Report of the Follow-Up Group on Incentives to Foster Implementation of Standards

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I. Key Findings and Recommendations

1. Implementation of international standards is a key component of efforts to strengthen domestic economic and financial systems and promote international financial stability.

2. ***Market incentives*** can encourage national authorities, and where relevant, the private sector, to implement international standards, provided certain preconditions are met. Consultations with market participants make clear that efforts are needed on many fronts to establish these preconditions.

3. Given their recent origin, most market participants are not very familiar with either the 12 standards recognised by the FSF as key to sound financial systems or the Fund-Bank *Reports on Observance of Standards and Codes (ROSCs)*. Thus, few market participants to-date explicitly take account of an economy's observance of standards in their lending and investment decisions, or use ROSCs directly for risk assessments leading to pricing and allocation decisions. However, there is implicit consideration of information on observance of standards insofar as market participants look at features of the economy covered by the 12 key standards, and interest in making greater use of standards and ROSCs as more information on them becomes available.

   - FSF members should mount a sustained education effort to help raise the general level of awareness of standards in their respective financial centres, drawing on resources and expertise from the international financial institutions (IFIs) and standard-setting bodies,
   - The FSF should encourage the IFIs and standard-setting bodies to enhance further their ongoing efforts to help raise the level of awareness of relevant standards. More active marketing is needed than merely placing information on websites.
   - The FSF should encourage the IFIs, standard-setting bodies, and national authorities to better demonstrate how information on observance of standards can help provide insights on the risk factors that market participants are most interested in. This would include using their outreach programmes to clarify the role of standards in strengthening financial systems, emphasising that standards have been developed in response to past crises and undertaking analytical work on the links between observance of standards and potential vulnerabilities.
   - The FSF should encourage: (a) the IFIs and standard setting bodies to enhance the availability of information on observance of standards; and (b) the IFIs to enhance the presentation of ROSCs taking recent feedback into consideration. FSF members should make a commitment to disseminate information on assessments they might undertake.

4. ***Official incentives*** can be a powerful means to encourage economies to implement standards and to reinforce market incentives. A three-pronged approach is proposed.

5. First, since achieving observance of all 12 key standards would be very demanding for many economies, emphasis could be placed on incentives that are aimed at *encouraging economies to adopt standards and credible implementation plans*. External assessments

of economies' observance of standards are necessary for market incentives and most official incentives to work; self-assessments might be a useful preparation for external assessments. Policy dialogues can provide effective peer pressure and assistance, and impetus for reform. Technical assistance and training can help economies build the capacity to implement standards and foster country ownership and buy-in.

- The FSF should encourage the efforts of the IFIs and standard-setting bodies in enhancing the conduct of *external assessments*, including those standards among the 12 key standards not currently included in the assessment programme. FSF members could demonstrate leadership by undertaking assessments of their own observance with relevant standards.
- The FSF should encourage the IFIs to consider how the mechanism for *policy advice* could be further enhanced, e.g. through giving greater weight to standards implementation issues within the IMF Article IV consultation process and the Fund-Bank *Financial Sector Assessment Programme (FSAP).*
- The FSF should encourage relevant international and regional groupings to promote *peer discussions* of progress in implementing standards, using ROSCs where appropriate.
- FSF members should make a commitment, and encourage other economies as well, to provide *technical assistance and training* for standards assessments and implementation, co-ordinated either bilaterally or through the IFIs and relevant international groupings, on the basis of assessed needs.

6. Second, incentives aimed at *promoting market discipline and disclosure of assessments* can help raise market participants' awareness of the role of standards, foster market demand for information on observance of standards, and place the onus on market participants to price the risks arising from material gaps in observance.

- FSF members should make a commitment to disseminate information on assessments of observance of relevant standards.
- FSF members should encourage the voluntary disclosure in prospectuses for international sovereign bond issues of material information on observance of relevant standards in the issuing economy and the use of similar information in financial institutions' risk assessment processes (e.g. in banks' internal credit ratings).

7. Third, market access measures and regulatory and supervisory actions aimed at *encouraging observance of relevant standards and disclosure of assessments* can be enhanced by building on current practice in many jurisdictions.

- FSF members should give greater consideration to a foreign jurisdiction's observance of relevant standards as one of the factors in making *market access* decisions, and in the *supervision and regulation* of (a) subsidiaries or branches of institutions from that jurisdiction; or (b) domestic institutions dealing with counterparties in that jurisdiction.

8. The implementation of the above recommendations will call for the commitment of substantial additional resources from the international community. The FSF should monitor the implementation and effectiveness of these recommendations. It is proposed that members of the Forum report progress in implementation on an ongoing basis.

II. Introduction

9. ***Background***. The implementation of international standards is an important component of efforts to strengthen domestic economic and financial systems and promote international financial stability. The international financial institutions (IFIs) and standard-setting bodies have done significant work in promulgating and assessing observance of standards. The IMF and World Bank have recently developed an organising framework for assessing observance of standards and relevant policies:

- The joint Fund-Bank *Financial Sector Assessment Programme (FSAP)* is aimed at assessing financial sector vulnerabilities and identifying developmental priorities, which involves an assessment of financial sector standards. The FSAP is a collaborative effort involving a range of national agencies and standard-setting bodies.
- The experimental Fund-Bank *Reports on the Observance of Standards and Codes (ROSCs)* are a vehicle for assembling summary assessments of standards across a range of areas, including financial sector standards assessed in the context of the FSAP and those covering data dissemination, fiscal transparency, and in the future, corporate governance and accounting.

The standard-setting bodies have or are in the process of developing detailed methodologies that could be used for self assessments or external assessments of their respective standards.

10. Drawing on this work, the FSF Task Force on Implementation of Standards, set up in September 1999, identified three key factors for fostering implementation of standards: (a) promoting country *ownership*; (b) providing a judicious blend of market and official *incentives*; and (c) mobilising *resources*. The FSF endorsed the report of the task force at its third meeting in March 2000.

11. ***Terms of reference***. To build on this, the FSF constituted a follow-up group to explore in greater depth issues related to market and official incentives that could encourage economies to implement standards.[1] In reviewing its terms of reference, the group agreed to focus on issues related to market incentives and regulatory, supervisory, and market access measures that could possibly serve as official incentives. The potential role of the terms and conditions attached to IMF and World Bank financing facilities in the context of official incentives is not addressed, in view of the ongoing review of these terms and conditions within the IFIs. To be specific when gathering market feedback and assessing possible official incentives, the group focused on the set of 12 key standards endorsed by the FSF.[2]

12. ***Key considerations***. This report provides an assessment of market incentives, based on a market outreach exercise; and a structured evaluation of various possible official

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1 The terms of reference and composition of this Follow-Up Group on Incentives to Foster Implementation of Standards are at Annex A and Annex B respectively.

2 A list of the 12 key standards is at Annex C.

incentives. It also sets out specific recommendations for the Forum's consideration. In making these recommendations, the group was guided by the following considerations:

- The implementation of standards is not an end in itself but a means to promoting sound financial systems, reducing vulnerabilities, improving transparency, and providing a benchmark to help guide domestic structural reform efforts.
- Market incentives can encourage national authorities, and where relevant, the private sector, to implement standards; official incentives can also play an important role in encouraging implementation and reinforce market discipline.
- Standards are diverse, varying in scope and specificity, and incentives to promote their implementation need to take this into consideration.
- Credible and timely information on economies' observance of standards needs to be available for market incentives and many official incentives to have effect.

III. Market Incentives

13. ***Rationale.*** Market incentives will have effect only to the extent that market participants use information on an economy's observance of standards in their risk assessments and reflect this in the *pricing or allocation* of *credit or investment* to that economy or institutions in that economy, e.g. in the form of differentiated credit ratings, borrowing spreads, or asset allocations.

14. ***Preconditions.*** For market incentives to work, market participants need to:

- be familiar with international standards;
- judge them to be of relevance to their risk assessments;
- have access to credible and timely information on observance of standards; and
- reflect this information in pricing and allocation decisions.

These preconditions provide a framework to consider issues related to promoting market incentives. The group conducted an informal dialogue with a wide variety of market participants from major financial centres to assess the degree to which these preconditions are present. A total of more than 100 financial institutions from eleven jurisdictions (Argentina, Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Sweden, UK, and US) participated in the outreach exercise.[3] The outreach was well-received by market participants; the key points from the feedback are highlighted here.

15. ***Familiarity with standards.*** Although the extent of familiarity varies widely, most market participants are not familiar with the 12 key standards. Sovereign risk analysts in

[3] The FSF outreach in Hong Kong was held in conjunction with separate outreach activities of the Bank and the Fund designed to increase awareness of the work underway in these two institutions; the Fund also participated in the outreach exercise in New York. The institutions that participated in the outreach include commercial banks, investment banks and securities houses, institutional investors and asset managers, and rating agencies. The outreach took the form of questionnaire surveys, bilateral meetings, and focus group discussions. A description of the modus operandi of the outreach exercise is at Annex D; a summary of the feedback is at Annex E.

rating agencies and banks appear to have a slightly higher degree of familiarity compared to institutional investors and fund managers. The best known standards are the *Special Data Dissemination Standard (SDDS)* and *International Accounting Standards (IAS)*, followed by the *Core Principles for Effective Banking Supervision*, *Code of Good Practices on Transparency in Monetary and Financial Policies*, and *Code of Good Practices on Fiscal Transparency*.

16. The limited awareness is not surprising as many standards were developed only recently and some are still in the final stages of gaining general acceptance. It is also not reasonable to expect that market participants, who undertake a diverse range of activities, would be equally familiar with all 12 key standards. On the whole, however, it is clear that there is a major challenge for the international community in raising the level of knowledge and understanding of standards and their potential value to market participants.

National authorities represented on the FSF should mount a sustained education effort to help raise the general level of awareness of standards among market participants in their respective financial centres, drawing on resources and expertise from the IFIs and standard-setting bodies.

The FSF should encourage the IFIs and standard-setting bodies to enhance further their ongoing educational efforts to help raise the level of awareness of relevant individual standards.

These efforts could take the following forms:

- ⇨ *Conventions and seminars*. Given the scarcity of available resources, initial outreach efforts could focus on: (a) a few key financial centres; (b) those standards that market participants are most interested in; and (c) those market participants most likely to use information on observance of standards, e.g. rating agencies and other information providers on whom other market participants depend. These efforts could also be organised in collaboration with professional associations.
- ⇨ *Publications and websites*. More active marketing is needed than merely placing information on websites. The standard-setting bodies could enhance the dissemination of the key standards under their purview and the FSF of the Compendium of Standards, through information brochures and pamphlets, special pages on their websites, and other channels. National authorities could provide in their regular publications articles on the key standards, e.g. the Bank of England's *Financial Stability Review*.
- ⇨ *Professional curricula*. The faculties of key business and finance schools and relevant professional bodies (e.g. the Institute of Chartered Financial Analysts) could be encouraged to highlight in their curricula, where relevant, the importance of standards and codes and brief information on the 12 key standards.

17. ***Role of standards in lending and investment decisions.*** At present, few market participants explicitly take account of an economy's observance of standards in their lending and investment decisions. However, observance of standards appears, to some extent, to be taken into account insofar as market participants look at features of the

economy covered by the 12 key standards. For example, an economy's observance of the *SDDS* would implicitly be taken into account - among many other factors - when determining its sovereign credit rating. Indeed, most market participants welcome the promulgation of standards, agreeing in particular that the 12 key standards endorsed by the FSF can play an important role in helping to foster sound financial systems.

