PART 2

PAPERS PRESENTED AT THE CONFERENCE

New International Standards for Financial Stability: Desirable Regulatory Reform or a Runaway Juggernaut?

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This paper briefly reviews the what, why, who and when of standards, discusses some of the motivational origins of the current impetus for standards, summarises the author's understanding of the official Indian view of standards, raises some doubts and issues for discussion, and ends with some concluding remarks.

What, Why, Who and When of Standards

What are standards? Perhaps the best concise description comes from the relevant page of the Financial Stability Forum (FSF)'s website:

> *Standards are codes, guidelines or principles that set out what are widely accepted good practices. Standards relevant for domestic and international financial systems cover a broad range of areas:*
>
> - *transparency of fiscal, monetary and financial policies;*
> - *dissemination of economic and financial data;*
> - *regulation and supervision of banking securities and insurance;*
> - *information disclosure, transparency, risk management and internal controls of financial institutions;*
> - *corporate governance, accounting, auditing and bankruptcy;*
> - *payment and settlement systems.*

For those who want more details, exploration of the FSF website is a recommended activity.

Why are standards important? According to the FSF website:

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[1]At the time of the Conference (June 2000) the author was Visiting Research Fellow at Merton College, Oxford University, on leave from regular assignment as Chief Economic Adviser, Ministry of Finance, Government of India. This paper was written in a personal capacity and the views expressed may not be attributed to the Government of India.

> *The widespread adoption of high-quality internationally accepted standards, or codes of good practice, can make an important contribution to effective policy-making, well-functioning financial markets and a stronger international financial system.*[1]

Who sets standards? The FSF lists a number of organisations, including the IMF, the Basle Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Committee on Payment and Settlement Systems (CPSS) and the Organisation for Economic Co-operation and Development (OECD).

When do standards become operational? There is no simple answer to this question. In the case of some standards, such as the Special Data Dissemination Standard (SDDS), a large number of countries (including many developing countries) have already made their prior commitments operational. In the case of others, many countries have accepted standards in principle without committing themselves to deadlines for their attainment. As a rule of thumb, most OECD countries are in compliance (or are close to compliance) with most standards, while many developing countries are at varying distances from compliance with regard to most standards. This is not surprising since financial development (including of institutions and standards) is closely correlated with overall development. One would expect a country like Belgium to be much closer to full compliance on the entire range of standards than a country like Rwanda!

The Recent Resurgence of Standards

Standards have been around for a long time, for example, the Basle prudential norms for the banking sector. Work on some standards, such as those for data dissemination and fiscal transparency, predate the onset of the East Asian crisis in mid-1997. There is no question but that the crisis and its various diagnoses imparted a strong impetus to the design, proliferation and implementation of standards. The IMF, the Bank for International Settlements (BIS) and the newly established FSF have become the nodal institutions for the resurgence of activity relating to standards.

There are several reasons for this resurgence. First, and most obviously, some analysts and policy-makers (especially in some G-7 countries) believe that more and uniformly implemented standards can provide a panacea for prevention of financial crises. For example, Eichengreen, a normally sober analyst of international economics, makes a passionate

[1]For more details, see Annex.

plea for stronger standards, strongly implemented:[1]

> *A first area requiring a major international initiative is international financial standards. In a world of integrated financial markets, international financial stability is impossible without domestic financial stability. Stabilising the financial system consequently requires institutional reforms extending well beyond policies towards external trade and payments. That it requires rigorous disclosure requirements and effective supervision of banks and corporations borrowing on financial markets is now agreed on. Some will argue that this is as far as the international community and the IMF should go in intruding into the internal affairs of countries. I argue that they must in fact go further . . . that the need for domestic institutional reforms with implications for the stability of the international financial markets extends beyond this point. It extends to the use of internationally recognised auditing and accounting practices so that lenders can accurately assess the financial condition of the banks and corporations to which they lend. It extends to effective creditor rights, so that claimants can monitor and control the economic and financial decisions of managers. It extends to investor protection laws to prevent insider trading market cornering, and related practices in whose absence securities markets will not develop. It extends to fair and expeditious corporate bankruptcy procedures, without which debt problems can cascade from borrower to borrower. While these are problems for individual countries to address as they see fit whether they arrive at an adequate solution is also of pressing concern to the international policy community, given the scope for financial problems to spill contagiously across borders.*

This paper will put forward some reservations about the 'intrusive' reform agenda outlined above. First it will outline some further reasons for the current preoccupation with standards.

