

IMF Managing Director's first Africa visit

De Rato lauds Nigeria's reform efforts

IMF Managing Director Rodrigo de Rato concluded his two-day visit to Nigeria on August 3, noting that he was very impressed by the Nigerian

government's strong commitment to its far-reaching economic and social reform agenda—the National Economic Empowerment and Development Strategy (NEEDS)—but warned against the potentially destabilizing effects of rising inflation. This was the first stop on a three-country visit to Africa, which also includes Gabon and Uganda. In a message to IMF staff from Gabon on August 4, he said that he was closely following the events related to the reported al Qaeda security threat to the IMF headquarters and other financial institutions, while keeping his commitment to meet with African leaders “in support of our important work in this continent.” He reassured IMF staff on steps taken to ensure their security, and stressed the importance of continuing the IMF's work on behalf of its members (see box, page 233).

In Nigeria, de Rato met with President Obasanjo and his economic team, other *(Please turn to page 233)*



From left: Rodrigo de Rato (IMF Managing Director), Abdoulaye Bio-Tchané (Director of the IMF's African Department), and Charles Chukwuma Soludo (Governor of the Central Bank of Nigeria).

New IEO report

Watchdog faults Argentina, but also IMF

In the 1990s, Argentina was held up as a model of successful economic stabilization and market reform. But in December 2001, the country plunged into a devastating crisis when it defaulted on its sovereign debt. Soon afterward, it abandoned the convertibility regime under which the peso had been pegged to the U.S. dollar since 1991. Output collapsed, unemployment surged, and political and social turmoil ensued. These events raised questions about the IMF's role. On July 29, the IMF's Independent Evaluation Office (IEO) released its report on the handling of the crisis. Shinji Takagi, IEO Advisor and team leader for the report, spoke with Christine Ebrahim-zadeh of the IMF Survey about the report's findings.

IMF SURVEY: Why does the role played by the IMF in Argentina's crisis—unlike other cases, such as Indonesia and Korea—deserve special attention?

TAKAGI: In Korea and Indonesia, the IMF wasn't involved immediately prior to the crises, and these crises came as a surprise. But the IMF was involved in Argentina almost continuously for 10 years prior to the crisis.

IMF SURVEY: Why wasn't the IMF able to help Argentina prevent the crisis?

TAKAGI: In all fairness, there is only so much an international institution can do to influence a country's policy choices. Ultimately, accountability for a *(Please turn to the following page)*



Takagi: “The IMF's role as a crisis lender doesn't justify its lending to a country in an unsustainable situation.”

For Managing Director
security update on
IMF, see page 233

229
MD visits Africa

229
IEO report on
Argentina

234
Risk management
in the insurance
sector

237
Cross border
cooperation in
financial sector
supervision

239
IMF 60th
anniversary
reflections

242
Fighting dirty
money

and...

236
New on the web

240
Selected IMF rates



IMF staff may not have fully appreciated the formidable political obstacles in Argentina.

—Shinji Takagi

Insights into Argentina's meltdown

(Continued from front page) country's economic policy must rest with its authorities. But having said that, there are several reasons why the IMF wasn't effective. First, IMF staff may not have fully appreciated the formidable political obstacles in Argentina. The authorities knew what they needed to do, but they didn't have the political ability to deliver. At the same time, the IMF didn't use the available tools from its surveillance and program relationships with Argentina as effectively as it could have. Conditionality was weak, and Argentina's failure to comply with it was often accommodated.

The IMF—although it wasn't alone in this—was also overoptimistic in its estimation of the impact of certain reforms that Argentina was undertaking and of the prospects for economic growth and manageability of debt. As a result, the IMF remained engaged in a program relationship too long, when the policies being supported were inadequate.

When the crisis unfolded and Argentina sought exceptional access, the IMF viewed its exchange rate or debt sustainability problems as manageable. Staff also had very optimistic assumptions about developments in the world economy.

IMF SURVEY: To what extent did IMF surveillance help identify the vulnerabilities that led to the crisis?

Key IEO findings and recommendations

Major findings

The crisis resulted from the failure of Argentine policymakers to take necessary corrective measures sufficiently early. IMF surveillance failed to highlight the growing vulnerabilities in the authorities' choice of policies and the IMF erred by supporting inadequate policies for too long. By 2000, there were concerns about exchange rate and debt sustainability, but recognizing the large costs of exit, the IMF supported Argentina's efforts to preserve the exchange rate regime. This support was justifiable up to January 2001 because large financial support, combined with strong policy corrections, had some chance of success. However, subsequent disbursements, made despite repeated policy inadequacies, only postponed the fundamental resolution of the crisis. In retrospect, the resources used in an attempt to preserve the peg could have been better used to mitigate some of the inevitable costs of exit from the peg.

Pre-crisis period. The IMF correctly recognized fiscal discipline and structural reform, labor market reform in particular, as essential to the viability of the convertibility regime. However, surveillance underestimated the vulnerability that could arise from the steady increase in public debt, when much of it was dollar-denominated and externally held, and

TAKAGI: Surveillance was not sufficiently candid about the inconsistencies between Argentina's choice of exchange rate regime and its other policies. The IMF recognized the need for fiscal discipline and structural reform—labor market reform in particular—to compensate for the fixity of the exchange rate and underpin the convertibility regime. But its surveillance underestimated the vulnerability that could arise from the steady increase in public debt—much of it was dollar-denominated and externally held—and did not consider exit strategies when it became evident that meaningful progress in structural reform was not going to materialize.

Part of the problem was that there were no accurate and timely data available to allow the staff to monitor provincial finances, where a lot of things were going wrong. Also, back then it was assumed that a debt-to-GDP ratio of up to 60 percent was acceptable—if it was good enough for Europe, it was good enough for Argentina. But that ratio was too high for an emerging market like Argentina with a history of defaults, extensive reliance on external borrowing, a relatively small export sector, and limited capacity to collect taxes. A more appropriate ratio, as staff now recommend, should have been, say, 30 percent.

the staff did not consider exit strategies when it became evident that meaningful progress in structural reform was not forthcoming. Long-standing political obstacles proved formidable, but the IMF also did not use the available tools effectively. Conditionality was weak, and Argentina's failure to comply with it was repeatedly accommodated.

Late 2000. The IMF increased its commitment of resources to as much as \$22 billion. The strategy viewed any exchange rate or debt sustainability problem as manageable with strong action on the fiscal and structural fronts, and it might well have worked if the underlying assumptions had materialized and the program had been impeccably executed. The authorities, however, proved unable to implement the policies as agreed, and the successive resignations of two ministers of economy in March 2001 shattered market confidence. Then the new minister of economy began to take a series of controversial and market-shaking measures. Yet the IMF, having no effective contingency plan, continued to disburse and augment funds in support of the existing policy framework.

Mid-2001. It should have been clear that the initial strategy had failed and that Argentina's exchange rate and public debt could not be considered sustainable. However, the IMF did not press the authorities for a fundamental change in the pol-



There were no accurate and timely data available to allow the staff to monitor provincial finances, where a lot of things were going wrong.

—Shinji Takagi

IMF SURVEY: How could the IMF have done a better job of dealing with the political aspects of the crisis?

TAKAGI: That's a very difficult question. As an Argentine economist said to me, if a commercial bank were to lend to a sovereign borrower, it would first carefully assess the country's political situation to determine its prospects of loan repayment. The IMF, in assessing whether loans to Argentina were justified, particularly in 2000 and 2001, didn't do this.

IMF SURVEY: But as lender of last resort of sorts, does the IMF have that luxury?

