The Implementation of Financial Architecture in Asia

On Incentives to Foster Implementation of Standards

By Axel Nawrath

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Four years ago, Asia stood on the brink of a regional financial and currency crisis with far-reaching social and political implications for the region and beyond. Among these implications was the call to reinforce the international financial architecture with the aim of making the global monetary and financial system less vulnerable to crisis and to strengthen the international financial institutions, the International Monetary Fund (IMF) and the World Bank.

Besides many other reform measures, developing and implementing standards and codes were at the forefront of global debate. They serve, among other things, to render economic and financial policy and government action more transparent and to codify best practices for financial market supervision, thus enhancing financial stability. The work to identify the most important standards and codes and to formulate approaches for putting them into effect is being advanced in particular by the Financial Stability Forum (FSF).

As Chairman of the Follow-Up Group of the Financial Stability Forum "On Incentives to Foster Implementation of Standards," I should like to report on the progress made to date in promoting the implementation of standards and codes. Let me begin by outlining the background of the FSF Incentives Group and in this context elaborate on how the standards and codes came to be developed and refined.

At its meeting in September 1999 the FSF initially set up a Task Force headed by Andrew Sheng, Chairman of the Hong Kong Securities and Futures Commission, charged with formulating a strategy to promote the implementation of international standards essential for promoting sound financial systems.

The Task Force comprised the standard-setting bodies, the international supervisory agencies, representatives of industrial and emerging economies and of international financial institutions such as the IMF and World Bank.

The inclusion of non-FSF member countries reflects the political endeavour to achieve a broad consensus from the outset and to increase the acceptability of the standards and codes. It must also be borne in mind that the standard-setting bodies such as International Organization of Securities Commissions (IOSCO) (with 165 members from 97 countries), International

Association of Insurance Supervisors (IAIS) (with more than 100 jurisdictions as members) and BCBS (with 22 institutions [banking supervisors and central banks] of 13 countries) represent in turn the interests of their entire global membership.

In its report presented in March 2000, the Task Force came to the conclusion that the implementation of standards should be furthered by selective activities in three key areas, namely ownership, incentives and resources.

On "ownership", it goes without saying that the implementation of standards should be in the self-interest of the countries themselves. Proceeding from this fundamental understanding, the Task Force placed special emphasis in its report on the importance of generating appropriate awareness of ownership in the countries for the implementation of standards. Allowance should be made for the respective circumstances of each country in setting priorities in connection with implementing standards. Analyses and assessments by the IMF and World Bank help to identify weaknesses in the financial systems, implementation priorities and the need for technical assistance. Additionally, implementing standards requires the deployment of suitable official and market incentives.

Based on the final report of the Task Force the FSF designated 12 key standards for sound financial systems from the FSF compendium comprising around 60 standards, which in a subsequent step were also endorsed by other international fora (e.g. G20).

> We agreed on the importance of international codes and standards to address these weaknesses, endorsed the Financial Stability Forum's recommendations, and encouraged continued work on incentives to foster implementation.
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> G20 – Press Release, October 25, 2000, Annex: Reducing Vulnerabilities to Financial Crises

In this context I would like to re-emphasise that the principle of "ownership" was observed in developing these standards and hence also in developing the 12 specially emphasised key standards. The standards are based on definitions by international (supervisory) bodies (such as IAIS, BCBS etc) and institutions (such as IMF, World Bank), with almost all countries as members of these organisations having been involved in drafting or adopting the definitions—even the number of nonmembers involved in the consultation process was large. The listing of the standards never has been nor is it exclusively an action by a specific group of countries such as the G7, something of which the industrialised countries (the G7 countries) have occasionally been accused.

I turn now to the activities of the Follow-Up Group "On Incentives", whose Chairman I have the honour to be.

Having endorsed the report of its Task Force on Standards and Codes, the FSF decided to analyse in greater detail the function of official and market incentives in fostering implementation and, hence, in March 2000 established the Follow-Up Group for this purpose. The Follow-Up Group was charged with ascertaining in particular how official and market incentives to foster the implementation of international standards relevant for financial stability can be developed. I state this in order to exclude from the outset any misapprehension: the Group undertakes no assessment of the progress on implementation made by any one country, nor is it concerned with drawing up appropriate implementation schedules. These are clearly the tasks of the IMF and the World Bank. The Group's attention is focused on the manner in which official and market incentives take effect and on the preconditions for fostering the different types of incentives.

