

**EMBARGO**

Embargoed for release until 11:30 a.m.  
EDT on Monday the 5<sup>th</sup> of October, 1998

**REPORT OF THE WORKING GROUP ON  
STRENGTHENING FINANCIAL SYSTEMS**

**October 1998**

2nd October 1998

In response to the crisis in Asia, Finance Ministers and Central Bank Governors from 22 systematically significant economies met in Washington, D.C. in April 1998 to examine issues related to strengthening the international financial architecture. This initiative was intended to complement ongoing efforts in the IMF, the World Bank and other international institutions and fora, and to help develop a broad international consensus on these important issues.

Ministers and Governors identified three key areas where action is needed: enhancing transparency and accountability; strengthening national financial systems; and managing international financial crises. Recognising the complexity of the issues at hand, working parties were formed to study these issues further with the aim of developing concrete proposals to strengthen the architecture of the international financial system. These groups, of which we are the co-chairs, benefited from the diversity of their participation and the openness of the consultation process. In addition to representatives from finance ministries and central banks with a breadth of experience in systemic issues, each working party included observers from international organisations. The working groups also sought and received the views and contributions of countries not represented in the working groups, private sector representatives and other international groups.

The working groups have prepared reports on their deliberations recommending actions in a number of areas. The international community is invited to consider these recommendations and to take actions to implement them.

These reports are being sent to the Managing Director of the IMF and the President of the World Bank with the request that they be forwarded through Executive Directors to Finance Ministers and Central Bank Governors in anticipation of meetings held at the time of the annual meetings of the Bretton Woods institutions. The reports will be discussed at a meeting of Finance Ministers and Central Bank Governors on 5th October.

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## **PREFACE**

The international financial crisis that began in Asia and has now spread to other continents lends urgency to efforts to strengthen the architecture of the international financial system. The importance of these efforts was first given prominence in 1995 at the Halifax summit of heads of state and government of G-7 countries, and progress since has benefited from the involvement of finance ministries and central banks from both developed and emerging market economies.

In response to the crisis in Asia, Finance Ministers and Central Bank Governors from a number of systemically significant economies met in Washington, D.C. in April 1998 to examine issues related to the stability of the international financial system and the effective functioning of global capital markets.<sup>1</sup> In their discussions, Ministers and Governors stressed the importance of strengthening the international financial system through action in three key areas: enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises.

Three working groups were formed to contribute to the international dialogue on how to proceed in these key areas. A strength of these working groups was the diversity of their participants and the openness of their consultation process. Each working group comprised representatives from finance ministries and central banks of developed and emerging market economies; international organisations were invited to participate in the discussions; and contributions and views from other international groups, countries not represented in the working groups, and private sector representatives were sought.

The three working groups have prepared reports on the outcome of their discussions and recommended a range of actions to strengthen the international financial system.

### **ENHANCING TRANSPARENCY AND ACCOUNTABILITY**

The Working Group on Transparency and Accountability considered the contributions that transparency and accountability can make to improvements in economic performance, as well as the nature of information needed for effective

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<sup>1</sup> The April meeting was attended by Finance Ministers and Central Bank Governors from Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom and the United States. The heads of the BIS, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee, attended as observers.

transparency and accountability.<sup>2</sup> Members attached particular importance to enhancing the relevance, reliability, comparability and understandability of information disclosed by the private sector. They recommended that priority be given to compliance with and enforcement of high-quality accounting standards.

There was consensus on the need to improve the coverage, frequency and timeliness with which data on foreign exchange reserves, external debt and financial sector soundness are published. Furthermore, members recommended that consideration be given to compiling and publishing data on the international exposures of investment banks, hedge funds and other institutional investors.

Transparency is an important means of enhancing the performance and public accountability of international financial institutions. Members recommended that international financial institutions adopt a presumption in favour of the release of information, except where release might compromise a well-defined need for confidentiality.

Members emphasised the importance of there being transparency about transparency. Members recommended that the IMF prepare a Transparency Report summarising the extent to which an economy meets internationally recognised disclosure standards.

## **STRENGTHENING FINANCIAL SYSTEMS**

The Working Group on Strengthening Financial Systems sought consensus on principles and policies that foster the development of a stable, efficient financial system.<sup>3</sup> Members identified several areas – corporate governance, risk management (including liquidity management) and safety net arrangements – where standards for sound practices need to be enhanced or developed. The report outlines elements that such standards might contain and suggests ways forward.

Members emphasised that the implementation of sound practices is best fostered through market-based incentives backed by official sector actions. The report sets out a number of concrete actions to promote implementation.

Members recognised that cooperation and coordination among national supervisors and regulators and international groups and organisations are crucial to the strengthening of domestic financial systems. The report sets out several options

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<sup>2</sup> Representatives of the following economies contributed to the Working Group on Transparency and Accountability: Argentina, Australia, Brazil, Canada, France, Germany, Hong Kong SAR (co-chair), Japan, Malaysia, Thailand, the United Kingdom (co-chair) and the United States.

<sup>3</sup> Representatives of the following economies contributed to the Working Group on Strengthening Financial Systems: Argentina (co-chair), Brazil, Canada, China, France, Germany, India, Italy (co-chair), Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Sweden, Thailand, the United Kingdom and the United States.

for enhancing international cooperation: for example, the establishment of a Financial Sector Policy Forum that would meet periodically to discuss financial sector issues.

## **MANAGING INTERNATIONAL FINANCIAL CRISES**

The Working Group on International Financial Crises examined policies that could help to prevent international financial crises and facilitate the orderly and cooperative resolution of crises that may occur in the future.<sup>4</sup> The report should not be considered an agenda for addressing the problems currently being experienced in many emerging markets.

Members stressed the need to encourage better management of risk by the private and public sectors, and recommended that governments limit the scope and clarify the design of guarantees that they offer.

Effective insolvency and debtor-creditor regimes were identified as important means of limiting financial crises and facilitating rapid and orderly workouts from excessive indebtedness. The report outlines the key principles and features of such regimes.

Countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. Unilateral suspensions of debt payments are inherently disruptive. The report sets out a framework to promote the collective interest of debtors and creditors in cooperative and orderly debt workouts, and principles that could guide the resolution of future international financial crises.

## **CONSULTATION**

The three Working Groups have sought to develop recommendations in areas where consensus could be achieved and have set out options for consideration in other areas. They recognise the importance of the views of others and welcome their advice and counsel. Interested parties in the private and official sector are invited to convey their comments to the secretariat (fax +41-61 280 9100) by end October, 1998.

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<sup>4</sup> Representatives of the following economies contributed to the Working Group on International Financial Crises: Argentina, Australia, Belgium, Brazil, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Korea, Mexico (co-chair), the Netherlands, Singapore, South Africa, Thailand, the United Kingdom and the United States (co-chair).



## Report of the Working Group on Strengthening Financial Systems

### EXECUTIVE SUMMARY

Like many crises before it, the international financial crisis that began in Asia clearly demonstrates the importance of robust and efficient domestic financial systems. Weak banking systems and poorly developed capital markets contributed to the misallocation of resources that led to the crisis. Key to the strengthening of domestic financial systems is the implementation of sound practices for supervision, settlement, accounting and disclosure. This requires close international cooperation and collaboration among those in the official sector who are involved in the supervision of financial systems.

Implementation of sound practices requires that, first, there be a consensus on what constitutes sound practices. In many areas of banking supervision and securities regulation, international consensus has been reached and principles or standards have been established. In other areas, there still is a need to define best practices and develop standards. Standards should be developed in a collaborative manner to ensure that both the developed and emerging world have a voice in the standard-setting processes. The inclusion of a wider range of countries helps to ensure that the standards developed are more widely adopted in a timely fashion.

**The Working Group endorses this broad international consultative process for the development and refinement of sets of standards and sound practices.**

The implementation of sound practices depends on incentives to do so. These can be in the form of market-based incentives, either alone or in combination with official or regulatory incentives. The global nature of financial markets highlights the importance of international cooperation among those in the official sector involved in the supervision of financial systems. The Working Group looked at ways to best foster cooperation and coordination to ensure consistent application and to make best use of the limited resources available to help strengthen financial systems.

#### STANDARDS

The Basle Committee on Banking Supervision (BCBS) has produced the *Core Principles for Effective Banking Supervision* and the International Organisation of Securities Commissions (IOSCO) has produced the *Statement of Objectives and Principles of Securities Regulation* and *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*. These, along with the

IMF's *Special Data Dissemination Standard*, represent a significant contribution to efforts to strengthen financial systems and should be implemented rapidly.

**The Working Group endorses these existing sets of principles and underscores the importance of their rapid implementation.**

The Working Party considers it essential to develop sets of sound practice in the area of corporate governance. Economies become vulnerable to systemic stress when a large number of individual firms fails to formulate and pursue prudent business strategies, to establish and apply effective systems of internal control, and to monitor and manage the full range of financial and commercial risks to which they are exposed. The Working Group attaches particular importance to elements of corporate governance and structure relating to risk management and control – most notably the management of liquidity and foreign exchange risk. The mismatch between the maturity of foreign currency assets and liabilities in national banking systems must not get too far out of line with the capacity of the domestic authorities to supply foreign currency liquidity from the official reserves and any contingent financing that may be available.

**The Working Group considers it essential that sets of sound practices in the area of corporate governance continue to be developed, and supports the related efforts of the OECD and the BCBS. The Working Group encourages the prompt implementation of the BCBS recommendations regarding internal controls. The Basle-based committees, working together with the IFIs, should also consider the management of both domestic and foreign currency liquidity in different sectors. The IMF should give priority to work on the macroeconomic dimensions of liquidity and related risks.**

The lack of well-developed money and capital markets is another important root cause of banking crises. The Working Party emphasised the importance of fostering the emergence and growth of these markets where they are not found currently and will seek concrete ways to give momentum to their development.

## **SAFETY NETS**

In the crisis in Asia the authorities faced difficult choices in considering whether, and on what terms, they would offer support so that financially troubled banks and non-bank entities could meet their obligations. Explicit safety net arrangements help to reduce the risk of indiscriminate extension of public guarantees. Yet care must be taken in designing them, as poorly designed or overly generous arrangements dull incentives to monitor risks, thereby increasing the likelihood of the crises they aspire to deal with. A well-designed set of explicit, ex ante procedures with pre-ordained hierarchies of claims and/or loss sharing

arrangements reduces the need for ad hoc, ex post actions. The Group stresses the importance of identifying criteria to determine the appropriate limits on the extension of public guarantees.

Having in place a well-designed framework for the resolution process in the case of a future systemic crisis will alter expectations by the public and by institutional investors and may thus help to enhance financial stability. The Group's report introduces some basic guidelines and urges that they be developed further in a collaborative effort, drawing on the experience of various international fora.

**The Working Group recommends adopting, implementing and enforcing a method of structured early intervention in the banking sector which includes a well-considered set of mechanisms to ensure a consistent, timely and graduated response by supervisors.**

Depositor protection schemes are also part of the financial safety net. Among their most important goals are: increasing the stability of the financial system by reducing the risk of bank runs and contagion, and assisting small depositors who typically do not have the capacity to monitor the soundness of banks.

**The Group encourages the BCBS, with substantive input from the IMF and the World Bank, to develop guidelines for deposit insurance with emphasis on measures to reduce moral hazard and adverse selection.**

Insolvency regimes are also an important part of an economy-wide safety net because they serve to make the risks and consequences of a failure of a corporate entity easier to quantify for all parties involved and lower the prospect of ad hoc, ex post assistance or guarantees which distort incentives. The Working Group on International Financial Crises developed key principles and features of effective insolvency regimes for commercial entities.

**The Working Group supports the key principles and features of insolvency regimes in view of their importance for enhancing financial stability.**

When ex post actions are necessary, however, it is important to distinguish between restructuring banks and other financial institutions in "normal times" (defined by the absence of systemic risk within the financial system and through the economy at large) and in crisis situations. The Working Group will continue in its efforts to develop guidelines for restructuring of financial institutions in normal and crisis situations.

## IMPLEMENTATION OF STANDARDS AND SOUND PRACTICES

Market discipline should be employed to promote the implementation of sound practices. However, such discipline does not work without adequate transparency and appropriate incentives to price risk. The lack of international consensus on sound practices for loan valuation, loan-loss provisioning and credit risk disclosure seriously impairs the ability of market analysts as well as regulators to understand and assess the risks inherent in a financial institution's activities.

**The Working Group supports the ongoing work of the BCBS in the improvement of asset valuation and loan loss provisioning and underscores the importance of IASC completing its set of core accounting standards.**

It may make sense for financial market participants to establish a mechanism for developing collective, publicly available assessments of key aspects of national financial infrastructure – such as the supervisory systems for financial institutions; accounting and disclosure practices; corporate governance; legal regimes relevant to investment, including arrangements for dealing with insolvency; and payment and settlement systems.

**The Working Group recommends that the official sector initiate a dialogue with relevant private organisations, professional groups and institutions on how the private sector can more effectively utilise the information that is now, or will become, available on the key institutional aspects of national financial systems.**

Among regulatory tools, the Basle Capital Accord is an excellent example of a relatively straightforward regulatory device that has proved useful in focusing attention on the importance of bank capital. The Accord is under review, motivated in part by a desire to foster improved risk evaluation and management in conditions where the nature of banks' activities and financial techniques are undergoing rapid change.

**The Working Group advocates timely progress on this review of the Basle Capital Accord.**

Access to major financial markets for emerging market institutions is an important element in the effort to strengthen financial systems. An international consensus on concrete criteria to be used by national authorities when determining conditions for market access could help to ensure equitable conditions for market entry and to prevent competition in laxity.

**The Working Group is of one view on the benefits of open access, but recognises that it should not occur in such a way as to undermine the quality of supervision. Principles guiding**

**national practices with respect to market access for banks should be developed jointly by industrial and emerging market countries. The IFIs could provide a forum for such efforts.**

Conditionality for IFI programmes is a powerful means of fostering implementation of standards and sound practices and the Working Group supports the application of conditionality to measures pertaining to financial stability, recognising that the proper sequencing must be carefully considered as well as the impact on social stability, particularly in crisis situations.