TAKAGI: As one of the members of the IMF's management team indicated to us, political risk shouldn't be overemphasized because, after all, the IMF is a crisis lender and, by definition, must be willing to lend when no one else is. And the IMF naturally tends to give the "benefit of the doubt" to its members. But at the same time, the IMF's role as a crisis lender doesn't justify its lending to a country in an unsustainable situation.

IMF SURVEY: In the fall of 2000, when Argentina effectively lost access to the capital markets, it approached the IMF for a major increase in financial support under the March 2000 loan, which up to that time had been treated as precautionary. In response, from January to September 2001, the IMF made three decisions to provide exceptional financial support, raising its total commitments to \$22 billion. In December,

the IMF decided to cut off its financial support to Argentina. The decision to call the program off-track was fully justified under the circumstances, but the way in which it was done meant that the IMF was unable to provide much help as the crisis unraveled. Exit from the peg would have been very costly regardless of when it was made, but an earlier shift in the IMF's strategy could have mitigated some of the costs because Argentina's economic health would have deteriorated that much less and more resources would have been available to moderate the transition process.

Key recommendations

IMF surveillance needs to be strengthened further, by making medium-term exchange rate and debt sustainability the core focus. To fulfill these objectives, the IMF needs to improve tools for assessing the equilibrium real exchange rate, examine debt profiles from the perspective of "debt intolerance," and take a longer-term perspective on vulnerabilities that could surface over the medium term. Systematic discussion of exchange rate policy must become a routine exercise on the basis of candid staff analysis.

The IMF should have a **contingency strategy** from the outset of a crisis, including "stop-loss rules"—a set of criteria to determine if the initial strategy is working and to guide the

however, the fifth review of the program was not completed, marking the effective cutoff of IMF financial support. What is your assessment of the IMF's crisis management strategy from late 2000 through the collapse of convertibility in early 2002?

TAKAGI: The IMF knew that there would be large exit costs and thus supported Argentina's efforts to preserve the exchange rate regime. This support was justifiable up to January 2001 because financial support, combined with strong policy corrections, had some chance of success. But after that, further disbursements—made despite repeated policy inadequacies—only postponed the resolution of the crisis.

The Executive Board didn't fully perform its oversight responsibility. It could have explored the potential trade-offs among alternative options, such as disengaging much earlier. Argentina's economic situation would have deteriorated that much less and the resources used to try to preserve the peg could have been better used to mitigate some of the inevitable costs of the painful exit. Of course, this is all hindsight, and the exit itself was bound to have unpredictable political consequences, but I should also note that some within the IMF were advocating an exit option from the beginning of 2001.

IMF SURVEY: One of your recommendations is that IMF support be predicated on a meaningful shift in policy when the sustainability of debt or the exchange

decision on when a change in approach is needed. Where the sustainability of debt or the exchange rate is in question, the IMF should indicate that its support is conditional upon a meaningful shift in the country's policy. High priority should be given to defining the role of the IMF when a country seeking exceptional access has a solvency problem.

The IMF should refrain from entering a **program relationship** with a country when there is no immediate balance of payments need and there are serious political obstacles to needed policy adjustment or reform. Exceptional access should entail a presumption of close cooperation, and special incentives to forge such close collaboration should be adopted, including mandatory disclosure to the Board of any critical issue or information that the authorities refuse to discuss with (or disclose to) staff or management.

To strengthen the **role of the Executive Board**, procedures should be adopted to encourage effective Board oversight of decisions under management's purview; provision of candid and full information to the Board on all relevant issues; and an open exchange of views between management and the Board on all topics, including the most sensitive ones. These initiatives will be successful only insofar as IMF shareholders uphold the role of the Board as the prime locus of decision making.



The Executive Board didn't fully perform its oversight responsibility.

—Shinji Takagi

rate is in question. But wouldn't you agree that any assessment of sustainability and of the genuineness of a shift in policy is probabilistic and does not override the need for judgment?

TAKAGI: That's true. The assessment of sustainability is always a judgment call. Certainly, the economics profession doesn't have the tools to make a precise estimate of the probability that a country will default on its debt. However, the IMF's decision, in September 2001, to continue to lend to Argentina had a low probability of success—and, in our assessment, was not justified.

IMF SURVEY: How does the IEO's assessment compare to the IMF's own assessment of the crisis, "Lessons from the Crisis in Argentina," released in October 2003?

TAKAGI: Largely, we have similar views, especially on the causes of the crisis and the IMF's crisis manage-

ment strategy. But we're a bit more critical about earlier decisions, especially the May 2001 decision to complete the review. We also take a much more detailed look at the decision-making process.

IMF SURVEY: Your report points out that the IMF should have been more attentive to whether Argentina's convertibility regime—the hard peg to the dollar—was consistent with other policies. What kept the IMF from doing so?

TAKAGI: First, a country's right to choose its own exchange rate regime is held very sacred in this institution, and staff and management are very reluctant to challenge the authorities' choice. It's part of the culture. Nevertheless, when it became evident that supporting policies weren't being implemented, the IMF should have told the authorities that they were going down the wrong path and disaster awaited the country. Second, the authorities wouldn't consider any other option because the public wouldn't allow it.

IMF SURVEY: Some critics have said that your report is somewhat unbalanced in that it focuses mainly on the role played by the staff and not so much on the roles of the IMF's shareholders, its Executive Board, and its management—or even the Argentine authorities.

TAKAGI: If there is any bias, it's because the overwhelming portion of the information we had related to the staff. We say very little about the role of the IMF's shareholders because communication between management and individual shareholders isn't documented. And if it were, we wouldn't have had access to it. We did have access to the minutes of the Executive Board meetings as well as the minutes of informal meetings, which were provided by individual Executive Directors.

IMF SURVEY: Some have accused the IMF of yielding to outside market and political pressures to support Argentina.

TAKAGI: The evaluation team is convinced that such a view is incorrect. It's one thing to say that management consulted with major shareholders; it's another to say they yielded to outside pressure against their own judgment. Those closely involved have emphasized that decisions were made in what was, in their view, the best interest of the international community, right or wrong. ■

The staff's response

The IMF's staff share the Independent Evaluation Office's (IEO) basic diagnosis of the crisis, which is similar to their own assessment, presented in the October 2003 staff paper "Lessons from the Crisis in Argentina." They also feel that the IEO report takes an important step beyond the staff paper in its detailed examination of how the IMF's decision-making processes contributed to the course of these events; by doing so, it provides a fresh perspective on IMF governance.

While the staff agree with many of the recommendations and are already acting on them, they do not concur with some of the report's interpretations and conclusions, some of which depend very much on hindsight. As the report itself notes, for example, it does not examine external influences on the IMF's decisions, nor does it consider informal channels by which the Board may have been given information by the staff and management. It may therefore understate the information on which the Board's decisions were based.

An important theme of the report is that the IMF should have taken a step back from the program relationship with Argentina to assess whether the economic policy strategy was on track to achieve its objectives. This is related to the need to strengthen surveillance in program countries, an issue stressed in the 2002 Biennial Surveillance Review. In light of that review, the IMF is taking greater care to ensure that Article IV consultations with program countries pay adequate attention to the issues that are most important from a medium-term standpoint.

A key area in which a more candid assessment of the economic policy strategy would have been desirable in the case of Argentina is the exchange rate regime and its consistency with other policies. The Argentine experience provides a graphic illustration of the need for a more pointed treatment of exchange rate issues in the context of surveillance—notably in staff reports, but also in staff discussions with the authorities and in the Board.

The full text of the IEO report, "Evaluation of the Role of the IMF in Argentina, 1991–2001," along with IMF management and staff responses and the summing up of the Executive Board's discussion of the report are available on the IEO's website at www.imf.org/ieo.