Standards are the lowest common denominator of agreement among key players (notably the G-7 and the IMF) regarding measures for restructuring the pre-Asian-crisis international financial architecture. While there has been a great deal of discussion of more radical suggestions, including restructuring the Bretton Woods Institutions (mooted by the British Government in the early stages of the Asian crisis), incorporating various alternatives of the 'lender of last resort' idea into the international architecture, various schemes for involving the private sector in crisis resolution and so on, the discussion has not yet yielded concrete results. Against such a background, the drive for standards might be responding

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[1]See Barry Eichengreen, *Towards a New International Financial Architecture*. Institute for International Economics, February 1999, p. 10.

to a thought chain of the following kind: there has been an international financial crisis; we (the 'international community') must do something; standards is something; let's do standards!

A third and related reason could be that implementing international financial standards by and large entails little fresh effort by the G-7 or OECD economies, which are the key decision-making countries in the international economic arena. So the burden of fresh effort involved in the new reforms is cast not on the key decision-makers, but on the rest of the (mostly developing) world. Fourthly, the impetus for standards might have drawn strength from the winds of 'glasnost' that have been blowing through the political and economic affairs of nations in the last 15 years, placing a greater premium on transparency and rules, and putting a discount on discretionary decision-making and opacity.

Standards: The Official Indian View

One interpretation of the official Indian view (the author's understanding is handicapped by ten weeks of absence from official corridors) may be summarised as follows:

- Agreement on international financial standards and commitment to progressive moves towards their attainment are a necessary entry price for India's policy of increasing integration into the world economy, including granting a greater role to foreign capital;
- Such moves are also impelled by an autonomous desire to reform the domestic financial sector and a growing commitment to greater transparency in economic and financial policies;
- Accordingly, India has established a Standing Committee on International Financial Standards and Codes, chaired by Reserve Bank Deputy Governor, Dr. Y.V. Reddy (one of the participants at this conference), which, in turn, has set up ten advisory groups with a general mandate to compare existing Indian practices with prevailing international standards and to make broad recommendations on strategies for bringing about greater convergence. These groups relate to the following subjects:

  – transparency of monetary and financial policies
  – corporate governance
  – payment and settlement systems
  – bankruptcy laws
  – data dissemination
  – insurance regulation
  – banking supervision

– securities market regulation
– fiscal transparency
– accounting and auditing

Clearly it is a serious enterprise.

At the same time, in various international fora such as the IMF and G-20, India has cautioned against inappropriate and untimely use of standards in international economic affairs. Specifically, India has:

- argued against a mechanical checklist approach to standards;
- strongly emphasised the importance of adequate and flexible transition periods for the attainment of standards, with due allowance for initial country conditions;
- expressed opposition to the deployment of standards in IMF conditionality.
- counselled in favour of identifying priorities in standard setting.

Having stated one view of the official Indian position (subject to suitable correction by Dr. Reddy), this paper will move on to raise some issues and doubts about the general enterprise of international financial standards.

Some Issues

At a general level, standards are clearly desirable – like motherhood and apple pie (at least in the old days!). Nevertheless, taking a cue from Amartya Sen's Harvard Commencement Address, delivered a fortnight ago and entitled 'Global Doubt', the paper will raise a few issues from a developing country perspective.

Firstly, the presumed importance of international financial standards in crisis prevention (as presumed, for example, by Eichengreen in the passage quoted earlier) may be exaggerated. Analysis of major recent financial crises, such as the (EU) Exchange Rate Mechanism crisis of 1992, the Mexican crisis of 1994 and the more recent East Asian crisis, suggests important causal roles for inappropriate exchange rate policy, excessive reliance on short-term external borrowing, high current account deficits in the balance of payments and premature adoption of capital account convertibility, to list just a few of the other important factors frequently cited in analyses of these crises. Hence, from the vantage point of crisis prevention, excessive preoccupation with improving financial standards could detract from adequate attention to other policy factors which are possibly at least as important as financial standards in explaining such crises.

Secondly, the importance of sound financial standards in crisis prevention probably varies with the degree of convertibility on capital account practised by a country. Financial standards in China and India may not have been better than crisis-impacted East Asian countries. But China and India were able to weather the gales of contagion at least partly because of their limited degree of openness on the capital account. Nor is full capital account convertibility an indubitably significant prerequisite for sustained economic development – both economic history and economic analysis demonstrate this.[1] Therefore, hurrying all developing countries down the path of rapid attainment of a uniform set of international financial standards may not be an analytically sound strategy.