18. The standards considered most relevant for lending and investment decisions are those cited in paragraph 15. The *SDDS* is viewed as particularly useful, in part because it presents information on an easy-to-use "yes/no" basis. On the whole, consideration of an economy's observance of standards seems to be gradually growing in importance in risk assessments associated with credit ratings and bank lending. It seems to figure less directly in portfolio investment activities.

19. Market participants offered a variety of other considerations in their lending and investment decisions in explaining why observance of standards has not to-date been an important factor in such decisions:

- *Need for adequate legal framework*. Many market participants view the existence of a transparent, predictable, and efficient legal and judicial system as a key precondition for accurate risk assessments, and being of greater importance than the observance of standards. When the legal infrastructure is unreliable - as in some emerging market economies - market participants attach greater importance to conducting due diligence on their individual potential counterparties compared to assessing observance of overall regulatory/supervisory standards. The existence of implicit government guarantees sometimes plays a role in this process.
- *Overriding importance of political risk*. For some countries, market participants place political risk well ahead of regulatory/supervisory risk in their considerations. Differences across countries in terms of the risks of nationalisation, imposition of capital controls, and policy reversals can often overwhelm differences in risks due to observance or non-observance of standards.
- *Relationship between standards and risks*. The significance of the observance of particular standards for the underlying risks involved in lending to or investing in a country is not yet clear. First, given that most standards are of recent origin, their relevance to such risks is not well-understood. Second, standards may not be relevant to all the different kinds of risks that market participants consider. Third, not all elements of a standard have equal weight in risk assessments.
- *Overriding importance of economic and financial fundamentals*. Many of the key standards are concerned with transparency. While this is undoubtedly a desirable objective, transparency alone is not enough; it is distinct from the question of whether what is being disclosed is satisfactory. Market participants prefer to use direct indicators of the soundness of the economy and financial system. Lack of transparency is nonetheless regarded as having a negative effect in the sense of raising market suspicions and leading to, all things being equal, lower ratings and exposures or higher capital provisioning.
- *Benchmark-based investment strategies*. Some institutional investors (such as pension funds and insurance companies) regard observance of standards as less relevant because their international equity portfolio investment decisions are guided

by the composition of international benchmark indices which are typically based on market capitalisation.

- *Availability of alternate sources of information*. Although rating agencies seem to be better acquainted with, and to pay more attention to, observance of standards, they claim that their direct access to national authorities (and sometimes confidential data) provides them with a more in-depth understanding of the quality of supervision and regulation, policy and data transparency, and market infrastructure.

The FSF should encourage the IFIs, standard-setting bodies, and national authorities to better demonstrate how information on observance of standards can help provide insights on the risk factors in which market participants are most interested.

⇨ *Clarifying the role of standards*. In their outreach programmes to promote the awareness of standards, FSF members should emphasise that: (a) in many cases, standards were developed as a response to weaknesses that precipitated or exacerbated financial crises; (b) to the extent that it enhances transparency and provides confidence in the integrity and quality of data, observance of standards can be useful in risk assessments even if observance in itself is not sufficient to identify all risks and vulnerabilities; and (c) standards do recognise the critical importance of preconditions for successful implementation, e.g. adequate legal framework, and market participants can potentially glean useful insights on the extent to which these preconditions are present from assessments of observance of standards.

⇨ *Analytical work*. The FSF should encourage the IFIs and standard-setting bodies to undertake and publicise analytical work aimed at: (a) showing how standards were developed in recent years as a means to help reduce vulnerabilities and risks; and (b) assessing the links between non-observance of standards and financial sector vulnerability, default risk, and other relevant risks.

⇨ *Engaging the private sector*. The FSF should encourage the IFIs and standard-setting bodies to continue to actively seek feedback from the private sector when developing new standards or methodologies and reviewing existing ones as a way of ensuring relevance to market participants. The IFIs and standard-setting bodies could consider working with private sector groupings engaged in sovereign risk assessments to examine ways in which information on observance of standards could be used in risk assessments.

20. ***Access to information on observance of standards***. To the extent they consider economies’ observance of standards implicitly in their risk assessments, market participants rely on two primary sources of information: (a) the private sector (rating agencies, industry groupings like the IIF, and, especially for large, internationally active financial groups, their own "people on the ground"); and (b) the official sector (e.g. databases, reports, and websites of the IMF and World Bank, and national authorities).

21. Market participants’ views on whether the private sector can and should play a role in generating information on economies' observance of standards are mixed. Some consider that currently there are insufficient market incentives for the private sector to undertake assessments and that the private sector is ill-equipped for this role given concerns about expertise, data confidentiality, and potential conflicts of interest. Some others, however, consider that the objectivity of assessments by IFIs could be

constrained by the nature of the IFIs' relationship with their member economies, and that there is scope for assessments by other third parties, such as by peer groups, rating agencies or consultancy firms. Indeed, some private sector firms are already gearing up for providing assessment services for observance of standards. As awareness of the potential value of standards grows over time, the private sector could increasingly play a role in generating information on observance of relevant standards. In the short to medium term, however, the resources for assessments would have to come primarily from the official community.

22. Given that ROSCs were introduced only in 1999, most market participants have limited awareness of them. With continued efforts at producing more ROSCs and publicising them, this knowledge gap should narrow over time.

The FSF should encourage the IFIs and standard setting bodies to enhance the availability of information on observance of standards.

⇨ *Information disclosure*. The IFIs and standard-setting bodies should continue to encourage national authorities to disclose information on both self assessments and external assessments of observance of standards. Where national authorities assess that it would not be appropriate for them to implement a particular standard or element therein, they should say so and be encouraged to disclose the reasons. National authorities represented on the FSF should demonstrate leadership by making a commitment to similarly disseminate information on self and external assessments.

⇨ *Leveraging on the SDDS*. Given that the SDDS is the most well-known and widely used of the 12 key standards and its easy availability on the Fund website, the IMF could give consideration to including within an economy's SDDS webpage hyperlinks to other standards assessments, and explore other potential hyperlinks.

23. ***Use of information on observance in pricing and allocation decisions***. Currently market participants have too little familiarity with ROSCs to use them directly in risk assessments leading to pricing and allocation decisions. Where they are used, it is as an additional source of information for assessing the quality and reliability of data. However, many of those who participated in the outreach were keen to know more about the ROSCs and indicated that they would want to consult ROSCs in future.

24. Apart from unfamiliarity, the following reasons were cited for the lack of use of ROSCs in risk assessments by market participants.

- *Quantitative information*. The qualitative nature of the information in ROSCs makes it difficult to incorporate it directly into quantitative risk assessment systems. The preference among many seems to be for a calibrated scoring system, say on a scale of 1-10, that would allow for a more nuanced presentation of the different degrees of observance of standards, rather than the two extremes of purely qualitative assessments on the one end and simple "yes/no" answers on the other.

- *Cross-country comparison and ranking*. Market participants want to know the relative degree of observance of standards from country to country, i.e. relative rankings. Even in their current form, ROSCs would be more useful if more of them were available so that some cross-country comparisons could be made. The current coverage of countries is insufficient for ROSCs to play a key role in risk models given that such models typically cover a large number of countries.

Market participants are, however, not homogeneous, with some desiring simple ratings and rankings, and others wanting more information and analysis.

25. Those familiar with ROSCs provided the following suggestions for improving them:

- *Availability*. Market participants note that when national authorities choose not to release ROSCs to the public it adversely affects the usefulness of the ROSCs.
- *Quality of observance*. There is demand among market participants for ROSCs to cover, over time, not just the monitoring of data transparency but also assessments of the definition and quality of the data that are being disclosed.
- *Length*. While recognising that details are necessary for good and credible assessments, market participants stress the importance of a concise executive summary.
- *Clarity*. Market participants would like to see shortfalls in the implementation or observance of standards more clearly identified in the ROSCs as well as information on any technical assistance that is being provided to address these shortfalls. There should be no "encoded messages".
- *Frequency*. To facilitate their incorporation into firms' risk assessment processes, market participants would like ROSCs to be updated at reasonable intervals.

26. Providing simple ratings and cross-country rankings on observance of standards risks subverting the appropriate role of the private sector in assessing and pricing risks. There is scope, however, to enhance the presentation of the ROSCs as part of their evolution. Since the assessment methodologies drawn up by the standard-setting bodies are a key input into ROSCs, they could be designed with a view to facilitating clear assessment reports.

The FSF should encourage the IFIs to enhance the presentation of information on observance of standards.

⇨ The FSF should encourage the IFIs to continue enhancing the clarity, relevance, presentation, and user-friendliness of the ROSCs, taking into account, where appropriate, the feedback obtained through recent outreach exercises.

IV. Official Incentives

27. ***Rationale***. Official incentives can be a powerful means to encourage economies to implement standards and to reinforce market incentives:

- Market incentives in themselves may be inadequate to encourage implementation, given that many market participants do not currently incorporate economies' observance of standards in their risk assessments.

- Weak domestic financial systems in some economies can impose negative externalities on international financial stability and stretch the resources of the IFIs. Such externalities may not be fully addressed by market discipline.
- Markets are focused on end-results and may not always recognise progress made by economies in implementing standards. Official incentives, if applied judiciously, can be useful in triggering and sustaining the commitment of national authorities to implementing standards.
- It would be inconsistent if, having encouraged the private sector to take account of observance of standards, the official sector does not similarly consider observance of standards in its own actions.

28. ***Principles.*** It would be useful to consider the following principles when applying official incentives:

- Incentives *should foster country ownership*. Adoption of standards and participation in external assessments should be voluntary. Countries should, nonetheless, be strongly encouraged to participate. Self assessments should be encouraged alongside external assessments. Prioritisation of standards for implementation should take account of country circumstances.
- Incentives *should be consistent with the broader public policy objectives* (e.g. regulatory or supervisory) that those who would apply these incentives are concerned about. Even if highly desirable from the perspective of encouraging implementation of standards, the application of incentives ultimately is a decision for those who apply the incentives, who must take account of many other factors.
- Incentives *should reinforce market discipline* and minimise moral hazard. In developing official incentives, feedback from market participants on how they might impact on their pricing and allocation decisions should be sought.
- Incentives *should be applied consistently*. Given that assessments of observance of standards are likely to be mostly qualitative in nature, the application of incentives based on these assessments should be governed by clear and transparent criteria, taking care to avoid the risk of abuse as a protectionist tool. At the same time, consideration needs to be given to differing country circumstances, particularly the stage of economic development and institutional capacity.

29. ***A catalogue of possible official incentives***.[4] The various possible official incentives could be broadly categorised by three main *objectives*. Many of these incentives are currently in place to varying degrees, while others are broadly consistent with existing practices even if they are not being explicitly applied as incentives. The three groups of official incentives are mutually reinforcing:

- The incentives in Group 1 (external assessments, policy dialogue and technical assistance) aim to get economies started on the implementation process by helping them to: (a) identify areas for improvement within their economic and financial systems; (b) adopt relevant international standards; (c) formulate, announce, and execute effective action plans; and (d) build the capacity to implement the standards.

[4] A detailed evaluation of each of the possible incentives is at Annex F.

