INTERNATIONAL MONETARY FUND

Financial Sector Regulation: Issues and Gaps—Background Paper

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August 17, 2004

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Glossary

BCBS	The Basel Committee on Banking Supervision
BCP	Basel Core Principles
CCP	Central counterparties
CDF	Credit default swaps
CDO	Collateralized debt obligations
CIS	Collective investment schemes
CGFS	Committee on Global Financial System
COIs	Cooperating official institutions
CRT	Credit Risk Transfer
FASB	Financial Accounting Standards Board
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
GATS	General agreement on trade services
GDP	Gross Domestic Product
IAA	International Actuarial Association
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
ICP	Insurance Core Principles
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
LCFI	Large and Complex Financial Institutions
MoU	Memorandum of Understanding
MWGED	Multidisciplinary Working Group on Enhanced Disclosure
NPLs	Nonperforming loans
OTC	Over-the-Counter markets
SFI	State-Owned Financial Institutions
WTO	World Trade Organization

I. Financial System Structure and Trends: Implications for Financial Regulation

1. **Financial systems across the world show considerable diversity and continue to evolve.** This section discusses selected structural features and recent trends in financial systems with important implications for financial sector regulation. These include the following: (i) increased conglomeration and risk transfer; (ii) significant and growing internationalization; (iii) growing dollarization; (iv) weaknesses in infrastructure underpinning regulatory systems; and (v) government ownership of financial institutions. Appendix I in Section I summarizes the key issues and regulatory challenges by region—as brought out by recent FSAP reports—in the same sample of 36 countries covered in the main paper.

A. Increased Conglomeration and Risk Transfer

2. **Growing linkages among different segments of the financial system—banks, insurers, pension funds, securities firms—are a key trend in the financial sectors.** These linkages are increasingly complex, due to a number of factors, including the formation of financial conglomerates and new methods of risk transfer, including credit derivatives.

3. **The main factor leading to the formation of conglomerates is financial system liberalization, allowing cross-ownership among firms in different sectors in many countries.** Improvements in technology, which lowered telecommunication and information costs, have also facilitated the expansion of these financial conglomerates across borders. The industry often cites revenue enhancement and diversification resulting from wider range of products and the ability to offer one-stop shopping to clients and economies of scope in the production of financial services as the reason for growing conglomeration. While there may be benefits in cross-selling some products and services, the evidence on economies of scope is not clear-cut. Globalization of clients of major financial institutions, who demand not only global access to services, but also wide product mix, likely contributed to the conglomeration trend.

4. **In emerging markets, the motivation for conglomeration is similar to the reasons in advanced economies, but the focus on banking has been stronger.** The catalyst here may have been the deregulation pursued in response to macroeconomic pressures and banking crises in the 1990s, combined with higher capital requirements, threatened profits, and an encouragement of more competitive behavior, see BIS (2001) and IMF (2001). Universal banking allowed banks to diversify from traditional commercial banking to retain customers who, for instance, started raising funds through securities rather than borrowing.

5. **The trend in conglomeration globally is documented in recent studies**. The conglomeration trend can be observed both in regions where conglomeration has been historically allowed (Western Europe) and in jurisdictions where restrictions on permissible activities of intermediaries have been lifted only recently (United States and Japan). The evidence on large financial institutions worldwide indicates remarkable increases in conglomeration in some emerging market countries.

6. **More specifically, the evidence in De Nicoló et al. (2003a) comes from an examination of firm-level data for the largest 500 financial institutions worldwide**.[1] These institutions were classified as conglomerates or nonconglomerates based on information on their major lines of business and/or main activities (for example banking, insurance, and securities). As suggested by Table 1 below, the predominance of conglomerates within the top financial institutions has increased between 1995 and 2000 from 42 percent to 60 percent, as measured by number of conglomerates in the sample and from 72 percent to 80 percent, as measured by assets held by conglomerates. The increase of conglomeration has been recorded in all subgroups, from the top 50 to the top 500 firms, with the level of conglomeration being the highest among the largest firms.

Table 1. Conglomeration Trends: by Asset Size

	1995			2000		
		Conglomerates (%)			Conglomerates (%)	
Size	Average Asset Size (bn US$)	Number	Assets	Average Asset Size (bn US$)	Number	Assets
Top 500	299.55	41.8	72.1	646.3	59.6	80.1
Top 250	310.79	69.2	80.7	657.7	72.2	83.6
Top 100	340.37	85.0	86.8	699.0	89.0	91.7
Top 50	379.72	88.0	89.4	769.5	92.0	94.2

Source: De Nicoló et al. (2003a), original data from Worldscope.

7. **In terms of regional trends, conglomeration increased in all regions depicted in Table 2 below as measured by the number of conglomerates among the largest financial firms.** The same holds true—except for the United States—if we measure the prevalence of conglomeration by total assets.

Table 2. Conglomeration Trends: by Region

	1995			2000		
		Conglomerates %)			Conglomerates (%)	
Region	Number of Institutions	Number	Assets	Number of Institutions	Number	Assets
Unites States	102	42.0	78.6	109	61.5	73.0
Canada	18	61.0	87.4	14	71.4	89.6
Japan	127	7.0	44.0	119	21.0	57.3
Australia	9	66.0	81.8	9	100.0	100.0
Western Europe	201	61.7	89.4	162	73.5	91.6
Eastern Europe	–	–	–	4	100.0	100.0
Latin America	5	40.0	64.6	16	93.8	96.3
Asia	32	31.3	31.2	51	64.7	68.4
Africa and Middle East	6	66.0	55.3	16	100.0	100.0
Total	500	41.8	72.1	500	59.6	80.1

Source: De Nicoló et al. (2003a), original data from Worldscope.

[1] Institutions ranked by total assets, as reported in the Worldscope database.

8. **The impact of conglomeration on systemic financial risk is not obvious.** Conglomerates may benefit from economies of scope and product diversification, helping them become more efficient and reduce their risk profiles. On the other hand, firms with a wider range of activities can be tempted to take on more risk, particularly if they are large (as illustrated in Table 1) and may be considered to be "too big to fail" or become difficult to discipline effectively. Also, complex structures may become difficult and costly to manage efficiently (including the management of risk) and the risk faced by the conglomerate as a whole may be larger than the sum of risks faced by individual units since the results of one unit may be affected by the actions of another unit.[2]

9. **De Nicoló et al. (2003a) found that large firms undertaking a wide scope of activities did not exhibit lower levels of risk than smaller and specialized firms in 1995, but exhibited higher risk-taking levels in 2000.** The authors interpret this result to suggest that the factors creating incentives for firms to take on more risk, including moral-hazard-induced incentives, appear to have outweighed the risk reduction potentially achievable through scale and scope economies, both regarding geographic placement and product diversification. It should be noted that these results are still tentative and more work is needed to explore the impact of conglomeration on systemic risk.

10. **From a regulatory perspective, there are several vulnerabilities**. Besides the potential for systemic risk due to contagion, there could be conflicts of interest in the ownership structure. Moreover, the financial safety nets can be de facto extended to nonbank financial firms, if banking activities are not effectively ring fenced and public expectations are not carefully managed. Large conglomerates with complex structures pose particular challenges to understand and supervise effectively. Perhaps even more important, conglomeration increases the opportunities for regulatory and supervisory arbitrage, with firms channeling more risky activities to areas with relatively less developed or stringent regulation and supervision.[3]

11. **Besides conglomeration, other forms of risk transfer within the financial sector have raised concerns of market observers, regulators, and policy makers.** For instance, IMF (2002 and 2004) point out that the recent growth in credit derivatives as complex credit risk transfer instruments and the relative lack of transparency of these transactions have prompted concerns about risks migrating from the banking sector. Recently, various official and private sector organizations have undertaken work, including surveys of market participants, to shed more light on these issues. A Fitch (2003) survey concluded that the global banking industry was a significant buyer of protection, since it transferred nearly US$100 billion of credit risk outside the industry. Also, the Financial Stability Forum initiated work on a study on credit risk transfer in 2003.

12. **IMF (2004) finds that there has been a relatively stronger growth in the credit exposure of the insurance sector compared to the banking sector.** This study also argues

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[2] See De Nicoló et al. (2003a) for a discussion of risk factors involved and additional references.

[3] IMF (2003) and Das, Davies, and Podpiera (2003) explore the potential for systemic issues arising from insurance, on the backdrop of growing interlinkages between the insurance and banking sectors.

that the broader and ongoing reallocation of credit risk could have implications for financial stability. This is despite the fact that the patterns and levels of insurer involvement in credit instruments differ widely across countries and, in gross terms, banks have conducted credit derivative transactions largely with other banks to achieve their desired exposures.[4] However, the cited IMF study concluded, albeit with important caveats, that the relative reallocation of credit risk between the banking and insurance sectors appears to have enhanced financial stability.

B. Significant and Growing Internationalization

13. **The increasing internationalization of financial sectors has been augmenting the regulatory challenges of conglomeration.** As foreign ownership of financial intermediaries increases, systems need to be put in place to ensure proper cross-border coordination among supervisors. At the same time, appropriate adjustments to laws regulations, and deposit insurance systems should be introduced. Effective collaboration among supervisors is growing in importance as financial market shocks become more easily transmitted across borders and sectors. This is not just a problem for regulators in developed countries, but is fast becoming one for a greater number of developing and transitional countries as they become integrated into the global economy and financial system. This of course creates a situation where they are more vulnerable to shocks that are transmitted through patterns of capital flows and international financial markets.

14. **Trends in internationalization have been given an impetus through discussions relating to market access, price limit issues, liberalization of financial sector, and the role of "prudential carve out" in the context of the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS) [see also Box 1]**. As cross-border capital movements become liberalized and exchange rate controls are abolished or reduced, financial markets are becoming increasingly integrated. Furthermore, economic globalization enhances the strategic motives for businesses to expand internationally to compete, spurring a boom in cross-border mergers and acquisitions and foreign direct investment.[5]

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[4] Insurance companies have been found to be a net taker of credit risk through credit derivatives, but the net positions formed only a small part—generally 3 to 4 percent—of their asset portfolios.

[5] One of the consequences of the internationalization of financial flows is the emergence of the major countries' financial systems as major "hubs" for gross international capital flows and investment.

Box 1. Financial Services Liberalization and Regulatory Standards

Financial liberalization, the emergence of integrated financial services, financial conglomerates, and integrated financial sector supervision pose challenges for the current standards and codes. In several countries, some of the basic preconditions for effective supervision remain absent.

Fund staff work has so far focused on the liberalization of the capital account and its sequencing and coordination with the liberalization of financial sector reforms. Although a systematic approach toward issues relating to financial services liberalization and its linkages with trade liberalization has not been fully developed, some efforts have been made in the context of the FSAPs and the work relating to standards assessment.

The main issues concerning the linkages between financial and trade liberalization are related to these issues: (i) sequencing of reforms and the best approaches to create and improve the operation of financial markets and infrastructure; and (ii) market access and movement of capital issues, including prudential rules on licensing financial institutions, and rules governing the handling of domestically-owned and foreign-owned financial institutions.

Although evidence on the benefits and costs of financial liberalization is mixed (Aizenman, 2002), it is usually suggested that liberalization increases the probability of crises (Williamson and Mahar, 1998, Kaminsky and Reinhart, 1999). A stylized fact is that boom-bust cycles in investment, asset prices, and output are preceded by financial liberalization. However, not all countries that have liberalized their financial sectors experienced financial crises (Ishii and Habermeier, 2002). Although economic fundamentals and policies differ from one country to another, a common element of economies avoiding crises appears to be the good management of moral hazard problems. Differences in corporate governance and institutional environment may explain differences in potential fragilities and severity of eventual crises after liberalization (Mitton, 2002, Lemmon and Lins, 2002).

In this regard, Fund work suggests a need for careful sequencing in financial services liberalization, not just in the liberalization of capital flows. Although liberalizing long-term flows is desirable in principle, there is no simple method for devising an operational plan for sequencing and coordinating capital account liberalization with financial liberalization. The present approach regarding financial services rules pursued by a number of bodies (such as the Committee on Trade in Financial Services) suggests that liberalization should be based on verifiable benchmarks and transparency rules. A rules-based approach would bind members in their commitments to the extent that a perceived violation could result in use of dispute settlement procedures. Such an approach raises a number of questions regarding verification and adherence to regulatory standards. The question also arises as to what body would provide verification of adherence. Currently, the competing sets of standards and codes are largely voluntary (“soft law”), and hence not subject to litigation.

15. **Significant and growing internationalization in the banking sector can be illustrated by foreign bank ownership data.** Data compiled on the total assets and foreign-controlled assets in 143 countries across the world (Table 3), (with foreign-controlled assets defined as total assets of banks in which more than 50 percent of equity is owned by foreign entities) shows that in absolute terms, foreign-controlled assets increased worldwide by almost 40 percent between 1995 and 2002. The total foreign-controlled asset share, or the ratio of foreign-controlled assets to total assets, has been growing gradually, from 19.7 percent to 21.5 percent during this same time period.