Official oversight is another way in which implementation can be encouraged. . The particular type and combination of oversight mechanisms (conditionality, surveillance, peer review, comprehensive technical assistance programmes) that are most suitable for enhancing financial stability will vary from country to country.

**The Working Group is of the view that all countries should go through some process of independent assessment, subject to the condition that the process meets certain minimum standards and contains a core set of elements.**

With respect to surveillance, the IMF has the advantage of having a well established surveillance mechanism that covers all member countries. However, it lacks the resources and expertise to conduct financial sector surveillance alone. The World Bank, on the other hand, has greater resources and expertise in this field, but its country coverage is limited. The Working Group recommends that financial sector surveillance be anchored in the IMF's surveillance process but benefit from expertise at the World Bank and elsewhere. Serious consideration of using peer reviews as a component of, or complement to, financial sector surveillance is warranted.

## **INTERNATIONAL COOPERATION**

At present, supervision of the global financial system is fragmented both functionally and geographically, while global financial markets are becoming increasingly integrated. Geographical fragmentation is addressed through cooperation among different international groupings of functional supervisors, and the functional separation by cooperation among international groupings of banking, securities and insurance supervisors in the Joint Forum. The Working Party exchanged views on the adequacy of these arrangements and how they can be improved or reformed.

**The Group also endorses the *G-7 Principles for Information Exchange*, and urges their implementation in industrial and emerging market countries.**

The Group also considered global oversight of – and accreditation mechanisms for – supervisors to promote coordination across functions and to help support the independence of supervisors. To this end some members suggested seeking the involvement of the private sector. Other possible approaches include an international group of eminent experts to consult with supervisory authorities, and consideration of standards for internal managerial audits of supervisors.

Cooperation among IFIs and international groupings – to ensure effective surveillance and develop sets of sound practices – is important for strengthening financial systems. The Group discussed the need for enhanced cooperation among the IFIs (including regional MDBs) and international regulatory groupings, but has not yet developed thorough and concrete proposals.

The Group agreed that it would not be feasible to overhaul the IFIs, or set up a new large international financial institution. The division of responsibilities should reflect operational efficiency, avoid extending into each others' core activities, and enhanced accountability. In areas where responsibilities are shared, the IFIs need to ensure collaboration. The Group sees considerable promise in the following innovations:

- a Financial Sector Policy Forum in which finance ministry, central bank, regulatory and IFI representatives could meet to discuss international financial sector issues, across functional levels, and with full inclusion of systemically important emerging markets;
- a system for the exchange of information on financial sector regulatory and supervisory methods and findings; and
- a process of coordination or a clearing house to match demands from individual countries for technical assistance in financial regulation matters with the supply of experts.

The Group welcomes the setting up of the Basle Core Principles Liaison Group and plans for cooperation between the World Bank and IMF, including the creation of the Financial Sector Liaison Committee to adapt the division of work to country-specific situations, foster dissemination of standards and sound practices and help optimise the use of resources and facilitate joint work. The subject of enhanced cooperation will be explored further by the Working Group.

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## Chapter 1

### INTRODUCTION

The objective of the Working Group is to develop concrete methods to strengthen financial systems in industrial and emerging market economies alike. A strength of the Working Group is that it gives central banks and finance ministries from industrial and emerging market economies the opportunity to work together as equal partners in the development of consensus on the principles and policies that foster a robust and efficient global financial system and the methods through which these principles and practices can be implemented.

A number of topics considered by the Working Group are closely linked with work going on elsewhere. For this reason, the Working Group seeks to work closely with others in the international community focusing on these issues. An important contribution of the Working Group is to lend its support to ongoing efforts by endorsing existing recommendations, to participate in the development of new ones and to foster further work and close cooperation among national and international authorities with a responsibility for financial stability.

The Working Group takes as its point of departure significant recent efforts in this area, most particularly:<sup>5</sup>

- the Concerted Strategy for Strengthening Financial Stability in Emerging Market Economies that sets out a framework of the key elements necessary for a robust financial system and a division of responsibility among national authorities and international groupings;
- the IMF's report on developing a framework for financial stability;
- the World Bank's work on financial sector development, developing tools for resolving financial crises and restructuring financial systems;
- the work of the international regulatory and standard-setting groupings, including:
  - the Basle Committee on Banking Supervision (BCBS) in producing the Basle Committee's Core Principles for Effective Banking Supervision;

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<sup>5</sup> *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption, and Implementation of Sound Principles and Practices to Strengthen Financial Systems*. 1997; Folkerts-Landau, David and Carl-Johan Lindgren (1998) *Towards a Framework for Financial Stability*. (IMF, Washington, D.C.); *Core Principles for Effective Banking Supervision*. Basle Committee on Banking Supervision, 1997.

- the International Organization of Securities Commissions (IOSCO) in producing the Statement on Objectives and Principles of Securities Regulation; and
- the International Accounting Standards Committee (IASC).

The first part of this report reviews existing sets of sound practices and ongoing efforts to formulate them, and goes on to consider the development of understandings on sound practices in certain areas where their existence could have contributed to preventing, or at least reducing the severity of, the crisis that began in Asia. The focus of the second part is on the concrete methods to foster implementation. The third and final part considers ways to improve the coordination of international efforts to strengthen financial systems. Annex A provides a list of ongoing and planned work in international fora that is related to the subject of this report.

## Chapter 2

### DEVELOPING STANDARDS AND SOUND PRACTICES

Having sets of universally accepted standards or a corpus of sound principles and practices is an essential first step in strengthening financial systems. A consensus has now emerged on how such standards should be developed. For any specific area or activity relevant for robust financial systems, the standards should be developed through a broad international consultative process involving national and international experts with extensive experience in the area in question. Ensuring that both the developed and the emerging world have a voice in the standard-setting process helps to make sure that the standards developed are adopted and implemented in a broad range of countries in a timely fashion. The principles developed for various areas should be mutually consistent and applied in the light of the circumstances of each country.

The standards and sets of sound practices need to be refined and further developed in the light of experience with their application and changes in economic and other conditions. For this reason there is a strong need to establish channels for feedback from those involved in implementing sound practices or conducting surveillance of financial sectors to those developing sets of standards and sound practices. The latter need to know whether their standards are sufficiently comprehensive, detailed and relevant to be of maximum use for building and maintaining healthy financial systems. Feedback on these topics from the private sector to regulators and standard-setting bodies is also very important.

**The Working Group endorses this collaborative approach and recommends that it be used to refine and develop sets of standards and sound practices.**

In that spirit the central banks and ministries of finance represented in the Working Group undertake to cooperate with other relevant groups seeking to develop sets of standards and sound practices for the financial system.

#### **2.1 Overview of work on standards for banking, insurance and securities supervision, settlement, accounting and disclosure**

The sound practices needed for robust financial systems are being developed by a number of international groups with appropriate expertise and authority.

### 2.1.1 Existing

Among the most important sets of sound practices that have been developed are:

The *Core Principles for Effective Banking Supervision (1997)* produced by the Basle Committee on Banking Supervision (BCBS). The Core Principles seek to promote and enhance standards of supervision. They cover: preconditions for effective banking supervision; licensing and structure of banks; prudential regulations and requirements; methods of ongoing supervision; information requirements; formal powers of supervisors; and cross-border banking supervision.

The IMF's *Special Data Dissemination Standard (1996)*. The SDDS has set important standards for the accurate, frequent and timely disclosure of macroeconomic data to specified quality thresholds. It was designed to guide IMF member nations which have or might seek access to global capital markets. There are various proposals to extend its coverage, including to encourage more comprehensive disclosure of private sector external debt.

The IOSCO statement of *Objectives and Principles of Securities Regulation (1998)*. The statement sets out 30 principles of securities regulation that are based upon three objectives: the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk. The statement includes principles relating to the regulator, self-regulation, enforcement and cooperation, and also sets out principles for issuers, collective investment schemes, market intermediaries and the secondary market.

IOSCOS's *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (1998)*. The standards consist of a set of non-financial statement disclosure standards for use in cross-border offerings and listings. The standards could also be used to enhance domestic disclosure requirements.

**The Working Group endorses these existing sets of principles, and underscores the importance of their rapid further implementation. At the same time, the Working Group urges that the SDDS be further strengthened (particularly in the areas of international reserves and external debt), and that the BCBS continue to elaborate the Core Principles for Effective Banking Supervision. The Working Group also endorses the recommendations of the Working Group on Transparency and Accountability, which are highly pertinent in this respect.**

### 2.1.2 Work in progress

There are a number of initiatives that are in the course of being developed or are envisaged:

The BCBS is engaged in monitoring the implementation of the Core Principles, undertaking work on enhancing bank transparency, updating supervisory guidance on banks' derivatives and trading activities, providing guidance on loan valuation and provisioning, and investigating new techniques for constructing capital standards for credit risk. It is also engaged in several initiatives to strengthen corporate governance and risk management practices, especially credit risk management and internal controls.

The International Accounting Standards Committee (IASC) is working towards agreeing on a core set of internationally acceptable accounting standards for cross-border offerings and listings that will be considered by IOSCO upon its completion. The IASC is also working closely with the BCBS on reviewing differences in supervisory approaches to loan valuation and credit loss provisioning.

The Committee on Payment and Settlement Systems (CPSS) is engaged in the development of sound practices for the design and oversight of payment systems, and in the elimination of settlement delays in foreign exchange markets through the planned creation of a multicurrency settlement system through a specialised bank - the Continuous Linked Settlement Bank - by 2000.

The International Association of Insurance Supervisors (IAIS) has produced a set of model principles for its sector and is currently focusing its work on licensing, use of derivatives and on-site inspections.

The Ad-Hoc Task Force on Corporate Governance set up by the OECD is developing guidelines and core standards for corporate governance. The Working Group welcomes these undertakings and underscores the importance of their rapid completion.

### **2.1.3 Prospective work**

In the spring of 1998, the Central Bank Governors of the Group of Ten Countries initiated a review of areas where internationally agreed sets of sound practices have not been developed and where their development would help to strengthen financial systems. This work led to the following conclusions:

- shortcomings in *transparency* and *the reliability of information* are being addressed by efforts to develop accounting standards and improve the quality, relevance and availability of data;
- guidelines that address the *corporate governance* gap are under development (e.g. by the OECD and the BCBS) although the diversity of practices and institutional differences make it difficult to go beyond broad principles;

- work on sets of sound practices to foster *deep and liquid markets* is being considered by the Euro-currency Standing Committee (ECSC).

As for other areas where standards or sets of sound practices could be developed – *making the best use of information, design and operation of the safety net, dealing with weak institutions, market access and the legal infrastructure* – some work has begun in some of these areas, but it is limited in scope and still exploratory in nature. Some areas (such as making the best use of information) do not readily lend themselves to international standards.

In July 1998, the IMF Executive Board considered a staff paper on International Standards and Fund Surveillance. The paper discussed general economic, financial and legal standards that could be used as benchmarks against which countries' performances could be judged, thus helping investors to evaluate risks that they might be undertaking. Although the value of such standards was widely accepted, their regular review would be necessary to ensure continued relevance. A 'one size fits all' approach would be unwise given countries' different stages of development. It was noted that it would be useful to consider whether existing market-based incentives were sufficient to encourage adherence to the suggested range of standards. Taking into account the initiatives described in the present and the previous section, the Working Group welcomes further progress in developing and refining sets of standards and sound practices relevant to financial stability, and its members undertake to cooperate in the development of new sets of sound practices.

The remaining sections of this part of the report concentrate on specifying areas where new standards are required but where there is at present a lack of clear assignment of responsibility for their development.

## **2.2 Strengthening corporate governance and risk management**

The Working Group has identified a number of areas where current practices need to be improved. Shortcomings in these areas contributed to recent financial crises. There is a need to continue to develop standards for the management of these risks, and to strengthen corporate governance in both financial institutions and non-financial corporations so that sound risk management practices will be implemented.

### **2.2.1 Corporate governance, internal controls and corporate risk management**

A major reason why economies become vulnerable to systemic stress is the failure of a large number of individual firms in both the financial and non-financial sectors to formulate and pursue prudent business strategies, to establish and apply

effective systems of internal control, and to monitor and manage the full range of financial and commercial risks to which they are exposed. This was an important factor in many crises, including the crisis that began in Asia.

Good corporate governance helps to correct these shortcomings. However, to be effective, corporate governance needs to operate in the context of continuing and strong market discipline. Existing stakeholders should exercise oversight over the agents that run the companies in which they have an interest. The development of markets for corporate control, by enabling shareholders to tender their shares to the highest bidder, will contribute to effective corporate governance. New shareholders may have a superior capacity to exercise oversight and control over the operations of a company.

Good corporate governance and an appropriate corporate structure are vital for ensuring that the incentives of managers of financial and non-financial corporations contribute to the soundness of the institution and reflect a professional assessment of all risks involved.<sup>6</sup> Corporate governance is primarily the responsibility of the private sector, but regulators and governments can play an important role in creating an environment in which efficient, credible and adaptable practices can flourish. There is no single blueprint for corporate governance but certain principles should be recognised:

- there should be transparent and reliable corporate disclosure;
- distinctions between public and private sector responsibilities should be clear;
- guidelines for best practice on accountability and board independence should be observed;
- frameworks must evolve in response to changing market forces.

The Working Group has not considered these issues in depth, but welcomes the work under way in the OECD and the BCBS on corporate governance, and endorses two key points:

- the board should be made up of individuals of suitable stature, knowledge and independence. The board must satisfy itself that the corporation has the personnel, systems and organisation necessary to ensure the soundness of the corporation. For this purpose the board must have access to adequate internal information from the institution and access to external checks (audit and accounting in particular) and powers to direct the strategy of the institution. Typically, such a board comprises executive and non-executive

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<sup>6</sup> OECD (April 1998).

members and owes a primary fiduciary duty to the shareholders who have provided the capital to enable the institution to undertake its business; and

- for the board to be effectively accountable to the stakeholders in the enterprise, stakeholders must have access to adequate, accurate and timely information about the institution and the manner in which the board is discharging its responsibilities. Such information should be available, in a non-discriminatory manner, to potential stakeholders as well as existing ones.

In addition to these general principles, the Working Group has examined two aspects of corporate governance and structure which have a specific bearing on financial stability – ownership structures, and risk management and control.