De Rato cautions Nigeria on inflation risk

(Continued from front page) senior government officials, and members of the National Assembly and state governors. He also met with representatives of the business community and labor unions, an HIV/AIDS clinic, and the Nobel laureate Professor Soyinka.

De Rato stressed that Africa ranked very high on his list of priorities and that he recognized Nigeria's critical role as a political and economic leader and as a potential role model for other African countries. Describing his time in Nigeria as a "valuable opportunity to gain a closer understanding of the Nigerian economy," he welcomed the government's implementation this year of a prudent set of macroeconomic policies aimed at achieving macroeconomic stability and further enhancing growth prospects. Sustained implementation of the NEEDS, together with the Nigerian states' parallel strategies (SEEDS), will improve Nigeria's position to better realize its considerable growth potential, he emphasized. However, he also cautioned the Nigerian authorities to take measures to use the excess of predicted oil revenue in a stabilizing way and to reduce inflation, so as not to risk undoing progress achieved so far under economic reforms.

Voicing the IMF's support for the overall thrust and direction of current policies, he particularly lauded the government's efforts to enhance public institutions' transparency and accountability, includ-



Ngozi N. Okonjo-Iweala (Nigeria's Minister of Finance) and Rodrigo de Rato (IMF Managing Director).

ing by participating in the Extractive Industries Transparency Initiative, the Group of Eight Transparency Initiative, and the African Peer Review Mechanism of the New Partnership for Africa's Development. Strengthening the Economic and Financial Crimes Commission and the Independent Corrupt Practices Commission were important steps taken to fight corruption, de Rato noted. He was hopeful that the tangible benefits of these and other recent measures to improve transparency and governance would become apparent soon, thereby allowing the government to allocate more scarce public resources toward poverty reduction.

At the same time, de Rato said that he and the Nigerian authorities agreed that the challenges of achieving higher growth and poverty reduction remain formidable. Meeting these challenges will require that Nigeria persevere with the stabilization effort and reinforce its reform agenda in areas such as privatization, public sector reforms, and financial sector restructuring. To this end, he stressed, timely passage of the pending Fiscal Responsibility Bill would provide the legal foundation for fiscal prudence and transparency at all levels of government.

De Rato announced that the IMF Executive Board had endorsed a request by the Nigerian government for an intensified surveillance framework, which would involve more frequent (quarterly) visits by IMF staff to review the economic policy program and semiannual information reports to the IMF Executive Board. He also pledged the IMF's willingness to help Nigeria in every way possible within the institution's mandate, adding that the IMF will continue to provide support by providing technical assistance in the area of budgetary reforms and monetary management. ■

IMF steps up security

Following a statement on August 1 by the U.S. Secretary of Homeland Security that evidence had been found that IMF headquarters, along with certain other financial institutions, had been targeted by the al Qaeda terrorist organization, Managing Director Rodrigo de Rato sent a message to staff on August 4 from Gabon. He said that all necessary measures were being taken to ensure their safety, in close consultation with the Washington D.C. authorities, the Federal Bureau of Investigation, and the U.S. Department of Homeland Security. He said that it was important to recognize the steps that have already been taken in recent years to bolster security, including fortifying the headquarters building, and that further steps had recently been made. He said that he believed that the IMF was a target "because of the critical role that we play as one of the global institutions that are promoting prosperity for all citizens of the world, including by fostering economic freedom and transparency. It is essential, therefore, that we continue to operate effectively to fulfill our responsibilities for the world economy and the interests of our member countries, including the poorest."

Risky business? It's a new world when it comes to risk management in the insurance sector



Tran: One of the most important changes in recent years has been the blurring of the demarcation line between different sectors of the financial services industry.

With some traditional roles within the financial system shifting rapidly, the IMF finds itself keeping a closer eye on sectors once largely outside its purview. One such sector is the insurance industry, whose risk management and impact on overall financial stability were the focus of a chapter in the IMF's April 2004 *Global Financial Stability Report*. Its findings, presented by moderator Hung Tran, Deputy Director of the IMF's International Capital Markets Department, served as the basis for a June 30 Economic Forum on managing financial risk in the life insurance industry. Joining him on the panel were Charles Lucas (AIG); Grace Osborne (Standard & Poor's), David Strachan (U.K. Financial Services Authority), and Keith Buckley (Fitch Ratings), who provided the perspectives of various industry participants.

"One of the most important changes in recent years in the international financial system," observed the IMF's Hung Tran, "has been the blurring of the demarcation line between different sectors of the financial services industry." The use by banks of credit derivatives first caught everyone's attention, he said, but perhaps a more important development has been the "steady, relative reallocation of credit and other risks from the banking sector to various non-banking sectors, including the insurance industry."

Just how large has this transfer been? The U.S. insurance industry, for one, has for the past couple of years held more nonfarm corporate credit risk than the U.S. banking sector. The transfers of risk to the insurance sector, Tran said, naturally raises questions. And the transfer of credit risk to nonbanking sectors more broadly raises questions about whether risk has been reduced for the overall financial system, or merely shifted to less transparent sectors, with different systems of regulation and, in some cases, less developed credit risk management skills.

For the IMF, this transfer also raises questions about its effect on global financial stability. In the interest of learning more about the new factors shaping financial market activities and of deepening its understanding of risk taking and risk management, the IMF's April 2004 *Global Financial Stability Report* included an in-depth look at developments in the insurance industry, and a similar study of the pension industry will be published in September 2004. On the insurance industry, the IMF's key findings included the following:

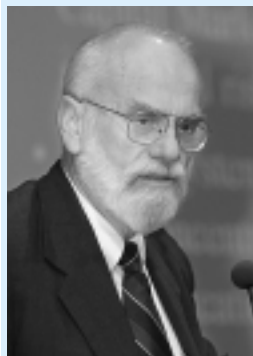
- differences in market characteristics and in regulations were factors behind the sometimes significant differences in the composition of asset portfolios across countries and regions;
- credit instruments are appropriate for the life insurance industry, given the nature of many of its liabilities;
- where credit markets are more developed, insurers have developed greater credit management capabilities and allocate a larger share of their asset portfolios to credit instruments;
- insurance sectors in countries with more developed credit markets and with a larger share of credit instruments in their asset portfolios have tended to be more stable; and
- in light of their experience during the equity market downturn of 2000–02, many insurance companies—particularly in Europe—have increased capital, strengthened risk management, and allocated more of their assets to credit products—that is, corporate bonds and other credit instruments, including credit derivatives.

All in all, these developments have, according to Tran, reduced the risk of balance sheet pressures in the insurance industry. Given also the recently demonstrated strength of the banking sector, the transfer of risk has been, on balance, "a positive development from the point of view of global financial stability."

Sea change in risk management

According to AIG's Director of Market Risk Management, Charles Lucas, the insurance industry is undergoing a huge change in the way it manages risk. It now talks of asset and liability risk much as a finance theorist would. AIG, for example, employs a small army of PhDs in mathematical physics and applied mathematics to build risk management models.

Much attention has been devoted to credit derivatives, but Lucas cautioned against overplaying their role in the insurance industry. It is on the liability side—particularly for life insurance and annuities—that "capital market technologies are invading traditional businesses and causing companies to completely rethink the way in which they construct and risk-manage classes of products." Insurance products are a class of exposure that is appropriately modeled by finance theory-based models (that is to say, inherently stochastic models), while actuarial



Lucas: The insurance industry is undergoing huge change in the way it manages risk.

approaches tend to be deterministic. Indeed, life insurance and annuity products provide benefits and related product features and rights that, for all intents and purposes, are quasi-financial options. What insurance firms are doing, he said, is taking standard finance theory in capital markets, modifying it as appropriate for an insurance contract, and estimating fair value and risk. This then becomes the foundation for hedging of risk using capital market instruments directly. It is in this form, he explained, that “capital markets are really penetrating the insurance industry most immediately.”