16. **These developments in foreign ownership have not been uniform.** Foreign-controlled assets have increased most in Latin America, most likely as a result of progress in privatization, and in Europe, due to an advanced process of European integration and ownership consolidation. A significant increase was also recorded in the United States, but the

foreign ownership share in Africa, the Middle East and Central Asia remained virtually unchanged, while East Asia recorded a 5 percent decline in foreign ownership share.[6]

Table 3. Foreign-Controlled Bank Assets: by Region

	1995		2000		2002	
Region	Total Bank Assets (US$ bn)	Foreign Asset Share (%)	Total Bank Assets (US$ bn)	Foreign Asset Share (%)	Total Bank Assets (US$ bn)	Foreign Asset Share (%)
North America (2)	3,759	2.5	5,647	8.2	6,292	9.5
Europe (22)	3,914	23.1	5,664	28.2	6,401	32.5
Latin America (29)	744	12.4	950	19.1	961	24.8
Africa (49)	258	8.7	323	7.8	319	8.7
Middle East (11)	371	25.1	599	22.5	624	26.2
Central Asia (6)	165	15.3	246	15.4	262	13.8
East Asia (24)	10,718	18.4	11,057	13.5	10,493	13.4
All countries (143)	19,928	19.7	24,486	20.7	25,352	21.5

Sources: Compiled from IMF's International Financial Statistics and Fitch-IBCA.

17. **Internationalization may allow economies of scale and favor financial firms' geographic diversification, thereby reducing the risk profile of those firms that expand internationally.** However, the possible capture of the highest quality customers by foreign institutions may leave domestic financial firms to serve a higher proportion of domestic higher risk customers, thereby worsening risk profiles. In addition, protected domestic institutions, such as state-owned banks, may respond to increased foreign competition by venturing into higher risk areas to maintain their franchise value. These developments reinforce the need to look at the challenges posed to supervision of financial sector activities across jurisdictions, such as the growing need for effective coordination of supervisory activities across borders.

C. Growing Dollarization

18. **One of the important trends in financial systems in recent years has been a substantial increase of de facto dollarization**, that is, the domestic use of foreign currency (mostly the U.S. dollar) in many developing, emerging market, and transition economies. In these economies, foreign currency partly assumes all three functions of money—means of payment, store of value, and unit of account. Dollarization can be "official," when the U.S. dollar is adopted as the legal tender, or "partial" when the local currency remains the legal tender but dollar-denominated transactions are permitted, effectively allowing a bi-currency system to take hold.

[6] Notwithstanding, financial systems are dominated by foreign banks in many developing and emerging market economies. For instance, the presence of foreign banks in Cameroon is overwhelming, with foreign banks controlling the majority of the banking systems in Tanzania, Kenya, and Uganda. In the transitional economies of Estonia, Hungary and the Czech Republic, foreign banks have a dominant position.

19. **While financial dollarization has not affected all countries equally, it is widespread, and on an upward trend**.[7] As documented by De Nicoló, Honohan, and Ize (2003), the annual growth rate in dollarization across the world during the 10 years to 2001 has been about 1 percentage point per year. There were important variations in dollarization trends, however, both across regions and across countries. Dollarization increased the most in Latin America and transition economies, increased moderately in Africa, Asia, and the Middle East, and remained constant or slightly declined in the Caribbean and in developed countries (Table 4). Even prior to the recent increases, however, the level of dollarization has been substantial. Most recently available, 2001, data show that deposit dollarization exceeded 50 percent in South America and was close to this level in transition economies.

Table 4. Average Foreign Currency Deposits to Total Deposits

Region	Number of Countries	1996	1997	1998	1999	2000	2001
South America	8	45.8	46.1	49.4	53.2	54.0	55.9
Transition economies	26	37.3	38.9	43.5	44.3	46.9	47.7
Middle East	7	36.5	37.2	37.7	37.5	38.2	41.9
Africa	14	27.9	27.3	27.8	28.9	32.7	33.2
Asia	13	24.9	28.0	26.8	28.8	28.7	28.2
Central America and Mexico	7	20.6	20.8	22.0	22.1	22.5	24.7
Caribbean	10	6.3	7.6	6.8	6.7	6.1	6.2
Developed economies	14	7.4	7.5	7.5	6.7	7.0	6.6

Sources: De Nicoló, Honohan, and Ize (2003), original data from IMF's International Financial Statistics, Economic Data Sharing System, and central banks' statistical publications.

20. **Dollarization can have important implications for financial stability.** Balance sheet effects and the diminished role of central banks as lenders of last resort are usually mentioned among the main risks entailed by dollarization. Although it is suggested that financial dollarization entails not only risks, but also benefits (Baliño, Bennett, and Borensztein, 1999), the exposure to solvency and liquidity risks might make financial systems inherently more fragile. Empirical evidence suggests that financial dollarization may increase the vulnerability of financial systems to solvency and liquidity risks. Cross-country estimates of the impact of dollarization on key financial soundness indicators are consistent with the hypothesis that increased dollarization increases financial vulnerability [see De Nicoló, Honohan, and Ize (2003) and Box 2]. The variance of deposit growth is positively and significantly correlated with dollarization, suggesting that dollarized financial systems may be more exposed to credit cycles and liquidity risk. Based on estimates of nonperforming loans (NPLs) or a composite systemic risk measure, dollarized economies also tend to be more exposed to solvency risk. The main risks likely result from the currency mismatches, which in the event of large depreciation can affect a financial institution's balance sheet both directly and indirectly by worsening the quality of its foreign currency portfolio.

[7] See, for instance, Reinhart, Rogoff, and Savastano (2003). A number of theoretical explanations have been suggested to explain this phenomenon: lack of monetary credibility (Calvo and Guidotti, 1989), moral hazard problems (Aghion, Bacchetta, and Banerjee, 2004**,** Burnside et al., 2001) or optimal portfolio allocations (Campbell, Viceira, and White, 2003).

21. **The limited backing of banks' dollar liabilities by U.S. dollars and their convertibility at par subjects the financial system to a very specific type of liquidity risk**. Systemic liquidity risk arises when the demand for local assets falls, due to a perceived increase in country or banking risk, prompting foreign banks to recall short-term lines of credit and depositors to convert their deposits into dollars or transfer them abroad. Unless liquid dollar liabilities are backed by sufficient liquid dollar assets abroad, banks may run out of dollar liquid reserves and fail to pay off dollar liabilities. Similarly, central banks may run out of international reserves to provide dollar lender of last resort support to distressed banks. When this happens, deposit (or loan) contracts may need to be broken and disruptive or confiscatory measures taken, imposing a heavy cost on the financial system.

Box 2. Dollarization and Regulatory Standards

Do regulatory standards directly or indirectly address the potential risks caused by dollarization? By promoting healthy institutions, ensuring sound supervisory and regulatory frameworks they can help strengthen individual financial institutions. Given the risks posed by dollarization, proper guidance is needed, particularly for emerging and developing market supervisors. Regulators do address dollarization risks directly by improving supervision, regulation, and the quality of surveillance, and indirectly by strengthening financial infrastructure. Moreover, the "preconditions" also assume special importance in the context of the risks posed by dollarized financial systems.

In particular, the principles relating to capital adequacy and risk management, and regulations regarding solvency and liquidity, can help national authorities to deal with potential vulnerabilities posed by dollarization by, for instance: (i) including capital requirements for exchange-rate-related risks; (ii) imposing adequate regulatory limits on banks' open foreign exchange positions; (iii) imposing adequate reserve requirements; (iv) setting out adequate requirements for evaluating asset quality and the adequacy of loss provisions and reserves for loans in foreign currency; (v) establishing adequate systems for the granting and managing of dollar loans and investments; and (vi) requiring banks to have in place proper systems to measure, monitor, and control foreign-currency-related market and material risks.

22. **Dollar deposits are often more vulnerable to runs than local currency deposits, even in the absence of exchange rate adjustments.** In highly dollarized countries, local currency deposits are mostly held for transaction purposes, and are less affected by expected yield differentials than dollar deposits, which are predominantly held as store of value and are close substitutes for deposits abroad or dollars cash. Moreover, even when the demand for local currency deposits is affected, the small size of these deposits in the most highly dollarized countries limits the threat they represent to banks' liquidity.

23. **The lack of dollar monetary instruments can further inhibit the scope for interest rate defenses against deposit withdrawals.** An interest rate defense may be ineffective once a run has started because the central bank has limited ability to raise the interest rate on dollar deposits. Banks are often reluctant to raise interest rates on dollar deposits, because of concerns that increasing rates may be interpreted as a sign of weakness, further exacerbating deposit withdrawals.

D. Weaknesses in Infrastructure Underpinning Regulatory Systems

24. **Regulation is only part of a wider range of measures that are needed to ensure the development, proper functioning and stability of financial systems.** The financial sector and its regulators must rely on the underpinning infrastructure that allows the economy to function properly. These arrangements are largely outside the authority of regulators and supervisors.

25. **The infrastructure underpinning regulation as noted within the various standards differs, but many common features exist.** In the area of banking, as recognized by the Basel Core Principles, this infrastructure includes (i) sound and sustainable macroeconomic policies; (ii) a well-developed public infrastructure, including reliable accounting, auditing, and legal and judiciary systems; (iii) effective market discipline; (iv) procedures for efficient resolution of problem banks; and (v) mechanism for providing an appropriate level of systemic protection (public safety net). In insurance, the first Insurance Core Principle addresses conditions for effective insurance supervision and states that insurance supervision relies on the following principles: (i) a policy, institutional, and legal framework for financial sector supervision; (ii) a well-developed and effective financial market infrastructure; and (iii) efficient financial markets. In the securities area, each jurisdiction is expected to have an appropriate and effective legal, tax, and accounting framework in place.

26. **Recent assessments of compliance with regulatory standards found a number of weaknesses in the underpinning infrastructure.**[8] The most frequent weaknesses in the case of the banking sector were (i) unstable macroeconomic conditions; (ii) obsolete bankruptcy laws, long judicial delays in loan collection and procedures for collateral foreclosure; (iii) weak accounting standards, lack of meaningful financial reports; (iv) inefficient resolution of bank problems; and (v) a widespread presumption that the authorities would not allow any bank to fail. In insurance, some countries have been found to have outdated laws and only few qualified insurance professionals, with other weaknesses—in judiciary and accounting, for instance—similar to those of banking. In securities regulation, the most frequently cited concerns relate to the inadequacy of the general bankruptcy and insolvency procedures, with enforceability of legal obligations, the operation of the judicial system and the quality of accounting standards being other major concerns.

27. **A survey of published Basel Core Principles (BCP) ROSCs, focusing on the preconditions for banking supervision, suggests that there are only minor weaknesses in developed countries** (Appendix II presents detailed results).[9] Preconditions for effective banking supervision are generally in place in advanced economies; in fact, in none of the five cases has there been any significant concerns reported. The ROSCs suggest that accounting and auditing are generally well developed and in compliance with international standards.

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[8] See IMF (2001, 2002b, and 2002c).

[9] FSSAs for 39 countries have been published and are available at www.imf.org. Several of them, however, do not discuss the preconditions in any detail, so our sample consists of 31 countries (5 advanced, 10 developing, and 16 emerging market countries).

Transparency requirements generally appear to allow investors to evaluate the financial condition of credit institutions. A range of corrective measures is available and, apparently, no major obstacles to their use exist. The legal framework is well established and comprehensive, the judiciary is well developed, and no problems with credit culture are reported.

28. **In developing countries, a number of shortcomings in the underpinning infrastructure were observed.** Transparency is rather low, at times due to opaque financial statements and problems in accounting and auditing. Although some countries have moved to International Accounting Standards (IAS) recently, there are problems with application of the standards. There are exceptions, however, where national accounting standards are closely aligned to IAS with relatively solid disclosure practices. Supervisors in developing countries generally have a range of corrective measures for problem bank resolution, but their practical application is often weak and slow.

29. **The emerging market economies exhibit considerable heterogeneity.** Some countries benefit from well-functioning accounting systems, auditing in line with international standards, considerable disclosure requirements, and efficient legal and judicial systems (albeit with some gaps). However, many emerging markets that recently experienced the transition to market economies face substantial challenges in making their accounting systems consistent with international practices, and the need to test and properly implement recent changes in their legal system.

30. **Overall, published ROSCs point to significant problems in preconditions, primarily in emerging and developing countries.** However, despite favorable ROSC assessments, advanced economies have not avoided manifestations of weaknesses in infrastructure in recent years. Since the late 1990s, aggressive accounting practices by some companies, lapses in investor oversight, and gaps in regulatory enforcement have been observed. In the past two years, investor trust in reported earnings and accounting practices was shaken by several major restatements of earnings by high-profile firms in North America and Europe, including WorldCom, Xerox, Parmalat, Vivendi and Nortel. These incidents brought the issues already raised by Enron's collapse into sharp focus, fueling the debate over accounting, disclosure and transparency issues. The need to further develop information-sharing mechanisms between regulators, both domestically and internationally, was also highlighted by these incidents.