Thirdly, the advocacy of uniform standards assumes 'one size fits all'. Surely some elements of the recommended standards (for example, those relating to bankruptcy laws and corporate governance) might be expected to differ considerably to reflect a variety of institutional structures present in different countries.

Fourthly, all this might not have mattered if attainment of the recommended international financial standards was a relatively low-cost proposition. If it were, one could argue that quickly strengthening standards was a good insurance against financial crisis. But available evidence suggests that attaining the recommended standards could be a long and arduous process. In that case it is surely relevant to essay some kind of cost-benefit assessment, however heuristic?[2]

Fifthly, in the absence of a sound analytical basis, it is surely premature to advocate, as Eichengreen does, the incorporation of standards as part of routine IMF conditionality. Such conditionality is already often burdened by dubious elements – the addition of a fresh new set of doubtful desired data is probably not called for.

Sixthly, before cheerleading for rapid adoption of uniform standards, there is an urgent need to prioritise and identify core standards. As Andrew Crockett of the BIS notes, there are now over 60 standards on

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[1]See, for example, Jagdish Bhagwati, 'The Capital Myth: The Difference between Trade in Widgets and Dollars', *Foreign Affairs* 77:7–12,1998 and various papers by Joseph Stiglitz.

[2]The argument that financial crises typically exact tolls amounting to a significant percentage of GDP, and that therefore standards are a good insurance, is not valid in the absence of evidence on either the relative roles of standards versus other factors (such as inappropriate exchange rate policy) in causing crises or the costs of attaining standards.

the website of the FSF![1] Prioritisation would lend greater credence and practicability to the enterprise of bringing in uniform international financial standards. Crockett appreciates the complexity of implementing standards. He states: 'It would be unreasonable to expect an emerging or developing country with a rudimentary financial sector to comply with standards that an advanced financial centre has reached only after decades of development. Sensitivity will be required to balance the desire to move quickly to best practice, with the need to recognise practical constraints.'

Seventhly, there may be greater need to involve the private sector in both the design and implementation of standards than is currently envisaged. We have to remind ourselves (and the standard setters) that a primary motive for having standards is to encourage more (and more orderly) private capital flows. Therefore it would seem reasonable to have greater consultation with the private sector, especially in identifying core standards. Furthermore, when it comes to implementation, it may be much more effective to rely on market incentives and disincentives rather than *dirigiste* tools such as IMF conditionality.

Concluding Remarks

So, returning to the title of this paper, are international financial standards desirable regulatory reforms or are they becoming a runaway juggernaut? This paper has attempted to raise issues and doubts as a warning against the danger of the latter possibility without wholly detracting from the real value of the former.

In answering these questions the following rules of thumb or guidelines should be considered:

- International financial standards can play a very useful role in strengthening domestic financial systems and, as a result, the international financial system.
- There is a need for prioritisation and identification of core standards. The pace, pattern and intensity of standards implementation should be left to member countries of the international community, with market incentives playing the key role.
- The IMF's role should be limited to the dissemination of information; it should not extend to the incorporation of standards into Fund conditionality.

[1]Andrew Crockett, 'Progress Towards Greater International Financial Stability'. Mimeo, May 2000.

- Above all, standards should not distract countries from the design and management of sensible macro-economic policy, especially with regard to exchange rates, external debt management and the pace of movement towards capital account convertibility.

Annex. Extract from the Financial Stability Forum website

Compendium of Standards

What are Standards?

Standards are codes, guidelines or principles that set out what are widely accepted as good practices. Standards relevant for domestic and international financial systems cover a broad range of areas:

- transparency of fiscal, monetary and financial policies;
- dissemination of economic and financial data;
- regulation and supervision of banking, securities and insurance;
- information disclosure, transparency, risk management and internal controls of financial institutions;
- corporate governance, accounting, auditing and bankruptcy; and
- payment and settlement systems.

Why are Standards Important?

The widespread adoption of high-quality internationally accepted standards, or codes of good practice, can make an important contribution to effective policy-making, well-functioning financial markets and a stronger international financial system.