The largest question associated with this trend, in Lucas’s mind, is the degree of “culture change” it will entail. He equated it to the sea change that the banking industry experienced 20–25 years ago when financial options appeared and the industry had to learn to think in very different ways and to develop very different analytical tools. Traditional insurance exposure is inherently diversifiable. Option risk, however, is generally not diversifiable, and that is why “it is so difficult to change the way in which these risk management approaches are executed within an insurance company.” You have to think about the problem in “a completely different way and manage the risk in a completely different way.”

Credit derivatives

In the view of Keith Buckley, a Managing Director of Fitch Ratings, credit derivatives have “significant implications for different sectors and different companies in the insurance industry.” He saw the rapidly growing and relatively new market as having the potential for the concentration as well as the dispersion of risk, and he pointed to potential areas of concern—notably information asymmetries, little transparency and disclosure, and the difficulty of tracking credit derivatives by region and sector.

In a survey of the global credit derivatives market published in 2003, and now being updated, Fitch found that global credit risk is being transferred to a variety of nonbanking institutions, including financial guarantors, the insurance and reinsurance industries, and regional banks. The key issues that emerge from the Fitch study, Buckley said, fall into the areas of information and risk management, financial disclosure, and hedge fund activity.

In terms of risk management, he saw most insurance companies as doing a “reasonably good job.” There were, to be sure, varying levels of sophistication, but the less sophisticated also tended to have relatively modest exposure. He was less upbeat on the disclosure front, where he argued that “if you are an outsider looking in and relying solely on public infor-

mation disclosure, you are unlikely to fully understand what companies are doing” in “shaping and reshaping their risks, and what type of risks they are taking on.” That is why, he said, Fitch is pushing hard for better disclosure for outsiders—investors, rating agencies, and the like—to be better able to understand the flows.

And should there be concerns about hedge funds? Anecdotal evidence suggests they may account for 20–25 percent of credit derivative activities, but they did not participate in the survey and tend to be secretive. Buckley added that this simply reinforces the importance of the disclosure issue and the need for more research and continued attention to the broad issue of credit derivatives.

Ratings risks

Both supervisors and rating agencies are meant, in their different ways, to keep an eye on risk management in insurance companies. But, just what does a rating agency do? According to Standard & Poor’s Grace Osborne, the ultimate goal of a rating agency is to “develop a timely, objective, well-informed assessment of the credit risk” associated with the company or issue being rated, and to provide this to the market so that participants can make informed decisions.

It’s an open process, she added, and all of S&P’s ratings and models are posted on its website. And the approach is global and systematic, examining competitive position, management and corporate strategy, operating performance, investment analysis, capital and reserve adequacy, and liquidity or financial flexibility.

When S&P goes into a life insurance company, it tries to figure out what capital is needed, given the risks being assumed. The factors impacting a rating vary, reflecting S&P’s assessment of the associated asset default risk (for credit instruments) or volatility (for equities). And these individual assessments, taken together, also paint larger regional and international trends. Osborne noted, for example, that the North American insurance sector is currently rated higher than its European counterparts, whose equity-heavy investment portfolios were hit hard and whose capital positions were devastated in 2001 and 2002.

But the industry learned from the recent experiences and, in S&P’s judgment, is in better shape today. Osborne saw strong, recovering capitalization; good credit trends; clearly improved asset quality; and greater operating efficiency. And S&P saw these trends continuing in a climate of a gradual rise in interest rates. But there are challenges ahead. Credit spreads have tightened and any sharp rise in interest rates could, she cautioned, have an adverse impact. She also



Buckley: Credit derivatives will have significant implications for different sectors and different companies in the insurance industry.



Osborne: The ultimate goal of a rating agency is to develop a timely, objective, well-informed assessment of credit risk.

saw evidence of increasing “product risk,” and reinsurers backing away from certain products and markets.

A regulator’s perspective

How can a regulatory structure help to support risk management? David Strachan, Director at the U.K. Financial Services Authority (FSA), acknowledged that the life insurance industry in his country saw its struggle with the 2000–02 bear market complicated by a relatively unresponsive capital regime.

What the FSA did, in response, was to suspend its stress test–related constraints and allow individual companies to apply for an exception to some of the rules, if and while they upgraded their risk management systems—all of which produced a “significantly beneficial effect on the market.” The United Kingdom is now moving to a new capital adequacy framework, whose major changes will include: requiring insurance companies to use more modern techniques for valuing options and guarantees, specifically provisioning for expected discretionary payments on insurance products; and insisting on an explicit capital requirement—a capital buffer—for investment risks.

But moving to a much more risk-based capital framework is bound to have some effects. In particular, it is likely to entail rebalancing of portfolios (with the portion of equities dropping from 70 percent at their recent high) as well as hedging of market and other risks, and a reduction in certain policyholder benefits and products.

Complementary roles?

Tran wound up the panel’s presentations with a provocative question. Are rating agencies effectively playing the role of regulators? Buckley, speaking from Fitch’s perspective, said: “We don’t consider ourselves

regulators, we do not want to be regulators, and we don’t want to be characterized as regulators.” Fitch can rate companies and seek voluntary information. It cannot demand or subpoena information or cause insurance companies to take action. But that said, Buckley added, Fitch is pressing its analysts to identify situations on a prospective rather than reactive basis. Osborne essentially agreed, while also acknowledging the influence rating agencies can exert and the capacity they have to develop ways of looking at risk and applying them across the entire sector. Buckley cautioned that the real problem would be the difficulty that both rating agencies and regulators have in assessing the models for capital adequacy and other risks that insurance companies are using. Information is hard to come by, and the range of models in use is “proliferating.” The bottom line, he said, is that the overall assessment of risk models is getting more difficult for both rating agencies and regulators.

For his part, Strachan said he would be “delighted to exchange my postbag of letters from policyholders and members of parliament” with those of S&P or Fitch. He also acknowledged that rating agencies provided a strict and complementary discipline over insurers’ capital. Going forward, he saw complementary responsibilities for rating agencies and regulators, not least because regulators perform functions outside rating agencies’ remit, such as consumer protection, but with rating agencies enhancing the effectiveness of market discipline. ■



Strachan: The United Kingdom is moving to a new capital adequacy framework.

The full transcript of this Economic Forum, “Managing Financial Risks—The Insurance Industry,” is available on the IMF’s website (www.imf.org).