31. **The relationship between preconditions and implementation can also be illustrated by the correlation between governance indices and average level of regulatory standards implementation.** To illustrate this point, an index of average implementation of three standards—BCP, IAIS, and IOSCO [10] core principles—is used for 36 Fund member countries. In these countries, an evaluation was undertaken across banking, insurance, and securities sectors in the context of the joint Bank-Fund Financial Sector Assessment Program (FSAP). All three standards classify the level of implementation of individual principles into four categories, denoted as compliant, largely compliant, broadly compliant, and noncompliant. Each of the categories was assigned a numeric value, from 4.0 (compliant)

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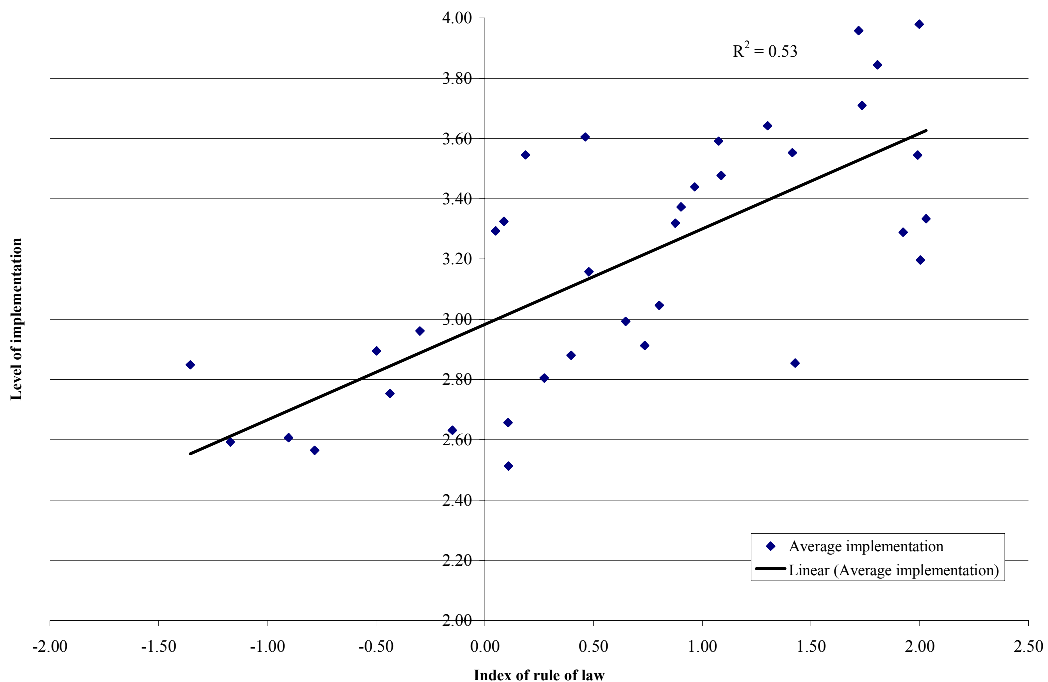
[10] Representing the Basel Core Principles, International Association of Insurance Supervisors, and International Organization of Securities Commissions.

to 1.0 (noncompliant). Simple averages of the regulatory principles compliance were used to obtain average level of implementation across the three standards. As a measure of preconditions, indices were used of the rule of law and overall government effectiveness compiled by Kaufmann, Kraay, and Mastruzzi (2003).[11]

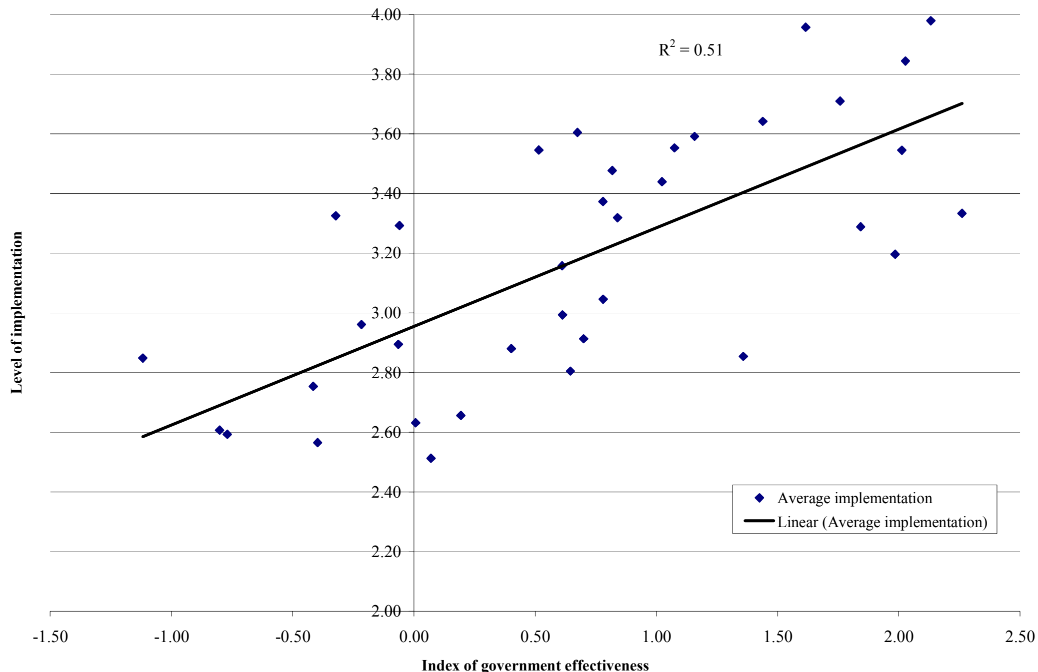
32. **The data show a clear positive relationship between rule of law and government effectiveness on one hand and the average level of implementation of standards on the other hand** (Figures 1 and 2). However, the level of preconditions observance—the rule of law index as well as other governance indicators like overall government effectiveness—is also positively correlated with the level of income across countries. In fact, the correlation coefficient between the rule of law and income was 0.84 in our sample, while the same indicator for government effectiveness and income stood at 0.85. 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.

Figure 1. Rule of Law and Implementation of Regulatory Standards



[11] 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.

Figure 2. Government Effectiveness and Implementation of Regulatory Standards



E. Government Ownership of Financial Institutions

33. **In many countries, the financial system structure is characterized by the prevalence of state-owned financial firms.** While the phenomenon of state ownership is more common in the banking industry, it is also seen in the insurance and securities sectors. State ownership generates special concerns which may not be addressed fully by the sector standards. We explore the first issue—the implications of government ownership—in this subsection.

34. **La Porta, Lopez-De-Silantes, and Sleifer, (2002) document the continuation of a large and pervasive government ownership of banks around the world.** Based on a sample of 92 countries, the authors found that in an average country 42 percent of the equity of the 10 largest banks was owned by the government in 1995. While this share was down from 59 percent in 1970, apparently due to the transition to a market economy in many countries, it remains sizeable.

35. **A recent Fund staff survey confirms that governments continue to be a major presence not only in banking, but also in the areas of insurance, contractual savings and investment schemes.**[12] In banking, despite several privatization initiatives over the past decade, public sector banks still account for an estimated 40 percent of total banking sector

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[12] Preliminary results of the survey were presented at the conference "The Role of State-Owned Financial Institutions" organized by the World Bank, IMF, and the Brookings Institution in April 2004 (available at www.worldbank.org/wbi).

assets. The survey also shows that a government presence also exists, albeit in a lesser degree, in insurance and contractual savings and investment schemes. In addition, although it is often more prominent in the developing world, a government presence can also play an important role in the developed world, taking a variety of forms from explicit (banking in Germany) to implicit (government-sponsored enterprises in the United States), see Table 5.

36. **The size of the SFI sector can be significant (Table 6).** In the sample, the size of the assets of the state-owned financial institutions (SFI) varied from insignificant to 159 percent of GDP. Among the different types of institutions, banks tended be the most significant in size, with the largest a single bank having assets equal to 47 percent of GDP, development banks 13 percent, insurance companies 2.9 percent, development financial institutions 2.3 percent and a pension fund 18 percent. The size of the assets under management of AMCs was not given.

Table 5. State-Owned Financial Institutions: A Cross-Country Survey

	Advanced Economies		Other Emerging and Developing Economies		Total	Total
	Institutions	Countries	Institutions	Countries	(Institutions)	(Countries)
Commercial banks 1/ 2/	19	5	56	11	75	16
Development banks	4	4	9	5	13	9
Commercial cum development banks	1	1	9	3	10	4
Postal banks	1	1	2	2	3	3
Nonbank finance companies	0	0	2	2	3	3
Development financial institutions	1	1	6	2	7	3
Leasing companies	0	0	2	1	2	1
Mutual guarantee companies	21	1	0	0	21	1
Insurance companies 3/	3	2	2	2	5	3
Asset management companies/funds	0	0	10	3	10	3
Mutual funds	0	0	2	1	2	1
Pension/provident funds	0	0	3	2	3	2
Investment companies/funds	0	0	4	1	4	1
Health insurance fund	0	0	1	1	1	1
Total 4/	50	–	108	–	159	–

1/ Under commercial banks, advanced economies, institutions, includes one bank providing both banking and insurance services, and another bank providing banking, insurance, and asset management services.
2/ Under commercial banks, other emerging and developing economies, the total number of institutions includes four banks providing banking and asset management services, and one bank providing banking, insurance, and securities services.
3/ Under insurance companies, other emerging and developing economies, the total number of institutions includes re-insurance companies.
4/ Under the total, advanced economies, the number of institutions exclude 520 savings banks owned by the state and local governments reported by one country for which aggregated data was reported.

Table 6. State-Owned Financial Institutions: Size

Size to GDP (in percent)	Advanced Economies	Other Emerging/ Developing
0-1	3	2
1-10	1	4
10-50	2	6
50-100	1	1
100+	1	1
Total	8	14

Note: Under the size to GDP column, 100+ includes 520 banks excluded from Table 1, which together account for 48 percent of GDP in the country.

37. **State-owned financial firms have the same need for adequate supervision as privately owned banks, insurance companies, and securities firms.** Government ownership creates a number of additional regulatory problems: (i) weak corporate governance structure and management; (ii) political interference with business decisions at the firm, such as taking on risks at unprofitable prices to support a political objective, (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 that would be normally imposed on privately owned firms; and (v) the absence of market discipline owing to the lack of influential public investors or the fact that counterparties assume that the government will bail out or act as a backstop to the obligations that its firms undertake.

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FSAP Assessments and Key Cross Sector Structural and Regulatory Risk Factors (36 countries)

Region	Structural Factors	Regulatory Risk Factors
Africa	***Financial structure*** • Rapid restructuring and liberalization under way. • Entry of new firms and increasing dominance of foreign banks with non bank affiliates. • Entry of internationally active financial conglomerates. ***Intermediation*** • Changing patterns. Growth in cross market products, and regional cross border activity. • Dollarized financial systems. • Linkages between banking and insurance and some evidence of bank assurance. ***Regulatory system*** • Steps toward regional integration, shared financial infrastructure, harmonization of laws and regulations. • Safety net arrangements weak. • Move toward unifying regulatory agencies.	• Operating environment weak and serious macroeconomic risks. • Regulators and regulated at less than arms' length distance. • Regulatory resources inadequate. • Credit risk management poor. • Scenario of exit by foreign banks. • Conglomerates taking advantage of different regulatory, prudential and tax policies. • Single licensing for banks and insurers. • Delays or reluctance to act on problem banks and insurers. • Consolidated supervision not in place, and regulatory cooperation ill defined. • Banks exposed to non deposit taking financial institutions (significant elative to bank capital).
Asia	***Financial structure*** • Large size of financial conglomerates and complex financial institutions in industrialized countries and financial centers. • Conglomerates also active in developing countries. ***Intermediation*** • Actively intermediating cross borders. • Participants in money, foreign exchange markets, and payments and settlement systems. • Stronger ownership and financial inter linkages across banking, insurance and securities. ***Regulatory systems*** • Existence of and move toward unified regulators. • Regulation still on single lines of activity. • Focus on public interest and prudential health.	• Less developed consolidated supervision, growing issues in market conduct, related party transactions, and investment management. • Contagion risk high but channels not well understood. • Problems in measuring interconnectedness and concentration. • Reputational risk factor. • Lack of insolvency regime for internationally active conglomerates. • Scope for regulatory arbitrage due to lack of unified approach to risk and capital.

