INTERNATIONAL MONETARY FUND

Financial Sector Regulation: Issues and Gaps

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Contents Page

Glossary 3

Executive Summary 4

I. Introduction and Background 6

II. Implementation of Regulatory Standards 9
- A. Framework for Analysis 9
- B. Implementation Overview 10
- C. Cross-Sectoral Regulatory Weaknesses 14
- D. Factors Explaining Implementation Weaknesses 18

III. Strengthening Regulatory Standards 23
- A. Diversity of Financial Systems 23
- B. Cross-Sectoral and Cross-Border Issues 26
- C. Objectives and Design of Regulatory Standards 30

IV. Issues Going Forward 31

V. Issues For Discussion 35

References 36

Table
Regulatory Standards: Areas Posing Problems in Cross-Sector Implementation 23

Figures
1. Regulatory Standards: Average Implementation by Main Components 12
2. Regulatory Standards: Average Implementation by Country Type 13
3. Rule of Law and Implementation of Standards 21

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Boxes

1. Regulatory Standards 8
2. Financial Regulation and its Four Main Components 10
3. Preconditions and Linkages with Regulation 19
4. Regulatory Implications of Dollarization and Government Ownership 25
5. Regulatory Implications of Conglomeration and Internationalization 27
6. Cross-border Regulatory Cooperation 29

Appendices

I. Income Level, Financial Deepening, and Standard Implementation....................38
II. Regulatory Standards: Main Gaps and Suggested Response 40

Appendix Tables

1. Correlations: Income Level, Financial Deepening, and Sector’s Implementation 39
2. Implementation by Regulatory Categories. 39

Glossary

AML-CFT	Anti-money Laundering-Combating the Financing of Terrorism
BCP	Basel Core Principles
BCBS	Basel Committee for Banking Supervision
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FSF	Financial Stability Forum
GDP	Gross Domestic Product
IAS	International Accounting Standards
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
MOF	Ministry of Finance
MoU	Memorandum of Understanding
OFC	Offshore Financial Centers
ROSCs	Reports on Observance of Standards and Codes
SROs	Self-Regulatory Organizations

EXECUTIVE SUMMARY

This paper addresses issues in financial sector regulation from two perspectives. First, it reports on the state of implementation of financial regulatory standards across banking, insurance, and securities sectors in a select group of Fund member countries. Second, it raises issues relating to the design of these three sector standards, arising from the implementation experience and the evolving structure of financial systems. In this regard, the paper identifies a few emerging regulatory risks and some cross-sectoral issues that may warrant further guidance by standard setters.

The implementation of regulatory standards is broadly satisfactory, on average, but masks underlying issues. There are also important variations in implementation across countries. For the majority of countries, prudential rules and regulations that create an enabling regulatory framework are in place. Significant weaknesses exist, however, in actual regulatory practices. The variations are observed particularly in areas related to regulatory sanctions and enforcement of laws, regulatory independence and legal protection of regulators, and financial integrity and safety net arrangements.

Several factors help explain the implementation shortcomings. The sound policy and operating environment required for effective regulation is not always present. A range of non-prudential considerations, often leading to regulatory forbearance, is another factor. This is particularly the case in financial systems with state-owned financial institutions. In several instances, regulators face a dilemma of having to balance the objectives of prudential regulation aimed at a safe and sound financial system, with the polices and objectives of other initiatives. Lack of human and financial resources often leads to faulty implementation.

Ongoing structural changes in the financial sector are posing a challenge for regulators. The Financial Sector Assessment Program (FSAP) reveals a growing integration not only across the various types of financial institutions, but also cross-border financial integration in Asia, Europe, and the Western Hemisphere, and in the recent period in Africa. These developments highlight the need for closer and more systematic monitoring of cross-border contagion risks, and of opportunities for regulatory arbitrage.

Implementation also suffers from a lack of clarity and practical guidance in some key regulatory areas. The standard setters have been revising regulatory standards. However, they typically focus on separate lines of financial activities, rather than on the treatment of system-wide regulatory issues. The standards also assume the existence of legal, institutional, and policy conditions ("preconditions") that are not directly under the control of the regulator, and which are often undeveloped in many countries. Differences in the treatment of similar elements (preconditions, methods of regulation, capital, and information sharing) among the standards also make implementation more difficult.

To strengthen regulatory systems, countries should be encouraged to provide greater attention to regulatory preconditions, cross-sector and cross-border information sharing. This will enable them to bring their regulatory regime into alignment with the evolving structure of the financial systems and the associated risks. Efforts at strengthening regulatory regimes could be combined with periodic reviews of the regulatory objectives, governance framework, resources, and financial infrastructure on a system-wide basis. This is particularly important as regulatory agencies are moving towards more sophisticated risk-based regulatory techniques.

The standards setters could support this by advancing the work on the required preconditions, possibly incorporating them into the standards. This could be done by taking into account the implementation experience and the emerging structural trends. Additional guidance could also be considered on issues relating to cross-sector regulation, regulatory governance, corporate governance, and public disclosure. Such guidance should explicitly consider the regulatory implications of the diversity of financial systems across countries.

The staff proposes to help address the issues identified in this paper, in close cooperation with country authorities, standard setters, and international organizations including the World Bank. The aim is to ensure that the regulatory framework is implemented in a manner consistent with international practices, yet flexible enough to allow market development and innovation. This will also help inform on issues that have general relevance to the FSAP, and the standards and codes initiative. Specifically, consideration will be given to strengthening the coverage of regulatory preconditions and practices in the context of its ongoing surveillance work. This will be in line with the ongoing effort to strengthen the coverage of financial sector issues in Fund surveillance. Staff will also continue to distill from ongoing surveillance and technical assistance research, issues relating to financial regulation. It proposes to provide the Board with periodic reviews on issues in financial regulation and their effect on financial stability.

I. Introduction and Background

1. **Financial sector regulatory standards comprise the essential, though minimum, principles for well-functioning regulatory systems (Box 1).**[1] The assessment of the quality of institutional and regulatory structures forms an integral part of the overall assessment of the financial sector carried out under the FSAP, which has emerged as the main international framework for financial sector standards implementation work.[2] The Joint Bank-Fund international standards and codes initiative provides the overall context for the work relating to financial sector standards.[3] Over 150 regulatory standard assessments have been completed so far in 67 countries where the FSAP evaluation has been completed.[4]

2. **Good quality regulation is a key element of financial stability.** Regulation, financial stability, and macroeconomic vulnerabilities are interconnected.[5] Financial system strengths and vulnerabilities critically depend on the design, practice, and implementation of regulatory systems. The assessments of financial systems against standards in the FSAPs are used to identify regulatory strengths, risks, and vulnerabilities and to assist country authorities to prioritize policy and operational reforms.

3. **The assessments are based on the internationally adopted regulatory standards using the assessment methodologies prescribed by the standard setters.** Evaluations of regulatory systems in the FSAP involve the participation of practicing regulators from central banks, ministries of finance, and regulatory agencies. This approach offers member countries a "peer review" of their national regulatory systems. Fund staff has been providing periodic feedback to the standard setting bodies on the assessment experience with individual standards as reflected in the recent revisions to the insurance regulatory standard and the securities standard assessment methodology.

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[1] Standards covered in this paper are (i) Basel Core Principles (BCP) for Effective Banking Supervision; (ii) International Association of Insurance Supervisors (IAIS) Core Principles; and, (iii) International Organization of Securities Commissions (IOSCO) Objectives and Principles for Securities Regulation. The three standards are included in the 12 areas endorsed by the Board in 2001 and 2002 as being useful to the Fund's operational work.

[2] See SM/03/77 for the most recent reviews of the FSAP. Assessments of regulatory systems in offshore financial centers (OFC) are also carried out under the OFC Program (See SM/04/92 for a recent update).

[3] See SM/03/86 for the most recent review of progress in implementing the initiative.

[4] For ease of reference, the term "regulation" is understood to include supervision.

[5] Some components of standards provide information on the core dimensions of financial stability. These include regulatory infrastructure, effectiveness of regulation, and macroprudential surveillance. In banking and insurance sectors, the assessment information is contributing indirectly to the surveillance by informing on the reliability of reported financial soundness indicators (See SM/03/176).

4. **This paper first reviews the implementation of financial sector regulations in 36 Fund member countries based on the findings of FSAPs completed from 2000–2003**. These are countries where regulatory systems have been assessed in three sectors—namely, banking, insurance, and securities.[6] **The second part of the paper discusses some issues regarding the standards themselves in light of the implementation experience.** It takes into account the regulatory challenges posed by financial conglomeration and internationalization of finance, and structural factors such as dollarization and state ownership of financial institutions. The paper also suggests steps for further strengthening of regulatory standards to take account of these developments and structural factors.

5. **A cross-sectoral approach to the review of standards implementation has been chosen to identify common regulatory vulnerabilities.** The need for a cross-sectoral view is heightened by the increasingly complex ways through which financial risks are managed by banking, insurance, and securities firms. These often erode the effectiveness of the traditional arrangements for regulatory oversight. However, a cross-sectoral analysis should keep in mind that standards seek to achieve similar, but not uniform objectives. Even where sectoral lines are blurred, technical complexities remain within each sector. Thus, while parallels may be evident in implementation weaknesses, their impact across the financial system may differ.[7] The divergence in regulatory focus also explains, in part, the varying relative importance of factors such as sound macroeconomic policies to the regulation of each sector.

6. **This paper is a first effort at a broader review of issues in financial regulation, including implementation and adequacy of regulatory standards.** [8] It is a work in progress, as more experience and knowledge is gained with assessments of regulatory systems under the FSAP. Work in this area is a cooperative endeavor involving the Fund, the Bank, country authorities, international experts, and the standard setting bodies. Thus, going forward, a cooperative approach will continue to be required involving all the relevant stakeholders. The staff intends to report periodically to the Board on issues related to

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[6] In addition, assessments of the three sectors were also carried out in another six jurisdictions under the OFC program. These assessments are not considered in this paper.

[7] For example, prudential deficiencies and confidence in the financial condition of firms can have a different impact on banks than on securities intermediaries and insurance companies. Moreover, for securities regulators, the primary emphasis is on investor protection and market efficiency considerations—relying more on disclosure, market discipline, and a sound legal and accounting framework. In the banking and insurance sectors, regulators focus primarily on an institution's ability to meet its obligations to depositors and policyholders, with some attention in banking to systemic stability.

[8] Individual reviews of financial sector regulatory standards have already been reported to the Board. These indicate substantial room for improvement in individual standards and the assessment process itself (See SM/01/266, SM/02/121, SM/01/266, and SM/04/92).

financial regulation and its implications for financial stability, including developments relating to regulatory standards.