Available on the web (www.imf.org)

Press Releases

- 04/151: Statement by the IMF Staff Mission to Honduras, July 16
- 04/152: IMF Managing Director Rodrigo de Rato to Visit Africa, July 20
- 04/153: IMF Executive Board Approves PRGF for the Republic of Mozambique, July 20
- 04/154: IMF Completes Third Review of the Republic of Tajikistan’s Three-Year PRGF Arrangement and Approves \$14.5 Million Disbursement, July 21
- 04/155: Statement by IMF Staff Mission to Angola, July 21
- 04/156: IMF Statement on Madagascar, July 21
- 04/157: IMF Gives Final Approval of Ghana’s Second Review Under the Poverty Reduction and Growth Facility and the Completion Point Under the Enhanced HIPC Initiative, July 23

- 04/158: IMF Approves \$8.2 Million in Emergency Post-Conflict Assistance for the Central African Republic, July 23
- 04/159: Statement by an IMF Staff Mission in Brazil, July 27
- 04/160: IMF Completes Second Review of Guyana’s Performance Under the PRGF Arrangement, Approves Disbursement of \$8.8 Million, July 28
- 04/161: IMF Completes Second Review Under Bangladesh’s PRGF Arrangement and Approves Activation of the Trade Integration Mechanism, July 29
- 04/162: IMF Deputy Managing Director Agustín Carstens’ Statement at the Conclusion of a Visit to Papua New Guinea, July 29
- 04/163: IMF Completes Eighth Review Under Stand-By Arrangement with Turkey and Approves \$661 Million Disbursement, July 30

HIPC=Heavily Indebted Poor Countries
PRGF=Poverty Reduction and Growth Facility

Fraudsters respect no borders

Country financial regulators need to boost cooperation, information exchange

With financial markets becoming more integrated and financial services becoming more international, cross-border cooperation among national regulators has become key to financial sector supervision. As part of its efforts to strengthen this cooperation, the IMF's Monetary and Financial Systems Department hosted a conference on July 7–8 to examine the current state of “Cross-Border Cooperation and Information Exchange.” Participants were drawn from onshore and offshore supervisory bodies; agencies combating money laundering and terrorist financing; standard setters in banking (Basel Committee on Banking Supervision), insurance (IAIS), securities (IOSCO), and anti-money laundering and combating the financing of terrorism (FATF); the Egmont Group of financial intelligence units; and the Financial Stability Forum (FSF).

Why convene a conference on cooperation and information exchange? Barry Johnston, Assistant Director in the IMF's Monetary and Financial Systems Department, explained that while each of the standard-setting agencies has provided extensive guidance on cooperation and information exchange, considerable work remains to be done in finding ways to share information, while protecting legitimate rights to privacy and supervisors' confidentiality obligations. The pending issues include sharing information among different sectors (for example, between banking and securities regulators); solving the complexity of multiple gateways for information exchange; and addressing possible differences in the standards' treatment of information sharing.

Why cross-border cooperation matters

Financial markets are global, financial institutions do business beyond their geographical boundaries, and fraudsters respect no borders, Ethiopis Tafara (U.S. Securities and Exchange Commission) and Tom Snow (U.S. Department of Justice) observed. Nevertheless, regulators' and law enforcement agencies' authority stops at national frontiers. The resulting gap between global financial markets and crime, and the limits of national authority create a loophole that can only be plugged by cross-border cooperation and information exchange among national supervisors. Cooperation fosters financial stability and integrity by helping supervisors acquire a consolidated view of the financial institutions they oversee,

regardless of the geographical location of their branches and subsidiaries.

Barriers and gateways to cooperation

The most common impediments to cooperation are secrecy, confidentiality conditions placed on requests, and supervisors' lack of power to collect the information, according to the preliminary results of a survey presented at the conference by Mary Zephirin (IMF's Monetary and Financial Systems Department).

Henry Schiffman and Richard Pratt (consultants) noted the conflict every regulator faces: promoting the public interest in sharing information versus protecting individual civil rights and the confidentiality of commercial transactions. These considerations have shaped the powers and cooperative gateways that legislators have granted to financial supervisors. However, each jurisdiction's legal and regulatory framework has approached the issue somewhat differently, and the gateway provisions therefore differ—hence the need for formal and informal arrangements to bridge the disparities among jurisdictions.

Wide variations in sectoral cooperation

To learn from experience, the conference devoted considerable time to reviewing the procedures, and the constraints, in each of the major financial sectors.

Banking In banking, Charles Freeland (Basel Committee on Banking Supervision) pointed out that the Basel Committee did not recommend a particular mechanism or formal agreement for information sharing. Both Yiu-kwan Choi (Hong Kong Monetary Authority) and Eva Hüpkes (Swiss Federal Banking Commission) explained that their jurisdictions do not require a formal agreement to share information with overseas counterparts, provided the recipient authorities are subject to adequate secrecy provisions in their own jurisdiction—a practice that other panelists endorsed.

Chris Gaskell (Australian Prudential Regulation Authority) noted the difficulty for a supervisor (whether home or host) in disclosing information to overseas counterparts in the context of looming problems in a particular bank. The concern in disclosing such information is that it could trigger premature action that could compromise recovery efforts.

A particular challenge to small jurisdictions, Rochelle Delevaux (Central Bank of The Bahamas) indicated, is “asymmetry” in relations with larger



Tafara: Financial markets are global, financial institutions do business beyond their geographical boundaries, and fraudsters respect no borders.



Carse: In some cases, a foreign offense related to market manipulation can be investigated only if it constitutes an offense under the laws of the authority that has been asked to provide such information.

jurisdictions. Small jurisdictions are subject to the demands of larger states that are sometimes unwilling to reciprocate. Giuseppe Godano (Bank of Italy) raised a similar point in the context of relationships between home and host countries.

Securities. The cooperation requested in the securities sector is often investigative in nature and frequently related to individuals, in contrast with banking and insurance, where the focus is on safety and soundness. Securities supervisors rarely have the relevant information on hand and need to take steps to acquire it, making cooperation relatively more difficult.

IOSCO has responded by developing a multilateral formal agreement. As Tafara explained, this entails the ability to share information with a foreign authority in the context of an investigation under way, conduct an investigation on behalf of a foreign authority, and safeguard confidential information. Most jurisdictions do not allow “fishing expeditions,” and requests for information must be backed up by evidence of an offense. Many jurisdictions also limit cooperation and the provision of information to supervisors who are exercising the same kind of function. David Carse (Jersey Financial Services Commission) noted that, in some cases, a foreign offense related to market manipulation can be investigated only if it constitutes an offense under the laws of the authority that has been asked to provide such information.

Insurance. Information gathering and exchange are less of an issue in the insurance sector, Peter Neville (IAIS) reported. Cheryl-Ann Lister (Bermuda Monetary Authority) explained that the information that the Authority is asked for typically is already in the possession of the supervisors, which greatly facilitates sharing. As in banking, most insurance requests fall into the area of licensing applications, consolidated supervision, and prudential issues. Göbel Henning (BaFin, Germany) reported good cooperation on insurance supervision among the 25 member states of the EU, and with the U.S. Association of Insurance Commissioners. Cooperation in insurance seems also to have been facilitated by various initiatives, such as the IAIS Insurance Laws Database. But, as Henning explained, challenges to insurance supervision also arise from financial conglomerates whose solvency requirements are increasingly difficult to assess.

Combating money laundering and the financing of terrorism. The hallmark of cooperation in combating money laundering and the financing of terrorism is that a fair share of the information exchanged is either customer or law enforcement related. The

issue of collection and sharing of information while protecting civil rights is relatively greater in this context. One of the most significant impediments is the requirement on the recipient supervisor not to pass on information received. However, Paul Wright (U.K. Financial Services Authority) and Jacqueline Wilson (British Virgin Island Financial Services Commission) reported cases where the requesting jurisdiction’s supervisors are legally bound to pass on information to criminal authorities. This evidently limits the scope of information exchange.

One of the areas that appears most in need of improvement is cross-sectoral cooperation. Increased requests for information in the context of fighting money laundering and the financing of terrorism have enhanced the need for cross-sectoral cooperation. Wright explained that, in the United Kingdom’s experience, cross-sectoral cooperation has taken place through “L-shaped” communications—for instance, a domestic regulator contacting a foreign regulator from another sector through its traditional foreign counterpart. To make progress on cross-sectoral cooperation, William Murden (FATF) reported that the FATF is in dialogue with the Basel Committee, IOSCO, IAIS, and the Egmont group to find ways to enhance cross-sectoral information sharing in general, and between financial intelligence units and banking supervisors in particular.

Road map for the future

More work is needed to facilitate cooperation and the flow of information. Standard setters have been encouraged to make more readily available supervisors’ contact information. National authorities were encouraged to publicize information on their legal provisions, gateways, and cooperation requirements (indicating “how” to communicate with them), as well as to publish statistics on information sharing.