Region	Structural Factors	Regulatory Risk Factors
Europe	***Financial structure*** • Some countries with a longer tradition of conglomerates. • Cross-sectoral interconnectedness on the rise. ***Intermediation*** • Financial systems strongly exposed to internationalization of capital flows. • Dollarized financial systems in developing countries. • Functional "blurring" occurring most in banking and insurance. • Cross-border, cross-sector, cross-currency transactions. ***Regulatory systems*** • Unified regulators recently set up in several countries.	• Emerging and developing countries practice different approaches toward consolidated supervision. • Unified regulator model, and cross-border, cross-sector conglomerate trends raise concerns relating to the lender-of-last-resort and safety nets. • Rising reputational concerns and risks intrinsic to each sector, both becoming correlated. • Growing moral hazard related to safety nets such as deposit insurance for deposits within a group offering non deposit saving products. • High potential for regulatory arbitrage across sectors.
Middle East and Central Asia	***Financial structure*** • Less evidence of conglomerate structures. ***Intermediation*** • Dollarization of developing country financial systems. ***Regulatory systems*** • No instance of a unified regulator. • Prevalence of Islamic financial principles.	• Stronger regulatory focus needed on the foreign exchange risk.
Western Hemisphere	***Financial structure*** • Prevalence of large internationally and regionally active financial conglomerates. ***Intermediation*** • Conglomerate activities in offshore financial centers • Dollarized financial systems.	• Problem of disclosure and related party and intra group transactions. • Absence of a uniform prudential requirements and accounting systems for financial groups. • Transactions across groups not "fire walled"; some conglomerates connected to nonfinancial companies.

Preconditions in Published BCP ROSCs 1/

No.	Country	Audit, Accounting, and Financial Reporting	Market Discipline	Resolution of Problems in Banks	Public Safety Net	Judiciary	Credit Culture	Legal Framework (Banking and Banking Supervision)	Corporate Governance
1	Finland	Well developed, generally compatible with international standards.	Transparency requirements allow investors to evaluate the financial condition of credit institutions.	FSA has a range of procedures to achieve resolution of problem banks (but these are not anticipatory in nature).	The safety net consists of the Deposit Guarantee Fund and central bank (CB) emergency liquidity assistance.		Credit culture fosters the honoring and enforcement of financial contacts.	Well developed and stable.	No prescribed corporate governance best practice, but no government efforts to influence commercial decisions.
2	Germany			Legal framework for resolution exists, but resolution is sought within the system itself.	Structure of deposit insurance is complex.	Efficient.		Comprehensive and regularly updated.	
3	Iceland	Broadly in line with international standards.						Generally adequate	
4	Luxembourg			The supervisor can use a range of formal and informal corrective measures.	A mutual deposit guarantee scheme providing limited protection to depositors and investors.			Established legal system	
5	United Kingdom	Well developed and subject to full liability for breach of duty	Market discipline is reinforced by the fact that the authorities have publicly stated that it is neither possible not desirable to remove all risk of financial failure.			Well-developed judicial system with a reputation for probity and professionalism			High standards for corporate governance
6	Georgia	Financial statements remain largely opaque.		CB has faced significant difficulties in the efficient resolution of problem banks.			Credit culture is generally weak	Legal and administrative procedures for collateral enforcement need to be strengthened.	Corporate governance remains weak.

No.	Country	Audit, Accounting, and Financial Reporting	Market Discipline	Resolution of Problems in Banks	Public Safety Net	Judiciary	Credit Culture	Legal Framework (Banking and Banking Supervision)	Corporate Governance
7	Kyrgyz			CB can impose a full range of corrective measures and penalties.		Judicial outcomes have at times been unpredictable and there are numerous reports of suspicious political influence within the judiciary.		Legal system appears to be the most serious constraint relating to public infrastructure. Laws are inconsistent and contradictory.	
8	Macedonia					Excessive delays, questionable court decisions, perceived political interference and corruption.	Lack of respect of law and culture of noncompliance and nonpayment.	Broader legal framework generally sound, but implementation and enforcement problematic.	
9	Mauritius	Accounting standards are based on IAS. The level of disclosure in the annual reports of the two large banks is of high standard.		A history of dealing decisively with problem banks; resolution–mostly rescues/takeovers by other banks.	No explicit deposit insurance scheme.	Legal proceedings can take an extended period of time to complete, but generally a strong rule of law.	Credit culture is well established.	Generally appropriate body of commercial law	
10	Morocco					Effort to streamline the operation of courts, commercial courts introduced in 1997.		Profound changes in legal system in recent years, several laws amended.	
11	Mozambique	Substantial further progress required.				The justice system is inadequate, which makes it difficult and time consuming for banks to take action against loan defaulters.	Credit decisions are often not made on an arm's length basis and do not take into account the willingness or ability of the borrower to repay.		Substantial further progress required.
12	Philippines	Accounting standards progressively evolving in the direction of IAS.		A number of procedures for bank resolution exist, but their application is hampered by the absence of coercive legal instruments, forbearance, and the possibility of judiciary interventions.		Developments in judiciary have led banks rely more systematically on contractual arbitrage and settlement outside the courts.		Operating environment for banks has been difficult.	Corporate governance promoted through regulatory changes.
13	Tanzania	Auditing guidelines modeled on international guidelines. Accounting standards closely based on IAS, to be fully harmonized by mid-2004				The judicial system needs to be resourced to enable it to efficiently process commercial litigation.		The legal system is being developed, Land Act one area of concern.	New Companies Act to strengthen some aspects of corporate

No.	Country	Audit, Accounting, and Financial Reporting	Market Discipline	Resolution of Problems in Banks	Public Safety Net	Judiciary	Credit Culture	Legal Framework (Banking and Banking Supervision)	Corporate Governance
									governance, but further strengthening is desirable.
14	Uganda	IAS adopted, but its application remains uneven. Greater disclosure is required.	Government's decision to fully compensate depositors of three closed banks undermined market discipline.	A broad range of remedial measures to deal with problem banks available, but response to developing problems in practice has been weak and slow.	Lender-of-last-resort (LOLR) facility of the CB has been historically available for extended periods without adequate security.			Generally appropriate framework of commercial law. Bankruptcy act outdated and in need of revision.	
15	Ukraine	Accounting standards in the enterprise sector far from international best practices, which makes it very difficult for banks to monitor borrowers.			Formal deposit insurance scheme and LOLR at CB.	The court system lacks expertise in commercial matters, resulting in long delays and legal uncertainty.		Important weaknesses in availability and realization of collateral.	Poor corporate governance in many enterprises.
16	Barbados	Generally sound						Generally sound	
17	Bulgaria	Accounting standards differ from IAS in some respects, but moving to IAS. Corporate accounts unreliable.	Markets unable to exercise discipline over banks	CB effective in closing banks but not in liquidation (slow).		Inefficient		Quite good; but delays in foreclosure up to several years	
18	Croatia	Annual accounts audited, both stand-alone and consolidated; auditors required to report violations to CB. IAS mandatory for banks.		Current Banking Law allows regulator to ensure banks comply with law.					
19	Czech Republic	Banks must appoint external auditors. Accounting standards required, differ from IAS somewhat; major banks use also IAS.		CB needs to work closely with government and other agencies		Inefficiencies and cumbersome administrative procedures impede enforcement	Attempts to remedy legal imbalance favoring debtors.	Legal system in transition, recent changes untested.	
20	Estonia			CB has a reasonable array of instruments to encourage compliance with prudential norms					
21	Hong Kong SAR	Audit in conformity with international standards. Well-functioning accounting system in place; NAS converging to international standards. Extra disclosure requirements in the			No deposit protection scheme in place.			Well-functioning system in place. Gaps: no corporate reorganization legislation.	

No.	Country	Audit, Accounting, and Financial Reporting	Market Discipline	Resolution of Problems in Banks	Public Safety Net	Judiciary	Credit Culture	Legal Framework (Banking and Banking Supervision)	Corporate Governance
		absence of accounting standards for financial institutions.							
22	Hungary			Delays imposed by the law on the use of certain types of remedial actions.					
23	Israel	Broadly in line with international standards.		No significant hindrances to application of remedial actions.	No deposit insurance.			Adequate	
24	Korea	Not fully compliant with IAS, moving to be fully consistent for banks.	Scope for strengthening market discipline by implementation of IAS and enhancing financial transparency of corporations.		Comprehensive public safety net and an explicit deposit insurance system.	Relatively efficient court system.		Significant body of recently revised laws.	
25	Latvia	Annual accounts audited by an auditor approved by the central bank.		CB is entitled to revoke licenses in the event of noncompliance.					
26	Lithuania	Scope for further progress.						Scope for further progress.	Scope for further progress.
27	Malta	Banks audited by recognized international auditing firms. IAS required for financial and enterprise sectors.		Broad framework for resolution of distressed banks if provided in banking legislation.	A new deposit insurance scheme, developed along EU standards, was introduced.	Foreclosure process can be lengthy and costly given the inefficiencies in the legal system.		Generally adequate. Legislative framework dealing with collateral and loan recovery requires strengthening.	
28	Mexico	Nontransparent disclosure of banks' financial condition.	Market discipline weak due to implicit blanket guarantee provided by the government.	Lack of well-defined process for the closure, resolution and liquidation of banks.	Universal deposit guarantee, to be gradually changed to limited guarantee.			New secured lending and bankruptcy laws need to be tested.	
29	Singapore	Standards of auditing are based on the international standards; banks employ international accounting firms as auditors, who have legal responsibility to report problems to the				The legal system operates efficiently, enabling creditors to secure interests in collateral or force bankruptcy or receivership on		The legal system incorporates well-established and globally accepted principles.	

No.	Country	Audit, Accounting, and Financial Reporting	Market Discipline	Resolution of Problems in Banks	Public Safety Net	Judiciary	Credit Culture	Legal Framework (Banking and Banking Supervision)	Corporate Governance
		supervisor. Accounting standards follow closely IAS. Banks face a statutory requirement of continuous disclosure; listing rules required additional disclosure.				delinquent debtors without undue delay or costs.			
30	Slovak Republic	Banks are audited, based on accounting standards, but foreign-owned banks increasingly receive dual audits (also IAS). Accounting standards different from IAS, which impacts the usefulness of bank reporting. Disclosure practices lag behind international best practices.	Market discipline is generally weak.	Exit policies should be improved, experience suggests weaknesses in bankruptcy law and procedures when applied to banks.	Deposit insurance is provided by currently insolvent Deposit Protection Fund.	General court procedures need strengthening to provide enforceability of contracts, collateral, and creditor rights.		A number of changes made recently in the legal framework.	Lags behind international best practices.
31	Slovenia				A replacement of the blanket deposit guarantee by limited deposit insurance scheme is imminent.			New EU-consistent banking law and numerous regulations have been adopted, implementation will be important.	

Source: Distilled from individual country ROSCs.
1/ CB = central bank, MoF = Ministry of Finance

II. Assessment of Regulatory Standards: An Update on Levels of Observance

38. **Assessments of regulatory standards are undertaken, primarily in the context of the FSAP**. The assessment findings are used to support the broader assessment of the macroeconomic and structural risks affecting financial systems. The FSAP also provides a common platform for policy advice and technical assistance relating to the implementation of regulatory standards. Specifically, the standards assessments under the FSAP are aimed at: (i) identifying regulatory strengthens, risks and vulnerabilities, (ii) assessing the level of observance of regulatory standards, (iii) ascertaining the financial sector's developmental and technical assistance needs; and (iv) prioritizing financial sector policies to meet these needs.

39. **Since the inception of the FSAP, 158 assessments of regulatory standards have been carried out as of end-June, 2004** (see Appendix I in this section).[13] These assessments have aimed at providing country authorities with: (i) a comparison of their regulatory system with the internationally accepted benchmark in this area, (ii) an identification of regulatory vulnerabilities that could feed into the overall assessment of the risks and vulnerabilities their economies are facing; and (iii) developmental needs pertaining specifically to financial regulation and to make informed policy decisions about the reforms needed. Motivated by the need to develop comprehensive and thoroughgoing standards assessment tools and techniques, Fund (and Bank) staff have been working with the respective standard-setting bodies to prepare methodologies, templates, guidance notes and review techniques to strengthen the assessment process.

40. **The experience thus far, has however, raised the following practical issues relating to the assessment process**: (i) how to assess actual implementation; (ii) the best way to account for country-specific factors; (iii) application of standards and the individual principles on the basis of their relative significance depending on stages of development and the regulatory preconditions; and (iv) cross-sectoral issues and interdependencies between standards.

41. **To address some of these issues, the Fund staff (together with the Bank staff) has adopted a four-pronged strategy, which encompasses:**

- An analysis and review of the experience with the assessment of individual standards. Based on the analysis, provide feedback to the standard setters suggesting issues to be considered while reviewing the standards and assessment methodologies.

[13] The regulatory standards assessed under the FSAP consist of: (i) Basel Core Principles for Effective Banking Supervision (BCP); (ii) International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation (IOSCO Principles); and (iii) International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP); in addition 14 of the 37 assessments have been carried out outside the FSAP, under the OFC Program.

- Obtain feedback from national authorities on the assessment experience and determine usefulness of the assessment outcome.

- Discuss with the FSAP mission chiefs and Bank-Fund staff the relevance of the standards assessments in the diagnosis of a country's financial system vulnerabilities and development priorities.