These incentives can foster country ownership and help build the infrastructure for implementing standards.

- The incentives in Group 2 (dissemination of information, and incorporation in risk assessments) focus on creating market demand for information on external assessments. They could: (a) encourage economies to undertake external assessments and disclose information on these assessments; and (b) promote market discipline to observe standards.
- The incentives in Group 3 (market access measures, and supervisory/regulatory actions) aim to encourage economies to enhance their observance of standards and to undertake and disclose assessments.

30. ***Incentives to encourage adoption of standards and implementation plans***. The incentives in Group 1 are relevant to all 12 key standards, and are mostly applied by international groupings and institutions.

- *External assessments* of economies' observance of standards are needed for market incentives and many other official incentives to work. They must: (a) be based on clear methodologies so as to achieve consistency and credibility; (b) take account of the economy's stage of development, institutional capacity, and structure of the financial system, so as to ensure relevance; and (c) be voluntary so as to foster ownership and co-operation. Disclosing the results of these assessments will make an important contribution to promoting market discipline. In exceptional cases, where concerns about disclosure are likely to discourage economies from undertaking external assessments, the emphasis – at least initially – might be placed simply on encouraging assessments.

⇨ The FSF should encourage the IMF, World Bank, and standard-setting bodies to continue enhancing the conduct of external assessments of observance of standards, including those standards among the 12 key standards not currently included in the assessment programme.

⇨ National authorities represented on the FSF could demonstrate leadership by undertaking assessments of their own observance of relevant standards.

- *Policy dialogues* can take the form of: (a) policy advice within the context of the IMF Article IV consultations, World Bank economic and sector work, and Fund-Bank Executive Board discussions; and (b) peer discussions within relevant regional and international groupings. Such dialogues help promote country ownership and can provide useful peer pressure and impetus for reform in a non-punitive manner.

⇨ The FSF should encourage the IMF and World Bank to consider how the mechanism for policy advice could be further enhanced, e.g. through giving greater prominence to standards implementation issues within the Article IV consultation process, with a view to helping economies identify an appropriate set of standards for priority implementation and develop effective action plans.

⇨ The FSF should encourage relevant international and regional groupings (G7, G20, APEC, ASEAN, CARICOM, CHFI, EFTA, EU, IAIS, IOSCO, MFG, MERCOSUR, NAFTA, OECD, and regional groupings of supervisors) to promote peer discussions of progress and experiences in implementing standards, using ROSCs where appropriate. National authorities represented on the FSF should encourage members in international or regional groupings that they are a part of to make a commitment to implement relevant standards.

- *<u>Membership</u>* in international groupings could be linked to commitments to adopt relevant standards or progress in their implementation. This is, however, ultimately for consideration by the relevant groupings that have to take account of factors besides standards implementation and deal with some of the practical difficulties and possible perverse effects in implementing this incentive.
- *<u>Technical assistance</u>* and training can provide a strong positive incentive in terms of helping economies build the capacity to implement standards and fostering country ownership and buy-in. When aligned with country-owned action plans for implementing standards, technical assistance can effectively address shortcomings identified in the course of self and external assessments of observance of standards. Technical assistance needs are large and will continue to grow. The international community needs to make a clear commitment to enhanced partnerships and co-ordination, and substantially scaled-up effort to augment the availability and effectiveness of technical assistance.

> ⇨ National authorities represented on the FSF should make a commitment, and encourage other economies as well, to provide technical assistance and training for standards assessments and implementation, co-ordinated either bilaterally or through the IFIs and relevant international groupings, on the basis of assessed needs.

31. ***Incentives to promote market discipline and disclosure of assessments***. The incentives in Group 2 are collectively relevant to all 12 key standards. They could be applied by international groupings and national authorities.

- *<u>Dissemination of information</u>* on observance of standards will help raise market participants' awareness of the significance of standards and help foster market discipline on economies to observe standards. The international community can encourage national authorities to disclose the results of assessments. Jurisdictions where international sovereign bonds are issued could encourage – within the framework of existing disclosure practices where possible – the inclusion in prospectuses accompanying such issues material information on external assessments of observance of relevant standards in the issuing economy. If such information is unavailable or an assessment not done, this could be reflected. Application of this incentive would be enhanced if financial centres co-ordinate among themselves to minimise the risk of uneven adherence to this principle across jurisdictions in the interest of attracting business.

> ⇨ There should be a presumption that national authorities disclose assessments of observance of standards. National authorities represented on the FSF should demonstrate leadership by making a commitment to disseminate information on self and external assessments.
>
> ⇨ National authorities represented on the FSF should encourage the voluntary disclosure of material information on observance of relevant standards in bond prospectuses for international sovereign bond issues.

- *<u>Incorporation in risk assessments</u>* by the private sector of information on observance of standards can be facilitated by national supervisory/regulatory authorities through: (a) encouraging institutions to consider in their risk assessments (e.g. internal credit ratings in the case of banks) information on observance of standards in jurisdictions with which they have counterparty dealings; and (b) informational advisories urging domestic financial institutions to exercise caution in dealing with counterparties in jurisdictions with material gaps in their observance of standards. These measures rely on market discipline rather than direct supervisory/regulatory actions to exert pressure on jurisdictions, placing the onus on market participants to price the risks inherent in transactions with institutions from such jurisdictions.

> ⇨ National authorities represented on the FSF should encourage domestic financial institutions dealing with counterparties registered in foreign jurisdictions to consider in their risk assessments (e.g. internal credit ratings in the case of banks) information from external assessments of observance of standards in these jurisdictions.
>
> ⇨ National authorities represented on the FSF should consider the desirability and feasibility of using informational advisories to urge caution in dealing with counterparties based in jurisdictions, or transactions involving jurisdictions, with material gaps in their observance of standards.

32. ***Incentives to encourage observance of standards and disclosure of assessments***. The incentives in Group 3 are relevant to the core principles on supervision and regulation in banking, insurance, and securities, and the FATF recommendations on money laundering. They could be applied by relevant national authorities, and are generally consistent with current practices in many jurisdictions.

- *Market access measures* may be applied in a manner that promotes observance of relevant standards by focusing prudential considerations on factors that could enhance the safety and soundness of financial institutions. This could be done under two broad sets of circumstances:

  (a) A *host* jurisdiction could take into account in deciding whether, and if so under what conditions, it will allow a foreign institution to operate in its markets, the degree to which that institution's home jurisdiction observes relevant standards.

  (b) Where regulatory approval is required, a *home* jurisdiction could place restrictions on its domestic financial institutions' operations in foreign jurisdictions with material gaps in observance of relevant standards.

> ⇨ National authorities should be encouraged to give greater consideration to a foreign jurisdiction's observance of relevant standards as one of the factors in making market access decisions.

- *Regulatory and supervisory actions*, as with market access measures, can also be taken by either host or home jurisdictions. Imposing higher capital charges or provisioning requirements for non-observance of standards is currently not under active consideration. (See Annex F, page 48 for details.) Other measures such as conducting more intensive examinations, imposing higher disclosure or reporting requirements, requiring more extensive external audits, restricting inter-affiliate transactions, and increasing the scrutiny of customer identification are worth consideration. It might not be appropriate to apply these measures solely on the basis that the particular foreign jurisdictions have material gaps in their observance of relevant standards; the relevant authorities, however, could give greater consideraton to the observance of relevant standards as a factor within the broader assessment that they have to make of the risk profile of the institution and the quality of supervision, or of anti-money laundering regulations, in the particular foreign jurisdiction.

⇨ National authorities should give greater consideration to a foreign jurisdiction's observance of relevant standards as one of the factors in supervision and regulation of (a) subsidiaries or branches of foreign institutions from that jurisdiction; or (b) domestic institutions dealing with counterparties in that jurisdiction.

Annex A

Terms of Reference

1. Building on the work of the FSF Task Force on Implementation of Standards the group should explore how market and official incentives, including those referenced in Box 1 of the March 15 Issues Paper, can be developed to encourage the implementation of international standards relevant for financial stability.

2. With regard to ***market incentives***, the group should explore how to:

   - enhance market participants' understanding of the role of standards in strengthening financial systems and their relevance to credit and investment decisions;
   - encourage economies to disclose and markets to generate more, better and timely information on observance of standards;
   - encourage the structuring and presentation of such information so that it can be more readily used in market pricing and allocation decisions;
   - encourage market participants to use this information in their risk assessments.

3. With regard to ***official incentives***, the group should:

   - take stock of the experience with existing incentives;
   - explore the desirability of further incentives that could potentially be applied by international institutions and groupings, and national authorities; and
   - evaluate options for the application of supervisory, regulatory and market access incentives by national authorities and consider how in practice they might be structured and activated.

4. The group should consider how the various elements of market and official incentives could best reinforce one another within the framework of the overall strategy to foster implementation of standards and outline possible next steps for the Forum's consideration in September 2000.

5. In undertaking its task, the group should informally engage in a dialogue a cross-section of relevant market participants drawing upon outreach programmes conducted by the IMF/WB in the context of work related to the implementation of standards, and solicit feedback from the FSF Task Force on Implementation of Standards.

Annex B

Members of the Follow-Up Group

Axel Nawrath (Chairman)
Ministry of Finance, Germany

Amar Bhattacharya
World Bank

Howard Brown
Department of Finance, Canada, and G20 Secretariat

Michel Cardona
Banque de France, France

Alastair Clark
Bank of England, United Kingdom

Yoshihiro Kawai
International Association of Insurance Supervisors

Goran Lind
Sveriges Riksbank, Sweden, and BCBS

Francesca Manno
Ministry of the Treasury, Italy

William Murden
Department of the Treasury, United States

Terry O'Brien
The Treasury, Australia

Martin Parkinson
International Monetary Fund

Andrew Powell
Banco Central de la Republica Argentina, Argentina

Andrew Procter
Securities and Futures Commission, Hong Kong, and IOSCO

Yasusuke Tsukagoshi
Ministry of Finance, Japan

Asuri Vasudevan
Reserve Bank of India, India

Secretariat

Ravi Menon (Secretary)
Financial Stability Forum Secretariat, Basel

Kate Langdon
Financial Stability Forum Secretariat, Basel

Iris Pieper
Ministry of Finance, Germany

Rolf Wenzel
Ministry of Finance, Germany

Annex C

Key Standards for Sound Financial Systems

The 12 standards highlighted here have been designated by the FSF as key for sound financial systems and deserving of priority implementation depending on country circumstances. While they vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice. Some of the key standards are relevant for more than one policy area, e.g. sections of the Code of Good Practices on Transparency in Monetary and Financial Policies have relevance for aspects of payment and settlement as well as financial regulation and supervision.

Subject Area	Key Standard	Issuing Body
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS)/ General Data Dissemination System (GDDS)[5]	IMF
Institutional and Market Infrastructure		
Insolvency	Principles and Guidelines on Effective Insolvency Systems[6]	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)[7]	IASC[8]
Auditing	International Standards on Auditing (ISA)	IFAC[10]
Payment and settlement	Core Principles for Systemically Important Payment Systems	CPSS
Market integrity	The Forty Recommendations of the Financial Action Task Force on Money Laundering	FATF
Financial Regulation and Supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Supervisory Principles	IAIS

5 Economies that have, or might seek, access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS

6 The World Bank is co-ordinating a broad-based effort to develop these principles and guidelines. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the *Model Law on Cross-Border Insolvency* in 1997, will help facilitate implementation.

