International Standards and Domestic Regulation

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Introduction

Standards and codes, in one form or another, have helped to shape the environment for international economic and financial relations for a long time. In some cases these standards and codes have been enshrined in treaties or other formal legal agreements. But in many cases they have not, and whether and, if so, how they have then been implemented has to a significant extent been at the discretion of individual countries.

This paper discusses current initiatives in the area of standards and codes under the headings of 'Why?', 'What?' and 'How?'. Why are these initiatives being pursued? What standards and codes are we talking about? How, in practice, is it proposed that they should be implemented?

Why?

A number of factors have contributed to the recent focus on standards and codes.

First, ***globalisation***. National economies are increasingly interlinked, so that problems in one can have rapid and significant knock-on effects in others. Put in a slightly different way, as countries seek to integrate themselves more closely into the global economy, the externalities associated with their conduct of national economic and financial policies increase. Other members of the 'club' may understandably look for reassurance that everyone is playing by broadly the same rules or, at least, is not exposing the club as a whole to unreasonable risks.

Second, the specific implications of ***greatly expanded international capital*** flows. Over the past 15 years, the outstanding stock of cross-border bank lending, as recorded in the statistics compiled by the Bank for International Settlements (BIS), has risen from under \$1 trillion to \$6½ trillion, that is by a factor of about seven. There has probably been even faster growth in other kinds of cross-border financial claims. This compares with an increase in nominal world GDP by a factor of about two and a half and in nominal world trade by a factor of about three. The extent of these financial exposures means that the transmission of shocks is likely to be quicker, and quite likely more damaging, than would arise purely from trade effects.

Third, the ***increased emphasis on private markets***. Not only has the value of capital flows risen but the sources of funding for some developing countries and many emerging markets have shifted decisively from public to private. Correspondingly, there has been greater focus on factors contributing to the efficient functioning of private markets, including especially the availability of accurate and timely information.

Fourth, ***recent experience***. The concern about knock-on effects is not simply theoretical – over the past 20 years there have been several examples of problems affecting sizeable economies which have threatened wider systemic damage. From Mexico in 1982 through the other Latin American debt crises of the 1980s, to Mexico again in 1994 and 1995, and then the East Asian debt problems of 1997 and 1998, to Russia in 1998 and Brazil in 1999 – all have called for intervention by the international financial institutions and/or by national authorities in order to contain the potential contagion.

No-one believes that formulating standards and codes, and monitoring and promoting compliance with them, is a complete response to these problems. There were clearly many contributory factors. But in most of the countries concerned there were areas where policy fell short of recognised good practice, or where features of the financial infrastructure – for example the regulatory regime – left the financial system excessively vulnerable or where there was simply not enough reliable information available for lenders and borrowers to make a proper assessment of risk. The position certainly differed from country to country. But there was sufficient commonality of experience to allow some general lessons to be drawn – and the current work on standards and codes is partly aimed at capturing those lessons.

What?

In referring to standards and codes it is worth emphasising that these are not legally enforceable rules. Most obviously this is because very little international legal machinery would be available to enforce such rules. But, even if the machinery were available, a legalistic approach might not be desirable for all sorts of reasons. (It is just worth noting, however, that in the admittedly special context of the EU, there are now many examples of transnational legally-enforceable standards and codes, including many relating to economic and financial issues.) This, of course, leaves open the question of what happens when a country fails to meet a relevant standard.

Codes have been drawn up and standards established by all sorts of bodies. This paper will not enumerate those currently recognised in the so-called Compendium. Depending on exactly what is counted, there are around 55 going on 65 in total. They can be classified in a number of different ways. In terms of subject, there are three main areas: macro-economic fundamentals; institutional and market infrastructure; and financial regulation and supervision. A list is shown in Table 1. But the list can also be divided up in other ways: between standards which are sectoral in scope (for example standards relating to banking supervision) and those which are functional (such as standards relating to corporate governance or accounting); between standards which take the form of broad principles (for example the Basle Committee's Core Principles for Effective Banking Supervision), those which spell out in more detail the intended practical application of the principles (such as the Basle Committee's Sound Practices for Loan Accounting) and those which set out detailed methodologies (such as the IMF's Special Data Dissemination Standard); and finally, the standards can be separated depending on their degree of formal international endorsement.