Cooperating official institutions

42. **Drawing upon the expertise of the Fund-Bank staff and experts from Cooperating Official Institutions (COIs), the regulatory standards assessment framework offers "peer review" of national regulatory, and oversight systems**. Fund staff has worked closely with COIs in identifying experts for use in various FSAPs. Starting from a small base in FY 2000, the list of COIs now comprise over 65 institutions (Appendix Table I in this section).

43. **The assessments are based on on-site discussions with country regulators and market participants**. Regulators primarily come from the supervisory agency, but discussions are also held with the staff from the other agencies. The draft assessment is required to be discussed with the regulators with a view to ensuring the accuracy of the information on which the assessment is based. This provides them with an opportunity to react to the assessment. The assessment template requires that authorities' views are recorded together with any disagreements about the assessment remain after these discussions. The draft assessment is usually discussed again at the end of the mission with a wider group of country authorities and left with them.

A. Basel Core Principles

44. **The last review of compliance with the BCP was carried out and reported to the Board in 2002 (SM/02/310)**. This update reveals that the overall profile of the results has not altered. Similar areas are showing strengths or weaknesses, and notwithstanding better overall performance of industrialized countries, similarities in relative strengths and weaknesses exist across country income groups (industrialized, developing and emerging). It is significant to note that in all countries the broad area of credit risk management has relatively low rates of compliance.

45. **Two crucial areas that are also relatively weak are those of capital adequacy and consolidated supervision.** The two areas are connected, as in a number of cases, capital adequacy systems were considered noncompliant or materially noncompliant because capital adequacy was not calculated on a consolidated basis. Also other prudential standards, such as those related to loan quality and other prudential standards are much less meaningful if supervision is not exercised on the basis of consolidated reports, accounts, and implementation of remedial action. The principle on anti-money laundering is also among those that are insufficiently implemented in many countries (Table 7).

Table 7. Observance of Basel Core Principles for Effective Banking Supervision

Core Principle (number and main topic)	Observance (in percentage of total countries assessed)[14]		Issues Raised by Assessors
	Compliant/largely compliant	Materially noncompliant/noncompliant	
1.1 Framework for supervisory authority/Objectives	89	11	Fragmented responsibilities; unclear role of external auditors
1.2. Independence	61	39	Political interference in licensing and remedial measures; forbearance; insufficient legal protection; weak autonomy; insufficient staffing.
1.3. Legal framework	90	10	Insufficient basis for cooperation and information exchange, also with foreign supervisors.
1.4. Enforcement powers	80	19	Legal basis inadequate or overly rigid; forbearance, court intervention, need to consult political authorities.
1.5. Legal protection	71	29	Rules on legal protection not explicit, inadequate or absent; no rules on legal expenses; accountability concerns.
1.6. Information sharing	71	29	Lack of legal basis or formal agreements; rigid confidentiality constraints, MoUs not implemented in practice.
2. Permissible activities	94	6	No authority to act against unauthorized banks; laws unclear on licensing requirements; no protection of the word "bank".
3. Licensing Criteria	84	16	Reputation of managers not tested; inadequate fit and proper tests, refusal to grant license can be appealed at Ministry of Finance; foreign supervisors not contacted; political interference.
4. Ownership	82	18	Prior supervisory approval not required; no fit and proper test for shareholders; no definition of significant ownership, nor qualitative criteria to determine ownership.
5. Investment criteria	75	25	No approval authority; inadequate definitions of investments requiring approval; no criteria for impairment of supervision resulting from acquisitions.
6. Capital adequacy policies	67	33	No calculation on a consolidated basis; no market risk charges, inadequate risk weightings, inappropriate capital components.
7. Credit policies	66	34	Insufficient supervisory guidance on credit policies; no rules on arm's length lending; unclear board and management responsibility for credit policies; no dissemination of policies to staff; insufficient supervisory monitoring.

[14] Figures do not always add up to 100, as "non-applicable" gradings have been excluded.

8. Loan evaluation	68	32	Insufficiently rigorous loan classification and provisioning rules, insufficient monitoring, no cash flow based assessment, rules too lenient on use of collateral, restructured or evergreened loans, no tax deductibility for specific provisions, off balance sheet items not included.
9. Large exposures	74	26	Exposures not reported/monitored on a consolidated basis, inadequate and/or overly rigid criteria to establish group connections.
10. Connected lending	59	41	Regulations absent or without sufficient legal basis; inadequate/overly rigid definitions of connectedness.
11. Country risk	38	48	Absence of regulations, usually because banks have little or no exposure.
12. Market risk	46	51	Absence of regulations, or inconsistency with Basel guidance, usually because banks have little or no exposure; no supervision on a consolidated basis, weak or no enforcement.
13. Other risks	51	49	Absence or inadequacy of rules on risk management, absence of guidelines on interest rate, liquidity and operational risk; inadequate supervisory capacity.
14. Internal control	66	34	Inadequate or no standards, unclear responsibilities of management for internal controls, examination mandate inadequate, no rules on corporate governance.
15. Anti-Money laundering	55	45	Inadequate or no legal framework.
16. On-site and off-site supervision	73	27	Inadequate frequency of visits, staff shortages, insufficient skills, no risk-based supervision, unclear objectives.
17. Contacts with bank management	83	17	Insufficient frequency, no clear procedure to maintaining contact.
18. Off-site supervision	74	26	No supervision on a consolidated basis, reporting framework not set by supervisor, nonbank affiliates not covered, inaccurate reporting.
19. Validation of information	77	23	Inadequate response to weak audits, no control over external auditors, insufficient frequency of inspections.
20. Consolidated supervision	39	45	No requirements on consolidation or consolidated supervision, no legal basis to require consolidated reporting, scope of consolidation too limited (e.g. not covering nonbank affiliates, no reporting of related interests).
21. Accounting	73	27	Standards do not comply with IAS, supervisor has no authority to set bank accounting standards.
22. Remedial measures	65	35	Insufficient legal basis, enforcement ineffective, forbearance, limited range of measures, proactive action not possible, court intervention.
23. Global consolidation	47	25	Scope too limited, no supervision on a consolidated basis, insufficient authority to oversee foreign banks, insufficient information exchange and MoUs.
24. Host country supervision	58	23	No formal arrangements for contacts with home supervisors, little contact in practice, confidentiality constraints.
25. Supervision of foreign establishments	77	20	Insufficient exchange of information, insufficient MoUs, no inspection authority for foreign supervisors.

B. IAIS Core Principles on Insurance Supervision

46. **Observance of the IAIS Core Principles on Insurance Supervision has been assessed in 42 jurisdictions**. The Core principles have been revised in October 2003, but the assessments on which the current review is based were adopted in October 2000. Overall, observance differs across core principles, with several weaknesses and strengths. As shown in Table 8, the area in which insurance supervision is most deficient relates to corporate governance of insurance companies. Less than one-third of countries is observant or broadly observant with this core principle. This is mainly a result of unclear jurisdiction of the insurance supervisory bodies over corporate governance issues. Rules on corporate governance are to be found in general in corporate law. Also in the field of internal controls the supervisory authorities seem to have limited jurisdiction, and the system depends on general corporate laws and regulations.

47. **The major areas of assessed weaknesses are organization of the supervisor and asset risk management**. The organization of a supervisory agency needs to be improved in broadly one-third of the countries assessed. In a significant number of cases, the insurance regulator was incorporated into the Ministry of Finance, but insufficient resources and unclear budgetary autonomy proved to be problematic in many cases. Although observance is better in this area, risk management with regard to the asset portfolio is still weakly supervised in approximately one third of countries, mostly concentrated in developing and emerging market countries. As in the banking sector, this is an area of serious concern, mainly because adverse developments in asset values would in all likelihood directly impact the financial viability of the institutions. Deficiencies also occur in supervision of off-balance sheet exposures, notably in derivatives in more than half of the countries assessed. These issues arise mainly in developing and emerging market countries, and consist primarily in the absence of any regulations in this area.

48. **Other areas of concern relate to market conduct.** Rules were in many cases limited to rules on registration of brokers and agents and cross-border operations. The most important issue with regard to this principle relates to deficiencies in the exchange of information with other supervisors.

Table 8. Observance of IAIS Core Principles

Core Principle (number and main topic)	Observance (in percentage of total countries assessed)		Issues Raised by Assessors
	Observant/ largely observant	Materially non-observant/non-observant	
1. Organization of an Insurance Supervisor	67	33	Weaknesses stem from incorporation with MOF, insufficient budget and staff resources and unclear decision making processes.
2. Licensing	92	8	
3. Changes in Control	77	23	Absence of ownership thresholds above which supervisory permission is needed.
4. Corporate Governance	32	68	Where rules and regulations in this area exist, corporate governance laws and regulations are usually part of general or corporate law and the insurance supervisor has uncertain jurisdiction. The supervisor has not made up for this shortfall by promulgating insurance-specific corporate governance regulations.
5. Internal Controls	49	51	Follows ICP4, above.
6. Assets	64	36	Weaknesses relate mainly to the lack of requirements for companies to have an investment and risk management strategy.
7. Liabilities	88	12	The lack of international standards on the strength of reserves means that countries are assessed to their own standards. The CPs describe the elements that should comprise reserves but do not specify a desired, targeted or required level. In this respect, the over-used and perhaps abused target of having "adequate" reserves gives too much leeway and allows weak reserving–which can undermine the capital adequacy regime.
8. Capital Adequacy and Solvency	84	16	The lack of international standards in this area mean that countries are assessed to their own standards.
9. Derivatives and 'Off- Balance Sheet' Items	48	52	Related to ICP6, above.
10. Reinsurance	76	24	This CP relates to the reinsurance arrangements of primary insurers, not to reinsurers.
11. Market Conduct	54	46	Regulations were generally limited to the registration of brokers and agents–not extending to the way in which they conduct business or treat customers.
12. Financial Reporting	90	10	The lack of international standards on financial reporting means that countries are assessed to their own standards.
13. On-Site Inspection	80	20	Constraints stem from inadequate resources.
14. Sanctions	90	10	The strong compliance reflects the existence of legislative powers. There is a measure of inconsistency amongst the assessments in the observation of whether the powers are used in practice.
15. Cross-Border Business Operations	65	35	Licensing requirements are almost entirely pervasive for both foreign companies in the local market and the ability to obtain information on foreign operations of domestic companies. Adverse comments relate to the inability of a supervisor to exchange information, following CP16, below. This CP was not applicable to countries that host entirely domestic markets and 26 percent (included within the 35 percent) of countries assessed were recorded as "NOT APPLICABLE" not as poorly compliant.
16. Coordination and Cooperation	78	22	Supervisors do not generally have the legal authority to cooperate with other supervisors.
17. Confidentiality	96	4	The high rate of compliance reflects the high ethical standards imposed throughout the population of supervisory authorities.

C. IOSCO Objectives and Principles of Securities Regulation

49. **In April, 2002, the Executive Boards of the Fund and Bank were provided with an overview of the experience with the assessment of the IOSCO Objectives and Principles of Securities Regulation**. The paper concluded that weaknesses in the implementation of many of the Principles were evident across the range of jurisdictions assessed, although the most marked concerns related to assessments of developing and emerging markets. The paper also touched on the difficulties in drawing clear connections between the weaknesses identified in regulation of securities markets and financial sector vulnerabilities.

50. **Since publication of the paper, a number of developments have occurred with respect to the assessment process.** For example, in late 2001, IOSCO recommended a new grading scale for the IOSCO self-assessment process that was subsequently adopted in the FSAP. The new scale introduced an additional assessment category of "broadly implemented," thus providing assessors with greater scope to reflect implementation of Principles that was substantially, although not fully, effected. In addition, in 2003 IOSCO finalized work on the development of an assessment methodology. The IOSCO Assessment Methodology provides a comprehensive framework for analyzing the implementation of the Principles and is especially strong in establishing the market and regulatory context for the various Principles. In some respects, however, the Methodology could be viewed as overly rigid in outlining the benchmarking process to determine grades.

51. **An analysis of a completed IOSCO assessment indicates that there are specific areas of weakness in the implementation of the IOSCO Principles.** Weaknesses in implementation are particularly evident with respect to principles for enforcement of securities regulation (Principles 8–10) and principles for issuers (Principles 14–16). Assessors overall found that regulators had a lack of authority to investigate, had limited access to time-sensitive data needed for surveillance purposes, insufficient resources for inspection, surveillance and investigation, and often a limited enforcement mandate. With respect to issuers, there is a clear need for more efficient methods to disseminate information to the public and to improve the quality of the information being released. In addition, there is a need to improve the legislative and policy framework relating to the treatment of shareholders, enhance the regulatory regime for auditors, and also address the lack of harmonization between international and domestic accounting and auditing standards.