In the view of the Working Group, it is of crucial importance that a financial institution operate at arm's length from other corporate entities and public sector authorities, to eliminate the risk of conflicts of interest endangering its long-term soundness. This may be achieved by it having a diverse portfolio of shareholders with no special relationship, other than normal commercial relationships, with other corporate entities or the public sector.

The Working Group recognises that in some emerging markets and transition economies more time will be needed to achieve effective implementation of the basic principles of corporate governance noted above.

**The Working Group therefore suggests that the OECD, the BCBS and other international regulatory groupings, and the World Bank further develop principles of sound corporate governance and structure.**

Implementation of such principles and enforcement of prudential norms that may limit directed and connected lending will minimise the risk of this type of lending, which has been a feature of a number of financial crises.

**The Working Group further suggests that the IMF, in cooperation with the World Bank, takes full account of these principles in its surveillance of financial sectors and that the World Bank and regional development banks do so in their technical assistance and financial sector restructuring activities.**

### **2.2.2 Corporate risk management and control in financial institutions**

Financial institutions carry a wide range of risks, including credit, interest rate, foreign exchange, liquidity, operational and reputational risk. These risks are

highly interdependent and events (whether expected or unanticipated) that affect one area of risk can have ramifications for a range of other risk categories.

Because of this, and owing to the clear public interest in the soundness of the financial system, regulators attach considerable importance to a financial institution's ability to identify, measure, monitor and control the overall level of risk undertaken. Good corporate governance arrangements play a major role in ensuring that such corporate risk management and control systems are in place and observed. The Working Group recommends that corporate governance assure much improved management and control of risks in the following areas, which have been particularly wanting in the period leading up to the crisis in Asia.

The management and board should ensure a strong credit culture, comprising both sound credit analysis and effective credit risk management. Extensive short-maturity borrowing through banks or the capital markets may prove difficult to roll over in some circumstances. For this reason bank and non-bank entities need to ensure that there is a reasonable match between their borrowing and the maturity structure of their assets.

More generally there is a corresponding need to develop internationally agreed prudential standards for bank liquidity. Managing foreign currency risk is another important element of risk management that was neglected ahead of the crisis in Asia. For banks, it is not enough to have a small open exposure to foreign currency risk in the sense of mechanically matching foreign currency liabilities and assets through both on- and off-balance-sheet operations. It is also important to adopt prudent policies with respect to the *liquidity* of liabilities and assets, especially when these are denominated in foreign currencies. The domestic authorities may not always be in a position to provide foreign currency liquidity support even in the event that they would choose to do so. The key in evaluating the liquidity of assets is *not* their contractual maturity, but rather how quickly they can be liquidated in troubled times.

Finally, non-financial companies should be very cautious about borrowing in foreign currency to an extent which is out of line with their foreign currency earnings stream. This is partly a matter of corporate governance, but may also be an issue for regulators of the lending banks. (When assessing risk and pricing the exposures, are the banks looking at the ability of borrowers to service their debt from foreign currency earnings, and are they stress-testing their exposures sufficiently?)

More generally, risk evaluation tools (including, where appropriate, value-at-risk models and stress tests) need to be used, and further developed and refined, so that they provide ongoing information for the management and boards of financial institutions and non-financial corporations, and for policy makers who must cope with the threat of systemic crisis. However, these tools need to be supplemented with

sound judgement and a sense of caution, since they do not always work well, especially in extreme conditions.

**The Working Group encourages the prompt implementation of the BCBS recommendations regarding internal controls and is of the view that further work should be pursued in the area of liquidity management.**

The Working Group will formulate recommendations for objectives of work on these questions and urges further action by the BCBS, OECD and others seeking to formulate codes of good practice. It undertakes to cooperate in developing these sets of sound practices.

### **2.2.3 Liquidity, interest rate and foreign currency risk in detail**

The *liquidity risk* of an institution refers to a situation where liabilities are of shorter maturity than assets, so that liabilities are subject to a rollover or refinancing risk. Institutions with maturity mismatches may suffer runs and be forced to sell assets at substantially reduced prices in a situation of stress when liabilities coming due are not rolled over. Such liquidity mismatches may occur in either domestic or foreign currency. *Interest rate risk* is a closely allied, but distinct concept. It normally refers to the risk that a rise in interest rates will depress the value of longer-duration assets more than the value of shorter-duration liabilities. This is a question of ‘solvency’ rather than liquidity although both stem fundamentally from a maturity (or, in the case of interest rate risk, more correctly a duration) mismatch. *Foreign currency risk* refers to the risk faced by an institution that has assets denominated in one currency (e.g. domestic) and liabilities in a second currency (e.g. a foreign currency) when there is a sharp move in the exchange rate (e.g. a devaluation).

In practice, there are significant relationships between liquidity, interest rate and foreign currency risk, even though in principle they may be separated. For example, a serious ‘systemic’ liquidity problem in domestic currency will normally force interest rate hikes as institutions scramble for liquidity, or force authorities to inject domestic liquidity, thus perhaps increasing pressure on the exchange rate.

Indeed, all three problems may arise at once. Authorities may be faced with adopting high interest rates to maintain the value of the currency, and the perceived risk of devaluation may give rise to liquidity problems as investors (both domestic and foreign) run from domestic assets to foreign assets. Domestic and foreign creditors may become nervous and refuse to rollover liabilities, aggravating the situation where there are liquidity mismatches. If there is then a devaluation, this will often be accompanied by a further period of stress as interest rates are kept high to prevent a surge in inflation and to give credibility to the new exchange rate. High interest rates and a sharply devalued exchange rate may then give rise to both liquidity problems and solvency problems, depending on the mismatches present

originally. (For instance, unexpected macroeconomic developments such as a sharp depreciation of a currency can reduce the capacity of borrowers to service loans denominated in foreign currency, and thus present a bank with a foreign currency exposure in addition to the credit risk in the original loan.)

### **2.2.3.1 Liquidity risk**

Recent crises in emerging markets have highlighted the importance of liquidity management in foreign as well as domestic currency. Depending on the structure of the assets and the liabilities of a country, liquidity risks may be concentrated in different sectors. Two areas of particular concern are the maturity structure of public sector debt (an issue in Mexico in 1994 and in Russia today) and also the short-term liquidity of the banking sector as a whole (important in Korea in 1997 and in Argentina in 1995). In addition, the non-financial corporate sector should not be ignored, as it played an important role in Korea and in the Indonesian crisis.

Foreign currency liquidity management is an important issue for any country. Since a country's ability to provide foreign currency liquidity is limited to its reserves, the selling of other liquid foreign exchange assets, and its borrowing potential, a pure foreign currency liquidity problem may quickly turn into a massive payment problem or even a problem of default. This implies that all parties which accept foreign currency liabilities should, depending on their asset structure, carefully consider the liquidity risks present, and that the authorities should monitor foreign currency liabilities and take appropriate action. Authorities should be particularly vigilant where foreign currency liquidity risks are concentrated. Governments that issue substantial amounts of short-term foreign currency debt and banking sectors that have a substantial amount of financing in the form of short-term foreign credit lines or foreign currency wholesale deposits (relative to foreign exchange assets) are especially vulnerable.

Domestic currency liquidity management is also an important issue. While countries ultimately have the ability to print domestic currency, this does not mean that domestic currency liquidity management can afford to be less strict than foreign currency liquidity management. The scope for domestic currency lender-of-last-resort operations may depend critically on a country's ability to sterilise successfully domestic monetary injections or on its willingness to see substantial movements in its exchange rate.

A problem that many emerging countries face, almost by definition, is that in the event of a perceived problem government bond markets sharply lose their liquidity. The evidence for this is the very sharp price changes that have recently been seen in virtually all emerging market debt instruments. This implies a serious impediment to the ability to sterilise domestic monetary injections, which in turn

suggests that significant domestic monetary injections are likely to place strong pressure on the exchange rate as in such circumstances it is unlikely that the additional supply of domestic currency will be accompanied by an extra demand. Indeed, one way of making sense of the very substantial devaluation witnessed for instance in Indonesia (much greater than warranted by any 'fundamental' purchasing power parity type calculation) is precisely this process at work.

Authorities should recognise that contagion effects arising from developments in third countries can trigger massive portfolio adjustments, thereby threatening the ability of borrowers in a country to rollover short-term funding. The subsequent effects on exchange rates and interest rates can have serious repercussions for the levels of economic activity, employment and growth. Moreover, particularly where a country's banks become unable to honour their foreign currency liabilities, there can be very large externalities (because of the impact on the international banking system) and on the stability of a country's own banking system.

The Working Group recommends that the IMF, in the context of Article IV surveillance and associated technical assistance activities, give due attention to the macroeconomic dimensions of liquidity and related risks. Working together with national authorities, it should develop understandings on sound practices in this area and consider establishing a quantitative framework for measuring liquidity for macro-economies. The Basle-based committees, working together with the IFIs, should also consider the management of aggregate domestic and foreign currency liquidity in different sectors, to complement work by the BCBS on risk management by individual banks.

#### **2.2.3.2 Interest rate risk**

As with liquidity risk, interest rate risk stems from maturity (or, more correctly, duration) mismatches in institutions' balance sheets. For example, banking systems normally have longer-duration assets than liabilities, such that if interest rates rise the present value of assets falls further than that of liabilities - potentially rendering banking institutions insolvent. This issue has been studied extensively for banks by the BCBS. In 1997 the BCBS issued a set of principles for the management of interest rate risk. However, to date no general agreement has been reached between countries on whether a capital requirement for this 'banking book' interest rate risk should be introduced for banks (in addition to credit and market risks) or whether supervisors should press banks to 'mark to market' their assets and liabilities that are not traded in liquid markets. Given the higher volatilities, this problem is probably most acute in emerging markets.

The Working Group recommends that national authorities consider establishing a monitoring regime to analyse interest rate risk in their banking systems, and that the BCBS should continue to consider the need for a capital charge for interest rate risk

### **2.2.3.3 Foreign currency risk**

In theory exchange rate risk could apply to any currency mismatch, but the Working Group was most concerned with the mismatch between foreign and domestic currency. In particular, the mismatch between bank liabilities denominated in dollars and bank assets in local currency and/or serviced from local currency earnings was significant in some Asian countries, and given the very sharp devaluations that have been seen this contributed to serious solvency problems in some financial institutions.

While the market risk amendment to the Basle Capital Accord covers a bank's trading exposure to foreign exchange rate movements, the Working Group considered that national authorities should monitor currency risks in their financial systems, and consider either direct limits on currency mismatches or capital requirements that depend on the extent of currency mismatches present.

The Working Group also considered, however, that interest rate and foreign currency risk should not be treated in isolation, but rather should be included in a general analysis of the risks run by financial institutions. In particular, the Working Group noted that a move to floating interest rate loans (to control financial institutions' interest rate risk) or a move to loans in foreign currency (to address institutions' currency risk) might simply increase the credit risk which institutions run vis-à-vis their counterparties. The Working Group therefore recommends that solutions for the management of these risks should take the whole risk profile of financial institutions into account.

The size of the maturity mismatches and currency exposures that were built up in South-East Asia illustrates the points just made. The scale of short-term borrowing, generally in foreign currency, was substantial. Of the US\$ 380 billion in international bank lending to Asian countries outstanding at end-1997, 60% had a maturity of less than one year. This short-term foreign currency lending was often used to provide long-term finance for activities that did not directly generate the foreign currency earnings needed to repay the loans. In many cases decisions by borrowers to rely on short-term foreign currency finance rested on the twin presumptions that the exchange rate would be maintained and that short-term borrowing could be rolled over. In the event neither presumption proved to be warranted. For example, the turnaround in international bank funding to the five most affected Asian economies between 1996 and 1997 was some US\$ 70 billion, or 7% of GDP. As a result borrowers proved to be incapable of meeting their

contractual obligations, and counterparties who relied on that performance to hedge other positions found themselves exposed.

#### **2.2.4 System-wide policies for containing risk, including liquidity risk**

Even though improved corporate governance and internal risk management will increase the robustness of a country's financial system, the dynamic interaction between macroeconomic developments and specific risks faced by individual institutions requires system-wide policies for identifying and managing risk. Such policies are particularly important for emerging market economies where liquidity may quickly dry up owing to sudden shifts in market sentiment.

To foster the system-wide resilience of financial systems, the Working Group has considered a number of options for action, which are set out below. Many of these are concerned with foreign exchange liquidity.

It is necessary to have accurate and timely information on the aggregate foreign currency liquidity of the bank (and ideally also non-bank) private sector jointly with the position of the public sector, i.e. the stock of net available reserves. It is also important to have similar information about external debt and the economic policies being pursued. The Working Group on Transparency and Accountability has developed a number of recommendations on the nature of the information that should be disclosed, as well as on further action in this area. This Working Group supports their recommendations.

Countries subject to volatile capital flows, and/or with domestic markets subject to shocks to liquidity provision and possible large-scale movement by domestic residents from domestic to foreign currency assets, need to maintain access to adequate foreign exchange. This requires adequate outright holdings, but it may also entail arranging contingent credit lines.<sup>7</sup> In relying on these credit lines, the country needs to determine the extent to which they will provide genuinely additional liquidity in times of stress.

The Working Group has not sought to develop very specific rules on domestic and foreign currency liquidity management. However, economic agents should consider carefully foreign liquidity mismatches - and also domestic currency liquidity mismatches - bearing in mind the constraints on the provision of foreign currency liquidity by the authorities (reserves and borrowing) and on the provision of domestic liquidity (capacity to sterilise and exchange rate targets).

Countries may wish to think in terms of developing an overall liquidity policy. In particular, it is suggested that the foreign currency liquidity positions of the

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<sup>7</sup> The Report of the Working Group on International Financial Crises discusses the benefits and limitations of contingent credit lines used for this purpose.

public sector and the banking sector should be monitored carefully and jointly. Thus, the extent of foreign currency liquidity transformation in a country's banking system should be related to the stock of net usable foreign currency reserves and any foreign currency borrowing capacity that is available to the authorities. For example, for countries subject to considerable instability, policy might be to ensure that, across the whole banking system, the aggregate foreign currency mismatch over say a three- or six-month period should not be hugely out of line with the potential pool of foreign currency lender-of-last-resort support that is available in the form of foreign exchange reserves plus standby facilities if they are assured. (In addition, the liquidity position of the corporate sector may be an area where at the very least monitoring is required.)