Box 1. Regulatory Standards

Regulatory standards represent the minimum requirements for good practice in financial regulation in individual sectors. These comprise of Basel Committee's Core Principles (BCP) for Effective Banking Supervision (September 1997) and the accompanying methodology (October 1999), IOSCO's Objectives and Principles of Securities Regulation (IOP) (September 1998) and the accompanying methodology (September 2003), and the IAIS's Insurance Core Principles and Methodology (ICP) (October 2003). Each standard is accompanied by a methodology providing detailed guidance on steps to be taken or requirements to be met which are specific enough to allow a relatively objective assessment of the degree of observance.

The standards for the most part are written in general terms, thereby offering a degree of flexibility in implementation to suit country circumstances. In several cases, however, the methodologies tend to be prescriptive and set forth specific requirements. The standards' framework also includes supporting documents covering topics relevant to each sector, such as accounting, disclosure and transparency, capital adequacy, information sharing, and risk management. Some of them spell out the practical application of the standards within a more narrowly defined context—for example, the Basel Committee's Sound Practices for Loan Accounting, IOSCO's Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms, and IAIS's Supervisory Standards on Licensing.

As presently drafted, the primary purpose of the standards is related to the regulation covering individual institutions. In March 2000, the Joint Forum set up a working group to compare the standards issued by the Basel Committee, the IAIS, and IOSCO by identifying common principles and understanding differences where they arose. Each standard provides an overview of the key elements of the supervisory regime in that sector at the time they were written. Notwithstanding different objectives served by the three standards, no evidence has been found of an underlying conflict or contradiction between the three sets of standards at the highest levels. There are numerous areas of common ground (e.g., authorization, organization of supervision, and intervention). However, in some cases variations were identified in the application of similar principles (e.g., different capital treatment of similar risks in different sectors). There are differences among the standards —some arising from intrinsic differences between the three sectors and others not readily explained in this way. Variations are found in preconditions, group-wide supervision, cooperation and information sharing, safeguarding of client assets, and application of uniform prudential standards.

Sources: Financial Stability Forum, www.fsforum.org; The Joint Forum, 2001

7. **The remainder of the paper is organized as follows.** Section II discusses the implementation record across sectors, focusing on the principal components of the regulatory standards. Section III reviews the main areas for strengthening implementation; and Section IV presents corresponding recommendations for improving implementation and strengthening regulatory standards. Section V then lists the issues for discussion. An accompanying Background Paper covers details of the implementation record, structural features and trends in financial systems, and work underway by the standard setters.[9]

II. Implementation of Regulatory Standards

A. Framework for Analysis

8. **The analysis of implementation experience focused on the main regulatory issues relevant from a financial stability viewpoint.** For this purpose, the regulatory standards were grouped into the following four main components, broadly based on the Joint Forum framework (2001) (see Box 2 for the list of principles included in each regulatory component):

- **Regulatory governance,** which refers to the capacity of the regulatory bodies to make decisions without interference and to formulate, implement, and enforce sound regulatory policies and practices.[10]

- **Prudential framework,** which comprises the rules, directives, and regulatory requirements that set forth the structure to govern the operations of financial firms.

- **Regulatory practices,** which refer to the practical application of the prudential framework.

- **Financial integrity and safety net arrangements,** which refers to the regulatory policies and instruments designed to promote fairness and integrity in the operations of financial institutions and markets, and the provision of safeguards for depositors, investors and policyholders, particularly during times of financial distress and crisis.

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[9] Financial Sector Regulation: Issues and Gaps—Background Paper.

[10] A recent IMF staff working paper shows that regulatory governance has a significant influence on financial system soundness (See Das, Quintyn, and Chenard, 2004).

Box 2. Financial Standards and their Four Main Components

Regulatory Governance 1/
- Objectives of regulation
- Independence and adequate resources
- Enforcement powers and capabilities
- Clarity and transparency of regulatory process
- External participation.

Prudential Framework 2/
- Risk management
- Risk concentration
- Capital requirements
- Corporate governance
- Internal controls.

Regulatory Practices 3/
- Group-wide supervision
- Monitoring and on-site inspection
- Reporting to supervisors
- Enforcement
- Cooperation and information sharing
- Confidentiality
- Licensing, ownership transfer, and corporate control
- Qualifications.

Financial Integrity and Safety Nets 4/
- Markets (integrity and financial crime)
- Customer protection
- Information, disclosure, and transparency.

1/ Includes BCP 1 and 19; ICP 1; IOP: 1,2,3,4,5,6, and 7.
2/ Includes BCP 2,3,4,6,16,17,18,20,22,23,24, and 25; ICP 2,3,4,5,12,13,15,16, and 17; IOP 8,9,10,11,12,13, and 29.
3/ Includes BCP 5,6,7,8,9,10,11,12,13, and 14; ICP 6,7,9, and 10; IOP 17,18,20,21,22,23,25, and 27.
4/ Includes BCP 15, and 21; ICP 11 and 16; IOP 14,15,16,19,24,26,28, and 30.

For this paper, the allocation of insurance principles are based on the 2000 IAIS standard.

9. **Using the framework outlined above, the record was reviewed in 36 countries to distill the level of implementation of various regulatory standards.** The sample of countries consisted of 10 industrialized countries, 12 emerging market countries, and 14 developing countries.[11] Financial systems in these countries show considerable diversity across dimensions such as ownership, financial depth, degree of concentration, competition, efficiency, and openness. In 12 of the sample countries, regulation across sectors was carried out by integrated financial agencies. The arrangements ranged from a regulatory agency overseeing all or a combination of sectors, to the central monetary authority being responsible for cross-sector regulation. In almost all cases, however, regulation was continuing to be carried out along sectoral lines, including the regulatory treatment of cross-sector issues.

B. Implementation Overview

10. **Drawing upon detailed data from individual assessments, indicators were constructed measuring the level of implementation for each of the four main regulatory components across countries and standards**.[12] Although the precise terminology differs,

[11] In terms of regions, there were 3 countries from Africa, 4 from Asia, 21 from Europe, 6 from the Middle East and Central Asia, and 2 from the Western Hemisphere.

[12] Additional details on the implementation record can be found in Section II of the Background Paper.

all three standards classify the level of implementation of individual principles into four categories, denoted for the purposes of this paper as compliant, largely compliant, broadly compliant, and noncompliant. Each of the categories was assigned a numeric value from 4.0 (compliant) to 1.0 (noncompliant). A simple average of the regulatory principles was calculated for each of the four regulatory components, implying that individual regulatory principles were given equal weight in the resulting indicator. Simple averages were also used to aggregate the indicators across countries and across standards.

11. **Potential statistical problems with the sample need to be kept in mind while interpreting the results.** The results reflect the financial sector landscape of the assessed countries and, while suggestions about representative behavior may be advanced, the relatively small size of the sample has to be acknowledged.[13] Also, the potential sample selection problems are a reason for caution. First, the FSAP is a voluntary exercise, potentially inducing self-selection of higher performers. Second, the 36 countries included in the sample went through assessments of all three sectors, that is, their insurance and securities markets were deemed important enough to warrant a formal assessment along with the banking sector.[14]

12. **Overall, the results show that for the majority of countries, the average level of implementation of the four regulatory components, across sectors, is broadly satisfactory in terms of the technical criteria under the regulatory standards.** The data suggest that the level of implementation has been rather even across the four main components. The average implementation of all four components falls between 2.8 and 3.3 on the above-mentioned scale (Figure 1). The prudential framework and regulatory practices components display a slightly stronger level of implementation than regulatory governance and financial integrity and safety net arrangements. At the same time, the implementation of the latter two components exhibits a relatively higher degree of variation across countries.

13. **Implementation of standards in industrial countries is better than in emerging markets and developing countries (Figure 2).** [15] The average implementation in industrial countries reached 3.6, on the 1.0–4.0 scale. Industrial countries thus were relatively close to full implementation. Emerging markets lagged behind, with average implementation slightly over 3.0, as did developing countries (2.9). Appendix Figures 1 and 2 confirm that the overall

[13] It is worth noting that the sample includes over half of the completed FSAPs.

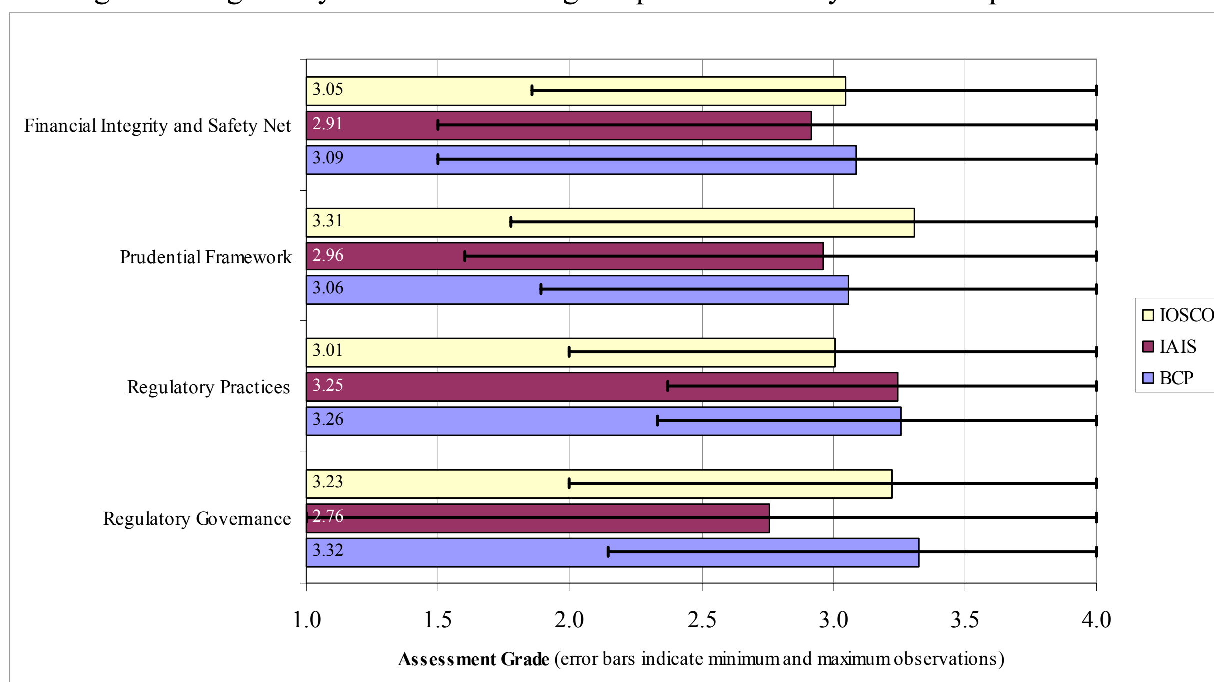
[14] These countries therefore tend to demonstrate relatively more developed financial systems. This is irrespective of the level of economic development, which may increase the average reported level of implementation. The latter point also likely contributed to relative over-representation of European countries in the sample.