52. **In turn, the Principles with relatively higher levels of full and broad implementation are regulation of collective investment schemes (Principles 18-19), market intermediaries and the secondary market (Principles 21 and 25) and Principles 1 and 4-5 regarding the regulator.** Some common deficiencies noted by the assessors in terms of the issues relating to the regulator include the following: a lack of operational independence; limited enforcement powers; and inadequate resources, thus hampering the ability to perform regulatory functions efficiently and effectively. The lack of operational independence raises particular questions as to control of resources (both human and financial). The lack of a clear mandate, or the lack of clear regulatory powers, also inhibits regulatory functions, such as licensing, access to necessary (sometimes confidential) data, and so forth. Other common deficiencies include the need for appropriate regulations dealing with collective investment

schemes; the need to expand the scope of the regulator's responsibilities; and improvement of licensing requirements for trading systems and increase the scope of trading arrangements.

53. **While assessors are not able to readily consider preconditions, the comments in specific assessments do, nevertheless, allude to the poor state of legal and accounting systems in many jurisdictions**. For example, many assessments note the inadequacy of the accounting framework—both in terms of standards and professional arrangements—as linked to weaknesses in the implementation of the Principles for issuers. Likewise, audit issues are commonplace and aspects of the oversight of auditors feature prominently in many assessments. The insolvency regime is, not surprisingly, often cited as requiring attention in those jurisdictions exhibiting lower levels of implementation of the Principles related to market intermediaries. An efficient court system, highly skilled legal profession, and well-designed administrative review processes would no doubt support strengthening of the enforcement of laws in those countries that have been assessed as not having fully implemented the Principles relating to enforcement and cooperation. (Table 9).

Table 9. Observance of IOSCO Core Principles for Securities Regulation

Core Principle (Number and Main Topic)	Observance (in % of total countries assessed) 1/		**Issues Raised by Assessors**
	Implemented/ Broadly Implemented	Partly Implemented/ Non-implemented	
Principles Relating to the Regulator			
Principle 1	86	14	Need for legislation that states clearly the responsibilities of the regulator, its objective, definition of key concepts. There is a lack of legislative harmonization that leads to fragmentation of responsibilities. There is a need for MoUs to streamline the scope of regulatory agencies' responsibilities.
Principle 2	38	62	Lack of operational independence (from the government or the central bank) in the following areas: in setting the salary of the regulator, the decision-making process, appointment of regulator and board members, reliance on state budget, and inability to propose legislation.
Principle 3	49	51	Deficiency with respect to adequate resources and capacity to perform its functions. This is found in these areas: insufficient resources, inability to do investigation of unsupervised entities, failure to hire and retain experienced and qualified staff, lack of access to data, no power to grant and revoke licenses and levy fines, inability to control the allocation of its own resources, and failure to facilitate the protection of investors' and shareholders' rights.
Principle 4	83	17	Need to improve information-sharing methods; lack of consistent regulation; need to educate the investors; lack of transparency with respect to formal rules for consultation procedure with market participants (thus perceived conflict of interests); need to publish the process of formulation of policy and rule-making, necessity to make available procedures for administrative disputes.
Principle 5	78	20	There is a need to introduce a Code of Ethics, particularly for those staff trading and holding securities, to increase professionalism, confidentiality and ethics, avoid conflict of interest.

Principles of Self-Regulation			
Principle 6	67	20	Need for clearly defined operational regulations for SROs (self-regulatory organizations): specifically regarding who supervises SROs, how they coordinate work with other supervisory agencies, and how they define objectives and responsibilities (operational independence).
Principle 7	67	35	There is a need for comprehensive regulations that outline supervision of SROs
Principles for the Enforcement of Securities Regulation			
Principle 8	66	32	Lack of authority to investigate cases; need access to bank data protected by secrecy law; need for automatic surveillance methods; insufficient resources to perform surveillance, investigation, and inspection.
Principle 9	60	38	Need for broader and more specific powers to regulate the market and take corrective actions, particularly to inspect non-supervised entities, investigate insider trading, and improve type and quality of sanctions and quantity of fines.
Principle 10	46	54	Limited enforcement mandate; limited resources to perform functions properly; need for training of supervisory staff.
Principles for Cooperation in Regulation			
Principle 11	66	34	Need for more extensive and frequent information-sharing methods.
Principle 12	60	38	Increased cooperation with domestic and international financial regulators needed (i.e., more extensive use of MoUs).
Principle 13	65	33	Need for improved methods for information collection; formalizing arrangements for information-sharing ability to gather information with domestic and foreign regulators.
Principles for Issuers			
Principle 14	55	42	Need for clear and efficient methods for dissemination of time-sensitive information; improvement needed in disclosure requirements and quality of information that is made available to the public, that is , information on unlisted issuers.
Principle 15	56	37	Need for improvement of rules outlining treatment of minority shareholders and ensuring their protection.
Principle 16	60	40	Close gap in the application of international and domestic standards of accounting and auditing; weak and unclear rules for auditors.
Principles for Collective Investment Schemes			
Principle 17	68	29	Need to improve the regulatory framework so that it covers all forms of collective investment schemes and sets out the eligibility criteria of a collective investment scheme; need to unify, simplify, and rationalize the current regulations.
Principle 18	75	22	The range of supervision of all types of collective investment schemes should be improved, so that all rules of custodial arrangements are clarified, in addition to the transparency of rules for investors, and rules for open-end funds.
Principle 19	72	23	Quality and quantity of information available to the public should be improved.
Principle 20	65	32	Regulation that states the mechanism to calculate asset valuation and pricing of units in the funds, calculation of net asset value, redemption of shares needs clarification.
Principles for Market Intermediaries			
Principle 21	76	17	Scope of regulations requires clarification of rules for entry requirements and licensing market intermediaries.
Principle 22	57	41	Monitoring and inspection systems to ensure compliance with capital and prudential requirements should be introduced.
Principle 23	63	35	A higher degree of investor protection should be added. This can

			be done through formalized rules, and an increased number of supervisory staff, as well as improved technology.
Principle 24	51	47	General bankruptcy procedures are inadequate.
Principles for the Secondary Market			
Principle 25	70	17	Licensing requirements for trading systems should be improved, and the scope of trading arrangements should be increased.
Principle 26	65	25	The inspection process needs improvement, for example, by increasing the number of on-site inspections and their frequency.
Principle 27	69	21	There needs to be increased transparency of trading and clearer guidelines established.
Principle 28	49	47	Market operation rules need to be expanded by including unfair trading practices, price manipulation, rules for governing the use of a related company for trading services, borrowing and lending between related companies, and the use of a third party custodian.
Principle 29	65	26	Improve mechanisms for addressing large exposures, default risk and market disruption, difficulties signals.
Principle 30	55	27	Improve clearing and settlement system.
All Principles	63	33	

Source: Monetary and Financial Systems Department IOSCO Database
1/ Common sample of countries assessed across the three sectors is 42.

Table 1. List of FSAP Cooperating Official Institutions

Country	Cooperating Official Institution
Argentina	Central Bank of the Republic of Argentina
Australia	Reserve Bank of Australia Australian Prudential Regulation Authority Australian Securities and Investment Commission
Austria	Austrian National Bank Financial Market Authority
Belgium	National Bank of Belgium Banking and Finance Commission
Brazil	Central Bank of Brazil
Canada	Bank of Canada Office of the Superintendent of Financial Institutions
Chile	Central Bank of Chile Superintendency of Banks and Financial Institutions
Colombia	Bank of the Republic
Czech Republic	Czech National Bank
Denmark	Denmark National Bank Danish Financial Supervisory Authority
Finland	Bank of Finland Financial Supervision Authority
France	Bank of France Banking Commission
Germany	Deutsche Bundesbank German Banking, Securities and Insurance Supervision Authority (BAFin)
Hong Kong	Hong Kong Monetary Authority
Hungary	National Bank of Hungary Hungarian Financial Supervisory Authority
India	Reserve Bank of India
Ireland	Central Bank of Ireland
Israel	Bank of Israel
Italy	Bank of Italy Italian Securities Commission
Japan	Bank of Japan Financial Services Agency
Malaysia	Bank Negara Malaysia
Mexico	Bank of Mexico Banking and Securities Commission
Morocco	Central Bank of Morocco
Netherlands	Bank of Netherlands Securities Board of the Netherlands Netherlands Pension and Insurance Supervisory Authority
New Zealand	Reserve Bank of New Zealand Securities Commission of New Zealand
Nigeria	Nigerian Deposit Insurance Corporation
Norway	Bank of Norway Banking, Insurance and Securities Commission
Peru	Central Reserve Bank of Peru
Poland	National Bank of Poland
Portugal	Bank of Portugal Portuguese Securities Market Commission
Saudi Arabia	Saudi Arabian Monetary Agency

Country	Cooperating Official Institution
Singapore	Monetary Authority of Singapore
South Africa	South African Reserve Bank Financial Services Board
Spain	Bank of Spain National Securities Commission
Sri Lanka	Central Bank of Sri Lanka
Sweden	Bank of Sweden Financial Supervisory Authority
Switzerland	Swiss National Bank Swiss Federal Banking Commission
Thailand	Bank of Thailand
Tunisia	Central Bank of Tunisia
Turkey	Central Bank of the Republic of Turkey
United Kingdom	Bank of England Financial Services Authority Financial Supervision Commission, Isle of Man
United States	Federal Reserve System Office of the Comptroller of the Currency Federal Deposit Insurance Corporation
ECB	European Central Bank
	Standard Setting Bodies
BCBS	Basel Committee on Banking Supervision
CPSS	Committee on Payment and Settlement Systems
IASB	International Accounting Standards Board
IAIS	International Association of Insurance Supervisors
IOSCO	International Organization of Securities Commissions
	Other Institutions
AfDB	African Development Bank
BIS	Bank for International Settlements
IADB	Inter-American Development Bank
COBAC	Banking Commission of Central African States (COBAC).
BEAC	Central Bank of Central African States (BEAC)
BCEAO	Central Bank of West African States (BCEAO)

Table 2. FSAP: Assessment of Regulatory Standards

FSAP	BCP	IAIS	IOSCO
AFR			
Cameroon	X	X	
Gabon	X	X	
Ghana	X	X	X
Mauritius	X		
Mozambique	X		
Nigeria	X	X	X
Senegal	X	X	X
South Africa	X	X	X
Tanzania	X		
Uganda	X		
Zambia	X		
APD			
Bangladesh	X		X
Hong Kong SAR	X	X	X
India	X		X
Japan	X	X	X
Korea	X	X	X
New Zealand	X		X
Philippines	X	X	X
Singapore	X	X	X
Sri Lanka	X		X
EUR			
Bulgaria	X	X	X
Croatia	X	X	X
Czech Republic	X	X	X
Estonia	X	X	X
Finland	X	X	X
Germany	X	X	X
Hungary	X	X	X
Iceland	X	X	X
Ireland	X	X	X
Israel	X	X	X
Latvia	X	X	X
Lithuania	X	X	X
Luxembourg	X	X	X
Macedonia, FYR	X		
Malta	X	X	X
Poland	X	X	X
Romania	X		X
Russia	X	X	X
Slovak Republic	X	X	X
Slovenia	X	X	X
Sweden	X	X	X
Switzerland	X	X	X
Ukraine	X		
United Kingdom	X	X	X
MCD			
Algeria	X		
Armenia	X		
Egypt	X	X	X
Georgia	X	X	
Iran, Islamic Republic of	X		
Jordan	X		X
Kazakhstan	X	X	X
Kuwait	X		X
Kyrgyz Republic	X		
Lebanon	X		
Morocco	X	X	X
Tunisia	X	X	X
United Arab Emirates	X		
Yemen, Republic of	X		
WHD			
Barbados	X	X	X
Bolivia	X		
Brazil	X	X	X
Canada	X	X	X
Colombia	X		
Costa Rica	X		
Dominican Republic	X	X	
El Salvador	X		
Guatemala	X		
Honduras	X		X
Mexico	X	X	X
Peru	X		
Total Completed	**70**	**42**	**46**

Table 3. OFC: Assessment of Regulatory Standards

OFC	BCP	IAIS	IOSCO
Andora	X		
Anguilla	X		
Aruba	X	X	
Bahamas	X		X
British Virgin Islands	X	X	X
Cyprus	X		
Gibraltar	X	X	X
Guernsey	X	X	X
Isle of Man	X	X	X
Jersey	X	X	X
Liechtenstein	X	X	X
Macau	X	X	
Marshall Islands	X		
Monaco	X		X
Montserrat	X		
Netherlands Antilles	X	X	
Palau	X		
Panama	X		
Seychelles	X		
Samoa	X		
Vanuatu	X	X	
Total Completed	**20**	**10**	**7**

III. Standard Setters: Ongoing Work Toward Strengthening Financial Regulation

54. **Various initiatives are under way toward strengthening international guidance on financial regulation by standard setting bodies.** The Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO) are pursuing a three-fold strategy: (i) working individually and through the Joint Forum (comprising the BCBS, IAIS and IOSCO), to define areas of financial regulation in which it is desirable to develop internationally agreed-upon standards of best practice; (ii) providing guidance through studies, surveys, and reports in areas where international agreement may be slow; (iii) working with the Fund and the Bank staff on the FSAP to help foster implementation and convergence by as wide a range of countries as possible.