7 The BCBS has reviewed relevant IAS, and a joint BCBS-IASC group is further considering bank-related issues in specific IAS. IOSCO has reviewed and recommended use of 30 IAS in cross-border listings and offerings, supplemented where necessary to address issues at a national or regional level. The IAIS's review of relevant IAS is ongoing.

8 The International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.

Annex D

Modus Operandi of Market Outreach Exercise

1. ***Objectives***. The objectives of the outreach exercise were three-fold:

- to gauge market participants' familiarity with the 12 key standards;
- to understand market participants' perceptions about the relevance of these standards to risk assessments;
- to gather feedback on market participants' expectations with regard to information on observance of these standards; and
- to assess the scope for market participants to reflect this information in pricing and allocation decisions

A *List of Issues*, that was used for the outreach exercise, is in Box A1.

2. ***Target audience***. The following types of market participants were targeted for the outreach:

- analysts in credit rating agencies, including export credit rating agencies, and other information providers (credit ratings);
- credit analysts and country risk managers in commercial banks undertaking sovereign and cross-border lending (credit allocation and spreads);
- analysts and risk managers in investment banks engaged in advising and underwriting cross-border bond issues (bond spreads);
- institutional investors (such as in large insurance companies) and fund managers in asset management companies doing country asset allocations for portfolio investments (bond and equity allocations); and
- analysts in securities houses setting benchmark market allocations (e.g. Morgan Stanley Global Capital Markets Index).

About 100 financial institutions from eleven jurisdictions (Australia, Argentina, Canada, France, Germany, Hong Kong, Italy, Japan, Sweden, UK, and US) participated in the outreach exercise. Members of the group co-ordinated the outreach in their respective jurisdictions.

3. ***Approach***. The outreach exercise comprised a two-pronged approach:

- *Surveys*. A *List of Issues* was sent to a selected set of market participants, with a request for written responses. The request was accompanied by a list of the 12 key standards endorsed by the FSF and a sample Report on Observance of Standards and Codes (ROSC).
- *Focus group discussions*. These were targeted at a subset of the market participants selected for the surveys, namely people who had a certain degree of awareness of standards to begin with and hence were thought likely to offer insightful feedback on issues related to the relevance of standards to risk assessments and expectations with regard to information on observance of standards. Typically, each focus group discussion comprised 10-20 knowledgeable market participants from varying backgrounds, and centred on addressing the questions contained in the *List of Issues*.

Box D1: List of Issues for Market Outreach Exercise

1. The Financial Stability Forum has identified 12 standards as being key to strengthening financial systems. (Please see attached.) Which of these 12 key standards are you aware of and familiar with?

2. Do you think the adoption and implementation of these standards play an important role in helping to foster sound financial systems? If not, why?

3. Do these 12 standards cover the areas in which you think it is most important that good practices be observed? If not, what other areas should be covered?

4. What are the most important sources of information that you use to do sovereign risk assessments?

5. Is an economy's observance of any of these 12 standards a material factor in your assessment of the risk of extending credit to or investing in that economy or particular institutions in that economy?

⇨ If not, why not?

⇨ If so, which of the 12 standards are most relevant to your risk assessments? Why?

6. If you use information on economies' observance of standards in your sovereign risk assessments, what are your current sources of such information?

7. As part of their activities, the IMF and World Bank undertake assessments of economies' observance of a range of standards. In some cases, summaries of these assessments are published as Reports on the Observance of Standards and Codes (ROSCs). (Please see attached a copy of the ROSC on Hong Kong.) Are you familiar with ROSCs?

8. If you are familiar with ROSCs, have you used the information in a ROSC in your risk assessments?

⇨ If so, how was this information used?

⇨ If not, what kind of information on observance of standards would be helpful?

9. Do you think the private sector could play a role in generating information on economies' observance of standards?

⇨ If so, what can be done to encourage the private sector to play a bigger role in this regard?

⇨ If not, why not?

10. How can the official community best to help increase the private sector's awareness and understanding of the significance of these 12 standards?

Annex E

Summary of Responses from Market Outreach Exercise[9]

FAMILIARITY WITH STANDARDS: Question 1

The Financial Stability Forum has identified 12 standards as being key to strengthening financial systems. Which of these 12 key standards are you aware of and familiar with?

General

Most respondents were generally aware of at least some standards, but few were familiar with many of them. The best known standards were the *Special Data Dissemination Standard* and the *International Accounting Standards*, followed by the *Core Principles for Effective Banking Supervision*, the *Code of Good Practices on Transparency in Monetary and Financial Policies*, and the *Code of Good Practices in Fiscal Transparency*.

Rating agencies (sovereign credit ratings) /Other information providers (country analysis)

No significant difference from General comments.

Commercial banks (credit allocations and spreads)

There was slightly greater awareness of the *Core Principles for Effective Banking Supervision* and *International Accounting Standards*, and less of the *Code of Good Practices in Fiscal Transparency*.

Investment banks and securities houses (bond underwriting)

There was slightly greater awareness of the *Principles and Objectives of Securities Regulation* and *International Accounting Standards*.

Institutional investors and fund managers (bond and equity allocations)

No significant difference from General comments.

FAMILIARITY WITH STANDARDS: Question 2

Do you think the adoption and implementation of standards play an important role in helping to foster sound financial systems? If not, why?

General

Most respondents agreed that standards played an important role in fostering sound financial systems:

⇨ Adherence to the standards will increase transparency and will thus enhance the availability, timeliness, and accuracy of information investors can base their decisions upon. They heighten awareness of each country’s internal policy, legal, and regulatory, environment.

⇨ Standards are very positive for reform-oriented leaders within a developing country, since they have a better chance of overcoming domestic political obstacles if the adoption of standards is seen as an important step in promoting international acceptability, IMF engagement and private sector lending. Emerging economies could use compliance with these standards to demonstrate their long-term commitment as evidence to potential investors of their intent.

⇨ Standards provide a benchmark against which to measure individual countries’ performance.

However, some caveats were raised:

⇨ An important factor that may limit the applicability of standards was the degree of consensus on

[9] In cases where there are differences in content or emphasis from the feedback included under "General", a breakdown is provided of the feedback across various types of market participants surveyed (rating agencies, commercial banks, investment banks and securities houses, and institutional investors and fund managers).

what constitutes desirable practice ("not just agreement between a handful of officials in the G7").

- ⇨ Substantial progress in strengthening financial systems will only be achieved if a majority of countries or a "critical mass" were to adopt these standards.
- ⇨ There is a major step between adopting and implementing the principles. This is where most of the work lies and where most emerging markets have a lot to do.
- ⇨ The implementation of standards, by and in itself, does not guarantee financial soundness or stability. Consideration must be given to the total picture, e.g. the macroeconomy, financial structure, and other circumstances and institutions, to fully evaluate the situation of a country. Liberalisation of financial markets was also a key factor. However, liberalisation can only follow the implementation of the key standards.
- ⇨ An over-reliance on assessments by others (e.g. IMF/OECD/IASC/IOSCO) could lead an institution to depart from otherwise prudent banking practice, by not conducting its own due diligence. Although many felt that we were some way away from this situation, it was acknowledged that even with perfect disclosure of information, one might still not pick-up on country risks until it was too late.
- ⇨ In view of the broad range of areas affected, the differing progress made on codification and implementation and the differences in national interests and circumstances, preference should be given to moving ahead on individual standards over striving for the complete compendium.
- ⇨ Standards were sometimes not robust enough.

ROLE OF STANDARDS IN RISK ASSESSMENTS: Question 3

Do these 12 standards cover the areas in which you think it is most important that good practices be observed? If not, what other areas should be covered?

General

Most respondents felt that the 12 key standards covered many of the areas the private sector considers in country risk assessments. Indeed, to evaluate countries' risk, many institutions used categories of information that closely mirrored the areas covered by the 12 key standards.

Besides the areas covered by the 12 key standards, there was interest in other areas as well:

- ⇨ <u>*Legal environment and rule of law*</u>. A transparent, predictable, and efficient legal and judicial system is a pre-requisite for the strengthening of financial systems. For example, following the OECD's *Principles of Corporate Governance* to the letter did not matter very much if the firm operated in a country where the rule of law will be ignored, or laws which protect property do not exist, or are not respected. The consistent application of the rule of law, whatever those laws were, promotes a climate where the outcomes of actions can be anticipated, and thus long-term investment decisions made. Standards should also cover the legal environment, e.g. areas relating to property law and the transfer of assets.
- ⇨ <u>*Insolvency*</u>. Close attention is paid to the "rules of engagement" in bankruptcy cases. There is a need to cover contract rights, debtor/creditor protection, legal settling, etc.
- ⇨ <u>*Political risk*</u>. Assessments of political stability, the risk of nationalisation, and the risk that they will not be able to take their money out in time of crises, are very important.
- ⇨ <u>*Statistics*</u>. More work should be done so that countries provide accurate information on sovereign and private sector short-term debt, timely information on central bank reserves, financing requirements and maturity profile of external and domestic debt. For example, it is key to know whether reserves are usable (e.g. have not been used as collateral) and whether the central bank has engaged in derivative transactions, and which parties were holding government debt and corporate debt respectively. The quality of data disclosed is as important as disclosure itself.
- ⇨ <u>*Accounting and auditing*</u>. The Big 5 accounting firms were criticised as having not enforced standards over their international branches. Auditors need to say when local standards differ from international standards/practices so as to give readers of financial statements a better sense of local practices.
- ⇨ <u>*Taxation*</u>. One reason often cited for not complying with international standards is that it would

have tax implication.

Commercial banks (credit allocations and spreads)

The following additional areas were also cited as being important to warrant some guidance: electronic finance; deposit insurance systems; and foreign exchange reserve management.

More information was also needed on:

- aspects relating to the corporate sector, such as consolidation of corporate accounts, ownership interests, cross-holdings, and bankruptcy laws; and
- national statistics and fiscal data, such as "extra-budgetary" data, "presidential funds", and capital flows between private entities and offshore centres.

ROLE OF STANDARDS IN RISK ASSESSMENTS: Question 4

What are the most important sources of information that you use to do sovereign risk assessments?

General

The main information sources to assess sovereign risk are:

Official sources:

- IMF databases and reports (However, some participants criticised IMF reports as not being useful owing to their convoluted wording and length. In their view, understanding the real messages hidden "between the lines" was too time-consuming, though more concise executive summaries would be helpful;
- World Bank, IFC, and regional development bank reports;
- BIS (for external debt data);
- OECD reports,
- Statistics and data published by national authorities (statistical agencies and central banks)

Private sector sources:

- Institute of International Finance (IIF),
- Rating agencies (S&P and Moody's);
- Publications (Economist Intelligence Unit, Institutional Investor, Euromoney);
- Financial and economic data providers (e.g. Bloomberg, Reuters, Oxford Analytica, and Datastream for monitoring credit spreads);
- International media;
- Local contacts.

Private sector sources of information are very important. Indeed, private sources of information, notably the IIF, allow market participants to know what is "really" going on in a country.

The degree to which local contacts are used depends on how strong a presence an institution had. For large economies, institutions prefer more direct sources to avoid time lags, whereas for small economies, they mostly rely on information from the IMF as the only source. In this regard, the SDDS is considered as one of the more important sources of information.