[15] In the case of banking, data also shows that financial strength of banks is generally lower in developing countries, and by and large this is associated with weaker implementation of the BCPs. In several cases, though, institutions remain financially weak despite a higher degree of implementation of banking standards.

levels of implementation across sectors and components are positively related to both income levels and financial deepening.

14. **Furthermore, the levels of implementation across sectors are correlated.** On average countries tend to display relatively similar levels of implementation in all sectors (Appendix Table 1). Also, the variation in implementation levels is substantial and greater for developing countries and emerging markets than for industrial countries. Thus, the average figures mask a substantial variation in individual country performance.

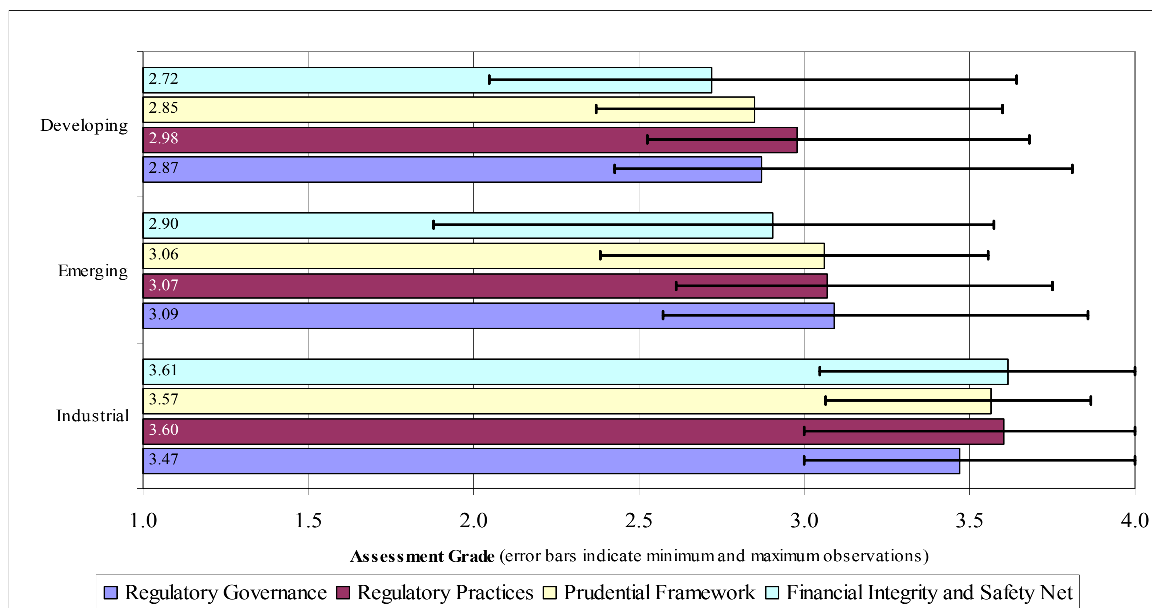
Figure 1. Regulatory Standards: Average Implementation by Main Components 1/ 2/



1/ Includes 36 countries.
2/ Grades Structure: 4=Compliant, 3=Largely Compliant, 2=Broadly Compliant, 1=Noncompliant. The higher the grade, the higher the compliance level. For core principles included in each of the four categories, see Box 2.

15. **High levels of implementation are noted particularly with respect to the legal foundation for the regulator.** In the case of industrialized countries, most regulators have adequate powers of inspection and investigation, providing for independence and accountability of actions, and over half utilize such powers effectively. Although the level of implementation drops in emerging and developing markets, the basic elements of an appropriate legal structure for regulatory agencies are generally observed to be in place, with additional needs for further strengthening of the legal and regulatory framework, particularly in terms of independence of agencies and clarity and consistency of regulatory powers.

Figure 2. Regulatory Standards: Average Implementation by Country Type [1/ 2/]



1/ Includes 36 countries.
2/ Grades Structure: 4=Compliant, 3=Largely Compliant, 2=Broadly Compliant, 1=Noncompliant. The higher the grade, the higher the compliance level. For core principles included in each of the four categories, see Box 2.

16. **In the prudential area, broad capital, solvency and margin requirements have been prescribed across sectors.** Financial reporting requirements have been established, with regulatory reporting at least quarterly, and audited financial statements required on an annual basis. Legal powers and a broad range of sanctions against problem financial institutions exist, although banking and insurance regulators continue to have limited discretionary powers and in many cases, the power can only be exercised by the government.

17. **The licensing process and designating minimum entry standards came across as being adequate in most countries, but more so in industrial and emerging countries.** In industrialized countries, the regulatory framework for self-regulation is also seen as having a relatively high level of implementation. This is an indication that in most countries, particularly those with larger and more complex markets, the regulatory regimes make appropriate use of outside participants in the regulatory process (such as auditors, actuaries, and Self-Regulatory Organizations (SROs)), which have some oversight responsibilities for their respective areas of competence. However, a wide variety of operational and legal arrangements relating to the use of third-parties makes the quality of implementation difficult to assess.

C. Cross-Sectoral Regulatory Weaknesses

18. **The implementation record, although relatively strong in terms of technical compliance with regulatory standards, also suggests that regulatory weaknesses exist in several areas**.[16] Implementation does vary in practice, across both standards and the four regulatory components. Even though prudential frameworks and some aspects of regulatory practices are well established and supported by a range of technical guidance from standard setters, implementation of the other regulatory components is strongly conditioned by country-specific factors. The main issues within each of the four regulatory components are set forth below.

Regulatory governance

19. **The main weaknesses relate to regulators' independence, regulatory objectives, and governance arrangements between the regulator and self-regulatory organizations.**

- **Regulatory agencies frequently lacked both formal and informal independence from political and industry influence.** In banking, one-third of the countries in the sample had deficiencies in this area, while in one-quarter of the countries the securities regulator lacked operational independence.[17] Similarly in insurance, lack of independence from the Ministry of Finance (MOF) was a major issue—mainly in developing countries, where over half of the sample countries exhibit poor implementation.

- **In many cases where formal independence had been granted to the regulator, the accountability arrangements were ill-defined.** Lack of accountability often led to a lack of clarity and predictability in rule-making and enforcement. Accountability and transparency are necessary corollaries to independence and affected the credibility of the regulatory process.

- **In some countries, different categories of deposit-taking institutions—commercial and savings banks, cooperatives, and credit unions—were regulated under different laws and often also by different regulators.** This often led to differences in the regulation of similar financial activities and instruments, resulting

[16] Twenty-nine out of the 36 countries in our sample published their FSSAs and financial sector ROSC modules. These, along with other published FSSA/ROSCs are available on the www.imf.org webpage, and provide country specific information. See also the Background Paper (Appendix II of Section I) for examples of some country specific weaknesses in banking area found during the FSAP evaluation.

[17] For the securities regulators, the principal issues concerned appointment and tenure of the Board of the agency, reliance on government appropriations for funding purposes, and inability to influence the legislative and regulatory framework pertaining to the role and responsibilities of the agency.

in arbitrage opportunities and competitive distortions between different types of regulated institutions.

- **Regulatory forbearance is a problem in some countries.** The incidence of regulatory forbearance or delays in adequately addressing financial system problems suggests that there may be some negligence in the regulatory attitude or that the regulatory governance framework is weak. The problems are compounded if the regulators are not immune from being sued for carrying out regulatory functions and if they fear to intervene in the absence of absolute proof.

- **Despite some regulatory regimes making use of SROs, oversight responsibilities were frequently ill-defined.** The governance arrangements between the insurance and securities SROs and the regulatory agencies show several accountability and transparency deficiencies. Over a third of the countries were found to need more clearly defined responsibilities for the securities SROs, as well as better arrangements for cooperation and information exchange between the regulator and SROs. Similar problems were found to exist in the case of the insurance sector.

- **Other recurring cross-sector issues.** Legal protection of regulators remains weak (e.g., an issue in one-third of the sample countries for banking regulators). Similar problems relate to clarity of regulatory powers, organization of the regulator, and remedial and enforcement powers.

Regulatory practices

20. **Actual regulatory practices on the ground are less robust than envisioned in the regulatory standards, weakening the effectiveness of regulation.** In most cases laws and rules were in place. However, weaknesses were found in many cases in the conduct of regulation, such as those relating to enforcement, consistent application of rules and laws, and the effective and timely application of regulatory powers. These weaknesses result in risk factors remaining unidentified or unaddressed. The main vulnerabilities across sectors relate to the following issues:

- **Consolidated supervision and regulation over all parts of a financial group—(domestic and foreign) remain weak and ill-defined.** Consolidated supervision was not effectively implemented in broadly one-third of the countries. In particular, consolidation of accounts and consolidated monitoring of prudential standards were in need of improvement.

- **Regulatory data and reporting shortcomings were recurrent across countries.** Financial information requirements were not comprehensive enough and, in some cases, consolidated reporting was not a requirement. In some emerging market countries, insufficient use was made of the data received, resulting in weaknesses in the level and regularity of market surveillance.

- **Powers to enforce regulations and impose sanctions were limited.** Even where powers were adequate in the emerging and developing countries, primary deficiencies were identified in the areas of post-inspection investigation and enforcement. Remedial measures were either not being implemented or delayed. In banking, the ability to take effective remedial action was insufficient in around one-third of countries. In some cases this was not as a result of weak laws and regulations, but due to forbearance. In the securities sector almost half of developing countries demonstrated significant weaknesses in the implementation of sound enforcement practices.

- **In the context of host country regulation of foreign institutions, cooperation between home and host country regulators were frequently found to be inadequate.** Taxes, accounting standards, investment restrictions, or capital adequacy requirements that differ across countries may create regulatory arbitrage opportunities warranting cross-border collaboration. In banking, where this issue is particularly important with a view to the implementation of Basel II, around one-fifth of countries had insufficient arrangements in this area.

- **Regulations did not fully address changes of control of regulated firms.** For instance, in around one-quarter of the countries examined, bank regulators had no clear definition of control on which to base their assessments, and in some cases, fit and proper criteria could not be applied to controlling shareholders.