55. **The ongoing work focuses specifically on a country's prudential framework and regulatory practices.** Work has also been accelerated in the area of financial integrity and safety net arrangements. It is widely recognized that regulators need to place a stronger focus on prudential standards, particularly on risk management and internal controls across sectors. However, issues such as the lack of a common accounting standards on the valuation of assets and liabilities of a regulated firm, and differing quality of auditing standards used to review them are keeping the process from reaching a meaningful convergence on the prudential framework across the three sectors. Attention is also being given to disclosure of accurate and timely information, sound legal environment, and financial market infrastructure, so as to strengthen the foundation for market discipline to complement official or regulatory discipline. Since many of these areas are outside the scope of the regulatory standard setters, substantial work is being undertaken in close collaboration with other standard setters such as the OECD, International Federation of Accountants (IFAC), FATF, and IASB.

56. **However, the regulatory standards remain voluntary and have no legal force.** The trend is toward their adoption by most countries. Their universality is considerably enhanced by their use in the FSAP. This is also helping in the adoption of a common regulatory approach, enabling countries to "benchmark" their current regulatory systems to international recognized practices. The Financial Stability Forum (FSF), set up in 1999, is also helping to facilitate both the development and the convergence processes. The principal standard setting bodies are the members of the FSF, and the Forum is welding together countries, international institutions and groupings, and the standard setters to work together closely on financial regulation issues.

57. **Fund staff has been participating in work of standard setters.** Recent Fund involvement, mostly through MFD staff participation, has been substantial in the Basel Committee on Banking Supervision, mainly through work in both the Core Principles Liaison Group and the Working Group on Capital. Participation in the work of other standard setters has been focusing on the key issues relevant for the Fund mandate, on transparency in the reinsurance sector regarding the IAIS (Task Force on Transparency and Disclosure in Reinsurance) or implementation issues in the case of the IOSCO (Implementation Committee). Details about Fund staff involvement in the work of standard setters are provided in Appendix I of this section.

A. Objectives and Design of Regulatory Standards

58. **The Basel Committee on Banking Supervision (BCBS) will review the Basel Core Principles for Effective Supervision (BCP).** This will likely take into account the framework for an updated Basel Capital Accord, so-called Basel II, issued by the Committee in June 2004. The Basel Committee member countries are expected to start implementing the new framework in 2007.[15] Other supervisory authorities worldwide are encouraged by the BCBS to consider adopting the framework when it is consistent with their broader supervisory priorities. Within the European Union the intention is to include all credit institutions operating in EU-countries under a directive based on Basel II rules. Basel II, as such, will not become part of the BCP because it is not an international minimum standard applicable to all countries. However, many of its components are already in the Core Principles, such as detailed requirements for risk management and capital adequacy. Regulators will be required to have more powers and responsibilities to validate and assess banks' management of risks and of capital. Banks' board and management will be held responsible for the implementation and monitoring of the operation of the risk management systems. Regulators will also require banks to enhance public disclosure, in particular on information pertaining to risks and capital.

59. **New guidance for the supervision of insurance is contained in a revised and expanded "Insurance Core Principles and Methodology" adopted by the International Association of Insurance Supervisors (IAIS) in October 2003.** The 28 principles cover all aspects of a supervisory framework—from licensing to closure of activities. The principles also address such issues as transparency of the supervisory process, assessment and management of risk, consumer protection, and anti-money laundering. Initial steps have been taken to develop a comprehensive framework for the supporting standards and guidance for insurance supervision, consistent with the three pillars highlighted by Basel II. Using the revised insurance regulatory standard as a foundation, documentation is being prepared that address a range of issues more fully, including capital adequacy and solvency, use of third-parties (actuaries) as part of the supervisory model, and stress testing by insurers.

60. **A Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation was adopted by the International Organization of Securities Commissions (IOSCO) in October 2003.** The methodology will assist jurisdictions in identifying areas where their securities regulations do not meet international standards. The methodology categorizes any failures in implementation by degree of severity, identifies areas for priority action, and helps developing action plans for any necessary reforms. IOSCO also updated and published in September 2003 a new version of the "Objectives and Principles of Securities Regulation", which includes references to work done from September 1998 to May 2003. A pilot program to assist its members in the completion of a self-assessment of their level of implementation of the IOSCO Core Principles was approved in February 2003. Pursuant to this pilot program, experts will assist each participating jurisdiction in the assessment and in the development of an action plan to correct identified deficiencies.

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[15] The Basel Committee member countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the U.K., and the U.S.

B. Regulatory Preconditions

61. **A platform of standards which will allow the adoption of International Financial Reporting Standards (IFRSs) in 2005 is being completed by the International Accounting Standards Board (IASB).** The IASB's initial efforts have focused on improving International Accounting Standards (IASs), providing guidance to those companies adopting IFRSs for the first time, and issuing standards in the areas where current IASB literature is deficient. The Financial Accounting Standards Board (FASB) of the United States and the IASB continue to make progress on their convergence project.

62. **The BCBS, IAIS, and IOSCO are providing input to the IASB in the development of standards in areas of supervisory interest.** The BCBS Accounting Task Force has started to revise the BCBS paper "Sound Practices for Loan Accounting and Disclosure" and is planning to publish the document for consultation. In October 2003, the IAIS sent a comment letter on the IASB exposure draft regarding insurance contracts, noting the need for comparable and consistent accounting policies and for prevention of the accounting mismatch of assets and liabilities. The IOSCO Technical Committee completed a survey on the accounting review and enforcement mechanisms currently in place. IOSCO has also initiated a project on regulatory interpretations of IFRSs. The aim of the project is to improve communications among members for a consistent application and enforcement of IFRSs, with the major expected outputs of this project being a central database of regulatory decisions and a process for facilitating communications and cooperation among regulators.

63. **In 2003, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) completed its standards related to audit risk assessment.** Standards on fraud, the form and content of the auditor's report, quality control for both audit firms and audit engagements, on group audits and reviews of interim financial information are to be updated in 2004. Additional projects to be completed in 2005 include updating current standards on audit materiality, auditing accounting estimates and the audit of related party transactions. To achieve convergence of auditing standards on a worldwide basis, the IAASB is working closely with IFAC member bodies on joint projects and seeking the input of experienced standard setters, international and national regulators, and regional accountancy organizations. The BCBS, IAIS, and IOSCO also evaluate International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Board (IAASB) in order to provide supervisory input. In October 2003, IOSCO endorsed two Statements of Principles relating to (1) Auditor Oversight, and (2) Auditor Independence, which now represent international standards relating to these issues.

64. **IFAC is working on achieving lasting reforms that increase confidence in the accounting profession and the credibility of financial information.** IFAC proposals were approved in November 2003, with the BCBS, IAIS, IOSCO, the World Bank, and the European Commission closely involved in all stages of development. IFAC encourages accountability of the profession notably through its Code of Ethics, Compliance Program and Transnational Auditors Committee. IFAC standard setting committees—auditing, ethics, education and public sector accounting—will enhance the operations of their respective Consultative Advisory Groups to solicit both strategic and technical guidance from interested external parties. During 2004, IFAC anticipates approving seven Statements of Membership

Obligations (SMOs) which will set standards of compliance. These will include following the IFAC Code of Ethics and using their best endeavors to support the adoption of the IFRS in their jurisdictions.

65. **The drafting of international standards of practice for actuaries working in the field of insurance by the International Actuarial Association (IAA) has been progressing rapidly.** While the impetus for this work was the IASB's project on accounting for insurance contracts, it will also contribute to the effectiveness of insurance supervision.

66. **A Survey on Auditor Oversight was undertaken by IOSCO.** The survey will cover not only compliance with the existing IOSCO principles, but other aspects of oversight including legal frameworks. The questionnaire will capture information on existing practices that may not be in conformity with the IOSCO Principles and include a progress report on implementation of the principles. The BCBS has also issued a paper on the supervisors relationship with external auditors in 2002.

67. **In the payment and securities settlement area, the Committee on Payment and Settlement Systems (CPSS) and the IOSCO are working together.** A CPSS working group on general principles for payments infrastructure will formulate practical guidance procedures on the development and evolution of payment infrastructure by 2005. In the light of the growing interest in developing central counterparties (CCP) and expanding the scope of their services, the CPSS and IOSCO concluded that international standards for CCP risk management are a critical element in promoting the safety of financial markets. In recent years, the use of CCPs has moved beyond derivatives markets to many securities markets, including cash markets and over-the-counter markets. Although a CCP has the potential to reduce risks to market participants significantly, it also concentrates risks and responsibilities for risk management. A joint consultative report "Recommendations for Central Counterparties" has been issued in March 2004 for public comment.

C. Prudential Framework and Regulatory Practices

Cross-border and cross-sector issues

68. **Building on the high-level principles for cross-border implementation of Basel II issued in August 2003, the BCBS is currently evaluating several case studies of internationally active banks.** In January 2004, the BCBS released for consultation a set of high-level principles governing cooperation and effective information exchanges between home and host supervisors. The document, designed to reduce duplication of supervisory rules while preserving the legal powers of host country supervisors, sets out basic principles for supervisory cooperation. Currently, much of the work of the BCBS Accord Implementation Group is devoted to issues pertaining to the cross-border implementation of Basel II. On a related matter, a paper looking at the implications of foreign direct investment in the financial sector of emerging market economies was also published by the Committee on the Global Financial System (CGFS) in April 2004.

69. **The BCBS, through its "offshore group", issued papers on "Shell Banks and Booking Offices", and "Parallel-owned Banking Structures" in January 2003.** These

papers set out recommendations for supervisors in licensing and supervising such institutions. The Financial Stability Forum (FSF) is presently reviewing its Offshore Financial Centers Initiative. In this document, the FSF encourages OFCs to enhance their prudential and supervisory standards.

70. **A report "Trends in Risk Integration and Aggregation" was issued in August 2003 by the Joint Forum (BCBS, IAIS, IOSCO).** The report builds on the previous efforts of the Joint Forum to better understand approaches to the management of major individual risks in the banking, insurance, and securities sectors. At the same time, the Joint Forum issued a report "Operational Risk Transfer Across Financial Sectors" to foster dialogue among supervisors and financial firms around the transfer of operational risk, both within a financial conglomerate and to third parties.

Risk management and internal control issues

71. **Banks' management of risk and capital will be more rigorously assessed by supervisors who, under Basel II, will be able to exercise more power and responsibilities.** Under this framework, an individual bank can be required to maintain capital above the regulatory minimum, if its risks are deemed high or if its risk management is thought to be inadequate in relation to the norms.

72. **A paper entitled "Management and Supervision of Cross-Border Banking Activities" was issued by the Electronic Banking Group of the BCBS in July 2003.** It also carried out, at the end of 2003, a stocktaking exercise to collect input from members on electronic security and IT outsourcing developments in their respective countries. A report will be released, summarizing the relevant supervisory rules, policies and guidance that are currently in place and tentatively addressing the main supervisory concerns associated.

73. **Best practices for risk management by banks have been identified by the BCBS.** In 2003, the BCBS issued papers entitled "Sound Practices for the Management and Supervision of Operational Risk," and "Consolidated Know-your-customer Risk Management", and a consultative paper "Principles for the Management and Supervision of Interest Rate Risk." The management of compliance risk (risk of legal or regulatory sanctions, financial loss or reputation damage) that a bank may suffer as a result of its failure to comply with applicable laws, rules and standards has been studied by the BCBS, with a consultative document on the compliance function in banks published in October 2003. Compliance risk management has become more formalized within the past few years and has emerged as a distinct risk management discipline.

74. **Latest developments on the credit risk transfer (CRT) market are to be reviewed by the Joint Forum with a particular focus on the most recent CRT techniques (credit default swaps–CDS, and collateralized debt obligations–CDO).** The Joint Forum will give emphasis to the issues most relevant for financial stability: (i) whether the instruments/transactions accomplish a clean risk transfer, (ii) the degree to which the CRT market participants understand the risks involved, and (iii) whether CRT activities are leading to undue concentrations of credit risk inside or outside the regulated financial sector. The Joint

Forum provided an interim report to the FSF in March 2004; a final report, potentially encompassing some recommendations, is expected in September 2004.

75. **The IAIS approved supervisory guidelines or issues papers "Quantifying and Assessing Insurance Liabilities," "Stress Testing by Insurers," and "Insurance Securitization" (life and non-life) in October 2003**. A paper on investment risk management is nearing completion. The IAIS is also revising its paper "Principles on the Supervision of Insurance Activities on the Internet" for adoption in October 2004. The IAIS is also preparing a paper "Disclosure of Technical Performance and Risks of Non-life Insurers and Reinsurers," to be completed in 2004, and one entitled "Disclosure of Investment Performance of Insurers and Reinsurers" expected in 2005.

76. **IOSCO published a "Report on Investment Management Risk Assessment: Marketing and Selling Practices" in September 2003.** It describes the relevant risk factors associated with the marketing and selling practices of a collective investment scheme operator as well as regulatory responses to those risks.