Table 1. International Standards

Macroeconomic Policy and Data Transparency	
Code of Good Practices on Fiscal Transparency	IMF
General Data Dissemination System (GDDS)	IMF
Special Data Dissemination Standard (SDDS)	IMF
Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Institutional and Market Infrastructure	
Principles of Corporate Governance	OECD
International Accounting Standards	IASC
International Standards on Auditing	IFAC
Core Principles for Systemically Important Payment Systems	CPSS
Real Time Gross Settlement Systems	CPSS
Settlement Risk in Foreign Exchange Transactions	CPSS
Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (The 'Lamfalussy Report'	CPSS
OTC Derivatives: Settlement Procedures and Counterparty Risk Management	CPSS
Clearing Arrangements for Exchange-Traded Derivatives	CPSS
Delivery Versus Payment in Securities Settlement Systems	CPSS
Ten Key Principles for the Improvement of International Co-operation Regarding Financial Crimes and Regulatory Abuse	G-7
The Forty Recommendations of the Financial Action Task Force on Money Laundering	FATF

How Should We Design Deep and Liquid Markets	CGFS
Financial Regulation and Supervision	
Core Principles Methodology	BCBS
Sound Practices for Banks' Interactions with Highly Leveraged Institutions	BCBS
Core Principles for Effective Banking Supervision	BCBS
International Convergence of Capital Measurement and Capital Standards	BCBS
Amendment to the Capital Accord to Incorporate Market Risks	BCBS
Supervisory Framework for the use of 'Backtesting' in Conjunction with the Internal Models Approach to Market Risk Capital Requirements	BCBS
The Supervision of Cross-Border Banking	BCBS
Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments	BCBS
Principles for the Supervision of Banks' Foreign Establishments (the Concordat)	BCBS
Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms	BCBS
Sound Practices for Loan Accounting, Credit Risk Disclosure and Related Matters	BCBS
Enhancing Bank Transparency	BCBS
Principles for the Management of Credit Risk	BCBS
Framework for Internal Control Systems in Banking Organisations	BCBS
Operational Risk Management	BCBS
Risk Management for Electronic Banking and Electronic Money Activities	BCBS
Principles on the Management of Interest Rate Risk	BCBS
Risk Management Guidelines for Derivatives	BCBS
Objectives and Principles of Securities Regulation	IOSCO
IOSCO Resolution: Principles for Record Keeping, Collection of Information, Enforcement of Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws	IOSCO
Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms which Permit the Use of Models under Prescribed Conditions	IOSCO
Guidance on Information Sharing	IOSCO
Report on Co-operation Between Market Authorities and Default Procedures	IOSCO
Principles of Memoranda of Understanding	IOSCO
Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms	IOSCO
International Disclosure Standards for Cross-border Offerings and Initial Listings by Foreign Issuers	IOSCO
Risk Management and Control Guidance for Securities Firms and their Supervisors	IOSCO
Client Asset Protection	IOSCO
Operational and Financial Risk Management Control Mechanisms for Over-the-counter Derivatives Activities of Regulated Securities Firms	IOSCO
Securities Activity on the Internet	IOSCO)
The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts	IOSCO

Principles for the Supervision of Operators of Collective Investment Schemes	IOSCO
Report on Investment Management Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum	IOSCO
Co-ordination between Cash and Derivative Markets: Contract Design of Derivative Products on Stock Indices and Measures to Mini	IOSCO
Insurance Core Principles	IAIS
Principles on the Supervision of Insurance Activities on the Internet	IAIS
Supervisory Standard on Group Co-ordination	IAIS
Insurance Core Principles Methodology	IAIS
Principles for the Conduct of Insurance Business	IAIS
Supervisory Standard on On-Site Inspections	IAIS
Supervisory Standard on Licensing	IAIS
Guidance on Insurance Regulation and Supervision for Emerging Market Economies	IAIS
Model Memorandum of Understanding	IAIS
Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-Border Operations	IAIS
Supervisory Standard on Asset Management by Insurance Companies	IAIS
Supervisory Standard on Derivatives	IAIS
Supervision of Financial Conglomerates	JF
Intra-Group Transactions and Exposure Principles	JF
Risk Concentration Principles	JF

All this illustrates the diversity of approach reflected under the general heading of standards and codes. The length of the list also indicates that it would be a tall order indeed to try to make progress on implementation uniformly across the entire list.