Rating agencies (sovereign credit ratings) /Other information providers (country analysis)

Particular importance is also attached to *direct* contacts with the fiscal and monetary authorities of assessed economies. As an "assessor" of sovereign risk at the request of the country in question, rating agencies have access to information directly from the government.

ROLE OF STANDARDS IN RISK ASSESSMENTS: Question 5

Is an economy’s observance of any of these 12 standards a material factor in your assessment of the risk of extending credit to or investing in that economy or particular institutions in that economy?

- ⇨ **If not, why not?**
- ⇨ **If so, which of the 12 standards are most relevant to your risk assessments? Why?**

General

Although observance of the 12 standards per se is not used as a direct factor in risk assessments, many respondents look closely at issues that mirror the areas covered by the 12 key standards. Indeed, there were a couple of institutions which felt that a country’s observance of the 12 standards measurably improves its risk evaluation. Some noted that while they may not use standards explicitly, they took comfort from a country having adopted a standard (e.g. SDDS) or having been assessed on a relevant standard. These actions were seen as positive from a risk assessment perspective.

If not, why not?

Insufficient track record. Most standards have only been agreed upon recently; their relevance to risk assessment is not well-established.

Relationship of standards to investment and lending decisions. There was a difference of view about whether adherence to standards actually affected the underlying risk incurred in lending to a country. Some felt that even the highest disclosure standards had not prevented significant financial crises in the past, as evidenced by the experience of the US. Others felt that adherence to standards, particularly those that enhanced transparency and resulted in more information being made available to the market could potentially benefit the borrowers by reducing the risk premium charged.

Difficulty of integration into risk models. A more important barrier to taking into account adherence to standards when assessing sovereign risk is the fact that qualitative assessments cannot directly be integrated into existing risk evaluation models which need quantitative inputs.

Overriding importance of legal framework. Assessment of compliance with standards is important only when there is a functioning rules-based legal system in place. However, when the legal infrastructure is unreliable - as in many emerging market economies - market participants use a "relations-based" system, that requires them to conduct due diligence on their potential local counterparties instead of the regulatory framework in place. Some institutions consider the legal environment of some countries to be so unreliable that they minimise country risk by completely avoiding any transactions with them: observance of standards in other areas becomes irrelevant.

Size matters. Many institutions reduce risk by dealing only with top tier institutions "too big to fail", preferably state-owned banks with very large market share. They assume that, owing to their size and large market share, these institutions are covered by an implicit guarantee from the government. Smaller institutions will not be considered unless a reliable legal system is in place.

Political risks. Some institutions focus more on political risk assessment than on regulatory risk. They also place more importance on assessing the risks of nationalisation or the possibility of not being able to withdraw their investments.

If so, which of the 12 standards are most relevant to your risk assessments? Why?

The most frequently cited were the *Special Data Dissemination Standard (SDDS)*, *International Accounting Standards*, *Principles of Corporate Governance*, *Code of Good Practices in Fiscal Transparency*, *Code of Good Practices on Transparency in Monetary and Financial Policies*, and *Core Principles for Effective Banking Supervision*.

- ⇨ The *SDDS* seemed particularly relevant for country risk assessments. It was often used because it presented information on a bimodal yes/no basis.
- ⇨ The *Basel Core Principles* were useful because supervision was usually quite opaque and there were few other sources of information on the quality of banking supervision.

Rating agencies (sovereign credit ratings) /Other information providers (country analysis)

Compared to other market participants, rating agencies seem to make greater use of information on observance of standards in their risk assessments, but in most cases it is only one factor among other more important considerations.

- ⇨ Although the quality of accounting standards is key for the analysis of any company in a country, there is need to go into more detail than simply knowing if a company or national authority has stated that it has met the *International Accounting Standards*.
- ⇨ Similarly, knowing compliance with the core principles on banking or insurance supervision would be useful but insufficient. Weaknesses in accounting, compliance, or legal systems can and do have an impact on the ratings assigned. Direct meetings with bank and insurance supervisors provide agencies with a much better picture of the quality of supervision in a country, and the intentions of those supervisors to prevent, or resolve any difficulties in those industries.

On the whole, an economy's observance of the standards is increasingly becoming a material factor in risk assessments. (Indeed, one rating agency indicated that it does cite in its reports non-observance of relevant standards.)

The most relevant standards were the *Special Data Dissemination Standard (SDDS), International Accounting Standards*, *Code of Good Practices in Fiscal Transparency*, and *Core Principles for Effective Banking Supervision*.

If a country does not comply with SDDS, then this would be taken into account in determining that country's rating (as one of many factors). The point would be noted in the written assessment, but investors would find it difficult to tell how much weight had been placed on any specific factor.

Commercial banks (credit allocations and spreads)

A growing number of banks are using information on an economy's observance of standards in their risk assessments, although specific adherence is not a material factor. Some of those banks who used mainly macroeconomic and financial indicators in their risk assessments indicated that efforts will be made to incorporate in future analysis at least some information on compliance with standards.

They noted, however, that transparency is not always a good indicator of risk: some countries may be quite opaque but nevertheless remain sound sovereign counterparts whereas others may seem to be far more transparent but are riskier.

Nor would non-implementation of standards be an absolute bar on banks' activities in these economies, otherwise they would have little business left. For example, according to one bank, while the *International Accounting Standards* were very important, if the bank insisted on its observance before doing business, it would cut off 25% of its emerging economy business. Business is made with the soundest counterparties and deals are structured so that risks due to non-observance of standards are minimised.

Observance of *Special Data Dissemination Standard (SDDS)* was considered by many banks to be the most valuable. In other areas, like *International Accounting Standards*, some participants viewed that it was sufficient to know that a country was compliant, without needing to know about the details.

Other standards which are sometimes considered in risk assessments include the *Code of Good Practices in Fiscal Transparency*, *Code of Good Practices on Transparency in Monetary and Financial Policies*, and *Core Principles for Effective Banking Supervision*.

Investment banks and securities houses (bond underwriting)

The responses varied:

- ⇨ In some cases, broad adherence to standards was a factor in risk assessments. Observance of data dissemination has a crucial influence on country risk assessment, as incomplete data can lead to downgradings. The quality of banking supervision also plays a role. It was important to know the size of non-performing loans, the quality of supervision, and the reliability of financial and economic data.
- ⇨ In other cases, there is no direct link but adherence to standards could affect decisions indirectly if

there were particular concerns. Also, given that the quality of data in emerging economies will generally tend to be treated with more scepticism than that for developed countries, adherence to disclosure and transparency standards by emerging economies may be a positive.

Market players even within the same institution have different perspectives: some assess risks while others target a return or a yield.

One major investment bank indicated that four standards were actively used in its assessment of risk, setting of ratings by HQ and pricing at branch level: *Special Data Dissemination Standard (SDDS)*, *International Accounting Standards, Principles of Corporate Governance*, and *Code of Good Practices on Transparency in Monetary and Financial Policies*. The other standards were not applied in a specific procedure for setting sovereign ratings, but were nevertheless sometimes taken into account.

Institutional investors and fund managers (bond and equity allocations)

Benchmark-based investment strategies. Several pension funds and insurance companies mentioned that national authorities' observance of international standards were less relevant for them as their international equity portfolio investment decisions follow a diversification strategy based more on international indices such as the Morgan Stanley Capital International (MSCI) indices.

Transparency. Many of the key standards seemed to be about transparency and while this was undoubtedly a good thing, it was not enough to mitigate risk. Economies need to be not only transparent, but present solid fundamentals as well. In some cases, countries were measured against such performance standards as IMF Article VIII status (currency convertibility), Moody's average bank financial strength ratings, and International Chamber of Commerce Uniform Customs and Practices for Documentary Credits. However, disclosure standards had some influence to the extent that if data were unavailable or suspect, they would, all else being equal, rate that country lower and restrict their exposure or call for more capital backing and provisioning.

Unfamiliarity with standards. Most of the standards were regarded as being in embryonic form, and investors were not familiar with them yet. Traders of sovereign debt (or derivatives linked to it), while normally experts in fixed-income products and derivatives, are often not familiar with regulatory/supervisory practices or governance standards. One result was that traders on multiple desks could take on individual risks that ultimately proved correlated. While country risk analysts and portfolio risk managers are well positioned to ensure that an institution took account of a country's disclosure standards, greater knowledge of these issues among traders would also be helpful.

INFORMATION ON OBSERVANCE OF STANDARDS: Question 6

If you use information on economies' observance of standards in your sovereign risk assessments, what are your current sources of such information?

General

Most institutions surveyed use private information supplemented with anecdotal information from "people on the ground", in addition to official reports/websites of the IMF, BIS, and FSF. The IIF was mentioned by several respondents.

Some institutions opined that information on compliance with standards in a systematic, multi-country form still tended to be rather fragmentary with ROSCs being available for only a small number of countries thus far.

Rating agencies (sovereign credit ratings) /Other information providers (country analysis)

Rating agencies also relied on direct answers from the governments concerned.

Commercial banks (credit allocations and spreads)

Banks also relied on reports from audit companies

INFORMATION ON OBSERVANCE OF STANDARDS: Question 7

As part of their activities, the IMF and World Bank undertake assessments of economies' observance of a range of standards? In some cases, summaries of these assessments are published as Reports on the Observance of Standards and Codes (ROSCs). Are you familiar with ROSCs?

General

Most of the respondents were unfamiliar with ROSCs. Several expressed surprise that such information was available on the IMF website.

There was a degree of confusion about the extent to which ROSCs covered the substance of policy as opposed to transparency about policy. It was mentioned that ROSCs should be clear about why countries are deficient in meeting any particular standard.

Commercial banks (credit allocations and spreads)

Very few were familiar with ROSCs, but many expressed growing interest in the information contained in ROSCs.

INFORMATION ON OBSERVANCE OF STANDARDS: Question 8

If you are familiar with ROSCs, have you used the information in a ROSC in your risk assessments?

- ⇨ **If so, how was this information used?**
- ⇨ **If not, what kind of information on observance of standards would be helpful?**

General

Of those respondents who were familiar with ROSCs, hardly any had actually used the information therein. But many were keen to know more about them. They said that they would look at the IMF web site to review the available ROSCs.

If so, how was this information used?

ROSCs have occasionally been used as an additional source of information for assessing the quality of a country's economic and financial infrastructure; though they have, so far, not been exploited systematically. One institution said that in the longer term it is conceivable that the standards and the ROSCs will be systematically included in the risk assessment process. It is, however, too early for this.

Respondents said that their use of the ROSCs would depend on the specific countries surveyed and the timing of the assessments. While several respondents said that they might consult ROSCs, they did not think that ROSCs in themselves would influence the decision-making process. One firm, however, stated that the information in ROSCs played an integral part in its sovereign risk assessment, while another planned to establish the feasibility of incorporating ROSCs into its formal country risk assessments as part of a current process review. A few other firms noted that the existence of ROSCs for certain countries in itself provided some level of comfort with respect to these countries.

If not, what kind of information on observance of standards would be helpful?

Several reasons were cited as to why ROSCs were not widely used.

<u>Coverage</u>. ROSCs existed only for a few countries. It was difficult to make comparisons.

