many cases, participants are unable to manage credit, liquidity and other risks, leaving the system unprotected against the inability of a participant to settle obligations. Other problem areas include deficiencies in the legal framework, rules and regulations pertaining to payment systems and security of operating systems. However, the volume of funds channeled through these systems is not as large as that in more advanced economies, and several countries are in the process of modernizing their payment systems.

The assessments of the ***IAIS Insurance Core Principles*** have highlighted limitations regarding the preconditions for effective insurance supervision such as appropriate accounting and actuarial practices and internationally acceptable standards relating to capital. Some of the other common weaknesses relate to: (i) the proper organization of the insurance supervisor and adequate supervisory skills; (ii) criteria for denying changes in control of institutions; (iii) corporate governance and internal controls; (iv) adequacy of prudential rules on investment and exposure limits; (v) the adequacy of the supervisors' power to review or set standards for the use of reinsurance by direct-writing companies; (vi) market conduct and a complaint-handling system; and (vii) rules for the use of derivatives and the disclosures. While in many cases the deficiencies identified do not appear to pose serious systemic risks, the insurance sector as a whole is exposed to equity risks and on account of guarantees given to the banking sector (including credit and mortgage guarantees). The more liberalized and competitive insurance markets are also posing new and increasingly complex challenges for the supervisory authorities.

The assessments of the ***IOSCO Principles*** have revealed a number of weaknesses in the regulation and supervision of securities markets in many countries. These include, in particular: (i) limited resources of the relevant supervisory authorities; (ii) diffusion of regulatory responsibilities across several agencies, with lack of clarity of roles; (iii) the lack of independence of the regulator, including with respect to budgetary allocations; (iv) inability of regulators to enforce compliance with the law and administer penalties; (v) inadequate sharing of information among domestic regulatory bodies; (vi) lack of adequate powers and the administrative capacity to prevent the issue of prospectuses that do not meet minimum information requirements; (vii) inadequate disclosure of information, both with respect to content and timeliness; (viii) weak provisions for the protection of minority shareholder interests; (ix) ineffectiveness of auditors in ensuring appropriate financial reporting and corporate disclosure; (x) inadequate regulation of intermediaries with respect to risk management and internal organization, capital adequacy and other prudential controls, and procedures in the event of failure; (xi) weaknesses in detection and prosecution of manipulation and other unfair trading practices; and (xii) inadequate oversight of clearing and settlement systems.

The assessments of the observance of ***IMF's MFP Transparency Code*** have underscored concerns in this regard in many countries (Box 1). Recommendations to address these have focused on the content and forms of disclosure. With respect to monetary policy, the need for better disclosure and explanation of the monetary policy analysis, framework and procedures and more public consultations on proposed technical changes to monetary regulations has been stressed. In the area of financial policy, the focus has been on greater transparency of relationships between financial agencies, information sharing, and frequency of data reporting by financial agencies. Common to both monetary and financial policies was the emphasis on achieving greater accountability and integrity of monetary and financial institutions. In response to the assessments, some authorities have taken steps to enhance transparency, which, in turn, should help strengthen market and policy discipline.

While most jurisdictions assessed have adopted some **AML/CFT** measures, there is considerable variation among AML/CFT systems and, in many jurisdictions (and most non-industrialized jurisdictions), key weaknesses still remain, particularly for CFT. In most cases, the authorities have set compliance with the FATF 40+8 as a key priority and are in the process of improving their AML/CFT systems to comply with those standards. Nevertheless, implementation is often hindered by the lack of skills, legal and financial sector infrastructure, and budgetary resources. The pilot program observations with respect to the vulnerabilities in the AML/CFT regimes are being reflected in the intensified IMF/World Bank technical assistance.

III. INSTITUTION BUILDING THROUGH FSAP FOLLOW-UPS AND TECHNICAL ASSISTANCE

Standards assessments usually result in recommended actions with an indication priority. This provides a basis for follow-up by the relevant authorities that can be supported by technical assistance from the Bank and the Fund. In a number of cases, the authorities have indicated that the recommendations helped them to formulate their own policy priorities.