For its part, the IMF, in collaboration with the standard setters, was encouraged to take stock of existing barriers, gateways, and practices. This exercise, participants suggested, could compare the principles on information exchange that exist in the four standards, identify common elements as well as differences, and suggest ways to strengthen compliance with the standards. ■

Ahmed Zorome
IMF Monetary and Financial Systems Department



Lister: As in banking, most insurance requests fall in the area of licensing applications, consolidated supervision, and prudential issues.



Murden: The FATF is trying to find ways to enhance cross-sectoral information sharing.

Photo credits: Henrik de Gyor, Eugene Salazar, and Michael Spilotro for the IMF, pages 229, 233–41, and 243; and Massoud Etemadi pages 242 and 244.

60th anniversary reflections

IMF needs to rethink “the voice and vote” of its members

At a high-level roundtable, held in Rome on July 22–23 and organized by the Reinventing Bretton Woods Committee and the World Economic Forum, “Sixty Years After Bretton Woods: Developing a Vision for the Future,” Jack Boorman, Consultant and Advisor to IMF Management, offered his thoughts on how to build further on the IMF’s record over the past 10 years of adapting itself to changes in the world economy.

Over the past decade, Boorman observed, the IMF has continued to evolve in response to a changing world. It has concentrated increasingly on crisis prevention, created new lending facilities and closed down such facilities no longer in demand, transformed itself into an exceptionally transparent institution, changed its staffing and structure, and vastly expanded its well-respected and heavily demanded technical assistance and training activities. At the same time, it has taken on new responsibilities.

The important thing now, Boorman argued, is to build on this record. He focused his remarks and suggestions on three specific areas for further change at the IMF: governance, surveillance, and the institution’s role in emerging market countries.

Governance at the IMF

Perhaps the broadest issue concerning governance for the IMF as an institution involves the “voice and vote” of its members, Boorman said. As the world becomes more complex and more closely integrated, there may have to be a different balance within the IMF and other international institutions between the ceding of more sovereignty by nations to the broader international community and applying the principles of subsidiarity. And, he emphasized, whatever sovereignty is ceded by the membership under the IMF’s Articles of Agreement, it should not be taken back over time through individual decisions. Major countries, in particular, need to play by the rules and refrain from using political power outside the IMF to force decisions within it. Smaller countries, for their part, need to resist the temptation to be passive when the major countries act this way. Moreover, all members must show renewed commitment to working through consensus.

The failure of voice and vote to keep up with changes in the world economy is reflected in distorted representation at the IMF, Boorman noted, citing, for

example, the seven largest Asian countries (other than Japan) having lower aggregate quotas than Austria, Belgium, Denmark, Finland, Norway, Sweden, and Switzerland—despite having seven times the share in global GDP and significantly larger trade. While not making an argument for any particular quota formula, he did suggest that quotas be based primarily on members’ participation in trade and financial flows. In the absence of change in this area, Boorman warned, such distortions would tarnish the legitimacy of the IMF’s decision making. To improve the institution’s efficiency, Boorman also suggested that the number of chairs on the IMF Executive Board be reduced, combined with an upgrading of the seniority of Executive Directors within their own governments.

Surveillance

Turning to the issue of surveillance—the IMF’s oversight of its members’ economic policies—Boorman remarked that this remains a poorly understood responsibility of the IMF and of its members—often visible only to a small group of officials. While the IMF is recognized as having staff that do first-rate work in this area, there remain basic questions as to the purpose of surveillance, as well as its audience and effectiveness.

In the first instance, Boorman noted, surveillance is a means of determining whether each member country is respecting its responsibilities under Article IV of the Articles of Agreement with regard to its exchange rate policies. The breadth of policies this encompasses is, in fact, wide. The IMF also advises and assists its membership through surveillance. In addition to macroeconomic assessment, which is the “stock in trade” of surveillance, country officials want IMF staff to bring the experience of other countries to the problems they are currently confronting. To be better able to share experiences and lessons across its membership, the IMF needs to distill the broad experience of its members and make sure the staff are conversant with those lessons, Boorman said.

The first requirements for effective surveillance are technical competence and some degree of political savvy. But another requirement—and the essence of crisis prevention—is the ability to get country authorities to take proper action when vulnerabilities threaten. Boorman raised the question as to whether this is best done by private persuasion or public warnings and asked whether this issue had been fully

Major countries, in particular, need to play by the rules and refrain from using political power outside the IMF to force decisions within it.

—Jack Boorman

The IMF needs to distill the broad experience of its members and make sure the staff is conversant with those lessons.

—Jack Boorman

resolved in the IMF's otherwise welcome moves toward greater transparency. Although much of the push toward transparency has been done voluntarily, the challenge as to how this would affect the IMF's role of confidential advisor and spur to policy action, versus its new role as informer of markets, requires further reflection. A difficult question, Boorman said, is whether the willingness of country officials to openly share information can be preserved if the staff are also writing, in effect, for markets.

IMF's role in emerging market countries

Four issues concerning the IMF's role in emerging markets are worthy of particular attention, said Boorman: signaling, access policy, debt workout mechanisms, and the IMF's policy on lending into arrears.

Signaling is most obvious through the IMF's approval, or not, of financial arrangements with its members. With increased transparency over the last decade, virtually anything the IMF does or says may be interpreted as signaling its views on a particular country, Boorman observed. The most obvious signals derive from approving, continuing, delaying, or halting lending arrangements with countries. But the nature of the arrangement itself also contains signals.

There are continuous calls for IMF signaling mechanisms, but some attempts at response have faltered. For example, the Contingent Credit Lines (CCL), created in 1999, were intended to protect countries from contagion, but the CCL failed from lack of use and have been allowed to expire. The problems are well known: creditors wanted more conditionality and slower disbursements, while borrowers wanted less conditionality and more

money up front; the entry signal would likely be positive and welcome, but the exit could be a problem; some saw moral hazard, others saw policy discipline. And yet others saw a risk of the IMF gravitating toward becoming a rating agency. Boorman noted that these issues will continue to bedevil attempts to create new and more imaginative signaling mechanisms in the IMF, but recommended that any such mechanisms be kept simple. Perhaps the answer, he suggested, is to stay with the blunt instrument of approval of a Stand-By Arrangement (SBA), and greater use of precautionary SBAs, and the more subtle (and public) assessment of a staff appraisal in the context of surveillance—and give up the search for something in between.

The issue of **access policy**, which helps to determine how much a member country can borrow from the IMF, also remains generally unsettled, said Boorman. Calls to restrict access are motivated by moral hazard considerations, alleged benefits of greater predictability for markets, and a desire to rein in IMF management following the Fund's responses to the financial crises of the 1990s.

But each of these motivations is subject to challenge. Few see moral hazard on the debtor side: most governments do not survive crises and are unlikely to invite them simply because the IMF may be there with large amounts of money. On the creditor side, there is an issue, Boorman conceded, but he did not see it as an overriding one, and limiting access to IMF resources is neither a necessary element nor a sensible response to this phenomenon. And, he continued, having the IMF deal more predictably vis-à-vis markets may be a recipe for one-way bets and well-timed exits, instead of appropriate caution.

Moreover, as liquidity needs can at times be large—and it can be appropriate to meet them (as in Mexico in 1995)—the IMF should be able to respond appropriately. Boorman welcomed the moves to put the burden of proof on those recommending exceptional access but hoped that this would not tie the IMF's hands when large resources are appropriate for a country in trouble. In this connection, he also noted that access would not look so large and would not be classified as exceptional if the size of the IMF's resources were better tailored to the new realities of the global economy.