The composition of the Follow-Up Group extends beyond the circle of FSF member countries to comprise France, Italy, Canada, United States, United Kingdom, Japan, Australia, India, Argentina, Singapore and Germany, as well as the IMF, World Bank, BCBS, IAIS and IOSCO.

The Follow-Up Group submitted its first report in September 2000. I shall deal in the following with the most important findings and recommendations.

Firstly:
In relation to official incentives it was found that two mechanisms would be working: Firstly, the domestic supervisory and regulatory bodies could call upon the financial institutions to include the use of information on the observance of standards in their risk assessments (with specific reference to the new Basel Capital Accord). Additionally, regulation of the market access of foreign institutions could be envisaged.

Secondly:
In relation to market incentives the Group came to the conclusion that two conditions must be satisfied so that implementation of codes and standards could work as incentives for pricing and allocation decisions:

- Market participants must be familiar with international standards and must include them in their risk assessments and internal risk assessment systems.
- Moreover, market participants must have access to reliable and timely information on the observance of standards.

To ascertain how far these conditions had already been met, the Group entered into an informal dialogue with a large number of market participants in the most important financial centres (this involved more than 100 financial institutions from 11 jurisdictions). Both this survey and the studies undertaken to date by the IMF and World Bank clearly show that the interest of market participants in codes and standards is increasing and that they support public institutions in their efforts to develop and to evaluate the standards. The private sector is interested in making greater allowance for standards and ROSCs—as a source of information—in their decision-making; evidently because this is expected to create a more dependable basis for lending and investment decisions.

It should be noted that the new Basel capital accord will support and promote the implementation of standards, as banks and rating agencies in future will automatically incorporate countries' observance of standards in their (external or internal) risk assessments. The most recent experience (surveys) shows that rating agencies have already started to do so. This puts pressure on the countries themselves to make assessments or to have them made as early as possible by the IMF and the World Bank and to disclose the results.

In this connection I should like to point to a few questions that still need to be answered:

- How is information about implementation of codes and standards disclosed? What information is made available and by whom?
- How is transparency in the provision of information to be assured?

- How could qualitative information of that kind be included in risk assessment models that are largely oriented to quantitative data?
- Do the markets set priorities with regard to specific information?

A further question may also be asked in this respect, especially for emerging markets: Is it of greater benefit for information on a country's standards observance to be prepared by the IMF and the World Bank using transparent methods, then disclosed and thus made accessible to the markets, or for rating agencies to include standards observance in fixing country ratings using methods that are not publicly transparent?

Thirdly:
Two preconditions are important for the implementation of standards:

- capacity building in countries by deploying appropriate resources, and
- preparation of road maps linked to the voluntary disclosure of information on or assessments of the respective progress made in putting standards into effect.

As early as last year, G20 members committed themselves to draw up schedules for their implementation of standards and to disclose the assessments of that implementation (i.e. the ROSCs). The voluntary disclosure of ROSCs is no longer an issue within the G20. Other countries may also be expected to follow the example set by the G20.

> To demonstrate leadership in this area, Ministers and Governors agreed to undertake the completion of Reports on Observance of Standards and Codes ("Transparency Reports") and Financial Sector Assessments, within the context of continuing efforts by IMF and World to improve this mechanism. This commitment will help mobilize support for measures to strengthen domestic capacity, policies and institution.
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> G20 - Statement, December 15-16, 1999, Berlin:

> ... we agreed that: 1. Governments should be encourage to publicly articulate their commitment to adopt key standards and, as appropriate, announce action plans for their implementation. They should be also encouraged to participate in external IMF-led assessments programs, and in the interim conduct on-going self-assessments of progress in observance of standards. In both cases, they should consider ways of disclosing information on progress in implementing standards, to enable more appropriate risk assessments.
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> G20 - Statement, October 25, 200, Montreal:

In concluding, let me briefly outline the next steps in the work of the Follow-Up Group:

1. A second market outreach survey will be conducted with regard to market incentives and the way in which they affect the implementation of standards. The aim is to study in greater detail the factors influencing the behaviour of market participants, distinguishing between different market segments and interests; and to find answers to some questions mentioned above.

2. The Group is also considering the possibility of sovereign bond issuers including in their prospectuses information on observance of relevant standards in the issuing economy. To this end a report on current practice in the major markets is in preparation.
3. Work is also in progress on the official incentives of market access and on technical assistance for standards implementation.
4. Finally, to enhance the awareness of markets and the information available to them, the Group has prepared a file binder of key standards, and renders assistance in organising symposia, seminars and round-table discussions on international standards.

The next report giving the results achieved by the Group will be presented to the FSF at its meeting in September of this year.