A large number of countries have requested technical assistance to help implement the FSAP recommendations and bolster institutional capacity (Box 2 provides an example). The assistance that has already been provided spans a wide range of areas including monetary policy implementation; banking sector, insurance, and capital markets supervision and regulation; unified supervision; AML/CFT legislation and implementation; payment system reform; legal reform; sequencing of capital account liberalization; public debt management; inflation targeting; and bank restructuring.

In insurance, follow-up technical assistance has been provided on insurance legislation, regulation, and organization of the insurance supervisory body. In the area of securities markets regulation, assistance has been somewhat limited, but growing importance of related development needs emerging in FSAP assessments may increase this in the future. In the area of payment systems, technical assistance has covered issues relating to the operation of real-time gross settlement systems (for example, queuing of payments, payment message types, and central bank intraday lending to participants), as well as broader payment system reforms involving large value and retail payment systems. As regards banking supervision, the demand for follow-up technical assistance remains high and is quite varied in terms of focus. In the area of AML/CFT, based on country requests, technical assistance has focused on such priorities as legislative drafting and review (especially with respect to the financing of terrorism) and implementation, capacity building, and training in the financia1 sector. Regional projects are being used to reach a large number of jurisdictions. A web-based database for the sharing of information on TA requests and responses is operational and is being used actively by FATF-style regional bodies, the Bank, and the Fund to identify technical assistance needs. Further follow-up with donors is planned to ensure that identified needs are addressed.

The Fund intends to continue to support its members with technical assistance aimed at addressing financial stability and developmental concerns, and to also work toward updating financial sector standards, in line with concerns emerging from the FSAP assessments. Technical assistance priorities based on FSAP findings are being incorporated more systematically in the Bank's and Fund's overall technical assistance programs. Mechanisms have also been set up for improved and more systematic follow-up on technical assistance needs identified in FSAP/ROSC processes. One response is the new multi-donor partnership—the Financial Sector Reform and Strengthening (FIRST) initiative, jointly undertaken by the Bank, the Fund, and national development agencies,[7] which have pledged to establish a trust fund to supplement Bank and Fund TA, to decide on the criteria, allocation and prioritization and to supervise and implement the TA to be financed by the trust fund. In doing so, FIRST will also help improve coordination of financial sector technical assistance between the Bank and the Fund and other donors.

[7] For details, see Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward, February 2003, Board paper SM/03/77.

IV. Further Strengthening the Role of Standards Assessments

Work is ongoing in close cooperation with standard setting agencies to improve consistency in standards assessments through adherence to assessment methodologies and guidance notes. Steps have also been taken to strengthen the post-assessment review process. The Fund has recently established a roster of external reviewers in banking, insurance, payment, and securities to reinforce the internal review process by enlarging the pool of available reviewers, generally drawn from the cooperating institutions.

Bank and Fund staff have actively participated in the recently completed work of the Joint Forum on the comparison of banking, insurance, and securities core principles, and in work with standard setters on reviewing methodologies based on assessment experiences. These experiences provide crucial feedback to the standard setters on the use of the codes and standards and form a useful basis for discussions with them on their implementation.

Bank and Fund staff will continue working on a number of issues relating to standards assessments. These include: (i) the appropriate scope and coverage of assessments; (ii) ways to account for country-specific factors based on their relative significance depending on stages of development, sector specific vulnerabilities, and the regulatory and supervisory preconditions; (iii) identification of cross-sector issues and interdependencies between standards; (iv) circumstances in which assessment of observance of a particular standard might not be warranted; and (v) more structured approach to assessing the preconditions for effective supervision.

Box 1. Observance of Transparency in Monetary and Financial Policies

Assessments of observance of the IMF's Code on the Transparency of Monetary and Financial Policies have highlighted a number of weaknesses. With respect to monetary policy these pertain primarily to:

- Clarity of roles, responsibilities and objectives of central banks—a general lack of clarity with respect to monetary policy objectives, responsibility for foreign exchange policy, legal provisions regarding disclosure and accountability, and institutional relationship with other governmental agencies.

- Open process for formulating and reporting monetary policy decisions—lack of adequate explanation regarding the rationale and functioning of monetary policy instruments and about the frequency and substance of disclosure.