77. **The transparency of corporate bond markets has been studied by IOSCO in a May 2004 report.** The report reviews trading methodologies, transparency arrangements and regulatory frameworks for corporate bonds, including reporting requirements, in 15 developed countries. A number of core measures directed at the implementation of Principle 27 of the IOSCO Core Principles are proposed. These core measures call for greater access to bond market trading information and market surveillance to improve price discovery mechanisms and deter market manipulation.

78. **A project on "outsourcing" has been undertaken by the Joint Forum.** Supervised firms are increasingly entering into arrangements whereby other firms perform significant aspects of the entities' regulated and/or unregulated functions. To the extent that such activities are outsourced to third party entities, supervisors need to ensure that the functions are performed in accordance with relevant policies and procedures, and that the supervisors can enforce compliance with such policies.

Capital requirements

79. **The quantitative capital requirements of Basel II cover a wider range of risks, including credit, market and operational risks.** Banks that have developed advanced risk measurement and management systems may be allowed by their supervisors to use these when calculating their capital requirements. Banks will also be allowed to benefit from a wider field of risk mitigates when calculating capital requirements.

80. **"Principles on Capital Adequacy and Solvency" were developed by the IAIS.** After having been adopted in 2002, they were incorporated as essential criteria under ICP 23 in the 2003 revision of the ICPs. A paper "Solvency Control Levels" prepared by IAIS was also adopted in October 2003. Two papers entitled "Appropriate Forms of Capital" and "Forms of Capital Adequacy Requirements" are expected in 2005. The IAIS has been supported in its work by the IAA, which has, for example, prepared a paper called "A Global Framework for Insurer Solvency Assessment" (adoption by the IAA expected in 2004). In addition, the

Solvency II project is working toward the development of a harmonized, risk-based, three-pillar approach for use throughout the European Union. It is part of a number of supervisory authorities' and multi-jurisdictional organizations' efforts to strengthen capital adequacy and solvency frameworks.

Corporate governance issues

81. **The OECD Steering Group on Corporate Governance has undertaken its assessment of the OECD Principles of Corporate Governance with a view to completing it by April/May 2004.** The OECD is also progressing on the development of new "Guidelines for the Corporate Governance of State-Owned Assets," due for completion by early 2005. In January 2004, the IAIS issued a compilation of existing documents detailing corporate governance requirements for insurers. The OECD should also complete new guidelines on governance of insurers in 2004.

82. **Governance systems of collective investment schemes' operators will be examined by IOSCO.** The intended output of this work will be the identification of general principles on infrastructures for decision-making, conflicts of interest, fiduciary duties, investor rights and the transparency of information. IOSCO will conduct a survey of the different models of governance for collective investment schemes and their internal control framework and procedures.

Remedial action issues

83. **A supervisory guidance paper "Solvency Control Levels," was approved by the IAIS in October 2003.** It emphasizes the need to intervene early when solvency levels are deteriorating.

84. **IOSCO will undertake an initiative called the "Review and Enforcement of Application of Financial Reporting Standards."** This will focus on the range of activities and powers that relate to reviews of public company financial statements by securities regulators and others. This project will focus on the powers and activities of a review process, and criteria and actions needed, regardless of the accounting standards in use. The major output of this project is expected to be an IOSCO statement of principles, best practices, and/or descriptions of effective models in use for such review functions. This project is expected to conclude in 2005.

D. Financial Integrity and Safety Net Arrangements

85. **A working group to follow up the April 2001 report of the Multidisciplinary Working Group on Enhanced Disclosure (MWGED) was created by the Joint Forum in 2002.** The group has met with relevant end users of financial reports to gain knowledge about their disclosure needs and with a number of firms including hedge funds to hear their views on the MWGED recommendations. The group issued its report in May 2004.

86. **The IAIS Reinsurance Task Force has developed a "Framework to Enhance the Transparency of the Global Reinsurance Market" in March 2004.** It suggests measures to improve risk-oriented disclosure by individual reinsurance firms. An IAIS Steering Group has

succeeded the Task Force to follow up on the various recommendations. The first report on global reinsurance statistics is expected to be issued by end-2004. Basel II requires enhanced public disclosure by the banks, in particular on information pertaining to risks and capital. This is intended to strengthen market discipline. The IAIS is currently preparing a paper "Disclosure of Technical Performance and Risks of Non-life Insurers and Reinsurers," which is expected to be completed in 2004. A paper "Disclosure of Investment Performance of Insurers and Reinsurers" is to be completed in 2005.

Consumer protection issues

87. **Recent high profile incidents in securities fraud and market abuse led IOSCO to set up a special chairmen's Task Force in February 2004 to organize and coordinate IOSCO's response.** The priorities of the Task Force are to do the following: (i) identify potential new issues, including concerns about transparency in the bond markets, unregulated entities, complex group structures and appropriate levels of sanctions; (ii) review existing standards, including current mechanisms for international cooperation; and (iii) suggest responses aimed at producing regulatory incentives, such as better risk identification and assessment by regulators together with enhanced attention to uncooperative and under-regulated jurisdictions.

88. **A consultation document "Performance Presentation Standards for Collective Investment Schemes (CIS)," was issued by IOSCO in 2003.** The final best practices paper on this topic was issued in May 2004. A new mandate to develop international best practices has been approved by IOSCO. Market timing, whereby arbitrageurs rapidly buy and sell shares in collective investment schemes to take advantage of out of date prices within a collective investment scheme's net asset value, raises costs for the collective investment schemes and harms other investors by lowering the collective investment schemes' overall returns.

89. **The IAIS is developing a guidance paper called "Anti-Money Laundering and Combating the Financing of Terrorism."** It will address topics such as features within the insurance industry, customer due diligence, role of the supervisor, and case studies. It is expected that the paper will be adopted in 2005. The IOSCO's Task Force on Client Identification and Beneficial Ownership has developed a paper "Principles on Client Identification and Beneficial Ownership for the Securities Industry," which was approved by the IOSCO Technical Committee in May 2004.

90. **The International Association of Deposit Insurers was established in 2002.** Its mission is to contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation.

91. **A special IOSCO Project Team on Cooperation has completed the development of a multilateral Memorandum of Understanding (MoU) to enhance information exchange among securities regulators and facilitate financial crime investigation.** The MoU, which was endorsed in May 2002, builds on the many previously existing IOSCO Resolutions and Principles to establish an international benchmark for cooperation and information sharing. A report "Regulation of Intermediaries in a Cross-Border Environment" was issued by the IOSCO Technical Committee in September 2003. This report addresses regulatory issues

relating to the increased provision of cross-border services by market intermediaries that do not have a physical presence in the jurisdiction in which the service is provided.

92. **Implications of the use of Internet in securities related activities have been considered in a series of roundtable discussions hosted by IOSCO.** Financial service regulators, consumer groups, financial service firms and relevant information services firms, such as Internet service providers, have been invited. A "Report on Securities Activity on the Internet III," summarizing the discussions at the Roundtables, was adopted in October 2003.

Standard Setters and Role of Fund Staff

Standard Setter	Membership	Fund Representation	Role of Fund Staff
Basel Committee on Banking Supervision (BCBS)	The Basel Committee member countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the U.K., and the U.S.	The Fund staff is represented in the Core Principles Liaison Group and Working Group on Capital and attends ICBS meetings.	Fund staff participates in the work of the Core Principles Liaison Group and the Working Group on Capital and promotes Fund's agenda. For instance, Fund staff recently highlighted the need for Basel Committee guidance on loan classification and provisioning to complement capital adequacy guidelines. Staff has also provided substantial input on the areas for revisions of the BCP and is included in key drafting groups, for instance, on guidance for the transition to Basel II and on revising the BCP.
International Organization of Securities Commissions (IOSCO)	IOSCO has over 184 members, representing most jurisdictions with a securities market.	The Fund staff is an affiliate member of IOSCO and Fund staff attends the annual meetings. Fund staff is a member of the Implementation Committee established to develop mechanisms to promote the implementation of IOSCO's standards among members of the organization.	Staff has participated in the development of the IOSCO Methodology on the implementation of the IOSCO Objectives and Principles of Securities Regulation. In consultation with the Bank and IOSCO, staff has implemented a program to test the IOSCO Methodology in the field and will be providing detailed feedback to IOSCO on the efficacy of the Methodology in the context of the FSAP.
International Association of Insurance Supervisors (IAIS)	IAIS: supervisory authorities of some 100 jurisdictions Reinsurance Task Force of the IAIS (TF Re): Supervisors and industry participants from the major reinsurance jurisdictions (US, UK, Germany, Switzerland, Bermuda, France, and Japan) plus IMF and WB.	The Fund staff has an observer status. IAIS Annual Meetings attended by Fund staff TF Re: Fund staff members were members of the TF secretariat	Reinsurance Task Force of the IAIS: Staff has provided input, both conceptually and practically, to the design of global reinsurance market database, which will form basis for greater transparency. Fund staff also provided substantial input into the final report of the TF.
Committee on Payment and Settlement Systems of the G-10 countries (CPSS)	Central Banks of G-10 countries (secretariat: the Bank for International Settlement in Basel)	The Fund staff is represented in both subgroups.	Staff will provide substantial input to the drafting of the General Guidance Report. The input will be based on the FSAP and TA missions in the payment area, as well as on the review and coordination of these missions. Significant input was also provided to the Task Force for securities and settlement systems
International Accounting Standards Board (IASB) (replaced the earlier International Accounting Standards Committee in April 2001)	The IASB has 14 Board Members, 12 of whom are full-time. They have strong and acknowledged background in accounting and represent nine countries	The Fund staff is represented on the SAC.	In addition review of the exposure drafts issued by the IASB and their implications for analysis of financial information in relation to the FSAP, staff actively participates in the regular meetings of the Standards Advisory Council.
International Association of Deposit Insurers (IADI)	Twenty eight member countries and nine associate members, the IMF, the European Forum of Deposit Insurers, and the EBRD.	Fund staff is a member, and has participated in several conferences hosted by IADI.	The first year of the institution has focused on internal development and structure. Staff has not participated in these discussions.
AML/CFT Standards and Organizations			
A. Financial Action Task Force on Money Laundering (FATF)	Established in 1989 by the G-7 Countries, the European Commission and eight other countries, FATF's membership has grown to 31 countries and territories and two regional organizations. Over 20 international organizations and bodies have observer status (the secretariat is located in Paris, France).	The Fund staff is an official observer at the FATF, and is represented at the plenary.	

Standard Setter	Membership	Fund Representation	Role of Fund Staff
B. Offshore Group of Banking Supervisors (OGBS)	Nineteen jurisdictions with offshore centers: Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Cyprus, Gibraltar, Guernsey, Hong Kong SAR, Isle of Man, Jersey, Labuan (Malaysia), Macau SAR, Mauritius, Netherlands Antilles, Panama, Singapore, and Vanuatu. Established in 1980 following an initiative of the Basel Committee of Banking Supervisors (BCBS). It is not an independent standard setter but participates in the definition of cross-border banking supervisions standards; it has a status equivalent to an FSRB and participates in mutual evaluations of members.	The Fund staff is usually invited to the plenary and attends in order to keep the group informed of our OFC program and obtain feedback from members.	
C. EGMONT Group of Financial Intelligence Units (EGMONT)	EGMONT is an informal gathering of Financial Intelligence Units (FIUs) without an internationally binding agreement or any formal mandate. Established in 1995, it currently has 84 members. Its objective is to strengthen the exchange of information and experiences in the fight against money laundering, among FIU.	Given the nature of the organization, the Fund staff is not officially an observer and is not routinely represented. Nevertheless, EGMONT has invited the Fund to discuss issues of common interest (i.e., last Plenary's explanation of the IMF role on AML/CFT assessments and technical assistance).	Outreach presentation of IMF anti-money laundering work and explanation of available TA.
D. "FSRBs" (FATF-Style Regional Bodies)	FSRBs are regional intergovernmental organizations established to pursue broadly the same goals of the FATF (with occasional additional mandates) within a specific geographic area (i.e., in the Caribbean, Europe, South-Eastern Africa, or South America). Some members of FATF are also members of their respective regional organization (e.g., Brazil, Russia)		The Fund staff's work with all FSRBs can be summarized as follows: a) Outreach through observer status of the IMF (a nonpaying member): IMF attends plenary meetings; explains its role on AML/CFT; encourages TA requests from countries and regional bodies; obtains global knowledge of issues, difficulties and problems in applying international standards; b) Coordination of assessment schedule mutual evaluations to avoid duplication and obtain information FSP/OFC assessments; supply of independent assessment experts (IAEs) for assessments; c) Cooperation (TA): exchange of countries' needs; training of mutual evaluators on the use of the methodology and assessment expertise; support for FSRB workshops; provision of regional TA; identifying IAE and other short term experts for assessments; d) Review of reports on proforma basis for IMFs internal use (still very few but expected to increase).