Prudential framework

21. **A strong focus on prudential regulation was evident across countries and sectors.** The objective is to ensure that prudence is exercised in assuming and managing risk. While the regulatory focus has moved toward ensuring that financial strength and soundness of financial firms are maintained, a few recurrent shortcomings remained:

- **Substantial deficiencies were found in the monitoring and oversight of country risk.** Despite the presence of foreign banks, insurers and securities firms, and internationally active financial conglomerates, one-third of the evaluated countries had not fully developed regulatory systems in this area. Half of the emerging market economies were assessed to have insufficiently implemented regulations related to country risk.

- **Regulatory requirements relating to connected lending or related party transactions were insufficient.** Approximately one-quarter of the sample countries did not have adequate definitions of what constitutes a related party. Where legal and definitional clarity was missing, the enforcement of financial groups was weak.

- **A significant weakness across sectors relates to the prudential requirements concerning corporate governance.** This was particularly weak for the banking and insurance sectors. In insurance, two-thirds of all the sample countries exhibited substantial weaknesses, with emerging markets and developing countries showing

problems more frequently. Also in this area, weaknesses in consolidated supervision led to deficient practices with regard to corporate governance.

- **Sector specific issues:** The following were also deficiencies in areas unique to each sector:

  - **Credit risk management.** In banking, a serious concern relates to credit risk management. Almost half of the countries reviewed had deficiencies owing to insufficient guidance with regard to credit risk management, loan classification and provisioning, large exposures and country and transfer risk.

  - **Asset quality.** In insurance, one-third of all sample countries (and the majority of developing countries) demonstrated weak regulation of asset quality, and 60 percent of developing countries insufficiently supervised reinsurance practices of insurance companies.

  - **Capital.** Deficiencies with regard to the monitoring and inspection systems ensuring compliance with capital and prudential requirements were found in approximately one-quarter of the assessments.

  - **Collective investment schemes.** In relation to collective investment schemes, around one-third of securities assessments identified the need for enhancements to the provision of information concerning scheme eligibility requirements.[18] A similar number of assessments recommended that regulators address weaknesses in the mechanisms in place to calculate asset valuation and pricing of units in collective investment schemes.

Financial integrity and safety net

22. **With respect to financial integrity and safety net practices, the regulatory approaches differed greatly and largely followed sectoral lines.** The implementation levels across sectors also differed and revealed the following weaknesses:

- **Content and timeliness of disclosure was a common issue across all countries.** In emerging markets, about a third of the sample countries demonstrated particular weaknesses in continuous disclosure requirements.

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[18] Eligibility requirements in this context relate to the regulator's role in imposing minimum standards of conduct prior to commencement of marketing an investment scheme, including the honesty and fairness of scheme operators, human and technical resources, diligence and effectiveness, and operator-specific power and duties in the investment process. In many of the assessments, assessors noted that several of these aspects were either lacking or needed to be enhanced through better guidance to schemes.

- **Protection of minority shareholder rights was another area of concern**, with less than half of all developing countries and only around two-thirds of emerging market countries having the necessary regulatory framework in place.

- **Accounting and auditing problems appeared in most countries across income groups.** In securities markets, the assessment of issuers indicated that approximately one-third of the countries sampled had gaps in the application of International Financial Reporting Standards or IFRS (formerly International Accounting Standards or IAS). The audit function was also weak in at least one-quarter of countries assessed, with assessors concluding that greater oversight of accountants and auditors—at an independent level—was desirable.

- **Procedures for orderly winding up of failed insurers and securities firms were absent in a significant number of countries sampled.** Approximately a third of those countries were assessed as having inadequate insolvency and bankruptcy regimes. In addition, improved mechanisms for addressing default risk and market disruption more generally were needed in these and other jurisdictions.

- **Anti-money laundering efforts were weak in many of the countries sampled across income groups.** For instance, under the banking and insurance standards, one-quarter of the countries exhibited serious deficiencies, primarily in the so-called know-your-customer rules.

D. Factors Explaining Implementation Weaknesses

23. **The assessments suggest that several factors typically impede the implementation of regulatory standards.** This issue becomes particularly significant when viewed in light of the fact that the regulatory standards represent the minimum requirements of a good regulatory system.

Regulatory preconditions

24. **Regulatory preconditions play an important role, and implementation problems often arise in countries where regulatory prerequisites are weak** (see Box 3). Although not part of the formal standards framework, regulatory preconditions consist of the general policy and environmental conditions and institutional infrastructure essential for effective regulation. Weaknesses in regulatory preconditions can impede the regulator's ability to fulfill the regulatory objectives. Regulators, in general, have limited ability to change these preconditions directly but may be able to take steps to compensate for some of the deficiencies.

25. **The sound policy and operating environment required for effective regulation is not always present.** Notably the absence of sufficiently strong legal and accounting frameworks and resources often pose problems. While such factors may be outside the authority of regulators, few regulators attempt to alert appropriate domestic authorities of any

material weaknesses. Regulators are also reluctant to prescribe enhanced requirements and other safeguards to compensate for precondition-related weaknesses.

26. **Evaluations carried out in conjunction with financial stability analysis under the FSAP reveal several precondition-related vulnerabilities.** [19]

- **Legal aspects such as inadequate financial legislation and bankruptcy laws and difficulties in judicial foreclosure processes are affecting regulatory practices**. There are also other issues, such as insufficient segregation of client assets, which should, if fully implemented, protect the clients in the event of failure of a market intermediary, and poor enforceability of legal obligations. These inadequacies obstruct the use of sanctions, timely corrective action, and winding up of insolvent firms. They also affect market conduct practices.

Box 3. Preconditions and Linkages with Regulation

Recent assessments of implementation of financial sector standards, as well as a survey of published financial sector ROSCs found a number of countries that did not have the regulatory preconditions in place. There are important linkages between preconditions and effective regulation that are often missed. Though not part of the formal framework, standards are premised on the existence of preconditions and a number of commonalities exist.

- The precondition of "sound and sustainable macroeconomic policies" has the most significant impact on the prudential elements such as the adequacy of capital, interest rate risk, foreign exchange risk and other market risks.

- The presumption of a "well-developed public infrastructure" affects the regulatory elements related to asset valuation, supervisory powers, enforcement, exercising rights against collateral, licensing, and accounting frameworks.

- "Procedures for resolving problem institutions" and "appropriate levels of systemic protection or safety nets," have a bearing on the principles related to market disclosure, market conduct, corporate governance, and the enforcement of corrective actions.

Where these preconditions are weak, it should not be surprising that implementation in the related area of the standards is also compromised.[1/] For instance, major shortcomings in accounting and auditing may prevent regulators from effectively monitoring the financial position of financial firms. Similarly, the absence of appropriate procedures for problem bank resolution may make regulators helpless when action to restore stability is needed. Information on the preconditions can also be derived from the assessment of other standards (such as, accounting and auditing, and corporate governance) where available.

1/ For another discussion of the role of external circumstances similar to preconditions, such as effectiveness of government, and control of corruption see Kaufmann, Kraay, and Mastruzzi (2003).

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[19] In the insurance area, the IAIS has taken a significant step forward by incorporating the basic conditions for good insurance regulation as the first principle of its recently revised regulatory standard.

- **Weak accounting standards and the absence of a high-quality audit profession are affecting the quality of regulatory reports and disclosure.** Many countries also face a scarcity of qualified financial analysts and actuaries—a situation which often results in unreliable regulatory and financial information.

27. **The relationship between preconditions and implementation can be illustrated by the positive correlation between the rule of law index and average implementation.** As the assessments do not provide enough information for quantitative work, the index of rule of law compiled by Kaufmann, Kraay, and Mastruzzi (2003) was used to illustrate the importance of preconditions in Figure 3 below.[20] The data show a clear positive relationship between rule of law and the average level of implementation of standards. However, the level of preconditions observance—the rule of law index as well as other governance indicators like overall government effectiveness—is also positively correlated with the level of income across countries.[21] Further research will be needed to disentangle the interaction between income level and regulatory preconditions and their relevance for standards implementation and performance of the financial sector.

Other country-specific factors

28. **The level of financial development is a factor explaining uneven implementation.** Countries with very limited resources face a particularly difficult challenge in addressing competing priorities and may not know how to build the requisite institutional and regulatory infrastructure. Moreover, given the size and depth of the market, certain components of the standards may have little relevance to a country's circumstances. Both of these factors lower the overall implementation rate. Also, regulators in such systems face very different challenges from those in well-developed financial systems.

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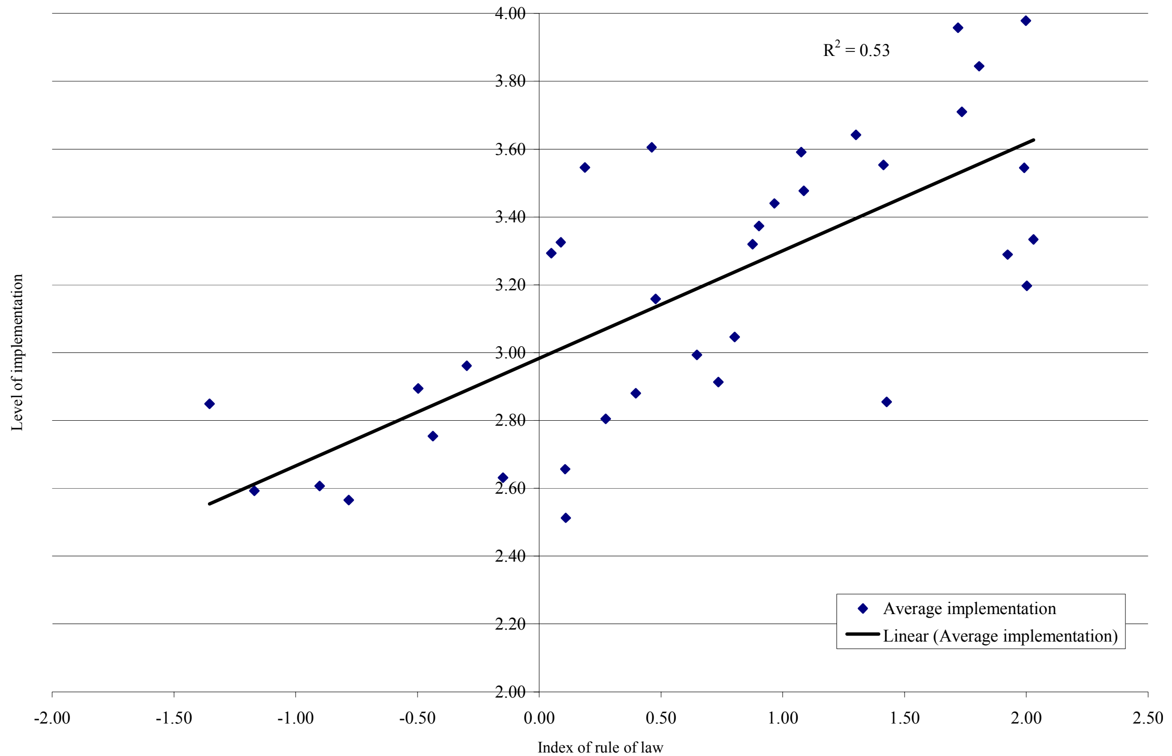
[20] The cited reference is an update of previous work by Kaufmann, Kraay, and Zoido-Lobaton (KKZ indices). The rule of law index includes perceptions of incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

[21] In our sample, the correlation coefficient between the rule of law and income was 0.84 and the same indicator for government effectiveness and income stood at 0.85.