- Accountability and assurances of integrity by the Central Bank—deficiencies were identified regarding the procedures in the areas of auditing and accounting, disclosure of internal governance procedures, and lack of legal protection for officials and staff in the conduct of their official duties.

Countries have responded positively to rectifying the weaknesses highlighted in the transparency assessments, as indicated by the following examples:

Hong Kong SAR

Financial supervision: The responsibilities delegated to top finance officials, including the Financial Secretary and Secretary for Financial Services and the Treasury were clarified, with policy formation and execution responsibilities clearly separated. A formal statement of monetary policy aims is also released, which made explicit the operating mandate of the Hong Kong Monetary Authority is to maintain exchange rate stability.

Insurance regulation: The Insurance Authority and Hong Kong Monetary Authority (HKMA) signed a memorandum of understanding (MOU) outlining their respective responsibilities for regulating banks' insurance business. Under the MOU, the HKMA is responsible for the daily regulation of banks' insurance business. In cases of complaints of malpractice, the two regulators share investigative work and take disciplinary action as needed.

*Banking supervision: A*nnual disclosure requirements were updated relating to the analysis of investments in securities and interim disclosure requirements were updated to include balance sheet information and further analysis regarding off balance sheet exposures. Disclosure requirements were updated for certain institutions to include overdue and rescheduled loans as well as derivative contracts exposure.

Russia

Monetary policy: Publication of the annual financial statement for 1999 containing a more detailed information on the relationship between the Bank of Russia and the Ministry of Finance, central bank income and expenditure, as well as new information on its capital, funds and profit distribution. The most important measure undertaken was the preparation and publication of the annual financial statement largely in compliance with international standards. Precious metals transactions and government securities, however, are still valued at acquisition cost.

Box 2. Mexico: An Example of Standards Assessments and Follow-up

Issues revealed from the assessments

The regulatory and supervisory environment has made great strides since the 1994-95 crisis. However, actions were required to achieve full observance on international standards and increase the system's resilience to shocks: (a) the legacy from the 1994/95 crisis of ad-hoc regulatory forbearance was a source of distortion of the Mexican banks' public disclosures—the assessments recommend a prompt corrective action framework in addition to resolution procedures for non-viable banks; (b) the definition of capital in effect did not reflect the actual banks' economic capitalization to cover losses; and (c) structural reforms to modernize the sate-owned development banks were recommended. Private securities markets in Mexico are underdeveloped. While government debt markets are deeper, private debt markets are shallow, the secondary market for non-financial private debt is illiquid and limited. The local institutional investor base is nascent and the retail investor base is miniscule. The FSAP recommended a major overhaul for the existing framework for housing finance to eliminate current subsidies that undercut private lending. These distortions stifle the development of private mortgage markets. Poor performance and opaque subsidies widen the government contingent liability related to private pensions.

Measures taken by the authorities as a result of the FSAP

The FSAP was requested by the authorities in order to gain input on a planned reform of the financial system. Though the Mexican authorities were well aware of remaining weaknesses in the financial sector, the FSAP contributed to sharpen some of their proposed legal changes. In April 2001, the authorities submitted to Congress a number of draft bills directly relevant to the financial sector, many of which have been recently approved. The room for ad-hoc forbearance was restricted, although the new framework still did not establish precisely the circumstances that would automatically move a troubled bank from intervention to resolution. Also, the Mexican definition of regulatory capital was strengthened. To foster consensus for the reform program, a Committee for the modernization of the financial system was established in may 2001.

Follow-up TA

The FSAP diagnosis regarding development banks was taken into account in designing a World Bank project loan to support reform in the cooperative and S&L sector ("cajas") and to sharpen the role of the newly created BANSEFI (a development agency). During 2002, the Bank has provided analytical and advisory services to the Mexican authorities to help assess options to restructure and modernize development banks. The Bank has also maintained continued policy dialogue and provided FSAP-consistent analytical and advisory services with respect to housing finance – mainly in the context of the supervision of an old project loan to FOVI—central bank administered housing finance fund, and was recently converted into the Sociedad Hipotecaria Federal, special purpose development banks.