A number of considerations shed light on how liquidity mismatches in individual banks should be measured and aggregated to calculate the mismatch in the banking sector as a whole. First, it should be noted that it will probably not be prudent to net the position of institutions with a possible shortfall of liquidity against those with a surplus. This is because domestic money markets often become segmented in conditions of stress, with institutions in surplus not necessarily prepared to make such funds available to firms with a shortfall.

Second, liquidity in a particular currency (i.e. foreign or domestic) is traditionally viewed in terms of mismatches along a maturity ladder, with mismatches in each time-bucket calculated by netting a loss of liquidity through maturing liabilities against incoming liquidity from maturing assets. To assess what liquidity gaps might be reasonable, a number of assumptions play a crucial role. On the liability side, different assumptions may be made on how many short-term liabilities are rolled over. (This may depend on the nature of the liabilities. For example, sight deposits in a banking system may be assumed to carry low rollover risk unless crisis conditions prevail, while interbank credit lines or wholesale deposits may be subject to stricter assumptions.) On the assets side, liquid assets may be treated as ready liquidity but, if they are domestic assets (in either local or foreign currency), subject to a significant discount to reflect probable price falls due to higher interest rates or worsened credit prospects.

One approach is to calculate liquidity mismatches in a number of particular scenarios. Four possibilities include (i) the contractual case where no rollover whatsoever is allowed; (ii) the "normal" case allowing rollover assumptions in line with recent historical experience and without discounting of asset prices; (iii) an individual liquidity problem where rollover assumptions may be more strict but asset prices are not discounted; and (iv) a general or systemic liquidity problem where rollover assumptions should be strict and asset prices discounted. In theory, limits may be placed on each scenario, although the most appropriate is likely to be the systemic liquidity problem scenario, which will be the most strenuous.

An important issue in some economies is whether liquidity gaps in different currencies should be treated independently or whether some aggregation of liquidity risks may be allowed. This is particularly important in economies where long-term assets are generally priced in foreign currency. In these cases it is likely (assuming a low rollover risk of sight deposits) that financial institutions will have a negative mismatch in domestic currency and a positive mismatch in foreign currency. One approach is to allow aggregation only where currency risks are fully and robustly hedged.

It is difficult to specify a precise rule for what liquidity mismatches should be tolerated within a country. To some extent this will depend on the room for sterilisation and the authorities' preferences for exchange rate stability. Nonetheless, domestic currency liquidity mismatches should be limited such that lender-of-last-resort assistance from the central bank is required only in exceptional circumstances.

The Working Group noted that banking supervision offers potential tools to address liquidity mismatches in individual institutions. While the Core Principles deal with the issue only briefly, the BCBS has previously issued material discussing some of the issues in liquidity management in individual institutions, and is well placed to discuss additional issues related to liquidity, such as maturity mismatches and the diversification of sources of funding.

**The Working Group recommends that the BCBS elaborate the Core Principles to include a more extensive discussion of sound practice in the measurement and management of individual banks' liquidity positions.**

In addition, to the extent that this has not been done already, some country-specific features of banking regulations in selected crisis countries in Asia should be reconsidered because they encouraged borrowing in foreign currency or favoured short-term borrowing through the banking system, and thus helped endanger financial stability.

## **2.2.5 Development of deep, liquid and sound short and long-term money and capital markets**

### **2.2.5.1 General considerations**

Aside from the consequences of shortcomings in bank management and supervision, the crises in Asia highlight the more general risks that are associated with excessive reliance on banks as a source of finance. Indeed, experience shows that the lack of well-developed money and capital markets is an important root cause of banking crises. Deep and liquid money and capital markets are also needed as elements of a balanced financial system.

In conditions of financial stress there is likely to be a systemic need for liquidity. A particular concern is that the disappearance of a deep and liquid interbank market may compel the central bank to meet that need by lending to individual institutions rather than providing liquidity through operations in the money market. This can be problematic if doubts exist about the solvency of counterparties. Moreover, when the domestic bond market becomes illiquid, it will be very difficult to sterilise any injections of liquidity by the central bank that are judged necessary.

More fundamentally, capital markets contribute to the efficient mobilisation and allocation of savings. They enhance the processes of risk management and corporate governance, in part by making it easier to borrow at longer maturities. Money markets are a prerequisite for the conduct of monetary policy. Government debt markets are especially important in current circumstances in countries where the fiscal costs of resolving systemic problems in the banking sector will be significant, and capital markets are needed to facilitate the restructuring and recapitalisation of banks and non-bank corporations. In such countries, the upgrading of both debt and equity market infrastructure is a high priority.

Development of the institutional, legal and regulatory infrastructure for well-functioning primary and secondary markets for bonds and equities is a multifaceted process. Some of the many elements needed are:

- the standardisation and broadening of the range of instruments in terms of issuers and maturities;
- the establishment of benchmarks (typically government securities) across a range of maturities;
- the establishment of a group of firms to provide core liquidity (for example, a market-making network), and of trading systems that ensure a transparent and efficient price discovery mechanism and liquid secondary markets;
- the promotion of securitisation and other mechanisms to allow risk pooling;
- the establishment of a sound legal basis for trading, ownership and settlement; and
- clearance and settlement systems (including depositories) that provide safe custody, reduce the principal risk in the settlement process, and promote overall market integrity.

The private sector (through self-regulatory organisations and other professional associations) and national authorities have made significant strides in some countries. The international organisations, including the World Bank and the

IMF, are devoting considerable resources to this process as well. In addition, research is taking place under the auspices of the Euro-currency Standing Committee regarding the determinants of market depth and liquidity. The three main questions being examined concern the effects of market microstructure and product design on market liquidity; the relationship between market liquidity and market stability; and the link between market liquidity and the information content in market prices.

IOSCO's Statement on Objectives and Principles of Securities Regulation (1998) provides an important reference point for regulators and others in considering the development of securities market regulation. The Statement sets forth prudential principles and practices for the regulation of securities markets.

The Working Group urges the various parties involved to attach high priority to the promotion of enhanced money and capital markets and market instruments.

#### **2.2.5.2 Observations on debt management strategies**

The public sector can play an important role in developing the domestic capital market. However, such action should in general not be based on fiscal incentives but on the pursuit of a consistent debt management strategy. For example, by its actions the public sector can help to create a yield curve with liquid instruments in the most important maturities. This can serve as a reference for the private sector to manage its liabilities, and to measure appropriately the country and foreign exchange risk. In addition, a well-developed sovereign yield curve serves as a benchmark for private borrowers, allowing them to lengthen their maturity profiles.

In the context of a need to develop a country's capital markets, a government's debt strategy could be based around the four elements outlined below. The first element is to develop a sound debt amortisation structure to avoid the concentration of payments of principal in any particular year, thus limiting the refinancing risk. To meet this goal, the government could issue most of its new debt at long maturities. However, in the absence of well-developed capital markets the government would still be faced with the difficult choice of issuing either long-term foreign currency debt or long-term floating or otherwise indexed domestic currency debt. In either case, the resultant risk exposures would need to be monitored and managed carefully. As a precautionary effort, the government could limit the size of short term debt to the amount that institutional investors including insurance companies, money market funds and banks are willing to invest on a fairly stable basis.

The second element is to secure a liquidity cushion at the ministry of finance and/or the central bank in order to provide flexibility in the timing of transactions and to avoid the need to issue debt at times of heightened volatility or high interest rates or during a liquidity crisis.

The third element is to diversify the sources of financing to increase the number of domestic and foreign investors that hold a country's debt, thus improving the chances of tapping the markets at all times. The development of a diversified investor base is helped by providing public access to clear and frequently updated information regarding the monetary, fiscal and external situation of the country, as well as by making special efforts to ensure that the debt strategy is conducive to an improvement in credit ratings by limiting the size of short-term debt.

Even with global financial markets, access varies across currencies and across types of investors. For instance, pension funds usually prefer long-duration instruments with potential capital gains, while money market funds lean towards debt instruments with low price volatility and preferably short-term. Also, different kinds of investors react differently to crises. Therefore, the country should take advantage of such opportunities and diversify its issuance to market segments, after comparing costs for different maturities and considering the composition and predictability of its flow of expenditures and receipts.

The fourth element of a debt management strategy is efforts to develop a domestic treasury market (including treasury bills and treasury bonds), in order to reduce vulnerability to and dependence on international capital markets. For most emerging markets, the domestic treasury bill market consists of local and foreign currency instruments, whereas the long end of the capital market functions primarily in foreign currency. The growth of players in fixed income instruments (such as pension funds, mutual funds and insurance companies) constitutes the base for the development of domestic capital markets.

Following the successful experience of many industrialised countries in reshaping their domestic treasury markets in the 1980s, the local market in emerging economies should issue in a predictable manner, resisting temptations to outsmart the market. Among other features that could help develop local markets are the existence of a group of market-makers who are willing to guarantee the success of the auction by ensuring the submission of enough bids to cover the size of the auction, providing adequate liquidity and improving transparency in trading activity.

Globalisation blurs the distinction between local and international investors. The introduction of standard and liquid debt instruments with internationally accepted settlement practices is advisable to develop the domestic market. In addition, there are advantages in having a predictable annual financing schedule that states the dates, amounts and maturities of the various auctions. The attendant greater predictability and efficiency will reduce the uncertainty associated with the financing programme, and help ensure a continuous supply of funds. Furthermore, experience has shown that an appropriately constructed centralised settlement system is necessary to develop deep local markets, for one thing because it reduces counterparty risk. The need for a secure settlement system increases in periods of

market turmoil that otherwise may lead to a virtual stop in market activity as a result of the risk involved. Central banks can play an important role by providing clearing services that they can set up rapidly because of their position in the financial system.

The Working Group recognises the benefits of countries developing deep, liquid and sound securities markets. It notes that countries may wish to diversify funding sources in terms of types of investors in order to reduce rollover risks, and should most certainly avoid a build-up of short-term foreign currency debt with its combination of foreign currency and liquidity risks.

**The Working Group also suggests that countries consider developing formal and routine procedures for debt issuance in accordance with a transparent financing plan.**

The more information on the timetable and the auction system that is given to the market, the more uncertainty is reduced and the more stable the investor base becomes. The Working Group also recognises the importance of developing a secure clearing system in order to develop deep, liquid and sound markets.

### **2.3 Preventing and handling financial crises**

In the crisis in Asia the authorities faced difficult choices in considering whether, and on what terms, they would offer support so that financially troubled banks and non-bank entities could meet their obligations. In some instances, decisions to provide extensive financial support were made reluctantly in the face of a widespread deterioration in financial conditions. In order to reduce the risk of an indiscriminate extension of public guarantees in the future, authorities should be explicit in describing the nature and extent of the safety net and should implement appropriate supervisory and regulatory policies. A safety net normally consists of contingency plans for dealing with troubled institutions, structured early intervention programmes, mechanisms to ensure the provision of liquidity in conditions of stress, depositor protection arrangements and insolvency procedures.

Each country should have a policy towards safety nets. In developing and implementing its safety net policies, great care must be taken to avoid dulling incentives to monitor risks (for instance by overly generous arrangements), as that would increase the likelihood of the very crises the safety net aspires to deal with. In framing the policy, countries will need to weigh the following considerations:

- the impact on incentives;
- the relationship between the different components;
- the degree of explicitness versus the benefits of constructive ambiguity;
- the limits to its application (instruments, amounts, counterparties);

- financing or loss-sharing arrangements;
- its application in normal times and times of systemic crisis.

### **2.3.1 Methods to ring-fence the socialisation of risk and to limit forbearance**

A well-designed set of procedures (for bank restructuring, depositor protection and dealing with insolvency) with preordained hierarchies of claims and/or loss sharing arrangements has four major advantages. First, such procedures help to ensure that the incentives facing market participants are not unduly distorted, for example by a widespread expectation that all bank liabilities ultimately have state underpinning. Second, credible plans with clear guidelines for the type of action to be taken in the event of a particular contingency help to limit forbearance. Third, such procedures should reduce the need for ad hoc, ex post actions which, even if effective in dealing with an immediate crisis, may, through ‘moral hazard’, significantly distort incentives for the future. Fourth, a clear ex ante procedure reduces uncertainty and can thus have the additional advantage of limiting depositors’ loss of confidence.

However, there may be limits to the adequacy of ex ante procedures in dealing with the most severe forms of crisis. For example, limited deposit insurance schemes do not cover large depositors and other creditors, including other financial institutions, which are most prone to run when the first signs of problems emerge. Also, even a deposit protection scheme with a substantial existing insurance fund cannot be expected to handle the costs of total systemic failure, involving the large-scale failure of banks. Insurance premiums would have to be so high as to induce very substantial moral hazard and inefficiency. Instead, systemic failure would require government involvement and guarantees, if losses exceeding the capacity of the deposit protection scheme were not to be absorbed by depositors and creditors after all.

The key in such circumstances is to minimise the impact of exceptional policy actions on *future* expectations, incentives and moral hazard. Public sector intervention should be kept to the minimum compatible with addressing the crisis. Generally, providers of equity funding (risk capital) and subordinated debt should not be bailed out. And senior management of financial institutions and other relevant corporates should be held to account for any failures of risk management or control. Explicit policy statements or laws on the nature of ex post public support or guarantees may provide further limits to the socialisation of risks. For instance, there may be legal injunctions prohibiting government assistance to deposits that are not covered by the deposit protection scheme, although there could be an explicit systemic risk exception to this rule.

### **2.3.2 Liquidity provision and management in conditions of stress**

In conditions of stress, it may be appropriate to provide liquidity assistance to certain financial institutions under some circumstances. The pros and cons of the following potential objectives of such action need to be weighed carefully by national authorities (and work is under way in the ECSC to aid in these considerations):

- to protect the integrity of the payment system and ensure continued interbank funding;<sup>8</sup>
- to prevent bank runs;
- to provide essential trade finance;
- to prevent a credit crunch, for instance if banks hold more liquid assets and fewer loans out of a fear of illiquidity.

In any event, it is of paramount importance to limit liquidity assistance only to solvent banks, while allowing insolvent banks to fail. This principle will of course only be effective if the solvency of a troubled bank is judged according to clear and meaningful standards, which has not been the case in a number of recent crises and is difficult to do during a systemic collapse.