Figure 3. Rule of Law and Implementation of Standards



29. **A range of "public policy considerations" to the regulatory process leads to regulatory forbearance and impacts implementation.** Assessments reveal that pursuit of multiple regulatory objectives and public policy considerations results in a range of regulatory forbearance practices. Some examples follow:

- Capital adequacy measures are often loosely applied to promote indigenous banks, or are unreliable due to weak loan classification and provisioning practices.

- Breaches of large exposure limits or other asset concentration guidelines are often tolerated, for instance, in cases of undiversified economies where there are few creditworthy borrowers.

- Loan loss recognition may be deferred in response to problems in systemically important institutions.

- Withdrawal of licenses are often delayed for extended periods in spite of serious solvency problems.

30. **Financial systems with predominantly state-owned financial institutions are particularly susceptible to many of the weaknesses identified above**. State-owned banks, insurers, and investment firms have generally been subjected to lighter supervision than privately owned firms. Frequently, regulators nominally have the requisite powers, but are hindered in taking adequate action, due to government involvement in the operation of state-owned financial institutions.[22]

31. **An overarching theme affecting implementation at the country level relates to human and financial resources.** Insufficient regulatory resources and, in some instances, an acute shortage of required skills within the country—such as actuaries, accountants, commercial lawyers, and finance professionals—often impede the adoption of good practices and the achievement of regulatory objectives. Insufficient numbers and quality of staff often affect not only the capacity to apply the rules as intended, but also issues such as operational autonomy, respect of the regulator by market participants, and the ability to stay abreast of new developments in markets.

32. **In some cases, implementation has suffered due to resistance on the part of the industry.** Efforts at bringing the regulatory framework into observance with international practices have been stalled because of institutional weaknesses, such as lack of development of local standards in general business practice or legislation. Often it is the perceived high regulatory burden relative to business prospects that results in industry resistance. In some cases, industry collusion with the government or political groups impedes implementation. The influence wielded by industry groups can be significant where there is a weak regulatory governance framework, particularly the absence of operational independence.

Implementation guidance

33. **Implementation also suffers because of a lack of clarity and practical guidance in some key regulatory areas (Table 1).** Implementation of regulatory and corporate governance, and improvements in the quality of financial information have suffered in some instances owing to a lack of in-depth guidance and consensus on minimum reporting and disclosure requirements. Similar issues arise with respect to the implementation of regulatory cooperation and coordination, which can represent channels for exchanging experiences and comparing regulatory techniques.

[22] In response to a recent Fund staff survey, regulators indicated that they could only "draw attention to problems in a bank and try to find a solution in consultation with the government which (is the only authority which) could take corrective action," while many stated that they would "take minor action while leaving stronger action to the government."

Table 1. Regulatory Standards: Areas Posing Problems in Cross-Sector Implementation

Cross-Sector Regulatory Areas	Areas Where Guidance is Needed
• Preconditions • Definitions of different types of cross-sector products and services • Risk management • Group-wide internal controls • Capital adequacy • Sanctions • Cross-sector and cross-border information sharing between regulators.	• Corporate governance within regulated firms. • Exit policies, winding up and insolvency of financial conglomerates • Asset classification and provisioning • Measuring adequacy of regulatory resources • Accounting, auditing and actuarial requirements • Cooperation and information sharing: legal authority, nature of relationship, topics on which information should be shared.

34. **The focus on the formal existence of regulatory arrangements rather than on implementation poses a challenge to the evaluation of the effectiveness of regulatory systems.** This is particulalry so when regulatory deficiencies are integrated with the analysis of financial stability in the FSAP. Assessment of implementation also requires a high level of cooperation on the part of the regulatory bodies, both domestically and internationally; often, confidentiality gets in the way. Lack of full information makes it difficult to form an in-depth judgment on the effectiveness of implementation, leading to disagreements on the assessments, interpretation, and appropriate actions to strengthen implementation.

III. Strengthening Regulatory Standards

35. **The above review of implementation of good regulation brings out a number of issues related to the regulatory standards themselves.**[23] The challenges are arising mainly due to three factors: (i) the diversity of financial systems; (ii) growing cross-sectoral and cross-border issues; and (iii) the objectives and design of regulatory standards.

A. Diversity of Financial Systems

36. **Financial systems are showing considerable diversity.** The FSAPs are highlighting differences across several dimensions such as ownership, the role of government in financial intermediation, financial depth, concentration, competition, efficiency, currency composition, and openness. Diversity also exists in relation to intermediation patterns, such as with respect to the scope of financial services (savings facilities, credit facilities, contractual savings and hedging). Aggregate balance sheet structures also vary across different financial (banks, insurance) and nonfinancial sectors (corporate, household, public sector), and highlight key linkages among balance sheet components.

[23] See Appendix II for an overview of the main gaps in regulatory standards.

37. **The diversity of financial systems poses challenges for the uniform applicability of the current sectoral standards across financial systems.** Some of the regulatory standards recognize elements that distinguish mature and developing financial systems.[24] This approach helps to enhance the universal applicability of regulatory standards. However, scope exists for further enhancing the inclusiveness of regulatory standards. Four broader issues observed in some countries deserve particular attention. These are: (i) regulatory preconditions; (ii) governance issues; (iii) treatment of financial systems with state-owned financial institutions; and (iv) prudential issues created by dollarization (see Box 4).[25]

Preconditions

38. **Implementation can be strengthened with additional guidance on the role and importance of preconditions.** Current standards have been formulated from the viewpoint of relatively developed and market-based financial systems. A number of their underpinning features are either not immediately available in some countries or these features are anchored to a different paradigm.[26]

39. **While mentioning the importance of preconditions, the standards provide little or no guidance on the impact on implementation if weaknesses relating to preconditions exist**.[27] The links between specific preconditions and particular elements of the standards are unspecified, leaving considerable room for judgment in assessing the regulatory implications.

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[24] This is done in the assessment methodologies. The banking and insurance standards distinguish the essential assessment or implementation criteria from the more advanced criteria.

[25] For a detailed discussion of financial stability in dollarized economies, see SM/03/112. In a recent discussion of this paper, the directors agreed that the dollarization of bank liabilities and bank loans poses unique challenges and generally agreed that the range of policy responses observed at the country level and recommended by standard-setting bodies often remain insufficient, particularly in the most highly dollarized economies (BUFF/03/77).

[26] For example, a legal framework built on approaches of arbitration and consensus may be no less effective that one where litigation is the principal means for dispute resolution.

[27] This limitation has been recognized in the 2003 revisions to the IAIS Insurance Core Principles, which now require an assessment of preconditions important for insurance regulation. The revised supervisory standard explicitly incorporates preconditions as an element of the standard. It also provides implementation guidance, and states that, where these conditions do not yet sufficiently exist, the supervisor could have additional powers to address the weaknesses. However, no guidance is provided on how precondition-related weaknesses should be taken into account when evaluating implementation.

Box 4. Regulatory Implications of Dollarization and Government Ownership

	Risk Factors	Regulatory Issues
Dollarization	• Higher balance sheet (solvency) risk, both due to direct (net open foreign exchange position) and indirect risk arising from unhedged credit exposure to the corporate sector. • Diminished role of central bank as the lender-of-last-resort. • Higher vulnerability of deposits to runs, with diminished scope of interest rate defense.	• Adjustment of prudential rules to limit risks. • Bank soundness as well as transparency critical to prevent banking instability.
Government ownership of financial institutions	• Weak governance and political interference in business decisions. • Conflicts of interests for supervisors and resulting forbearance. • Absence of market discipline.	• Introduction of proper governance structures and minimization of conflicts of interest. • Uniform treatment of financial institutions by regulations and supervision, irrespective of ownership.

State-owned financial institutions

40. **Regulatory standards need to take into account the phenomenon of state-owned financial institutions and policy-based financial activities.** In many countries, the financial system structure is characterized by the prevalence of state-owned financial firms. This is particularly so in banking, where despite several privatization initiatives over the last decade, public sector banks still account for a significant portion of total banking sector assets.

41. **State ownership of financial firms raises several regulatory issues.** These include: (i) weak corporate governance structure and management; (ii) political interference with business decisions; (iii) conflicts of interest, such as preferential lending to state-owned enterprises or investing assets in other state-owned firms without prudent due diligence; (iv) difficulties in implementing and enforcing any remedial measures; and (v) absence of market discipline. The current regulatory standards do not adequately address the numerous regulatory issues raised by state ownership of financial institutions.

Dollarization

42. **Prudential issues raised by dollarization could also be explicitly addressed by standards.** An increase in de facto dollarization has been observed in many developing and emerging market economies. While it has not affected all countries equally, it is widespread and increasing (Reinhart, Rogoff, and Savastano, 2003, and De Nicoló, Honohan, and Ize, 2003). Dollarization can have important regulatory implications for stability of financial

systems. Balance sheet effects of asset and liability valuations and the diminished role of central banks as lenders of last resort are usually mentioned among the main risks. Although it is usually suggested that financial dollarization entails not only risks but also benefits (Baliño et al., 1999), the exposure to solvency, unhedged credit and liquidity risks might make financial systems inherently more fragile. Since dollarization is prevalent in developing and emerging market countries, more detailed international guidance on its regulatory implications would be helpful.

B. Cross-Sectoral and Cross-Border Issues

43. **Cross-sectoral and cross-border linkages in the financial sector are growing.** These include ownership and transactional linkages among banks, insurers, pension funds, and securities firms through conglomeration.[28] Conglomeration and risk transfer among different sectors increases contagion risks as cross-sectoral linkages in the financial sector mature. Also, as cross-border capital movements become liberalized and exchange rate controls are abolished or reduced, financial systems are becoming increasingly integrated. The substantial volume of financial transactions recorded in the offshore financial centers is another indication of significant internationalization of financial flows. Thus, the conglomerate phenomenon is being amplified by increasing internationalization of financial sectors across countries, resulting in new forms of risk transfer. These developments transcend regulatory frameworks provided by sectoral standards and call for strengthened guidance on cross-sectoral and cross-border regulatory issues (see Box 5).