Debt workout mechanisms. Related to access policy—and on the positive side—Boorman said he considered the debate and discussions over the sovereign debt restructuring mechanism, collective action clauses (CACs), and codes of conduct to have been enormously productive. This has not only pushed

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
July 26	1.89	1.89	2.91
August 2	1.91	1.91	2.94

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2004).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Finance Department

practice forward by moving emerging market countries to include CACs in their bond issues but also greatly increased the international community's understanding of the issues. While he did not see CACs as having the power to do what is needed in more complex cases, the international financial system is nevertheless better off than before they became more extensively used. Boorman believes the discussion of some kind of statutory mechanism will be revived in the not too distant future, thereby urging that all of the institutional, academic, and legal work that had been done in the context of the recent debate be kept near at hand.

Concluding his speech with remarks on the IMF's policy on *lending into arrears*, Boorman described this as straightforward, built on experience, and attempting to strike a balance. If a country falls into arrears to its private creditors, he noted, the international community cannot hand the discretion to help that country to those same creditors, who may demand that agreement on a debt deal precede any IMF lending. At the same time, the official commu-

nity needs to recognize creditors' legitimate rights. The country must be judged to be acting in good faith with its creditors in finding a solution to its debt problem in order for the IMF to initiate or continue lending to the country.

Referring to the case of Argentina, he argued that it is untenable to pursue a policy that leaves the determination of such a country's medium-term fiscal path—beyond that required to service debt to the international financial institutions—to the debtors and private creditors rather than to the IMF. This is because, ultimately, the IMF will have to judge the sustainability of Argentina's position under any debt deal that is struck. He further emphasized that if the IMF is to distance itself from a hands-on role in the debt restructuring process, then some will demand that its preferred creditor status be rethought. And this, Boorman said, is a development that would do irreparable harm to the IMF and to its future role in helping countries deal with the debt crises that inevitably will continue to occur. ■

A difficult question is whether the willingness of country officials to openly share information can be preserved if the staff are also writing, in effect, for markets.

—Jack Boorman

Highlights of roundtable discussions on developing a vision for the IMF's future

Coinciding with the 60th anniversary of the IMF and the World Bank, the first roundtable in the series "Sixty Years After Bretton Woods: Developing a Vision for the Future" was held to take a new look at the architecture of the international monetary system. The roundtable discussion gathered senior policymakers from 14 countries, leading financial market executives, and many of the world's foremost academic experts to discuss how international monetary institutions and arrangements should be adapted to meet contemporary challenges. A few central themes dominated the discussions:

Are the U.S. deficit and Asian surpluses sustainable?

Views on the U.S. current account deficit, the related Asian surpluses and reserve accumulation, and the sustainability of each diverged considerably. One side pointed to the U.S. deficit's relatively small share of world savings (10 percent) and the dynamism, growth record, and stability of the U.S. economy. Counterarguments underscored the continued buildup of U.S. liabilities held overseas by official entities, and suggested these were both untenable and risky.

Shifting power to the periphery. Countries at the international monetary system's periphery now have the power to affect the center. With many countries at the periphery maintaining fixed or pegged exchange rates and capital controls, participants argued that different rules are required

for different IMF member countries, with some suggesting a renewal of the debate that took place in 1996–97 on whether the IMF should be given jurisdiction over the capital account as a means to better develop these rules.

Quality institutions matter. Institutional development has lagged stabilization and the improvement of macroeconomic policies in many countries. Participants were nearly unanimous in urging more attention to areas such as governance, the development of supervisory and regulatory agencies, the rule of law, and labor market reform to enable the open market model to succeed and be sustained in the developing world.

How much conditionality? The appropriate extent of conditionality in IMF arrangements was debated, with some participants arguing that the problem was more one of focus and the IMF's will to stick to its demands and resist granting waivers.

Resolving crises. While there was little support for an early reconsideration of the proposal for a sovereign debt restructuring mechanism, there was a widespread and sympathetic view on the need for some kind of standstill mechanism and guidelines for its use as a complement to the IMF's role in capital market crises.

Clarifying IMF and World Bank roles. Some participants called for elimination of the overlap between the functions of the IMF and the World Bank. They saw the IMF as the "financial watchdog" that intervened in financial crises with short-term conditional loans, with the Bank handling the longer-term development and poverty reduction work.

Fighting dirty money

No one quite knows how much money is laundered every year, but informed guesses estimate that the illicit economy could amount to as much as 2–5 percent of world GDP. National law enforcement agencies have been fighting financial crime for many years, and the terrorist attacks of September 11, 2001, made the fight against money laundering and the financing of terrorism a top priority also for the international community. The IMF has emerged as a key player because of its expertise in financial systems and near-universal membership of 184 countries. Camilla Andersen of the *IMF Survey* asked Barry Johnston, Assistant Director in the Monetary and Financial Systems Department, who leads the IMF's financial sector work on anti-money laundering, and Jean-François Thony, Assistant General Counsel in the Legal Department, who is in charge of the legal aspects, about the progress made to date.

According to Johnston, September 11 brought home clearly that “money laundering and terrorism financing are a global problem, and you need to develop global systems to combat them. If one country has a weakness in its system, then there is a risk that the money laundering and terrorism financing will gravitate to that country.”

The social and political costs of money laundering are serious. Organized crime can infiltrate financial institutions, gain control over large sectors of the economy, and corrupt the political system. Dirty money can also destabilize a country's financial systems, and lead to serious financial crisis. “Money laundering may be symptomatic of broader problems of governance within financial institutions and that

can have significant implications for a country's economic development,” Johnston said. Money laundering has, for instance, been a factor in some recent banking crises in Latin American and elsewhere.

How money is laundered

Illicit transfers of money are carried out for two main purposes: to hide the criminal origin of the funds and to protect them from confiscation. According to Thony, criminal proceeds are usually in cash, so the first—and usually the most difficult—thing the launderer has to do is to integrate the cash into the financial system. Once this has been done, the money undergoes a series of transactions, all of which are aimed at having it appear as if it has a legitimate origin.

In the third phase, the funds—now almost clean—are spent or reinvested in the licit economy. According to Thony, this is usually done in one of three ways. “First, through consumption—criminals like big boats, cars, and houses. Second, through normal investment. It is not unusual to see criminals investing as ‘bon père de famille’ in nonrisky instruments such as bonds or annuities. Third, the almost-clean money is invested in businesses such as casinos, restaurants, cinemas, and hotels that typically involve a lot of cash payments. In fact, such businesses can themselves serve as money laundering machines.”

The IMF's role

Because of its expertise in financial matters and global reach, the IMF has become a key player in fighting money laundering and the financing of terrorism. In March, following the successful completion of a 12-month pilot program during which the IMF and its partners assessed the anti-money laundering regimes of more than 50 countries, the institution's shareholders decided to make such assessments a standard feature of the institution's work. They involve the following elements:

- assessing member countries' compliance with an international standard—in this case, the 48 recommendations developed by the Financial Action Task Force (FATF) against money laundering and the financing of terrorism (see box);
- providing technical assistance to member countries to help them meet the FATF's recommendations;
- providing training to other organizations to help them develop the capacity to conduct assessments and deliver their own technical assistance;
- conducting outreach through organizations such as the Global Organization of Parliamentarians

FSAPs are voluntary, but not à la carte!

—Jean-François Thony

The 48 recommendations of the Financial Action Task Force

The Financial Action Task Force (FATF) has spearheaded efforts to counter the use of the financial system by criminals. In 1990, it established 40 recommendations that set out a basic framework for combating money laundering. The recommendations were last revised in 2003 with input from the IMF and the World Bank. Following the terrorist attacks in the United States, the FATF expanded its mission beyond money laundering to also cover terrorist financing, and issued eight special recommendations that aim at denying terrorists and their supporters access to the international financial system.