<u>Quantitative ratings</u>. As the information in ROSCs was purely qualitative, it was difficult to integrate it directly into quantitative risk assessment systems. One bank proposed adding an index value comparable to the EBRD transformation index. While they recognised the concerns of the IFIs regarding scoring of assessments, they noted that this would be done in any event by the market in considering whether to recommend to buy, sell, or hold. Presently, the information in a ROSC was targeted more towards the needs of the IMF than private market participants.

Information on observance of standards would be most useful if, in addition to the comprehensive information provided in the ROSCs, it came in the form of a figure on a scale of, say, 1-10. This would have two major advantages: First, a number could more easily be integrated into existing sovereign risk models. Second, assessing compliance on a scale rather than with a simple "yes/no" scheme would make it possible to recognise improvements on the way towards compliance. Using a scale would also give due consideration to the fact that the standards are, in fact, rather encompassing so that compliance can hardly be captured by a simple "yes/no". While the sales and marketing sides of institutions were comfortable with this approach, the credit and legal areas suggested that this would not alleviate the need to conduct their own due diligence.

Cross-country comparison and ranking. A consistent 'score card' for a comprehensive list of countries would facilitate comparisons across countries. The score card could be used in the same way as rating agency ratings. It would be useful to know how countries observed standards vis-a-vis one another, preferably through a ranking list.

Single source. Information on observance of standards should be available from a single source, such as ROSCs. (However, this did not imply that the institutions publishing the information should necessarily be the one that assesses observance of all standards.)

Length. Several respondents noted the unwieldy length of the ROSCs, and said that some of the material was indigestible. While recognising that detailed material was needed for good and credible assessments, they stressed the importance of a concise executive summary, akin to a good prospectus.

Clarity. Deficits in implementation/compliance must be clearly identified, i.e. there must be no "encoded messages". Moreover, the IMF and World Bank should publicly single out countries that disseminate information that is not reliable, incomplete or timely.

Frequency. The ROSCs should be brought up to date at relatively short intervals so that changes occurring in the meantime can be promptly included in risk assessments. As implementation was by necessity a dynamic process, it is "inconsistent" to have ROSC assessments scheduled only every 3-5 years.

Quality of compliance. The monitoring of data transparency should extend in the medium term to assessments of data quality as well.

Rating agencies (sovereign credit ratings) /Other information providers (country analysis)

Almost entirely unfamiliar with ROSCs.

Commercial banks (credit allocations and spreads)

Several banks were aware of but not familiar with ROSCs. ROSCs were considered too detailed and therefore difficult to use. Some advocate more schematic information, possibly accompanied by a valuation expressed by a grade. Coverage of countries is now insufficient for ROSCs to become useful in risk models, given that such models typically cover a large number of countries. More coverage would be highly welcomed.

The frequency of assessments was not timely enough to factor directly into risk assessments. Quarterly updated are needed. To address resource constraints, assessments should be focussed mainly on emerging market economies. A true third party assessment (peer group, etc.) could be provided annually with a more thorough assessment done by the IFIs every couple of years.

Investment banks and securities houses (bond underwriting)

It would be helpful to know to what extent countries fulfilled standards; this could take the form of a ranking list. It is important to have short, clear assessments (not long reports).

The IMF and World Bank should publicly single out countries that disseminate information that is unreliable, incomplete and/or with a long time lag.

Institutional investors and fund managers (bond and equity allocations)

Investors had a strong preference for quantitative-based models that made comparisons between a given economy's fundamentals actual and forecasted. ROSCs did not meet this need.

The helpfulness of ROSCs could be improved if data concerning standards' observance were made more schematic, easier and faster to understand, possibly providing for a description of the level and quality of the observance of the individual standards in the different countries, and further allowing for a comparison between them.

INFORMATION ON OBSERVANCE OF STANDARDS: Question 9

Do you think the private sector could play a role in generating information on economies' observance of standards?

⇨ **If so, what can be done to encourage the private sector to play a bigger role in this regard?**

⇨ **If not, why not?**

General

Responses were mixed, though relatively more respondents appeared to think that the private sector could play a greater role in generating information on observance of standards and even more in "packaging" information garnered from official assessments. Highlighting the importance of private sector involvement in providing information on observance of standards, several respondents pointed to a potential conflict of interest in the IFIs providing assessments as these could not be truly objective given the nature of their relationship with their clients. There was need for a true third party assessment by, for example, professional peer groups.

If so, what can be done to encourage the private sector to play a bigger role in this regard?

Incorporation in risk assessments. Creditors and/or rating agencies could take observance of relevant standards into account in lending decisions, including pricing, possibly in conjunction with internal capital allocation/portfolio management rules.

Provision of micro information. The private sector could provide micro-level information, primarily on bank lending, credit quality of borrowers, bank loan rates, borrowers' payment history, etc. This could be aggregated to offer where relevant additional perspectives on the observance of standards. If financial institutions disclosed their exposure to emerging markets, this could demonstrate to the countries concerned the significance of the commitments of their creditors, and potentially how important the issues were (aggregate data could be provided when confidentiality is required).

Awareness raising. The financial sector might contribute to more awareness of the importance of codes and standards by discussing them and referring to them in their publications.

Assessments by private sector groupings. Some respondents noted that the IIF had done its own assessments of countries' adherence to transparency standards and thought this avenue could be further developed.

Enhanced communication channels with official sector. One institution proposed that a centre of evidence should be installed (with the BIS or IMF) where private banks can send their findings on violations of international standards by individual countries.

Involvement in development of standards. The private sector should be involved in the process of formulating the standards so that they would have a bigger sense of buy-in and understanding regarding standards.

If not, why not?

Lack of incentive. Effective monitoring and use of the standards is resource intensive work, in which they will only invest the time if the rewards are there. This is better done in the public sector.

Confidentiality of information. The generating (and exchange) of information by the private sector would be a big help, but the sharing of information with potential competitors is a major hurdle. Private creditors may be willing to play a bigger role in sharing information if they are offered a greater and earlier role in the design of policies that affect them directly (e.g. debt restructuring).

<u>*Conflict of interest*</u>. The big problem for private sector banks is that invariably these countries are their clients so it is hard to be overly critical. It was argued that the private sector should not play a role in generating information on observance, as this might lead to conflicts of interest. However, the private sector may play a role in disseminating and providing more focused analysis of information regarding implementation and observance of standards. One way of doing so would be by including this information in country reports. Another might be to refer to this information in bond prospectuses. General statements on observance should rather be reserved for the official institutions. <u>*More leverage*</u>. The official sector is probably in a better position to push for increased transparency.
Rating agencies (sovereign credit ratings) /Other information providers (country analysis) Rating agencies said they already provided quite a lot of information that is relevant to observance of standards. Whenever they rate banks, insurance companies, corporates, municipalities or asset-backed securities in a country, they invariably do an investigation of the accounting, reporting, and legal regimes in the country concerned. They often, if not always, publish their views on these issues in the context of either the individual rating or an overview piece on the sector in that country. This information would be regularly updated in reviews of the rated entity. The private sector's role in this area will be driven largely by investor demand. As economies mature and companies within those countries seek stock market listings, the listing and ongoing information requirements for those exchanges will be key to transparency in those markets.
Commercial banks (credit allocations and spreads) Some banks suggested the following as ways in which the private sector could play a bigger role in fostering implementation of standards: <u>*Prospectuses*</u>. Some banks suggested that material information on observance of relevant standards could be included in the set of information considered relevant by private lenders in determining the price of financial products (bonds, syndicated loans). Many suggested that this should be voluntary - perhaps at the suggestion of the sovereign who had undergone the assessment. Eventually, this could increase disclosure and the adherence to standards. The key question seems to be more producing unbiased, balanced judgment and analysis in order to compare countries, than generating additional information. The IIF was cited as a good source for such information. <u>*Collective action*</u>. The possibility was raised of collective action by private sector participants requiring recipient countries to observe certain standards as loan conditionality <u>*Use of accounting firms*</u>. Some respondents suggested the commercial use of private accounting firms for evaluating the observance of standards. Respondents supporting this were concerned about the quality and quantity of information provided by the official sector. However, several other banks believed that responsibility for assessing observance of standards should be left to sovereign or multilateral authorities. The main concern was the lack of expertise in the field of collecting and processing this kind of information.
Investment banks and securities houses (bond underwriting) <u>*Dialogue with the official sector*</u>. While there was some uncertainty over whether the private sector could play a role, some felt that a useful starting point could be the FSF or the IMF establishing a regular dialogue with the ratings agencies and/or a few large commercial banks. <u>*Collective action*</u>. Another possibility was to include collective actions requiring recipient countries to observe standards as investment and loan conditionality.
Institutional investors and fund managers (bond and equity allocations) Investors cited the IIF as a worthwhile interlocutor. The ratings agencies – Moody's, Standard & Poor's, Fitch IBCA, Duff & Phelps, Japan Credit Rating Agency, and the International Chamber of Commerce - were also cited as being able to play a role. Others mentioned that the private sector already played an important, albeit indirect, role in the implementation of standards, through the provision of market incentives, e.g. ⇨ seeking the best returns under a given level of risk or the lowest risk given a level of target return;

and

- ⇨ when assessing the different investment opportunities, requiring a higher risk premium from "issuers" - companies who do not produce clear financial statements or economies which do not provide sufficient guarantees as to the transparency of its monetary and fiscal policies.

The private sector may also play an active role by financing or carrying out research on the role of standards.

Some investors cited their limited influence individually on national regulators in emerging economies as limiting the role of the private sector.

INFORMATION ON OBSERVANCE OF STANDARDS: Question 10

How can the official community best to help increase the private sector's awareness and understanding of the significance of these 12 standards?

General

Private sector participants were appreciative of the outreach exercise and the opportunity to provide feedback. They were generally supportive of the work being carried out on international standards and assessment and encouraged further outreach initiatives. Various ideas were suggested on how the official sector could help.

Education and publicity. Most notable were calls for more education and publicity - one respondent thought that the official community's promotion of these standards has been woefully inadequate. Further dialogue was necessary to raise consciousness about the standards, although roundtables that included participants with different roles from a range of firms were not thought optimal for in-depth discussion. Instead, groups of people from the same firm (to overcome the problem of giving away proprietary information) or doing the same job (to provide a better focus) were suggested. The following were suggested:

- ⇨ an FSF annual conference in one of the major financial centres;
- ⇨ seminars as part of the IMF/World Bank annual Meetings:
- ⇨ a regular publication (say quarterly, as with the joint IMF/World Bank /OECD/BIS data on external debt) summarising as briefly as possible which countries complied with which standards would help participants focus on the issue systematically
- ⇨ an annual survey on some standardised key factors on the existence and actual observance of main pillar in each standard and code
- ⇨ the IMF should take the opportunity of its annual meetings to make the work on standards, particularly ROSCs, better known; specific ROSCs could even be presented at these meetings to maximise their impact.

Presentation of information. The way that information is presented was also felt to be very important. Participants urged the official sector to summarise the standards and cut down on jargon.

- ⇨ A one-stop information shop was agreed to be a big help, with appropriate links to individual countries.
- ⇨ A simple rating based system, or 'traffic lights', was suggested by several firms. This could take the form of composite indices or rankings that would make it easy to monitor the standards on a regular basis. It was appreciated in discussion, however, that the official sector does not want to be perceived as a quasi-rating agency.
- ⇨ The IMF web site could be configured so that when click on country information, available ROSCs would be indicated as well as technical assistance being provided to enhance implementation.
- ⇨ Others thought that to show their practical use, the ROSCs should be presented more as a forward looking tool rather than explaining past problems. The IMF could make greater comments in its Article IV consultations on how well a country meets the market infrastructure/financial supervision standards and provide some updated on important issues previously highlighted in the

ROSC modules. Regulatory incentives also attracted mild support.