44. **There are also specific vulnerabilities to financial system stability in countries that are major international financial centers or operating offshore financial centers.** Many financial institutions have established themselves in such markets, often under more favorable tax regimes.[29] They provide services to nonresidents and are often subsidiaries or branches of major internationally active (and often cross-sector) groups. The business objectives and incentives for cooperation with the regulator are generally different for those institutions operating primarily in the domestic market. The standards do not explicitly identify and address any additional vulnerability to financial stability that may arise in an international or offshore financial center.

45. **In countries with cross-sector financial groups, the prudential framework must cover risks pertaining to each group as well as additional risks due to the cross-sector interlinkages.** Financial legislation is often drafted on an institutional basis alone and, particularly where regulation of the financial sector is shared among several agencies, gaps are possible, leaving entities or activities that may pose risks to financial stability

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[28] See Section I of the Background Paper. Also, other sectors not considered here may offer substantial potential for regulatory arbitrage. These include banking activities of various kinds of nonbank financial institutions, leasing and factoring companies, and pension funds.

[29] The scope for regulatory arbitrage by these institutions using offshore centers is being minimized through the OFC and similar initiatives.

insufficiently regulated.[30] Standards need to emphasize that all relevant firms operating in the financial system, particularly those that may entail systemic risk, should be under regulatory review.

Box 5. Regulatory Implications of Conglomeration and Internationalization

	Risk Factors	Regulatory Issues
Increased conglomeration and risk transfer	• Higher contagion risks. • Regulatory and supervisory arbitrage. • Conflicts of interests. • Implicit extension of financial safety nets. • Exposure of parts of the financial sector to complex risk transfer instruments.	• Effective tools and political mandate to regulate large conglomerates. • Adequate expertise to supervise complex structures. • Harmonization of regulation and supervision of similar products to avoid arbitrage. • Coordination among different regulatory agencies.
Significant and growing internationalization	• Higher transmission of financial sector shocks across borders.	• Cross-border coordination and information sharing. • Adjustments to laws, regulations, and deposit insurance systems to reflect cross-border issues.

46. **Risks common across sectors are not dealt with consistently across standards.** This situation poses risk-assessment problems and creates arbitrage opportunities. The Joint Forum has noted that the regulatory standards treat risks in different ways: banking specifies several risks on the asset side, while the insurance standard places more emphasis on the liability side "insurance risks." The securities standard stresses market risks. Recently, standard setters have begun to emphasize a broader set of risks. The insurance standard now includes more risks on both sides of the balance sheet, while the Basel Committee has focused more strongly on liquidity and other liability-side risks. The securities regulatory standard expressly references the need to address all risks faced by the firm—including market, credit, and liquidity.

47. **Definitions and calculations of capital requirements differ among the sectors and across borders.** To be effective, capital must be adequate both on a group or consolidated level and on a single entity "solo" level. However, proper monitoring is complicated by differences in the definitions and calculations of both actual and required capital among the

[30] The securities standard states that where responsibilities are shared for securities regulation, there should be no inequities of regulation. However, this does not address inconsistencies between the various sector supervisors.

sectors and across borders. For instance, some countries' regulations accept the inclusion in capital of unrealized gains on financial or real estate assets. Others may be flexible in accepting various forms of collateral for reducing risk weights when calculating capital adequacy ratios. As a result, the same nominal capital adequacy level of financial firms in different countries may provide different levels of resilience against adverse developments.

48. **There is a lack of convergence stemming from the different focus of sector regulators.** Accounting rules are not fully harmonized—either among the sectors or across borders—and similar transactions may thus affect a group's capital differently depending on where within the group they are carried out.

- **In banking**, the Basel Committee standard on capital is adequately comprehensive but its application needs to be underpinned by a harmonized approach to loan classification and provisioning.

- **In insurance**, the most important characteristics of a capital adequacy and solvency regime are covered at a fairly high level in the standard. Therefore, a wide range of approaches to capital adequacy and solvency are in use, some of which may be deficient in their ability to identify and require capital for significant risks to financial stability or the solvency of an insurer.[31]

- There is no international standard for capital for **securities** firms. The lack of a common standard could lead to financial stability concerns if lower standards in one jurisdiction lead to failures and the problems spill over into other jurisdictions. However, this problem is somewhat ameliorated by the dual objectives of minimum capital under the securities standard. Rather than focusing solely on maintaining solvency, it also has the objective of enabling a firm to wind down its operations over a relatively short period of time without loss to its customers and without disrupting the orderly functioning of the financial markets. If the local standards meet this latter objective, the chances of contagion are slim.

49. **Notwithstanding these country nuances, other cross-country issues exist in the area of the preconditions and governance**. The prevalence of complex financial organizations has increased the need for good corporate governance of financial institutions. Overall, the coverage of corporate governance in the standards is limited. Although the insurance standard explicitly addresses corporate governance, the banking standard does not explicitly recognize the role and importance of good corporate governance. The securities standard does not address corporate governance in a systematic way, although the importance

[31] The capital required by an insurer under the index-based solvency regime currently used in the European Union and various other jurisdictions does not depend on the composition of its investment portfolio. The IAIS and other organizations are working to strengthen and bring convergence to standards in this area, although much remains to be done.

of good corporate governance at public companies, collective investment schemes and market intermediaries is generally recognized.

50. **Cross-sectoral and international financial intermediation also requires more active and extensive coordination and cooperation among supervisory authorities across sectors and borders.** Several countries have opted to either consolidate the regulatory authorities, or set up other forms of institutional arrangements that secure adequate exchange of information and cooperation among regulators. Regulatory standards outline frameworks for dealing with cross-border operations, and coordination and cooperation between national authorities. In practice, the degree and effectiveness of coordination and information sharing vary across countries. As suggested by IMF (2002e) cross-border information sharing and cooperation between regulators tend to be stronger when formalized arrangements are in place (such as, Memoranda of Understanding or MOU). Overall, information sharing requirements among regulators should be strengthened (see Box 6).

Box 6. Cross-Border Regulatory Cooperation

A recent Fund staff study of cross-border regulatory cooperation issues reveals the following characteristics:1/

- While channels for cooperation and information exchange are being established, they are far from being effective.
- Although there are historical differences in emphasis in the objectives of cooperation and information exchange in the different sectors—banking and insurance were focused on solvency while securities focused on enforcement investigation—anti-money laundering/combating the financing of terrorism (AML/CFT) customer due diligence requirements and conglomeration in the financial services industry are bringing the requirements closer together.
- There is a spectrum of instruments that facilitates cooperation including informal contacts and MOUs. Many countries rely on informal and flexible arrangements, although in the absence of legal gateways, informal contacts may not be adequate for civil and criminal proceedings.
- It is essential that national laws provide the basic gateways and do not impede cooperation and information exchange. It is important that an appropriate balance be achieved between the public interest in obtaining and using information and protection of civil rights.

To enhance cooperation, the following suggestions have been put forward by some regulators:

- Standard setters should consider making information on contact persons more readily available to relevant agencies.
- National authorities should consider publishing information on contacts, gateways, and requirements indicating "how" to communicate with them, including their statistics on information sharing as well as unsolicited transmission.

1/ IMF Conference on Cross-Border Cooperation and Information Exchange held in Washington D.C., July 7–8, 2004.

C. Objectives and Design of Regulatory Standards

51. **The objectives of regulation and regulatory components could be more expressly linked to the goal of system-wide financial stability.**[32] The standards are useful to regulators charged with assessing the strength of regulated entities within each sector. However, their use in addressing system-wide stability issues is limited, partly because they were not written for this purpose. The standards take little account of structural issues, or of interlinkages among different types of financial firms and markets.[33]

52. **Guidance is needed on the interrelationships among key components of the regulatory standards.** Several components of the standards are dependent on each other and the standard setters should provide explicit guidance on how these interdependencies should be addressed during implementation and assessment. For example, if the minimum requirements on regulatory information sharing are not fully implemented, then it is very unlikely that other elements, such as regulation of conglomerates, which are dependent upon the existence of a well-functioning information-sharing framework, will be effectively implemented.

53. **Additional guidance on the applicability of different regulatory approaches would be helpful.** Depending on legal tradition and culture of compliance, highly detailed and explicit legislation and regulations may be required in some countries. In other cases, countries can manage with overriding principles, for instance "managers must ensure the safe and sound conduct of the firm," which are then interpreted by the regulator based on institution-specific factors. Guidance would be useful on the conditions under which detailed and prescriptive regulation, as opposed to flexible and discretionary regulation, is desirable.

54. **The standards should be strengthened in the area of information disclosure and made more explicit in dealing with the integrity of financial reporting.** For market discipline to work effectively, the requirements regarding public disclosure by market participants and the applicable accounting and auditing standards need to be comparable across firms, yet the current standards do not address this point in sufficient detail. Also, the

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[32] The standard setters could articulate the direct or indirect link between principles and financial stability wherever applicable. This would help address some of the important practical issues involved in the FSAP assessments, including an evaluation of the actual regulatory practices on the ground, and linking the assessment outcome with the financial stability analysis.

[33] Both banking and insurance standards do mention financial stability as an objective of regulation but do not provide guidance on how the various elements of the standards are linked to that goal. In the securities areas, this is not traditionally thought of as something that securities regulators are involved in, with a focus mainly on investor protection. However, given the number of integrated regulators, the need for more cohesive guidance on cross-sector regulation, and the overall role of regulation for ensuring market stability, financial stability objective could be integrated within the elements of various standards.

standards could deal with issues affecting the integrity of financial reporting more comprehensively. The need for robust accounting, auditing and actuarial standards, together with the existence of skilled professionals and quality control mechanisms, is critical. Given the growing emphasis on financial and risk measurement and disclosure (such as Pillar 3 of Basel II, or the EU Solvency standards for insurers), the importance of express standards in this area is increasing.