How?

The infeasibility of an 'across-the-board' approach for 50 or so standards over 180 countries is of course well recognised, and there are several ways of making the task more manageable. The first has been to identify a much smaller group of 12 key standards. A second has been to acknowledge that different standards have different priorities for different countries, and that these priorities are likely to change over time. Indeed, in some cases there is probably a rather strict sequencing implicit in the standards themselves – it would, for example, be foolish to put a lot of effort into the more esoteric aspects of prudential banking supervision in the absence of a proper accounting framework for the measurement of asset values, capital and so on. The 'key' standards are key in the sense that the aim of meeting them would make sense for many, even if not all, countries.

The second point to make under the heading of 'How?' is that, without someone to orchestrate and monitor the process of implementation, there is a risk that momentum will be lost. Even if everyone accepted in principle that all the standards and codes were sensible – and that would probably be an optimistic assumption – there are many potential difficulties in turning theory into practice, sufficient certainly to threaten that the process of implementation would run into the sands. Who should this orchestrator be? No institution has an operational remit which runs across all the areas covered by the various standards and codes. But the IMF probably comes closest – *pace* those who would curb its role – and it is arguable that the IMF is the appropriate body to take on the task. The task, however, is to monitor and co-ordinate the overall process, not to be responsible for each of the individual parts. As Jack Boorman of the Fund aptly describes it, the IMF would maintain the 'loose-leaf binder' into which reviews and assessments of progress, produced in some cases by the IMF but in many cases by others, could be slotted. The so-called ROSC process, and the work on FSAPs, involving both the IMF and the World Bank, are practical manifestations of this approach.

A third important, but contentious, aspect of implementation is the question of incentives. Why should a country commit itself to observe these standards and codes? The general incentive, if the standards and codes are well formulated, should be that compliance will improve national economic performance. But there is an issue whether, beyond that, there are specific incentives which the private sector or the public sector might provide. This paper will not enter into the detail of the arguments, except to note that one approach to the question is from the point of view of the identification, measurement and management of risk. It would be quite reasonable for private lenders and investors to take into account compliance with relevant standards and codes if they thought that it affected the risks they were running. It would also seem reasonable, on the same basis, that public sector lenders should take these considerations into account. But public sector lenders also need to have in mind 'systemic' externalities, that is, that the failure of a country to meet its obligations may threaten the financial system generally and require their intervention to contain the consequential systemic damage. To that extent, they may put more weight than the private sector on compliance with standards and codes as providing some protection against this risk.

A final, and again important, consideration under the heading of 'How?' is that of technical assistance and training. Whatever the incentives, there are bound to be limits for many countries to their technical capacity to implement standards and codes; and there may also be constraints on the capacity of the IFIs and/or standard setters to monitor implementation. In turning the standards and codes programme into reality, it will be necessary to address these resource issues.

Conclusions

This paper has been pitched at a rather general level but it is intended to give a flavour of some of the issues which have arisen in discussions about the formulation and implementation of standards and codes. Overall, the setting out of these standards, and transparency about their implementation, could make a significant contribution to strengthening the international financial system.

Three further points are relevant to any discussion of standards and codes in the global financial system.

- First, better information about borrowers is only half the story. The counterpart is the need for lenders and investors to make proper use of that information. The evidence on the extent to which they do this is patchy but it certainly cannot be taken for granted that all lenders, even all major lenders, will give due weight to additional information when it is available. There is an important challenge to find incentives which can be applied to lenders so as to encourage them to pursue improved risk-management practices in this area.
- Second, effective implementation of the standards and codes programme involves many different parties. The official interest is reflected in various international committees; but it is important also that the private sector should be engaged. For that reason, a number of initiatives under the general heading of 'outreach' are underway, aimed at telling private market participants what is going on, seeking their views on what information and in what form they would find most useful, and encouraging them to make use of it. The IMF and the Financial Stability Forum have been particularly active in promoting such dialogue.
- Third, it is important to have a realistic timetable for carrying through the standards and codes programme as it has now been set out. It is not something which can be delivered overnight, within a few months or even within a year or two. It is bound to be a long-term exercise. Recognising that, however, should not become a reason for delaying progress now.