Articulation of action plans. More needs to be done at the government level to demonstrate a commitment within individual countries to adopt codes and standards, with a more rigorous timetable for their implementation. A clear message from official and commercial users of the information subject to these standards might help convince countries of their importance. There is a risk that the issues are only addressed in the aftermath of a crisis, when resources are thin and management attention is focused on stability.

Dialogue on risk assessments. The official sector should promote enhanced co-operation and information sharing between international organisations and the private sector (forum on best practices in country risk assessment, meetings between country analysts of international organisations and the private sector, etc.)

Research. A research project aimed at showing that observance of standards reduces financial sector vulnerability would heighten awareness of their importance.

Official incentives. The official community should explore ways to introduce official incentives/sanctions to help foster implementation of standards. The IMF should prominently flag countries that do not materially observe key standards.

Official financing. For a limited period of time, official sector should be prepared to offer better conditions on bilateral and multilateral loans to those countries that observe standards. This would not only provide a very strong incentive for their adoption, but would also not go unnoticed by the private sector. To encourage the market to provide incentives to implement standards it would be good if the IFIs (e.g. IMF) built incentives into the access to their own financing. There is a principal-agent problem in application of market incentives as there is only so much pressure that an individual bank can exert to foster implementation.

Compliance culture. The buy-in of domestic authorities was needed to generate incentives. Non-compliance needed to be punished by local authorities.

Quantitative ratings. The Fund and Bank should publish grades on the observance of standards by individual economies in a comparative manner. They should produce “ratings” and “benchmarks”, based on clear definitions and rating procedures, allowing for a quick comparison between the levels of implementation of individual standards in the different countries or by the different actors.

Rating agencies (sovereign credit ratings) /Other information providers (country analysis)

The official sector should focus on making market incentives work.

- The single most significant step was when the Basel Committee suggested that sovereigns would be eligible for weightings below 100% under the Standardised Approach only “if they subscribe to the IMF's Special Data Dissemination Standards (SDDS).” This step gave the countries in question an incentive to improve their standards, and helped make investors aware that such standards exist. (This proposal is no longer under active consideration by the Basel Committee).
- Similar efforts by world financial exchanges (i.e. to list/sell bonds or stocks on that market an issuer must meet certain standards) would be a significant advance.

Commercial banks (credit allocations and spreads)

Dialogue on standards. Official institutions should increase information and dialogues (about the core principles and other standards) with different categories of market participants, e.g. through seminars. As an example, if a country assessment was published, an information meeting about that country and about the evaluation process could be held.

Annex F

Evaluation of Possible Official Incentives

1. This annex provides a detailed discussion of each of the possible official incentives to foster implementation of international standards, organised under the following headings:
   - the specific steps in the implementation process that the application of the incentive might be most effective in encouraging (Why Applied);
   - the bodies that could be expected to apply the incentive (Who Applies);
   - the bodies to whom the incentive would be applied (Whom Applied To);
   - the standards for which the incentive would be most suitable (Which Standards);
   - the current status or extent of application of the incentive by national authorities or relevant international groupings (Status);
   - the benefits of applying the incentive (Benefits);
   - the key considerations or challenges in applying the incentive (Considerations); and
   - options for further consideration (Recommendation).
2. Box F1 provides an overview of the possible official incentives.

Box F1: A Catalogue of Possible Official Incentives

Group 1: To encourage adoption of standards and implementation plans

1. External Assessment

(a) Conduct ***external assessments*** of economies' observance of standards.

2. Policy Dialogue

(a) Provide national authorities ***policy advice*** on implementing standards.

(b) Encourage within relevant international and regional groupings commitment to implementing standards and ***peer discussions*** of progress and experiences in implementing standards.

3. Membership

(a) Link economies' ***membership in international groupings*** to: (a) adoption of relevant standards (for aspiring members); and (b) progress in implementing standards (for existing members).

4. Technical Assistance

(a) Provide ongoing ***technical assistance and training***.

Group 2: To promote market demand for disclosure of assessments and market discipline

5. Dissemination of Information

(a) Encourage the ***disclosure of external assessments*** of observance of standards.

(b) Encourage the inclusion in ***bond prospectuses*** for international issues by sovereign jurisdictions material information on external assessments of their observance of relevant standards.

6. Incorporation in Risk Assessments

(a) Encourage domestic financial institutions dealing with counterparties registered in foreign jurisdictions to consider in their ***risk assessments*** (e.g. internal credit ratings in the case of banks) information from external assessments of observance of relevant standards in these jurisdictions.

(b) Issue ***informational advisories*** to domestic financial institutions urging caution in dealing with counterparties based in jurisdictions, or transactions involving jurisdictions, that have material gaps in observance of standards as highlighted by assessments, which need to reflect countries' specifics and vulnerabilities, or have refused to undertake assessments.

Group 3: To urge observance of standards, where material gaps are prevalent, and disclosure of assessments

7. Market Access Measures

Apply market access measures in the following ways :

(a) A *host* jurisdiction could take into account in deciding whether, and if so under what conditions, it will allow a foreign institution to operate in its markets, the degree to which that institution's home jurisdiction observes relevant standards.

(b) Where regulatory approval is required, a *home* jurisdiction could place restrictions on its domestic financial institutions' operations in foreign jurisdictions with material gaps in observance of relevant standards.

8. Regulatory and Supervisory Actions

Consider tightening supervision and regulation of:

(c) ***subsidiaries or branches of foreign financial institutions*** based in jurisdictions with material gaps in their observance of relevant standards; and

(d) ***domestic financial institutions*** dealing with counterparties based in foreign jurisdictions with material gaps in their observance of relevant standards by

- ⇨ conducting more intensive examinations
- ⇨ imposing higher public disclosure requirements (for listed entities)
- ⇨ increasing regulatory reporting requirements
- ⇨ requiring more extensive external audits
- ⇨ restricting inter-affiliate transactions
- ⇨ increasing scrutiny of customer identification
- ⇨ strengthening oversight of payment system providers

1. EXTERNAL ASSESSMENT	
Incentive	Conduct ***external assessments*** of economies' observance of standards
Why applied	Help/encourage economies to: ⇨ identify areas for improvement ⇨ adopt relevant standards ⇨ formulate a credible action plan for implementing standards, through links to IMF and World Bank country work
Who applies	⇨ IMF and World Bank, in co-operation with standard-setting bodies ⇨ FATF
Whom applied to	All economies
Which standards	All 12 key standards (see below under Status)
Status	The IMF-World Bank Reports on Observance of Standards and Codes (ROSCs) provide a framework to assemble assessments of observance of standards across the range of areas for which they are currently being conducted: ⇨ Assessments of observance of financial sector standards are conducted within the context of the joint Fund-Bank Financial Sector Assessment Programmes (FSAPs) aimed at assessing financial sector vulnerabilities. The standards include the *Code of Good Practices on Transparency in Monetary and Financial Policies* and the *Core Principles for Effective Banking Supervision* (in collaboration with the BCBS) and, where relevant, the *Insurance Supervisory Principles* (in collaboration with the IAIS), *Objectives and Principles of Securities Regulation* (in collaboration with IOSCO), and the *Core Principles for Systemically Important Payments Systems* (in collaboration with the CPSS). ⇨ Assessments of observance of the *Special Data Dissemination Standard* and *Code of Good Practices in Fiscal Transparency* are undertaken in the context of the IMF's technical assistance activities or as stand-alone exercises in the context of the Fund's surveillance and programme reviews. ⇨ Assessment methodologies are being developed by the World Bank for the *International Accounting Standards* and *Principles of Corporate Governance* (in collaboration with the OECD). The Bank is also developing an assessment matrix for insolvency regimes and creditor rights. IOSCO has formulated questionnaires for self-assessment by jurisdictions on their observance of the *Objectives and Principles of Securities Regulation*; in a second step, peer reviews are being considered and planned for among the members to verify the accuracy of the responses. The FATF conducts a detailed mutual evaluation of members' progress in implementing measures to counter money laundering.
Benefits	⇨ helps the economies being assessed to gauge where they stand in terms of implementing relevant standards, to identify areas for improvement, and to develop appropriate action plans and technical assistance programmes ⇨ helps generate information on observance of standards that, when disseminated to market participants (as in incentive #5) and used by them (as in incentive #6) could enhance market discipline on economies to implement standards

	⇨ provides the basis for the successful operation of most other official incentives, and is an integral part of incentive #2 of promoting policy dialogues with national authorities and incentive #3 of linking progress in implementation to membership in international groupings.
Considerations	⇨ assessments are extremely resource-intensive and require highly skilled personnel if they are to be comprehensive and credible ⇨ external assessments should be based on clear and detailed assessment methodologies so as to ensure consistency and credibility ⇨ to foster ownership and co-operation, external assessments must be voluntary ⇨ in view of resource constraints, there is a need to prioritise standards for implementation: this should take account of the economy's stage of development, institutional capacity, and financial structure ⇨ while the standards are designed to apply universally, assessments of observance need to take account of domestic economic circumstances in order to promote country buy-in and ownership ⇨ to maximise the benefits of this incentive, there should be strong encouragement to disclose the results of external assessments (incentive #5), thereby facilitating market discipline on economies to observe standards ⇨ for effective implementation of standards, assessments should provide the basis for developing concrete action plans. ⇨ where concerns about disclosure of assessment results may discourage some economies from undertaking external assessments, the emphasis may have to be placed – at least initially - on undertaking these assessments rather than disclosure.
Recommendation	⇨ The FSF should encourage the IMF, World Bank, and standard-setting bodies to continue enhancing the conduct of external assessments of observance of standards, including those among the 12 key standards not currently included in the assessment programme. ⇨ National authorities represented on the FSF could demonstrate leadership by undertaking assessments of observance of relevant standards.
2 (a). POLICY DIALOGUE: Fund-Bank Policy Advice	
Incentive	Provide national authorities ***Fund-Bank policy advice*** on implementing standards
Why applied	Help/encourage economies to: ⇨ adopt relevant standards ⇨ formulate a credible action plan for implementing standards
Who applies	⇨ IMF ⇨ World Bank and regional development banks
Whom applied to	National authorities who are members of the IMF and World Bank
Which standards	All 12 key standards
Status	This is currently being done within the context of the IMF Article IV Consultations and World Bank economic and sector work and Fund-Rank Executive Board discussions with inputs from the pilot Fund-Bank Financial Sector Assessment Programmes (FSAPs) and experimental Fund-Bank Reports on Observance of Standards and Codes (ROSCs).