In August 2002, the IMF and the World Bank endorsed the 48 FATF recommendations as the standard for their operational work.

Against Corruption to build political consensus for the need to take action against money laundering and terrorist financing; and

- conducting research, often in collaboration with other organizations.

This work is carried out in close cooperation with other organizations, including the World Bank, whose staff conduct assessments and provide technical assistance alongside that of the IMF as part of the joint Financial Sector Assessment Program (FSAP). The IMF also works closely with FATF in developing methodology, with the seven FATF-style regional bodies, which conduct their own assessments, and with the United Nations—including the counter-terrorist committees in New York and the global program against money laundering in Vienna. According to Thony, “The efforts of the international organizations can be summarized as, first, making sure that countries have the capacity to fight crime and, second, helping them harmonize their legal frameworks so that criminals or terrorists cannot take advantage of differences in legislation from one country to another.”

Countries, not the IMF, fight the crime

But is it really possible to fight crime with standards? According to Johnston, this is not how the IMF’s work should be understood. “Countries fight crime. Standards simply help us benchmark their capacity so that we can determine whether they have the requisite laws and institutional arrangements in place to carry out that fight effectively.” In this respect, “the assessments are primarily a diagnostic tool for us to help identify strengths and weaknesses in countries’ anti-money laundering regimes. We would then—if the authorities request it—follow up with technical assistance to help them build up capacity.”

Assessments under the FSAP are voluntary, but once a country has agreed to have its financial sector analyzed, assessment against the standard for anti-money laundering and countering the financing of terrorism will also be included. As Thony puts it, “the FSAPs are voluntary, but not à la carte!” To broaden the reach of the assessments, the IMF has also circulated questionnaires to countries undergoing Article IV consultations (the IMF’s regular assessments of its member countries’ economies). Johnston says he hopes that all the IMF’s 184 member countries will eventually undergo assessment, either by the IMF itself, or by the FATF and FATF-style regional bodies.

Unequal treatment?

The IMF also has a special Offshore Financial Center (OFC) Program for assessing nonmember jurisdictions such as Bermuda, the Cayman Islands, the Isle of Man,



Jean-François Thony (left) and Barry Johnston. The IMF has emerged as a key player in the fight against money laundering and the financing of terrorism.

Guernsey, and Jersey (see *IMF Survey*, February 16). In fact, practically all offshore financial centers in the world have already undergone a first round of assessments.

Such thoroughness has led some observers to criticize the IMF and other institutions fighting money laundering for cracking down on small countries with thriving offshore centers, while turning a blind eye to illicit transactions in large industrial countries. According to Johnston, this criticism is misplaced: “The IMF’s approach has always been uniform, voluntary, and cooperative. While we have been assessing a number of small offshore financial centers such as the Bahamas, Bermuda, the Cayman Islands, and the Cook Islands under the OFC Program, we have also been assessing the major countries as part of the FSAP—including, for example, Canada, France, Germany, Singapore, Switzerland, and the United Kingdom.”

Thony says that the perception of unequal treatment may have sprung from the fact that many industrial countries legislated in this area early, and so have had a head start compared to smaller countries with less capacity.

While the industrial countries are ahead in terms of legislation, this has not prevented them from becoming magnets for money that has already been laundered. “Industrial countries become involved usually at the second phase of money laundering. Historically, cash has been introduced into the financial system in countries that have little or no anti-money laundering legislation, where a person could bring a suitcase of dollars to the bank and openly ask the cashier to deposit it into his or her bank account. The money is then transferred into the heart of the most solid financial systems, and at this stage it becomes very difficult to distinguish between a criminal and a legal transaction,” Thony says. However, he acknowledges that,

Money laundering may be symptomatic of broader problems of governance within financial institutions and that can have significant implications for a country’s economic development.

—Barry Johnston



Laura Wallace
Editor-in-Chief
Sheila Meehan
Managing Editor

Christine Ebrahim-zadeh
Production Manager

Camilla Andersen
Elisa Diehl
Jacqueline Irving
Assistant Editors

Niccole Braynen-Kimani
Maureen Burke
Editorial Assistants

Julio Prego
Graphic Artist

Graham Hacche
Senior Advisor
Prakash Loungani
Associate Editor

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 22 times a year, plus an annual *Supplement on the IMF* and an annual index. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Text from the *IMF Survey* may be reprinted, with due credit given, but photographs and illustrations cannot be reproduced in any form. Address editorial correspondence to Current Publications Division, Room IS7-1100, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to imfsurvey@imf.org. The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged \$79.00 annually. Apply for subscriptions to Publication Services, Box X2004, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

August 9, 2004
244



while many loopholes have been closed, money launderers are also becoming more sophisticated.

Poor countries remain the most vulnerable to criminal exploitation of their financial systems. Indeed, recent findings suggest that there is a need to focus the international community's efforts on fighting money laundering where the main risks are. For the IMF, this means spending more resources on technical assistance to help poor countries build capacity. Over the past 12–18 months, the institution has allocated some two-thirds of the resources devoted to this area to technical assistance, with over 80 countries benefiting from the IMF's technical expertise.

Hawala dollars

The IMF is also studying informal transfer systems, such as hawala, which are especially common in the Middle East. These systems are particularly vulnerable because "hawala dollars" leave no paper trail. The challenge is to crack down on criminal uses of these systems without harming legitimate clients, which include foreign workers remitting pay to their home countries.

According to Johnston, there is a need for more research to identify an effective approach. "The private sector is not necessarily averse to regulation per se, because it acknowledges that it faces the risk of being associated with criminal or terrorist financing activities. We are seeking to build a consensus to establish regulation that would not significantly damage the legitimate purposes of informal fund transfer systems."

Results so far

After little more than two years, the work of the IMF and other organizations involved in the fight against money laundering and the financing of terrorism is already seeing tangible results. For instance, before September 11, only four countries had ratified the UN Convention for the Suppression of the Financing of Terrorism. The following year, that number grew to 43. Today, 117 states are parties to the convention.

But the chief achievement may be somewhat less tangible. "The major part of our success is that we

have created a global process," Johnston says. "Before the IMF's involvement, a number of other organizations were conducting their own assessments against the FATF standard, but there was no common approach. The IMF and the World Bank have created a global system using a common methodology. This has improved the utilization of scarce international resources by avoiding the duplication of efforts. In my view, this constitutes a major change in the way the world approaches the fight against money laundering and the financing of terrorism."

Still, Thony acknowledges that he and his colleagues "have no pretension of stopping money laundering tomorrow." One area where more needs to be done, he says, is helping countries establish financial intelligence units designed to centralize intelligence gathered by financial institutions on suspected criminal transactions. "Such units have proved to be a central element of anti-money laundering efforts, but half the countries in the world still need to develop such a capacity," he says.

Critical to the entire effort, of course, is political commitment. "Even though we can get buy-in at the technical level for new laws or strengthening supervisory systems, unless we have the high-level political commitment, things don't happen—the laws don't get passed, resources don't get assigned. We need to ensure that the political commitment is there, internationally, for this effort to be successful in the long run," Johnston says.

The recent revisions to the FATF recommendations have expanded their coverage to a range of new sectors, including charities, accountants, lawyers, and real estate brokers. In this area also, "lower-income countries will face significant challenges in meeting the higher standards, and we will need to be sensitive to their development needs in our assessments and technical assistance," Johnston says. The IMF expects to begin its assessments against the revised standards later this year and is already gearing up its technical assistance and training in preparation. ■