Also, to maintain incentives for good management, liquidity assistance should be provided only for short periods; the loan should be fully collateralised, and granted at a penalty rate.

Approaches which may offer an alternative to the provision of liquidity by the central bank in some circumstances are:

- The use of contingent credit lines, supplied for instance by large international commercial banks. It is important to ensure that a potential or impending systemic failure does not automatically render such credit lines inaccessible.
- Insurance or insurance-like arrangements. Such schemes would not remove the need for an ultimate public sector safety net for at least the core of the banking system, because there is a limit to the capacity of the private sector to provide insurance of this kind, at least at reasonable premiums. However, it might be possible to develop approaches involving shared private and public insurance, which would have the advantage of direct market

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<sup>8</sup> Since a bank's liquidity problems do not necessarily originate in its traditional banking business, but - for instance - in its securities business, this points to the need for a comprehensive regulatory structure that addresses all activities conducted by banks.

discipline coming from the private sector insurers. To reduce moral hazard and adverse selection, risk-related insurance premiums would have to be assessed consistently across the public and private sector insurers.

- Bridge bank and related arrangements. By underpinning the continued availability of credit to creditworthy borrowers, these may permit a wider range of options to be considered regarding the resolution of financial institutions in difficulties, including outright closure.

### **2.3.3 Dealing with weak banks**

Given the close and complex interrelationships among financial institutions and the importance of continued confidence, the maintenance of a robust financial system requires strong financial institutions. The existence of weak financial institutions – especially banks – can undermine the entire financial system. Therefore weak financial institutions should either be on a path that will restore their financial health or, if that is not deemed to be feasible, closed in a timely fashion.<sup>9</sup>

A coherent system for the restructuring and resolution of weak financial institutions, that is properly implemented, is crucial in reducing the risk of contagion within the financial system and to the economy at large. An effective resolution system also reduces the overall costs to the government of dealing with failing institutions, as well as other costs (ranging from the loss of asset values to the social costs of having a smaller banking system). Finally, it plays an important role in reducing supervisory forbearance, because it greatly facilitates the alternative of taking action at the right time. For these reasons, methods for the restructuring and resolution of financial institutions are important for maintaining financial stability.

There is a need to be able to adapt restructuring and resolution mechanisms to specific situations. Also, it may be beneficial to reduce moral hazard by avoiding too much precision (i.e. to preserve some constructive ambiguity), for instance concerning the lender-of-last-resort function.<sup>10</sup> The following discussion therefore focuses on key principles that can help to minimise the costs associated with weak financial institutions.

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<sup>9</sup> It should be recognised that because of the key role of banks in the economy (for example in the payments system), and because of the loss of value which typically occurs if a bank is closed and illiquid loan-book assets are sold, the approach of bank regulators to resolution and insolvency is quite different from that of corporate bankruptcy practitioners. The main concern of securities regulators also differs in that they seek to ensure an orderly wind-down to protect the interests of the customers and counterparties of the troubled securities firm.

<sup>10</sup> At their meeting on 9th September 1974, the G-10 Governors “recognised that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity”, and this position still stands.

First, and as a matter of high priority, it is essential to determine whether the bank problem is likely to have substantial systemic implications or not. A single bank's problem may have systemic repercussions; alternatively, there could be simultaneous problems in a number of banks without there being systemic implications. The central bank and (where different) the supervisory authority (among others) should prepare for this task by continuously collecting and analysing information concerning specific institutions and sectoral trends as well as macroeconomic developments which have implications for financial institutions and markets.

Authorities in many countries apply *Early Warning Systems* to help identify emerging problems. These are a useful supplementary tool to traditional supervisory analysis, and should be developed further. Even earlier indications of potential future problems may be provided by central credit registers, which a number of countries have found beneficial to identify loan concentrations and heavily indebted borrowers.

The Working Group encourages ongoing discussion in appropriate fora on improving the efficiency of central credit registers. This might include cross-border exchanges of information between national central credit registers, and should address the issue of appropriate safeguards to protect privacy.

Experience has shown that a bank's financial strength can erode very quickly once problems are detected. In addition, the likelihood of inappropriate risk-taking increases when capital is running low. Furthermore, there is the risk of forbearance by the authorities. This has proved to be an unsuccessful policy which has exacerbated problems in the vast majority of cases, for instance by engendering a credit crunch when prudential norms are enforced belatedly, and thus on a rather large scale. Also, it is often perceived by apprehensive domestic and international counterparties as revealing the authorities' inability or unwillingness to adopt the necessary remedies.

**The Working Group recommends adopting, implementing and enforcing a method of structured early intervention in the banking sector.**

A method of structured early intervention in the banking sector should have the following properties:

- a well-considered evaluation mechanism that ensures a consistent, timely and graduated response by supervisors. Depending on the nature of the banking and the supervisory system, this mechanism may rely on automatic quantified triggers for action (in which case there should be a provision for overriding the triggers by following a prescribed process with appropriate checks and balances). Such automatic quantified triggers may not always be

the preferred option, though - for instance, if the banking sector is very heterogeneous;

- a set of explicit rules, procedures and options to allow owners and managers to assess in advance the consequences of alternative courses of action. In particular, these rules should allow for a range of actions depending on how serious a problem has become. In the early stages of a problem the early intervention procedures may require only some constraints being put on the troubled institution's activities (for instance, it may be prevented from engaging in new activities or extending new credit), while advanced problems may require the unwinding of existing positions;
- having effective processes in place for the supervisory authority to collect and analyse the information necessary for the above procedures to work efficiently;
- legal and other arrangements which ensure that decision-makers do not incur legal liability for exercising their supervisory authority, and have the right incentives to take prompt action where required.

Reliance on structured early intervention may require considerable groundwork, though. In particular, the Working Group realises that strict enforcement of structured early intervention may not be consistent with the legal systems and judicial processes of some countries, and that this system demands both superior information and good supervisory skills, the absence of which characterises many lower-income countries.

The Working Group touched on the importance of identifying criteria to determine the appropriate limits on the extension of guarantees (for example, whether there is a case for restricting their application only to banks), and encourages work on this subject.

If the analysis of a troubled bank's (or multiple banks') problems shows no risk of systemic destabilisation, reconstruction of the bank through early intervention, or by use of a bridge bank for a bank in default, should generally only involve public funds if (1) an obligation is identified to exist with respect to insurance coverage for insured deposits at the institution, and (2) such intervention represents the least-cost alternative for an existing insurance fund. A second exception would be if there were a lack of liquidity while solvency remained good, but such situations are often hard to determine as the liquidity problem often indicates an underlying solvency problem. As noted earlier, in this situation the central bank may offer liquidity support against good collateral. The central bank may also act in different ways to smooth the functioning of financial markets, for instance by acting as an "honest broker" or by standing between a firm in difficulty

and the market but protecting its own position through collateral. Finally, if the deposit insurance agency, or a separate restructuring agency, is empowered to facilitate bank restructuring it can do so by assisting in selling the bank's assets or by facilitating the sale or merger of the whole bank.

Apart from avoiding contagion and maintaining liquidity so as to limit the potential for systemic risk, the main goals of the orderly restructuring or winding-up of a bank are to secure fair and equitable handling of all counterparties and to reduce the loss of asset values and other costs usually connected to a bank failure. For these purposes, the existence and strict implementation of applicable laws on liquidation, bankruptcy, the assumption of collateral and seniority rules for claims are crucial.

Some crisis measures recommended in these guidelines (for instance the establishment of certain organisations) cannot be fully legislated for in advance. Much critically important time can be saved, however, if *preparations* have been made in advance. An explicit advance commitment to follow certain widely accepted practices can reduce uncertainty and facilitate later decision-making. It may also be desirable to prepare a blueprint for crisis measures in advance, which could be presented to the government and the legislature, so that there are broad rules in place should a crisis erupt. If the restructuring scheme is correctly implemented it increases the chance that the restructuring will be less costly, thus benefiting the government and public.

In sum, the Working Group recommends the following guidelines for the restructuring of banks in normal times:

- regulators should fail banks when warranted. It is well worth stressing that the occasional failure of a bank is fully consistent with good supervision and a sound financial system. The task is to limit supervisory forbearance and ensure a speedy and efficient resolution, in order to prevent a narrow problem from growing into circumstances that threaten systemic financial stability;
- structured early intervention rules should be drawn up and followed, in order to avoid supervisory forbearance and to give banks and other market participants clear rules of the game; an override mechanism should exist to enable the authorities to deal with exceptional circumstances;
- a non-systemic bank problem should be resolved without public money, except if there is an obligation with respect to insurance coverage for insured deposits, and such intervention represents the least-cost to an existing insurance fund. However, the central bank may provide liquidity support against good and full collateral, but never to an insolvent bank;

- the resolution mechanism for troubled banks should provide alternatives to simply liquidating the institution's assets and paying creditors, as often this does not result in the most efficient (i.e. Pareto-optimal) allocation of resources. For example, a failed institution could be recapitalised and then sold to a healthy institution - provided the healthy institution agrees to the transaction. In all cases, the choice of mechanism should be guided by cost effectiveness and the need to preserve competitive equality and to avoid surreptitiously increasing the coverage of the deposit protection system under which the solution is carried out;
- the use of a criterion of least cost to the public sector to choose among alternative ways of restructuring an institution;
- the relevant legislation for the orderly restructuring of a bank must be in place and be strictly enforced, in addition to legislation on liquidation, corporate bankruptcy, collateral, legal liability of decision-makers and seniority of capital;
- the use of ex post public guarantees should meet the following criteria:
  - (a) the extension of guarantees should be strictly limited, possibly by class of institution, instrument and agent;
  - (b) guarantees should always be given in ways to reduce moral hazard risk, i.e. providing an 'upside' risk to the guarantor.

#### **2.3.4 Restructuring and resolution of troubled financial institutions**

There is an important difference between restructuring banks (and other financial institutions) in normal times and in crisis situations. Normal times are defined by the absence of systemic risk, from contagion within the financial system *and* from the economy at large. In a *systemic crisis*, financial problems are more widespread and affect other parts of the economy. Time and human resource constraints will also be more pressing than during normal times, and political pressures will probably also be more intense. Finally, not only can monetary and currency crises erupt as a result of problems in the financial sector, but macroeconomic disturbances can weaken bank asset quality and therefore cause banks to fail. In such circumstances the financial crisis cannot be addressed separately from other crises that may be unfolding at the same time.

The manner in which a systemic crisis in a financial system is resolved will be an important determinant of the future strength and viability of the system. It will also affect expectations and, therefore, the behaviour of participants in the financial

system. If the process works well, behaviour will be changed in a way that reduces the risk of future crises.

A number of practices have proved successful in solving systemic banking problems in many countries and in particular in achieving the following key results:

- a framework for reorganisation of the banking and financial sector;
- restoring confidence in the financial system; and
- establishing rules and constraints on the use of public money.

These practices, which are listed below, necessarily differ from the considerations relevant to resolving troubled banks when there is no threat of systemic crisis. The Working Group recommends their use as general guidelines, with two caveats. First, the guidelines should be implemented flexibly, according to specific circumstances. Second, their adaptation will be particularly important in some emerging market economies, where a lack of developed markets for financial assets, know-how and expertise often exists. Under such circumstances, the restructuring mechanism should probably be very straightforward; and it may be advisable for national authorities to prepare a framework in advance jointly with an IFI, so that expert advice or technical assistance can be put in place as quickly and efficiently as possible:

- there must be a high degree of transparency on the size and nature of the problems and measures required. Senior politicians and officials should inform domestic and international counterparties and seek to dispel uncertainties;
- political agreement must be sought regarding diagnosis of the character and magnitude of the crisis, and on the nature of the response, including the nature and size of public support to be provided. Clear up-front loss-sharing arrangements will be helpful in this respect. Lack of political support leads to uncertainty in markets and exacerbates and prolongs the crisis;
- there should be clear rules for assessing the various financial costs of the support measures - including direct outlays and contingent liabilities - and, whenever they involve the public, they should be explicitly accounted for (normally in the fiscal budget). The recent IMF recommendation on how to treat such costs in the budget should be adhered to;
- the different institutions and organisations involved in the solution of the crisis must have clear and distinct roles. After having set the framework of rules, politicians and other third parties should refrain from interfering in its application. The authority for deciding on and dispensing the actual support

to the problem banks should be at arm's length from the ministry of finance, but accountable to the executive or legislative branch of government. Circumstances permitting, the bank support authority should be separate both from the central bank and the supervisory authority to avoid the risk of conflict with the other tasks of these authorities. If an asset management corporation is established this should also be separate, reflecting its special character and its need for staff skilled in diverse fields. It should be noted that some countries have found it useful to combine the roles of a deposit insurance corporation and an asset management corporation. More generally, practical issues (such as a scarcity of experts or the complexity of putting in place a new institution) may sometimes speak in favour of making the bank support authority (and asset management corporation) an independent division of the central bank. Regardless of the actual organisational structure used for the solution of the crisis, there must be a system for close cooperation, consultation and exchange of information in order to avoid conflict and to make sure that actions are not conflicting;

- a common framework for all problem banks should be established. The framework should describe the forms, terms and conditions for receiving public financial support. The support given would be decided on a case-by-case basis but within the common framework. When applying the framework, the authorities should also have a view of the future optimal structure of the domestic financial system, i.e. the bank restructuring process should lead to a more efficient and profitable banking structure;
- steps must be taken to constrain the use of public money and to minimise the risk of moral hazard. The most desirable solution is that new private funds are invested. If public funds are needed, incentives should be provided to also involve private capital. Should the public become a major owner of equity capital in a bank, the explicit and publicly expressed intention must be to sell the equity and to re-privatise the bank as soon as a reasonable price and acceptable buyers can be found. To protect its investment, the public owner should take an active role in the strategic governance of the bank, but should not interfere in daily business decisions. In particular, the public owner should not wield its power to use the bank for other than purely market-related activities (i.e. policy lending and similar practices must be avoided);
- bank owners (holders of bank equity) should not be bailed out. They should lose their investments when banks are given public support, or their investments should at least be diluted through sales of equity (or some

convertible instrument) to a government agency, which is then in a position to benefit and recover costs if the institution's condition improves;