55. In **banking**, there are currently no specific requirements on banks' disclosures to the general public, with the exception of an annual financial statement.[34] In **insurance**, public disclosure by insurers of relevant information on a timely basis is required. The criteria that such disclosures must meet are comprehensive, but quite high-level. The financial statements of insurers are often difficult to understand and open to manipulation, for example, through the modification of actuarial methods and assumptions. Disclosure requirements in a jurisdiction could be assessed as observing this principle, without ensuring the existence of clear and meaningful disclosure of the financial positions and risk exposures of its insurers. As regards **securities**, there are extensive public disclosure and transparency expectations that apply to public companies, securities supervisors, collective investment schemes and organized markets. However, public disclosure of the financial condition of market intermediaries is not addressed directly.[35] [36]

IV. Issues Going Forward

56. **The analysis in Sections II and III indicates the need for improving implementation and adopting regulatory standards.** The staff proposes to continue working closely with country authorities, standard setters, and international experts and organizations, including the World Bank, to enhance implementation and help in adapting regulatory standards to the challenges identified in the paper. The aim shall be to ensure that implementation takes place in a manner that is consistent with international practices while flexible enough to reflect countries' particular stage of market development.

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[34] The Basel II framework will introduce detailed requirements on disclosures.

[35] This gap only applies to privately owned securities firms, as firms with public shareholders are subject to extensive disclosure requirements.

[36] The Fund staff, in collaboration with the standard setters, is undertaking a stock taking of barriers, gateways, and practices on the basis of an expanded survey and information from FSAP and OFC assessments. The stock taking could include a comparison of the standards' principles on information exchange to identify common elements and differences and ways to help facilitate compliance with the standards.

Country authorities

57. **At the country level, the following steps could help strengthen implementation:**

- **Provide greater attention to meeting regulatory preconditions.** Countries should have adequate supporting legal and financial infrastructures, and could undertake a review of how well the regulatory system is aligned to the operating environment. The state of regulatory preconditions may influence the design of the regulatory approach, and in specifying the regulatory priorities and goals.

- **Carry out periodic reviews of the governance framework of regulatory bodies.** Periodic review could assist the countries in identifying issues related to the adequacy of the legal protection of regulators, their operational autonomy, and the adequacy of supervisory and supporting judicial resources. In this context, the accountability framework should also be examined. A strong governance framework will help countries make timely interventions in problem institutions, and help establish a clear institutional framework among regulators for crisis management.

- **Undertake and update self-assessments of implementation of regulatory standards.** Using the methodologies prescribed by the standard setters, this exercise could be undertaken periodically. Since financial structures are not static, regulatory regimes would need to adapt and adjust. A process of self evaluation would help monitor the progress. Publication of such assessments and any follow-up actions would provide information to other regulators and stakeholders on emerging regulatory practices and could lead to convergence of regulatory views.

- **Discuss mechanisms with relevant constituents for cross-sector, cross-border regulatory coordination and information-sharing.** Consideration could be given to establishing and maintaining regular contacts with the most relevant authorities and making a joint effort to understand each others' systems, while working towards an international arrangement or an institutional mechanism for improving domestic and international regulatory coordination and exchange of information. This will facilitate the regular monitoring of potential contagion and regulatory arbitrage risks. It would also facilitate the sharing of information regarding the linkages between banks and the nonbanks operating as part of complex groups on a cross-border basis.

- **Augment regulatory oversight with a focus on system-wide issues.** Enhanced research and supervisory capacity is needed on regulatory issues, especially relating to the interlinkages between financial regulation and financial stability. Regulatory responses could be swifter and more focused if a better understanding exists at the country level of the interrelationships in the financial system. Issues such as the nature of systemic exposures among banking, insurance, securities sectors, and other sectors not analyzed in this paper, including leasing, factoring, nonbank financial institutions, and pension fund managers deserve attention.

Standard setters

58. **The standard setters have adopted a pro-active stance of critically reviewing the regulatory standards and assessment methodologies**.[37] The IAIS has recently completed its revisions of the insurance standards, while the Basel Committee has begun a review of the banking standard. IOSCO has issued its first implementation methodology. Based on the above review of the actual implementation practices, however, the opportunity exists to make the regulatory standards more reflective of the structural shifts and diversity across financial systems. A more consistent approach also appears possible on issues that commonly arise in all sectors. Specific areas of further work could include the following:[38]

- **How might regulatory standards best recognize the diversity of financial systems, including financial systems in an early stage of development, dollarized financial systems, and those where state-owned financial institutions are significant?** Standard setters could provide guidance on trade-offs between different regulatory approaches and how regulation might be adapted to different types of financial systems.

- **Consideration should be given to including preconditions as a component of the standards framework.** To the extent possible, preconditions should be harmonized across sectors, and the links between preconditions and the elements of standards elaborated.

- **Regulatory principles relating to cross-sectoral and cross-border issues could be laid out in a comprehensive and consistent manner.** Consideration should be given to issuing a separate set of standards or guidance for addressing cross-sectoral regulatory issues and their interdependencies.

- **More extensive and harmonized guidance on regulatory governance requirements would be helpful.** Also, developing more specific guidance in the areas of corporate governance and public disclosure could be considered.

- **Standard setters could work with country authorities on information exchange arrangements.** The aim would be to provide practical support for formal arrangements for improving domestic and international regulatory coordination and exchange of information, while fostering informal contacts and communication.

59. **The recommendations made by the Joint Forum in 2001 on the issue of greater coordination and harmonization among standard setters could be revisited.** Consistency

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[37] Ongoing work by standard setters is reviewed in Section III of the Background Paper.

[38] The main areas for strengthening standards and suggested responses are detailed in Appendix II.

among regulatory standards might be achieved at two levels: (i) in the content and design of regulatory standards (definitions and terminology, cross-referencing, and uniform mechanisms for keeping the standards current with new guidance); and (ii) consistency in the implementation process (assessment grading, self-assessment tools, assessment methodologies and procedures, and linkages with formal stability analysis). However, harmonization and coordination among standards must leave room for addressing aspects that are unique to each sector, and how regulation might be adapted to different types of financial systems.

Fund staff

60. **To assist the above steps, the Fund staff could play the following supporting role:**

- **Consider undertaking together with other relevant bodies and the standard setters, a study of different types of regulatory systems.** This will help to determine how well the individual regulatory standards apply across the financial sectors (such as, how well do the banking standards apply to the securities-like operations of banks) The study could specifically have a cross-sector and cross-border focus, and look into the depth and intensity of regulation based on different environments.

- **Give priority to the coverage of regulatory preconditions and regulatory practices in the context of ongoing financial sector surveillance work.** In assessing and conducting surveillance of regulatory systems, devote more attention to the underlying infrastructure (i.e., the preconditions) and the adequacy of the regulatory approach given the stage of development and particular challenges facing the country.

- **Continue working with standard setters in a cooperative manner in providing further guidance on implementation of good regulatory practices, and laws and regulations.** In this regard, a framework could be developed on what constitutes a well-regulated financial system, including a consistent set of metrics to evaluate regulatory performance and implementation practices. This will also help to focus technical assistance more sharply on regulatory strengthening in areas where the main vulnerabilities exist.

- **Continue to provide technical assistance** to help countries strengthen regulatory systems, in close cooperation with FIRST, the World Bank, and other donors.

- **Build on the existing research agenda and include financial regulation, financial stability and linkages with macroeconomic stability.** Based on this work, the Fund staff will provide the Board periodic reviews on issues in financial regulation and their effect on financial stability.

V. Issues For Discussion

61. **Do the suggested approaches in Section IV seem appropriate towards strengthening implementation and fostering stronger practices in financial regulation?**

Specifically:

- Is there a need for stakeholders (e.g., countries, standard setters, and staff) to pay closer attention to the adequacy of regulatory preconditions?
- Given the importance of cross-sectoral and cross-border issues in regulation, should the Fund, in collaboration with standard setters, conduct a stock-taking of barriers, gateways, and practices, in order to identify common elements and differences and ways to improve domestic and international coordination and exchange of information?
- As the standards are applied mainly on a sectoral basis within a country, is there a need for overarching guidance on the regulation of financial operations with cross-sectoral and cross-border features?
- Should regulatory standards better recognize the diversity of financial systems, including financial systems in an early stage of development, dollarized economies, and counties where state-owned institutions are significant?
- Is the envisaged role of Fund staff in the right direction and in line with the call by the Board for strengthening the coverage of financial sector issues in Fund surveillance across all member countries?

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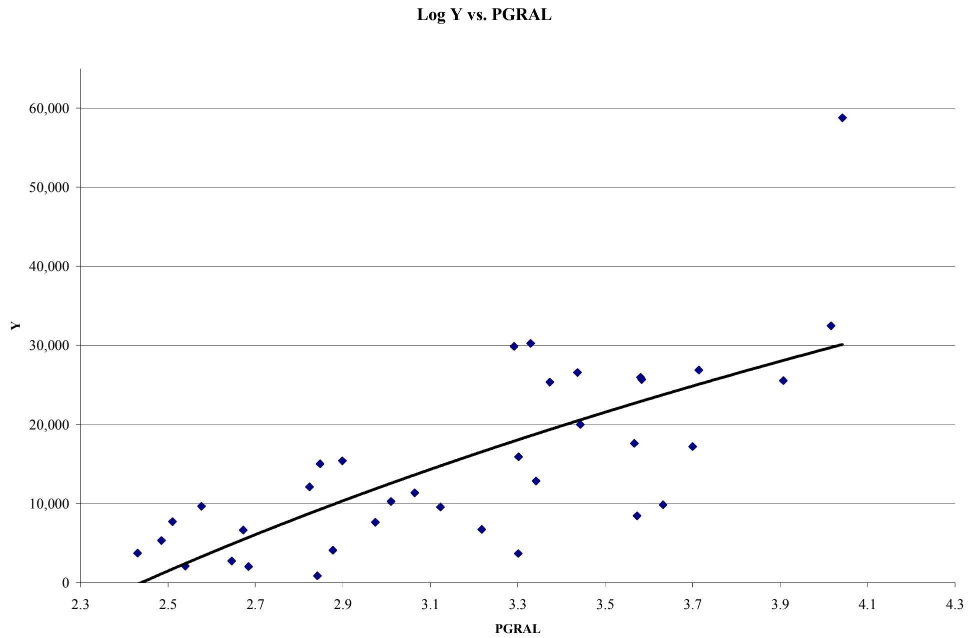
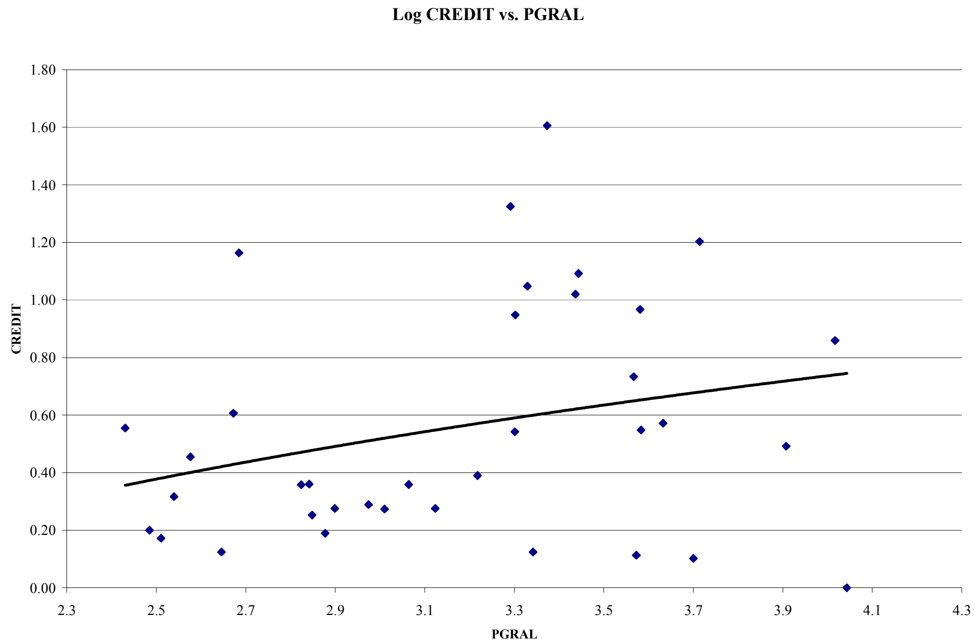
Income Level, Financial Deepening, and Standard Implementation

Appendix Figure 1. Income Level and Implementation



Appendix Figure 2: Financial Deepening and Implementation



Notes:
Y = GDP Per Capita, Credit=Credit to the Private Sector by Banks/GDP,
PGRAL=Average level of compliance across sectors and components.