Enhanced disclosure of economic and financial statistics and greater transparency of the processes by which governments formulate macroeconomic and financial policies will improve the accountability of policy-makers and help markets to adjust more smoothly to economic developments, minimise contagion and reduce volatility. Adopting internationally accepted standards of financial supervision and regulation will help policy-makers implement policies that promote sound and efficient markets and enhance credibility and investor confidence.

Providing market participants with internationally recognised benchmarks on disclosure, transparency, risk management and other practices and procedures against which to compare information, should lead to better informed lending and investment decisions. Transparency of the private sector is of particular importance to the orderly and efficient functioning of financial markets.

Through promoting sound policy-making and orderly and efficient markets, the voluntary adoption of standards of good practice will in turn help to make the international financial system stronger and more stable.

Who are the Standard-Setting Bodies?

International Monetary Fund (IMF): The IMF develops and monitors international standards in areas of direct operational relevance to its mandate to carry out surveillance over the international monetary system. In collaboration with other standard-setting bodies, it has developed international standards for data dissemination and transparency practices in fiscal, monetary and financial policies, and has contributed to the development of international standards for banking supervision. The IMF has prepared on an experimental basis several country reports on implementation of standards and codes of best practices.
http://www.imf.org

Basel Committee on Banking Supervision (BCBS): The BCBS, established by the G10 Central Banks, provides a forum for regular co-operation among its member countries on banking supervisory matters. The BCBS formulates broad supervisory standards and guidelines and recommends statements of best practice in banking in the expectation that bank supervisory authorities will take steps to implement them.
http://www.bis.org

International Organisation of Securities Commissions (IOSCO): IOSCO is an organisation for co-operation among national regulators of securities and futures markets. IOSCO develops and promotes standards of securities regulation in order to maintain efficient and sound markets. It draws on its international membership to establish standards for effective surveillance of international securities markets and provides mutual assistance to promote the integrity of markets by a rigorous application of the standards and effective enforcement against offences.
http://www.iosco.org

International Association of Insurance Supervisors (IAIS): The IAIS, established in 1994, is a forum for co-operation among insurance regulators and supervisors from more than 100 jurisdictions. It is charged with developing internationally endorsed principles and standards that are fundamental to effective insurance regulation and supervision. After having developed the IAIS Core principles, Insurance Concordat and several other standards, much of the IAIS's recent work on standard setting has focused on developing standards in the areas of solvency, insurance concordat to cover cross-border service provision, asset risk management, group co-ordination of financial conglomerates, reinsurance, market conduct and electronic commerce.
http://www.iaisweb.org

Committee on Payment and Settlement Systems (CPSS): The CPSS, established by the G10 Central Banks, provides a forum for regular co-operation among its member central banks on issues related to payment and settlement systems. It monitors and analyses developments in domestic payment, settlement and

clearing systems as well as in cross-border and multi-currency netting schemes. It also provides a means of co-ordinating the oversight functions to be assumed by the G10 Central Banks with respect to these netting schemes. The CPSS formulates broad supervisory standards and guidelines and recommends statements of best practice in banking in the expectation that bank supervisory authorities will take steps to implement them. In addition to addressing general concerns regarding the efficiency and stability of payment, clearing, settlement and related arrangements, the Committee pays attention to the relationships between payment and settlement arrangements, central bank payment and settlement services and the major financial markets which are relevant for the conduct of monetary policy.
http://www.bis.org

Organisation for Economic Cooperation and Development (OECD): The OECD aims to promote policies designed to achieve sustained economic growth and employment in its member countries. In the area of promoting efficient functioning of markets, the OECD encourages the convergence of policies, lawshttp://www.oecd.org

How is the Compendium Organised?

The standards contained in the *Compendium* can be referenced by: (a) the **subject areas** listed below; (b) the **issuing bodies** listed in the previous page; or (c) **date**, by clicking on the relevant links in the horizontal "Browse by" navigation bar above. The subject areas are:

- Public sector;
- Banking;
- Securities;
- Insurance;
- Corporate; and
- Payment and Settlements.

These subject areas are further categorised into relevant sub-sections. The standards are listed under these sub-sections with their full titles and a synoptic description. Each of these standards is in turn linked to a more detailed **data field** which contains the following information:

- Document Name:
- Subject Area:
- Issuing Body:
- Date:
- Status:
- Language:
- Location: *this is a hyperlink to where the source standard is located on the issuing body's website*
- Synoptic Description: 30–50 words
- Detailed Description: 200–1000 words