- supervisors should look closely at how bank management may have contributed to the failure of the institution and should require changes to the management structure as necessary. In appropriate circumstances, senior managers in failed banks should lose their positions. Owners and managers should be liable to prosecution for criminal or fraudulent activities or for gross negligence;
- as a precondition for receiving public support, the bank must perform a detailed due diligence analysis and diagnostic review, for determining the amount and form of the support needed. To get a fair picture of the financial standing of the bank and to compare it with other banks, standardised accounting and valuation rules must be in place;
- even in a crisis situation, banks should fail. Banks deemed by the support authority as not having a viable future even after assistance (e.g. by a recapitalisation) should not be given public support. The difference between a bank failure in a crisis and during normal times is that extra care must be taken in the handling of the exit so that the failure does not worsen the systemic problem (particularly the lack of confidence in the system);
- in a crisis that is judged to have systemic implications, it is crucial that all insolvent institutions are dealt with more or less simultaneously, thereby reducing concerns of depositors (and, as far as possible, of other institutions in difficulty) that they might be affected next, protecting the functioning of the payment system, and minimising the ability of individual banks to lobby for and obtain preferential treatment;
- different methods of exit will be appropriate, depending on the specific situation. An important aspect is the criterion of least cost to the economy as a whole. What are the options? Banks may be liquidated and their assets and liabilities sold. They may be merged with stronger banks, so long as the health of the stronger bank is not jeopardised. New owners may be found with the inducement of a limited guarantee or strictly defined and limited financial incentives from the deposit insurance fund (or potentially the government, if no formal funded deposit insurance scheme is in place);
- if the total amount of impaired bank assets is large, an explicit and transparent system for the disposal of such assets should be established;

- the support framework should counteract the risk of a credit crunch. A key direct reason for a credit crunch is a lack of liquidity and/or solvency, although perceptions that credit risk has increased markedly, or a tighter risk management regime (introduced by banks' own management or regulators), can also be a crucial factor. The former is an instance where public support to restore adequate liquidity and solvency in the financial system may be necessary (and least distorting) to avoid more serious disturbances;
- all support measures (whether in money or other forms) should conform to market terms and practices as much as possible, and should be properly and transparently accounted for. All banks incorporated in the country should obtain support on equal terms. Foreign institutions and capital should be allowed to take part in the restructuring framework on the same conditions as domestic institutions, for instance when submitting bids for mergers, assets or deposits.

**The Working Group recommends that these guidelines for normal and crisis situations be developed further in a collaborative effort, drawing on the experience of various international fora. Members of the Working Group undertake to co-operate with others addressing this question, including G-10 Governors' committees and the IFIs.**

### **2.3.5 Depositor protection schemes (including deposit insurance)**

Deposit protection schemes have two principal goals. The first of these is to increase the stability of the financial system by reducing the risk of bank runs and contagion. This is achieved through a mechanism that ensures that small depositors (i.e. those whose deposits fall within an explicit ceiling) who do not withdraw their deposits will not suffer compared with those who "rush for the exit" when doubts emerge about the capacity of banks to meet the deposit liabilities.<sup>11</sup> The second principal goal is to assist small depositors who typically do not have the capacity to monitor the soundness of banks.

In addition, the following objectives for deposit protection schemes are important:

- to avoid the diffuse but potentially extensive moral hazard and other market distortions arising from expectations of case-by-case public bailouts when no deposit protection scheme is in place;

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<sup>11</sup> A degree of co-insurance in deposit insurance arrangements helps to limit moral hazard, but may reduce the efficacy of deposit insurance in preventing "runs" by small depositors.

- to help limit supervisory forbearance and its associated costs;
- to ensure that smaller banks operate on a level playing field (vis-à-vis banks so large that they are considered too big to fail), thereby encouraging a more diversified financial sector and increased competition; and
- to ensure that the costs of deposit protection are allocated fairly and efficiently.

For these reasons the Working Group recommends that each country put in place depositor protection arrangements if those arrangements can be made to satisfy important criteria. The Working Group puts forward the following criteria for assessing the adequacy of deposit protection arrangements, but recognises that a range of issues relating to the design of deposit insurance arrangements warrant further research and analysis:

- the arrangements should be explicit, with a clear specification of the nature of protection provided and the means for defraying the cost. For one thing, this will limit the coverage in state-owned banks to a level similar to those in private banks;
- the arrangements should be limited with respect to the amount of protection provided, the type of customer benefiting from protection and the instruments covered by the scheme. The purpose of this is to avoid distortions in incentives by restricting protection to those who would not otherwise monitor the risk of their counterparties. In general only small depositors should benefit, and even in their case consideration may be given to partial indemnification;
- deposit protection schemes must be well funded or have clear loss-sharing provisions;
- consideration should be given to basing contributions to the cost of the scheme on relative risk in order to reduce moral hazard and avoid implicit cross-subsidies among banks;
- deposit protection arrangements should be run in an efficient manner, relying where possible on expertise in the industry;
- membership of the deposit protection scheme should not be voluntary, and it may be appropriate to apply it through compulsion to all institutions that deal with small (retail) customers to avoid adverse selection and to limit undue concentration in the banking system associated with too-big-to-fail politics;

- to the extent that the arrangements erode incentives of depositors to monitor banks, bank supervision and market discipline should be strengthened in tandem with the introduction of a deposit protection scheme. Internal controls, procedures for assessing and monitoring risks, criteria for valuing non-performing assets and providing against them, and a strong role for auditors are areas for heightened attention by bank supervisors.

**The Working Group encourages the BCBS to develop guidelines for deposit insurance, with an emphasis on measures to reduce moral hazard and adverse selection. This work should benefit from substantive input from the IMF and the World Bank.**

Other forms of deposit protection schemes that warrant consideration are:

- the approach taken by a few countries such as Argentina and Switzerland where bankruptcy procedures for banks ensure that depositors have a priority claim on assets and that the disbursement of funds from the disposal of assets will be fast; and
- loss-sharing conventions in lieu of deposit insurance. This approach does not require the build-up of an insurance fund, thereby reducing the up-front direct costs of the scheme and providing an incentive for potential contributors to monitor vulnerable institutions, but may require other measures or give rise to problems when large disbursements become necessary.

### **2.3.6 Role of efficient insolvency regimes**

The fundamental role of an insolvency regime, for both banks and corporations, is to ensure that stakeholders are treated in a non-discriminatory way that respects their contractual rights in the event that an enterprise cannot meet its obligations, and that the value of the insolvent entity is maximised.

Among the main reasons why an efficient, non-discriminatory insolvency regime that respects contractual rights is an essential component of an economy-wide safety net are:

- it makes the risks and consequences of the failure of a corporate entity easier to quantify for all parties involved, and will speed up the resolution of claims. Consequently it reduces the risk of contagion to other entities in the economy; and
- it lowers the prospect of ad hoc, ex post assistance or guarantees, which distort incentives.

For the banking sector, a well-designed insolvency regime will include alternatives to immediate and full liquidation (subject to suitable least-cost criteria), helping ensure the continued provision of credit. This will reduce the temptation to engage in forbearance and thus lower the probability that problems at individual entities will become a large burden for other components of the safety net.

The Working Group on International Financial Crises will endorse key principles and features of effective insolvency regimes for commercial entities.

**The Working Group supports the key principles and features of insolvency regimes in view of their importance for enhancing financial stability.**

## Chapter 3

### **CONCRETE ACTIONS TO FOSTER THE IMPLEMENTATION OF STANDARDS AND SOUND PRACTICES**

The establishment of existing sets of standards and sound practices, and the development of new ones, do not in themselves strengthen financial systems. For that, action to implement these standards is required. This part of the report examines how market-based incentives to implement these principles might best be strengthened, and also what action the official sector should take to foster the most rapid possible implementation.

#### **3.1 Enhancing incentives to strengthen financial systems**

##### **3.1.1 Provision of more and/or better information on key elements of the financial system**

Markets cannot price the risk associated with weak financial systems unless they have sufficient information to evaluate the full set of features that are relevant to the robustness of financial systems. The role of more and better information in enhancing market incentives is primarily the domain of the Working Group on Transparency and Accountability, whose findings and recommendations are strongly endorsed by this Working Group.

The appropriate identification and pricing of risk depend on the provision of full, timely and accurate disclosure of financial results and other information that is material to market participants' investment decisions. As discussed in the report of the Working Group on Transparency and Accountability, as well as in a report on bank transparency prepared by the BCBS, this means that information should be released on a regular and appropriately frequent basis. Financial statements should be compiled using a set of high-quality, internationally acceptable accounting standards, and accounting methodologies should be applied consistently over time. Financial statements should cover all relevant transactions. Firms should disclose the strategies they use to manage risks they may face. And financial statements should be reviewed annually by an independent auditor.

General improvements in transparency need to be accompanied by improvements in the quality and comparability of accounting practices specific to the financial sector, such as accounting for non-performing loans. The lack of consensus on sound practices for loan valuation, loan-loss provisioning and credit risk

disclosure seriously impairs the ability of supervisors, regulators and market analysts to understand and assess the risks inherent in a financial institution's activities. The BCBS aims to release a consultative report later this year that will provide guidance on sound practices concerning the accounting for loans.

**The Working Group supports the ongoing work of the BCBS in the improvement of asset valuation and loan loss provisioning and underscores the importance of IASC to complete its set of core accounting standards.**

### **3.1.2 Private sector evaluation of key features of national financial systems**

Financial markets can generate incentives for countries to improve the quality of the institutional infrastructure of national financial systems. In recent years, however, clear and consistent signals from financial markets have not been apparent. For example, well-known structural weaknesses in the financial systems of a number of Asian countries were not generally reflected in the terms of credit offered to the relevant borrowers prior to the onset of the recent financial turmoil. In addition, significant efforts over the last year by some emerging market countries to make improvements in their financial systems did not generate a substantive response from credit markets.

Improvements in publicly available information on the adequacy of national financial systems (as discussed in the Report of the Working Group on Transparency and Accountability) will help financial markets to make better assessments of the adequacy of critical financial market infrastructures. This in turn should enable markets to price credit flows so that prices reflect the risk in the financial system structure. The capital-importing countries making improvements in this area will then be able to improve the terms on which they obtain credit.

There is an important role for the public sector in providing some of this information. This role stems in part from the public-good nature of information that is privately produced, which tends to limit the provision of information by the private sector substantially, often to much less than what is socially desirable. Moreover, private sector evaluation may be fraught with a variety of conflict-of-interest problems.

But there are limits to the appropriate role of the public sector in providing this type of information to financial markets. First, the resources available for the task in the public sector are limited. It is therefore important to consider options for bringing additional resources to bear on this problem. Second, the provision of assessments by the public sector may dull the incentives for the private sector to evaluate the risk associated with its decisions. It is thus worth considering ways of encouraging the private sector to play a greater role in this area.

In this context it should be noted that financial institutions have incurred large losses over the last two years on investments in emerging market economies, caused, to a significant degree, by poor information on, and assessments of the vulnerabilities and the adequacy of national financial systems. Thus the private sector has an incentive to produce better assessments for its own purposes. At present, such information is being produced privately. That is, some firms earn profits by collecting and evaluating information to better inform their own decisions, or by explicitly selling their assessments to other investors.

It may make sense for financial market participants to establish a mechanism for developing collective, publicly available assessments of key aspects of national financial infrastructure - such as the supervisory systems for financial institutions; accounting and disclosure practices; corporate governance; legal regimes relevant to investment, including arrangements for dealing with insolvency; and payment and settlement systems.

It is significant that in other contexts private agents have found it desirable to share proprietary information. For example, in the United States private firms that provide credit reports on individuals routinely share proprietary information. In addition, private collective systems, based on peer review, have evolved in the United States for evaluating hospitals and universities. While none of these examples is directly analogous to the problem of evaluating national financial systems, they do suggest, given the great need for progress in this area, that it is worth considering whether the development of some type of collective private sector mechanism to pursue this objective is feasible and desirable.

**The Working Group recommends that the official sector initiate a dialogue with relevant private organisations, professional groups and institutions on how the private sector can more effectively utilise the information that is now, or will become, available on the key institutional aspects of national financial systems.**

These discussions would have the ultimate objective of improving the signals financial markets send regarding the adequacy of national financial systems, thereby enhancing countries' incentives to make improvements in this area.

### **3.1.3 Country ratings for compliance with international standards**

A step going well beyond the provision of information that can be used to evaluate the robustness of a financial system is the preparation and disclosure of a standardised assessment of countries' compliance with international standards and guidelines. This is a contentious issue, but its advocates suggest that this assessment could be expressed as a rating along a scale, or as an outright judgement indicating whether a country's compliance was acceptable or not. Such an assessment could be

performed by the private sector, provided it had access to relevant information from the official sector.

One argument for such a rating is that it would increase pressure on countries to implement needed reforms. Another argument is that such a rating would be useful for counterparties to the country or its institutions, for instance its banks.

An important argument against such ratings is that, in many instances international standards and guidelines are not (and cannot be) very precise. A considerable amount of judgement would therefore be necessary, creating a risk that some ratings would be too judgemental in nature. A further reason why governments may want to avoid such ratings is concerns that they might thereby incur some (moral if not legal) responsibility if other parties acted on the ratings. A final concern is that if the IFIs were to publish ratings, that process would jeopardise the close and confidential relations that are vital to the advisory role played by the IFIs.

The Working Group was divided on this issue and some judged it an unrealistic proposition. In any event, further work is necessary on standards and guidelines and on how to evaluate their implementation before a systematic rating of countries' compliance can be applied. Some Working Group members felt that given the urgent need for enhanced transparency, a database for public access should be established as a first effort. Given the prominent role of the Bretton Woods institutions in surveillance work, it would seem practical for either the IMF or the World Bank to take responsibility for maintaining this database, with the other being a major contributor. This database would contain factual information on standards and guidelines and to what extent these have been implemented, both formally and in practice, in individual countries. Information in the database would need to reflect the fact that some international standards are minimums, and some countries will have opted for higher domestic standards. The material for the database would come from various sources, such as surveillance missions and peer reviews, as well as from countries directly. It might be possible to put a significant amount of high-quality, relevant information into the database without compromising confidentiality between countries and the IFIs. A number of Working Group members suggested that the idea of a database was impracticable, not least because of the subjective nature of many aspects of adherence to standards.