Appendix Table 1. Correlations: Income Level, Financial Deepening, and Sector's Implementation

	GDP Per Capita	Credit/GDP	BCP 1/	IAIS 1/	IOSCO 1/
GDP Per Capita	1.000	0.617	0.664	0.543	0.587
Credit/GDP		1.000	0.458	0.214	0.242
BCP			1.000	0.481	0.474
IAIS				1.000	0.560
IOSCO					1.000

1/ BCP, IAIS, IOSCO are the grades of implementation with standards in each sector: 4=complaint, 3=largely complaint, 2=broadly compliant, 1=non-compliant.

Appendix Table 2. Implementation by Regulatory Categories

	Regulatory Governance	Regulatory Practices	Prudential Framework	Financial Integrity and Safety Net
BCP				
Industrial	3.729	3.650	3.567	3.700
Emerging	3.194	3.107	2.968	2.964
Developing	3.179	3.153	2.824	2.750
Average	3.367	3.303	3.120	3.138
IAIS				
Industrial	3.100	3.563	3.400	3.550
Emerging	2.923	3.148	2.986	2.714
Developing	2.364	3.122	2.625	2.708
Average	2.796	3.277	3.004	2.991
IOSCO				
Industrial	3.586	3.600	3.733	3.593
Emerging	3.153	2.952	3.230	3.031
Developing	3.074	2.667	3.102	2.698
Average	3.271	3.073	3.355	3.107

Grades of implementation: 4=complaint, 3=largely complaint, 2=broadly complaint, 1=non-complaint.

Regulatory Standards: Main Gaps and Suggested Response

Regulatory Component	Main Gaps	Suggested Response
Regulatory Preconditions	• A framework for preconditions for effective regulation and its implementation is not expressly included in the standards. • Interlinkages between specific preconditions and principles of good regulation are unclear. Guidance is missing on how preconditions affect the macro-financial situation, the crisis management framework, and overall implementation. • Strong reliance is placed on regulatory judgment on how weaknesses in preconditions can be compensated for.	• Preconditions could be made an integral component of the standards framework. (Insurance has incorporated preconditions in 2003 which could benefit from strengthening.) • Interlinkages between legislative and the judicial processes and effective regulation (enforcement, sanctions and remedial action) could be covered in detail. • Evaluation of implementation should require an assessment of the application of "rule of law" and of "debtor discipline" by the judicial system. • Specific guidance could be provided on how preconditions affect implementation of other regulatory components.
Regulatory governance	• Focus is mainly on regulatory independence. Implementation guidance is, however, missing on defining and evaluating regulatory independence in some common situations. • Other components of regulatory governance (accountability, transparency and integrity) are not adequately covered by the governance-related requirements in all sectors. • Regulatory surveillance of macro-financial issues and monitoring overall financial stability is not an expressly-stated objective for regulators. The objective of reducing systemic risk is noted, but the term is undefined and applied differently across sectors. • Standards adopt a segmented, or 'silo' approach toward regulation. Thus the issue of regulatory overlap is not explicitly dealt with.	• Regulatory governance requirements could be expanded, harmonized, and made applicable to all types of regulatory bodies (solo or integrated). Guidance could be provided on the pros and cons of different approaches to regulation (individual versus integrated, and prescriptive versus reliance-based). • Guidance could also be provided to facilitate the assessment of regulatory governance components, particularly independence. • The concept of systemic risk could be clarified and the monitoring and reduction of such risk could be included as a regulatory objective.

Regulatory Component	Main Gaps	Suggested Response
		• The standards framework should facilitate regulation of all types of financial activities, without gaps and overlaps, while promoting a fair and equitable competition. • Guidance is required on assessing the adequacy of regulatory resources.
Regulatory Practices	• Cooperation and information sharing are mentioned but the focus is more on the ability to share information rather than on the actual practice and effective mechanisms of information sharing on conglomerates. • The standards lack guidance for regulators on how to develop techniques to adequately address the risks posed by financial conglomerates and cross-sectoral products and services, including regulatory vulnerabilities arising from on and offshore financial activities. Guidance is also absent on how regulators should identify the systemically important cross-border, cross-sector firms.	• Requirements could be tightened on effective exercise of powers within an accountable framework ("ladder of intervention"), and for monitoring sectoral and cross-sectoral risks and not just institution-specific risks. • Regulatory authorities, in cooperation, should have powers to monitor all relevant activities of conglomerates, including those of affiliated unregulated entities and the different categories of financial institutions within a sector. • Regulatory cooperation could be suggested in the monitoring of risks arising from less-regulated parts of the financial system, especially where market participants are not part of a financial conglomerate. • More guidance could be provided on the identification of vulnerabilities to financial stability in a range of situations, e.g., in an international financial center or a jurisdiction where government-owned entities are prevalent. The need for proper oversight by both parent organizations and home country supervisor(s), with relevant information being accessible to the host regulators, could be emphasized.
Prudential Framework	• Risks common across sectors are not being dealt with consistently. Operational and reputational risks are mentioned but not comprehensively addressed.	• A common categorization of risks and their regulatory treatment could be incorporated within the standards, and the extent to which these risks are relevant to each sector.

Regulatory Component	Main Gaps	Suggested Response
	• A lack of consistency exists in the capital adequacy treatment for some financial products and services across sectors. Emphasis is lacking on ensuring that capital must be adequate, both on a group or consolidated level and on a single entity or individual level. • Implementation guidance on risk management requirements, including corporate governance, internal controls, and management of risk concentration is not fully dealt with. In securities, this is particularly the case with respect to market intermediaries and collective investment schemes. The focus of the prudential framework is at the firm level, and not at the level of the system as a whole. In securities, the coverage of secondary market issues does not expressly cover all possible types of securities markets, such as the over-the-counter (OTC) market (interbank derivatives trading and sovereign debt market).	• Further cross-sectoral work could be undertaken to achieve greater harmonization in both the acceptable forms of capital and the level of capital required in respect of particular risks. While cross-sectoral harmonization at a detailed level (such as that of Basel II) may be both unnecessary and unachievable, harmonization at the level of the regulatory standards may well be possible. • Stress testing by financial firms could be suggested across sectors, at the legal-entity level and on a group-wide basis. Regulators should review the results and use the information as part of their own analyses of sectoral and cross-sectoral risks. • More consistent and comprehensive guidance could be provided on corporate governance and internal control as key elements of prudential framework.
Financial Integrity and Safety Net	**Consumer protection** • The banking standard does not explicitly recognize consumer protection as a regulatory objective. The focus is on risks to the bank and less on depositors or other counterparts. Insurance standard does not explicitly address the role of the regulator in the review and approval of products and premium rates, which may affect solvency, consumer protection and market stability. With securities, a stronger focus is placed on protecting investors and ensuring fair and efficient markets. However, deficiencies relating to regulation of secondary markets lead to lower requirements of integrity and fairness. **Financial safety net** • Both the concern relating to "moral hazard" and the role of "lender-of-last-resort" need to be integrated within the standards framework. For cross-sector groups, the safety net arrangement must be able to deal with "ring-fencing" and protecting a part of the group from problems in other	• Standards should highlight the importance of maintaining the confidence of consumers in the fairness and integrity of the financial system. The tools used to achieve this could be appropriate disclosures, and business conduct and conflict of interest rules. In banking, explicit mention could be made to consumer protection as an objective of regulation and the requirement for a mechanism for handling consumer complaints. • In insurance, the regulatory review of products and premium rates, where it exists, must be transparent, timely, and fair. It should not impede market innovation and unduly compromise solvency (through premium rate caps) nor significantly distort pricing. • In securities area, requirements relating to secondary markets should be the same as for other organized markets.

Regulatory Component	Main Gaps	Suggested Response
	parts. The same applies to cross-border groups. In insurance, criteria for assessing the appropriateness of policyholder protection funds are missing.	• Financial safety net issues that arise with respect to cross-sector and cross-border groups could be explicitly addressed. Harmonized criteria for assessing the appropriateness of financial safety net arrangements could be established. • Financial safety net issues that arise with respect to cross-sector and cross-border groups could be explicitly addressed. Harmonized criteria for assessing the appropriateness of financial safety net arrangements could be established.
	Disclosure of information • Different approaches are adopted across standards. In banking, the focus is on regulatory reporting and less on public disclosure. In insurance, emphasis is placed on public disclosure by insurers but at a high level. No uniform requirements exist for disclosure of the financial positions and risk exposures of insurers. In securities, public disclosure of the financial condition of market intermediaries is not directly addressed.	• Further development work on disclosure requirements might be accelerated on a cross-sectoral basis. Responsibility of regulators should include reviewing the manner in which regulated firms are implementing disclosure requirements, so as to ensure that meaningful information regarding their financial position and risks is disclosed. In banking, an explicit requirement for disclosure should be included, while the securities standards should require disclosure of the financial condition of market intermediaries. • For market discipline is to work effectively, requirements regarding public disclosure by market participants and the applicable accounting and auditing standards need to be made comparable across sectors. Standard setters should continue to provide inputs to the developers of such standards and might coordinate their efforts in doing so.