#### **3.1.4 Use of risk weights and provisioning norms to sharpen incentives**

The Basle Capital Accord is an excellent example of a relatively straightforward regulatory device that has proved very useful in focusing attention on the importance of bank capital. At the same time, the risk weightings in the Basle Accord may have introduced distortions. For example, from the perspective of the prudential soundness of individual lending banks, short-term lending is less risky than longer-term commitments, and the Basle Accord recognises this in its treatment

of bank loans to emerging market banks. However, the much lower capital charge for lending to emerging market banks where this is under one year in maturity<sup>12</sup> may have encouraged emerging market banking systems towards short-term borrowing at the expense of loans with longer maturities. With respect to the crisis in Asia, there is evidence that the distortions induced by the Basle Capital Accord may have been significant, but they were probably not huge.<sup>13</sup>

The Accord does not deal with operational and legal risk, and the treatment of country risk in the Accord is at present based around the crude criterion of whether a country is a member of the OECD. There is currently no international consensus on a more sophisticated approach criterion. As in other areas of prudential regulation, one potential way forward, at least for the supervision of “sophisticated” banks, may be greater reliance on their internal models of country risk. The BCBS and the BIS are conducting further work in the area of country risk, and the Working Group welcomes these efforts.

The Basle Capital Accord is now under review, owing in part to a desire to foster improved risk evaluation and management in conditions where the nature of banks' activities and financial techniques are undergoing a process of rapid change. The review is expected to lead to a reduction in distortions and to the internalisation of risk factors that are at present not taken into consideration, while still providing an essential set of straightforward ground rules. The Working Group advocates timely progress with this review.

It would be useful to examine alternative prudential arrangements that would depend on the nature and sophistication of the banking establishment. For those operating in an environment of effective corporate governance that provides for the accurate pricing and the effective control of risk, the regulatory approach could stress strengthening these systems and ensuring that they are effectively applied. However, for banks operating in an environment devoid of these structures, more pronounced prudential restrictions would be needed and appropriate.

### **3.1.5 Market access and market entry**

Enhanced market access for foreign financial firms can be an important element in efforts to strengthen financial systems.

**The Working Group is of one view on the benefits of open access, but recognises that it should not occur in such a way as**

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<sup>12</sup> Bank lending to banks in “Zone B” attracts a weight of 20% if under one year in maturity, but a weight of 100% if of longer maturity.

<sup>13</sup> If a lending bank has a regulatory capital ratio at the Basle minimum of 8%, and the difference between the cost of equity funding compared with debt or deposit finance is 10%, then the difference in the capital charge referred to in paragraph 9 would lead to the capital cost of under one year lending being 64 basis points lower than the over-one-year alternative.

**to undermine the quality of supervision. Principles guiding national practices with respect to market access for banks should be developed jointly by industrial and emerging market countries.**

In these efforts, account should be taken of existing principles that are currently applied, including proper screening of the capabilities and integrity of management. In addition, the following considerations should be borne in mind.

Even within its current Articles, the IMF offers advice to countries considering capital account liberalisation. The experience of numerous industrial and emerging market countries demonstrates the importance of having financial systems that are robust enough to weather the effects of the large capital flows associated with unfettered capital movements. The Working Group encourages the IMF and World Bank to give high priority to studying how capital account liberalisation should be associated with steps to strengthen financial systems.

Market entry by financial institutions from industrial economies into emerging economies can go a long way in fostering skill building in the latter through transfer of technology and strategic investment. Similarly, market entry of financial institutions from emerging into industrial countries allows learning by doing and the transfer of technology from the host to the home country.

However, owing to wide differences in the quality of supervision among countries, the benefits of free market entry need to be weighed against costs arising from increased risks for financial stability in host countries that stem from inadequate supervision in some home countries. Linking market access to minimum standards of supervision in the home country of a financial institution may be in the interest of both home and host country. This is not a new practice, but has been used in country-specific forms by a number of countries for some time. The issue is whether a set of common standards on market access can be drawn up to foster financial stability, prevent competition in laxity and keep the international playing field level.

Although it may be questioned whether a set of high quality common standards on market access can be drawn up that will both foster financial stability and avoid any lowering of national standards, the Working Group recommends that the development of such financial standards be considered in a collaborative and collegial effort by industrial and emerging countries, founded on the fact that enhanced financial stability is in their mutual interest. The IFIs could provide a forum for such efforts.

One of the Core Principles of banking supervision states that in considering entry by a foreign bank into their home market, authorities should ensure that the institution applying for entry is adequately supervised. This requirement ensures that

the safety and soundness of the domestic banking system are not undermined by the presence of foreign institutions that are not subject to appropriate supervision in their home country. While the primary objective of this basic requirement is prudential, i.e. to protect the safety and soundness of domestic banking systems, its application can provide an incentive for other countries to improve the quality of their prudential supervision. If their banks want to operate in other markets where this core principle is strictly applied, they will have to convince the authorities in those countries that the quality of supervision in their home country is adequate. This can create powerful new incentives for improvements in supervision.

Countries implement this core principle in different ways. In the United States, since 1992, following passage of the Foreign Bank Supervision Enhancement Act, the Federal Reserve has not been able to approve an application from a foreign bank to establish an office in the United States unless it concludes that the bank is subject to comprehensive consolidated supervision (CCS) by its home-country supervisor. In 1996, with the Federal Reserve's support, Congress amended CCS to allow somewhat more flexibility, with a standard of "moving toward CCS". The Federal Reserve has the authority to close or restrict the activities of existing branches and agencies if CCS is missing, but has not yet considered it necessary to exercise this power. Other major countries also use the principle of consolidated supervision as a minimum standard, but since it is not statutory as it is in the United States, it can be – and is – applied flexibly.

Experience suggests that the enforcement of this core principle regarding entry has, at the margin, encouraged other countries to improve their supervisory systems. For example, Argentine banks that wanted to establish or expand operations in the United States following the adoption of the CCS requirement, became important advocates for the improvements in the supervisory system in Argentina. Other Latin American countries (e.g. Peru) have adopted new laws that establish CCS but are still being implemented.

It is worth considering whether or not countries should try to coordinate their policies in this area. There are two advantages to such coordination. First, it would help to ensure that the criteria are applied consistently across all countries. Second, it could heighten the positive incentive effects. There are difficulties with such an approach, however. These difficulties would be greatest if it were thought that international cooperation would need to go beyond coordination of policies, and require that a single instance determine whether or not a particular bank meets the criteria. The Working Group encourages other relevant consultative bodies, such as the BCBS and the ECSC, to consider whether international coordination in this area is desirable and feasible.

The more widespread use of market access standards raises the question of how to treat the existing local operations of institutions from home countries whose

banks would no longer qualify for new entry into host-country markets. In this respect, grandfathering clauses, an agreement on a timetable for progress in supervision, and the use of ongoing special audits from a supervisory or accounting body (that is acceptable to the country granting the special access) may need to be considered.

### **3.1.6 Conditionality: application of financial sector conditions in lending by international financial institutions**

The use of conditionality in IMF and World Bank programmes is a powerful means of fostering the implementation of standards and sound practices directly. Moreover, by limiting moral hazard and thus sharpening incentives for improved practices of potential programme countries, conditionality can foster higher standards and improved practices indirectly. By way of example, financial sector restructuring has been one of the central components of the programmes with the three Asian countries, Indonesia, Korea and Thailand. In all three countries, broadly similar strategies were pursued focusing on immediate action to resolve existing problem institutions, prevent the emergence of new problems, ensure a core banking system capable of fulfilling intermediation functions, and minimising associated fiscal and quasi-fiscal costs. Reforms have included:

- an assessment of the situation of financial institutions, closure of those deemed non-viable with the associated write-down of shareholders' capital, and intervention in other troubled institutions. Assets of closed institutions have been transferred to a special agency;
- preparation of a strategy for recapitalisation or merger of remaining financial institutions and design of a strategy for the privatisation of banks where the public has become a major shareholder as part of the crisis resolution process;
- announcement of limited use of public funds for financial restructuring and inclusion of expenses in the budget;
- strengthening of prudential regulations – including a commitment to adopt Basle standards over the medium term – and of the legal, regulatory and institutional framework for the supervision of financial institutions;
- reduction or elimination of restrictions on foreign ownership or management of banks so as to increase competition in the domestic financial system; and
- introduction of a funded deposit insurance scheme.

In other programmes where the problems of the financial sector have not been as acute, such as Egypt and the Philippines, efforts have included an assessment of the health of the banking system, privatisation of state-owned banks, and measures to strengthen prudential regulations to ensure effective supervision.

The Working Group supports the application of conditionality to measures pertaining to financial stability, recognising that some specific socio-economic circumstances of individual countries must be taken into account. For instance, appropriate time must be allowed for implementation, the right sequencing of measures must be carefully considered, and their impact on social stability should be weighed. Also, conditions would certainly have to be different in normal and in crisis situations.

## **3.2 Monitoring and skillbuilding by the official sector**

Oversight, training and technical assistance by the official sector can help to strengthen financial systems. The Working Group is of the view that all countries should go through some process of independent assessment, subject to the condition that the process meets certain minimum standards and contains a core set of elements. The country could then opt for the set of processes (conditionality, surveillance, peer review, comprehensive technical assistance programmes) that is most suitable for its conditions in covering the various elements of oversight and skillbuilding.

The resources available for oversight, peer reviews and technical assistance are scarce relative to the needs. For that reason it is important that they be put to the best use and allocated to the areas of highest priority. The following section considers the alternative ways in which the expertise in the public sector can be deployed.

### **3.2.1 Institutional responsibilities for surveillance and monitoring**

In the present context, surveillance refers to some international organisation scrutinising and monitoring economic developments in a group of countries on a regular basis. The countries involved are also assessed for their adherence to international standards and guidelines in various functional areas. A surveillance report typically results in a judgement on what has been achieved and what remains to be done. The report may also propose measures to deal with remaining inadequacies, including training and technical assistance.

Which organisations should assume responsibility for surveillance and monitoring of countries' efforts to strengthen their financial systems? Bodies such as the Basle Committee, IOSCO and the IASC would be best placed to interpret their own standards and guidelines, but have neither well-established mechanisms nor the

requisite authority and resources to conduct global surveillance. In addition, some of the bodies have limited membership, which might affect their ability to perform surveillance in all countries. Even so, these organisations should be prepared - as far as their resources permit - to offer assistance with the interpretation of standards and guidelines and with technical assistance and training.

The IMF Article IV process is a mechanism for monitoring countries' macroeconomic and structural policies. It has the considerable advantage of being an established process that extends to almost every country in the world. In the past, financial sector stability has not been an integral part of this process, but the scope of the surveillance process is being extended to cover this area insofar as it has a bearing on macroeconomic stability, and particularly to cover the banking system.

The World Bank has more experience in financial sector reform and more resources, but its activities are confined to a smaller set of countries. Regional institutions also often have extensive financial sector activities, but again their scope is constrained by their limited membership.

The Working Group is of the view that these various processes, together with the peer review practices discussed below, should be coordinated to ensure that scarce official sector resources are used effectively and that priority is given to surveillance in areas where vulnerabilities are the greatest. In addition, resources from the private sector should be drawn into the process.

### **3.2.2 Peer review**

Peer reviews would entail a review of a country's supervisory and regulatory systems by supervisors/regulators from other countries. Peer review is an exercise among colleagues who are charged with the same or closely related responsibilities in another jurisdiction. This process may have the potential to broaden the pool of experts available. In the right circumstances, it may also be more effective than existing surveillance mechanisms because of such features as collegial relationships, familiarity with regional conditions, and participants treating one another as fellow practitioners. Peer review is also very well suited for regional processes, which have become more intense in recent years.

**In the light of these benefits, the Working Group recommends that peer reviews be given serious consideration as a component of, or complement to, financial sector surveillance, subject to the caveat that peer review should be understood and implemented as a voluntary device, to preserve its key feature of collegiality.**

For the successful implementation of peer review processes, the Working Group offers two suggestions:

- to achieve benefits from collegiality, arrangements for peer reviews should offer some flexibility, and alternative options for country groupings and lead organisations should be considered carefully. Indeed, peer review may be most effective if exercised among groups made up primarily of countries with similar levels of financial market development and regulation; and
- the peer review process should accommodate cultural differences concerning the giving and receiving of frank comments (which may well be perceived as criticism) among colleagues. Clear ground rules concerning the ways in which peer review results would be made public should be established, to help strike a balance between enhanced frankness among colleagues and the added discipline and credibility that are afforded by making key results available to the public. More generally, a method to enhance the credibility of peer reviews would be to formulate a “best procedure” for their organisation, including content, evaluation procedures and dissemination.

One of the challenges of initiating a peer review process is the current lack of an institutional framework that might already be charged with undertaking the necessary coordination. To overcome the absence of an institutional structure for peer reviews and to enhance accountability and consistency, the Working Group tends to favour anchoring peer review processes in the IFIs, but with technical expertise provided by supervisors or regulators and ample cooperation with other institutions. A more specific assignment (for instance to Article IV surveillance, the World Bank, or the new World Bank/IMF Joint Liaison Committee) should be made in accordance with the nature of the topic and the coverage of countries in a specific peer review process.

### **3.2.3 Technical assistance and training**

The provision of technical assistance can be a cost-effective means of transferring know-how from industrial to emerging countries. In the financial sector, appropriately focused technical assistance can help to introduce into less-developed markets ideas and practices that have been tried and tested in established markets. It can provide resources to enable skills to be built up locally and adapted to the needs of different markets.

Areas where the Working Group has identified particularly strong needs for skill development are:

- banking supervision (including learning from the private sector);
- accounting, loan valuation, provisioning;

- deposit insurance and structured early intervention mechanisms (to help ensure that systems that may have been designed with outside assistance can be operated with vigilance and independence);
- resolution of troubled or failed financial institutions; and
- the process of policy-making, including information sharing and accountability among official bodies.

## Chapter 4

# ENHANCING THE EFFECTIVENESS OF INTERNATIONAL ORGANISATIONS AND GROUPINGS

### 4.1 International coordination of supervision and regulation

The financial sector has been marked by rapid global integration and the emergence of financial conglomerates that span the full range of financial activities and are active in all major markets around the world. At present, supervision of the global financial market is fragmented both functionally and geographically. The geographical fragmentation is addressed through cooperation among different international groupings of functional supervisors, and the functional separation by cooperation among international groupings of banking, securities and insurance supervisors in the *Joint Forum*.

The Joint Forum has developed a set of principles for supervising internationally active financial groups, which includes coordination and cooperation among supervisors. The Forum is reviewing a series of papers on the supervision of individual conglomerates. G-7 finance ministries have agreed on Principles for Information Exchange that would help overcome barriers between national supervisors that are currently impeding the coordinated supervision of internationally active financial institutions.

**The members of the Working Group endorse the G-7 Principles for Information Exchange, and urge their implementation in industrial and emerging countries.**

They note the need to find innovative ways to address questions raised by the geographical and functional fragmentation of supervision, especially in ways that involve a full range of systemically significant economies.

### 4.2 International oversight of and accreditation mechanisms for supervisors

Aside from the issue of how supervisors can cooperate more closely across functional lines and national borders, the Working Group also discussed various options that may enhance the quality and effectiveness of supervision. Some of the options discussed included:

- *a global oversight mechanism for supervision and surveillance* to promote coordination across different functions and help to support the independence

of supervisors. This could be achieved by a suitably balanced forum of representatives of central banks, ministries of finance and national and international supervisory and regulatory agencies, and should seek the involvement of the private sector. Some Working Group members do not consider that there is a need for such a forum and are doubtful that it would have credibility with national governments;

- *an international group of eminent experts* to meet annually and consult with supervisory authorities in various jurisdictions;
- as discussed in the section on *peer review*, a peer review process based on surveillance by IFIs to assess the quality of national financial sector supervisory regimes; and
- consideration of standards for internal managerial audits of supervisors.

#### **4.3 Division of labour and coordination among international financial institutions**

The G-7 Halifax Summit and the 50th anniversary of the Bretton Woods institutions sparked the beginning of a debate in the international community on the architecture of the international monetary system. One element of this discussion has been the question of whether, and if so in what way, there is a need to redesign the IFIs. In response, considerable work has been done on delineating areas of responsibility of the IFIs, coordinating their activities, and enhancing joint work where this is deemed desirable. The Working Group very much welcomes these efforts. They demonstrate the capacity of the IFIs to change from within, which is a crucial asset during periods of crises and changing external demands.

For its part, the Working Group has begun studying a spectrum of options, ranging from small-scale adjustments in the division of responsibilities among the IFIs to forming joint committees or joint units. An important aim of this effort is developing a consensus among industrial and emerging economies on a subset of options. Thus far, the Working Group has reached the following conclusions:

- first, there is broad agreement within the Working Group that it would not be feasible to overhaul the IFIs fundamentally, or to set up a new large international financial institution;
- second, views on the division of responsibilities between the IMF and the World Bank (and corresponding needs for cooperation and joint work) reflect (i) considerations of operational efficiency, (ii) concern that neither institution should attempt to extend activities and programmes that are the agreed responsibility of the other, and (iii) a desire for enhanced

accountability and (when appropriate) the hearing of views held on a subject by the other institution;

in areas where responsibilities are shared, it is important to have effective arrangements to ensure collaboration. In putting such arrangements in place, attention should be paid to the incentives to cooperate.

The Working Group sees considerable promise in small-scale institutional innovations, which capitalise on the strength and infrastructure of existing bodies. Among such small-scale institutional innovations under consideration are:

- a ***Financial Sector Policy Forum*** which would meet annually, or semi-annually, to discuss international financial sector stability issues, across functional lines. The forum would consist of representatives of finance ministries, central banks and financial supervisors from interested systemically important industrial and emerging market economies, as well as the IFIs and the international regulatory bodies. The forum could be organised through an existing institution, for example the BIS;
- a ***system for the exchange of information on financial sector regulatory and supervisory methods***. Multilateral institutions, international regulatory bodies and national authorities would participate in this information exchange, provided appropriate mechanisms for safeguarding confidentiality were in place; and
- a ***process of coordination or a clearing house to match demands from individual countries for technical assistance and training in financial regulation matters with the supply of experts***. This could be based on, and benefit from, earlier efforts, such as those for Eastern Europe, APEC, and the training programmes of the BCBS, IOSCO and IAIS, and draw on two new institutions - the Toronto Centre and the BIS Institute for Financial Stability.

#### **4.4 Cooperation to ensure effective surveillance and the development of sets of sound practices**

The Working Group is of the view that effective cooperation among official institutions is important for strengthening financial systems. A process anchored in IMF surveillance but drawing on the broader expertise of the World Bank will utilise the universal nature of the Article IV process and help ensure effective use of scarce surveillance resources. It is important that the process permit the use of resources from other sources, including the private sector. Finally, the results of the surveillance process should be fed into the continuing efforts to refine existing standards and develop new ones.

The Working Group discussed the need for enhanced cooperation among the IFIs (including the regional development banks) and the international regulatory groupings, but has not yet developed thorough and concrete proposals. The Working Group welcomed the setting-up of the Basle Core Principles Liaison Group, with supervisors from G-10 countries and emerging markets and representatives of the IMF and the World Bank. Similarly, members took note of the proposals for cooperation between the World Bank and the IMF that the managements of the two institutions have developed. This proposal, which has been supported by the Executive Directors of both institutions, entails the establishment of a joint Financial Sector Liaison Committee to adapt the division of work to country-specific situations, to foster the dissemination of standards and sound practices, to help optimise the use of resources, and to facilitate joint work. The subject of enhanced cooperation will be explored further by the Working Group.

## **LIST OF ABBREVIATIONS**

APEC	Asia Pacific Economic Cooperation
BCBS	Basle Committee on Banking Supervision
BIS	Bank for International Settlements
CCS	comprehensive consolidated supervision
CPSS	Committee on Payment and Settlement Systems
ECSC	Euro-currency Standing Committee
FDICIA	Federal Deposit Insurance Corporation Improvement Act
GDP	gross domestic product
IAIS	International Association of Insurance Supervisors
IAPC	International Auditing Practices Committee
IASC	International Accounting Standards Committee
IFI	international financial institution
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MDB	multilateral development bank
OECD	Organisation for Economic Cooperation and Development
SDDS	Special Data Dissemination Standard

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<sup>†</sup> In addition, Sherman Boone and Paul Moser-Boehm made valuable contributions to the work of the Group and the completion of this report.

## ANNEX A

### LIST OF ONGOING AND PLANNED RELATED WORK IN OTHER INTERNATIONAL FORA

This Annex provides an overview of specific initiatives other than the Willard process that are in progress or planned in international fora and have a significant bearing on strengthening financial systems. For the sake of brevity, ongoing policy implementation activities such as surveillance by the IMF and programme lending by MDBs are not listed. The information in the table is current as of September 1998. In broad terms, the table follows the structure of the main body of the report.

Topics and projects	Forum	Status and notes
<i>Developing standards and sound practices – banking</i>		
Enhancing bank transparency	BCBS	A report was released on 22 <sup>nd</sup> September. It provides guidance to supervisors and other public policy-makers on the role of public disclosure and supervisory information in effective market discipline and effective banking supervision, and to the banking industry on core information to be disclosed to the public to achieve a satisfactory level of transparency.
Sound practice guidance for loan valuation, provisioning and credit risk disclosure by banks	BCBS	The BCBS aims to release a paper later this year. The paper will provide guidance on sound practices concerning accounting for loans, to fill a gap in existing international accounting guidance.
Framework for internal control systems in banking organisations		A report was released on 22 <sup>nd</sup> September.

<b>Topics and projects</b>	<b>Forum</b>	<b>Status and notes</b>
Revision of the supervisory information framework for the derivatives activities of banks and securities firms (originally published in 1995)	BCBS and IOSCO	Released in September 1998. The revised framework consists of: a catalogue of data that IOSCO and the BCBS have identified as important for an evaluation of the risks present in trading and derivatives activities; and a common minimum framework of internationally harmonised baseline information on derivatives activities that supervisors are recommended to have available to them.
Development of supervisory guidelines	World Bank	Best practice guidelines on supervisory arrangements in developing countries.
Development of information databases	World Bank	Databases and research on financial structures and financial regulation.
<i>Developing standards and sound practices – securities</i>		
Objectives and principles of securities regulation	IOSCO	IOSCO's Statement of Objectives and Principles of Securities Regulation, completed in September 1998, sets out 30 principles of securities regulation that are based upon three objectives: protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk.
Trading and derivatives disclosure survey reports	BCBS and IOSCO	Survey reports were released in November 1995, 1996 and 1997; and a further report is planned for 1998.
Non-financial statement disclosure standards	IOSCO	IOSCO's International Disclosure Standards for Cross Border Offerings and Initial Listing by Foreign Issuers, completed in September 1998, consist of a set of non-financial statement disclosure standards for use in cross-border offerings and listings, and may also be used to enhance domestic disclosure requirements.

<b>Topics and projects</b>	<b>Forum</b>	<b>Status and notes</b>
Risk management and control by securities firms and supervisors	IOSCO	IOSCO released a paper in 1998 that provides guidance to securities firms and their supervisors on risk management, control policies and procedures, and internal risk control systems.
Methodologies for determining minimum capital standards for internationally active securities firms which permit the use of models under prescribed conditions	IOSCO	In 1998 IOSCO released a report on methodologies for determining minimum capital standards for internationally active securities firms which permits the use of models under prescribed conditions.
<i>Developing standards and sound practices – insurance</i>		
Model principles for insurance	IAIS	Principles on insurance supervision and on the supervision of international insurers and insurance groups and their cross-border establishments, as well as guidelines for insurance regulation and supervision for emerging market economies were approved at the IAIS annual conference in September 1997, and are now a focus of training activities. With regard to the principles of insurance supervision, an exercise to assess the status of their implementation is currently under way.
Supervisory standards for the licensing of insurance companies	IAIS	Standards to be submitted for approval at the annual IAIS conference in October 1998.
Supervisory standards on the use of derivatives by insurance companies	IAIS	Standards to be submitted for approval at the annual IAIS conference in October 1998.
Standards for on-site inspections at insurance companies	IAIS	Standards to be submitted for approval at the annual IAIS conference in October 1998.

<b>Topics and projects</b>	<b>Forum</b>	<b>Status and notes</b>
Standards for solvency and solvency assessment of insurance companies	IAIS	A subcommittee of the IAIS Technical Committee has produced a first version; work is continuing, in close contact with the International Actuarial Association (IAA).
<i>Developing standards and sound practices – other</i>		
Set of core accounting standards	IASC	Completion of standards by IASC expected by early 1999.
International auditing standards	IAPC	The IAPC is studying possible revisions to international auditing standards.
Development of sound practices for the design and oversight of payment systems	CPSS	A task force (G-10 and non-G10) has been formed and an initial report is planned for May 1999, although it is recognised that the work may take until December 1999.
Code of good practices on transparency in monetary and financial policies	IMF	Under development.
<i>Integrated risk management</i>		
External debt data	IMF jointly with World Bank	An inter-agency task force has been reconvened to assess the coverage and timeliness of debtor-side data and to explore ways to improve the collection of data on external debt.
Enhancing transparency regarding the authorities' foreign currency liquidity position	ECSC	The ECSC is studying this issue.
Determinants of market liquidity	ECSC	A study under the auspices of the ECSC is under way.
Repo markets	ECSC	A study under the auspices of the ECSC is under way.

<b>Topics and projects</b>	<b>Forum</b>	<b>Status and notes</b>
International financial flows and portfolio management activities	ECSC	A report has been completed.
Reducing foreign exchange settlement risk	CPSS	A progress report was issued in July 1998.
Implications of structural change for the nature of systemic risk	ECSC	A report has been completed.
Operational risk in banking	BCBS	A report was issued on 22nd September.
Core standards and guidelines for corporate governance	OECD	A first draft report by the Ad Hoc Task Force on Corporate Governance will be discussed by the Task Force in October 1998; a report for consideration by ministers at the OECD Council is planned for April 1999.
Guidelines on corporate governance	BCBS	Being drafted.
Developing deep and liquid markets	OECD	Research is under way.
<i>Preventing and handling financial crises</i>		
Insolvency laws	BCBS	Research is being undertaken on national insolvency laws.
Guidelines for deposit insurance	BCBS	Work is under way.
Dealing with weak institutions	BCBS	Case studies are being undertaken.
<i>Concrete actions to foster the implementation of standards and sound practices</i>		
Monitoring the implementation of the Basle Core Principles on Banking Supervision	BCBS	Ongoing. A worldwide survey has been completed, and overall implementation results are to be presented at the 1998 ICBS meeting.

<b>Topics and projects</b>	<b>Forum</b>	<b>Status and notes</b>
Improvements in the BIS International Banking Statistics	ECSC	The ECSC set a list of priorities in June 1998, and implementation efforts are currently underway. These focus on the consolidated statistics, and aim at increased timeliness, expanded coverage and enhanced quality.
Enhancing the usefulness of data by improving comparability of different sources	ECSC	An initial report is planned.
Macroeconomic data	IMF	Revisions designed to strengthen the SDDS will be proposed by the end of 1998.
Use of information and country risk management by international banks	ECSC	Work is under way.
Review of the Basle Capital Accord	BCBS	The review is under way, and may result in changes to risk weights and provisioning norms.
<i>International coordination of supervision and regulation</i>		
Supervision of financial conglomerates	Joint Forum	A number of public consultation papers were released in February 1998, on capital adequacy principles, fit and proper principles, a framework for supervisory information sharing, and coordination among supervisors.
Information exchange between national supervisors	G-7 finance ministers	Agreement on "Ten Key Principles for Removing Barriers to Information Exchange" has been reached.
Information exchange between national insurance supervisors	IAIS	A model memorandum of understanding was approved by the IAIS annual conference in September 1997, and an IAIS subcommittee is continuing work on improving the exchange of information among supervisors.

Topics and projects	Forum	Status and notes
<i>Division of labour and coordination among IFIs</i>		
IMF-World Bank collaboration in strengthening financial systems	IMF and World Bank	A proposal to enhance collaboration and coordination was discussed by the Executive Boards of both institutions in September.