Benefits	⇨ provision of policy advice and encouragement is consistent with promoting country ownership and buy-in for standards implementation ⇨ discussion of an economy's observance of standards at the IMF Executive Board can create useful peer pressure
Considerations	⇨ jurisdictions can choose to ignore policy advice without much short term cost ⇨ this is a critical component of any system of official incentives ⇨ effectiveness of this incentive is closely linked to incentive #1, i.e. external assessments of observance of standards ⇨ while all 12 key standards are amenable to this approach, in practice, given that policy dialogues serve several ends, detailed discussion of standards implementation can realistically focus on only a few standards ⇨ the cost associated with ignoring the policy advice is linked to whether the content of such advice is disclosed publicly: disclosure may facilitate market discipline on economies to heed the advice but could also impede candour in the review process
Recommendation	The FSF should encourage the IMF and World Bank to consider how the mechanism for policy advice could be further enhanced, e.g. through giving greater prominence to standards implementation issues within the Article IV consultation process, with a view to helping economies identify an appropriate set of standards for priority implementation and develop effective action plans.
2 (b). POLICY DIALOGUE: Peer Discussions	
Incentive	Encourage within relevant international and regional groupings ***peer discussions*** of progress and experience in implementing standards
Why applied	Help/encourage economies to: ⇨ adopt relevant standards ⇨ formulate a credible action plan for implementing standards
Who applies	⇨ G20 (Group of Twenty) ⇨ APEC (Asia-Pacific Economic Co-operation) ⇨ ASEAN (Association of South-east Asian Nations) ⇨ CARICOM ⇨ CHFI (Committee on Hemispheric Financial Issues) ⇨ IAIS ⇨ EU (European Union) ⇨ IOSCO ⇨ MFG (Manila Framework Group) ⇨ MERCOSUR ⇨ OECD ⇨ UNCTAD ⇨ Regional groupings of supervisors ⇨ Regional development banks
Whom applied to	National governments/central banks/supervisory or regulatory authorities who are members of such groupings

Which standards	All 12 key standards
Status	In 1999, members of the G20 committed themselves to participate in FSAP and ROSC exercises, involving assessments of observance with standards. Within APEC, Part 2 of the current project on a voluntary action plan for freer and more stable capital flows "VAP" is being used to promote peer discussions of progress in implementing standards. This process has highlighted the 12 key standards designated by the FSF as key to sound financial systems. In the area of insurance supervision, the regional supervisors' groups in several emerging market economies meet at least annually within the framework of the IAIS, OECD, UNCTAD, and regional development banks.
Benefits	⇨ such discussions could exert peer pressure and create a collective impetus for reform in wavering jurisdictions, within a collegial and familiar environment that promotes country ownership ⇨ it could complement the assisted self assessment process ⇨ it provides a useful mechanism to share experiences among fairly similar economies regarding implementation issues and provide guidance
Considerations	⇨ jurisdictions can choose to ignore peer exhortations without much short term cost ⇨ regional groupings may lack the mandate or institutional capacity to carry out such peer discussions in an effective manner ⇨ may not be effective on its own, but could potentially be a useful adjunct to policy discussions with the IMF and World Bank ⇨ would require that these regional and international groupings endorse and recognise the significance of international standards relevant to them
Recommendation	The FSF should encourage relevant international and regional groupings (G7, G20, APEC, ASEAN, CARICOM, CHFI, EFTA, EU, IAIS, IOSCO, MFG, MERCOSUR, NAFTA, OECD, and regional groupings of supervisors) to make, where appropriate, peer discussions of progress and experiences in implementing standards a regular part of their agenda. National authorities represented on the FSF should encourage members in international or regional groupings that they are a part of to make a commitment to implement relevant standards.

3. MEMBERSHIP: Membership in International Groupings

Incentive	Link economies' ***membership in international groupings*** to: (a) adoption of relevant standards (for aspiring members); and (b) progress in implementing standards (for existing members)
Why applied	Encourage economies who are aspiring members to: ⇨ adopt relevant standards ⇨ formulate a credible action plan for implementing standards ⇨ announce action plan for implementing standards Encourage economies who are existing members to: ⇨ implement and observe standards ⇨ undertake external assessments of observance of standards ⇨ disclose information on external assessments of observance of standards

Who applies	⇨ BCBS and related groups (e.g. OGBS, or Offshore Group of Banking Supervisors) ⇨ CPSS ⇨ IAIS and related groups (e.g. OGIS, or Offshore Group of Insurance Supervisors) ⇨ IOSCO ⇨ OECD ⇨ FATF
Whom applied to	National governments/supervisory or regulatory authorities who are members or aspiring members of these international groupings
Which standards	⇨ Principles of Corporate Governance (OECD) ⇨ Core Principles for Systemically Important Payments Systems (CPSS) ⇨ The Forty Recommendations of the Financial Action Task Force on Money Laundering (FATF) ⇨ Core Principles for Effective Banking Supervision (BCBS, OGBS) ⇨ Insurance Supervisory Principles (IAIS, OGIS) ⇨ Objectives and Principles of Securities Regulation (IOSCO)
Status	There are provisions in several groupings for this incentive to be implemented. ⇨ Membership in IOSCO is conditional on jurisdictions endorsing IOSCO's *Objectives and Principles of Securities Regulation* and undertaking to implement this standard ⇨ Membership in the OGBS requires adherence to a specific checklist, with respect to legislation, political commitment to standards, etc. Some applications have failed to meet the criteria and have been denied membership. ⇨ The OGIS requires acceptable regulatory legislation, its effective enforcement, and adequate resources as prerequisites for membership. The OGIS also monitors their existing members for continuous observance with the membership criteria. The degree of enforcement of this incentive, however, varies across groupings.
Benefits	⇨ in wavering jurisdictions, the attraction of membership in international groupings could provide additional impetus for adopting relevant standards ⇨ if existing members had their membership "qualified" because they have not adopted the standards or made sufficient progress towards implementation, it could act as a strong incentive to implement standards ⇨ this measure is broadly consistent with existing practice in many groupings, e.g. FATF, IOSCO, OGBS, OGIS, etc.

<table>
<tr><td>Considerations</td><td>⇨ excluding from international groupings economies which do not commit to implement relevant standards could remove a potential source of peer pressure on these economies
⇨ exclusion could undermine country ownership and buy-in
⇨ gauging “progress” in implementing standards can be fairly subjective without the benefit of credible external assessments of observance of standards
⇨ principle of equal treatment could imply having to expel existing members of such groupings if they have persistently not made sufficient progress towards implementation; this could be highly contentious
⇨ this is ultimately for decision by the relevant groupings who have to take account of various other factors besides implementation of standards
⇨ if this incentive is to be applied to new members it may be necessary to have a clear transition period to allow countries to implement standards
⇨ to maximise peer pressure effects, jurisdictions that are keen but have yet to adopt relevant standards could be granted “observer” status which would allow them to participate in the group’s activities
⇨ to encourage economies to move beyond adopting relevant standards and make progress in implementing them, a two-stage membership process could be envisaged for new members whereby probationary membership is granted when a jurisdiction commits itself to implementing the relevant standards and full membership (including voting rights) is granted when there is verifiable progress in implementing these standards</td></tr>
<tr><td colspan="2">4. TECHNICAL ASSISTANCE: Technical Assistance and Training</td></tr>
<tr><td>Incentive</td><td>Provide ongoing technical assistance and training</td></tr>
<tr><td>Why applied</td><td>Help economies to:
⇨ build the capacity to implement standards
⇨ make progress in implementing standards</td></tr>
<tr><td>Who applies</td><td>⇨ economies with well-developed financial systems
⇨ standard-setting bodies
⇨ international financial institutions
⇨ multilateral development banks
⇨ Financial Stability Institute (FSI)</td></tr>
<tr><td>Whom applied to</td><td>Economies that require technical assistance to address weaknesses and that have demonstrated commitment to implement international standards</td></tr>
<tr><td>Which standards</td><td>All 12 key standards</td></tr>
<tr><td>Status</td><td>Secondment programmes and study visits – for the purpose of training and exchange of experiences - are quite common among supervisors and regulators. Most such bilateral technical assistance programmes are unconditional and not structured as incentives.
Technical assistance and training is also being provided by the IMF, World Bank, regional development banks, standard-setting bodies, and the FSI.</td></tr>
<tr><td>Benefits</td><td>⇨ sends a strong positive signal that the international community is willing to support economies in their implementation efforts</td></tr>
</table>

	⇨ helps ensure that the momentum of implementation is sustained ⇨ helps address shortages of local expertise, which is a major obstacle to implementing standards, especially in emerging market economies
Considerations	⇨ financial and human resources are limited internationally ⇨ given that jurisdictions compete among themselves, there could be a natural reluctance to offer to or seek assistance from other jurisdictions ⇨ scarce resources – often concentrated in a few jurisdictions - would need to be judiciously channelled to jurisdictions where they can have the greatest impact on improving standards and which have access to international credit and bond markets or which subscribe to the SDDS ⇨ prioritising the delivery of bilateral technical assistance is a difficult task ⇨ technical assistance would be most effective following an external assessment of observance of standards that highlighted areas for improvement; co-ordination of technical assistance with assessments of observance of standards should be further enhanced ⇨ in some countries, there might be a funding issue when independent supervisory agencies – which are best placed to provide some of the technical assistance – work on a cost-recovery basis ⇨ greater co-ordination among different technical assistance programmes can help reduce demand for additional resources for such programmes
Recommendation	National authorities represented on the FSF should demonstrate leadership by making a commitment to provide technical assistance and training for standards assessments and implementation, co-ordinated either bilaterally or through the IFIs, on the basis of assessed needs.
5 (a). DISSEMINATION OF INFORMATION: Disclosure of External Assessments	
Incentive	Encourage the ***disclosure of external assessments*** of observance of standards
Why applied	⇨ to promote market discipline on economies to observe standards ⇨ to provide basis for application of other official incentives
Who applies	⇨ IMF and World Bank ⇨ FSF ⇨ G20
Whom applied to	All economies who have undertaken external assessments of observance of standards
Which standards	All 12 key standards
Status	To-date, most economies who have undertaken ROSCs have voluntarily disclosed the results of these assessments.
Benefits	⇨ highlighting economies that are in observance of standards could create international peer pressure on other economies to enhance their own implementation and observance of standards ⇨ could enhance market discipline on economies to implement standards ⇨ provides the basis for the successful operation of most other official incentives, and this is an integral part of incentive #2 of promoting policy dialogues with national authorities

Considerations	⇨ pressure to disclose assessment results may discourage economies who are concerned about possible adverse implications of such disclosure from undertaking external assessments ⇨ where concerns about disclosure of assessment results may discourage some economies from undertaking external assessments, the emphasis may have to be placed initially on undertaking these assessments rather than disclosure.
Recommendation	⇨ There should be a presumption that national authorities disclose assessments of observance of standards. National authorities represented on the FSF should demonstrate leadership by making a commitment to disseminate information on self and external assessments.
5 (b). DISSEMINATION OF INFORMATION: Bond Prospectuses	
Incentive	Encourage the voluntary inclusion in ***bond prospectuses*** for international issues by sovereign jurisdictions material information on external assessments of their observance of relevant standards.
Why applied	To encourage economies to: ⇨ undertake external assessments of observance of standards ⇨ disclose material information on external assessments of observance of relevant standards To promote market discipline on economies to observe relevant standards
Who applies	Jurisdictions where international bonds are issued
Whom applied to	National governments issuing international bonds
Which standards	⇨ Code of Good Practices on Transparency in Monetary and Financial Policies ⇨ Code of Good Practices in Fiscal Transparency ⇨ Special Data Dissemination Standard
Status	Many jurisdictions already have detailed disclosure requirements for bond issuances. The application of this incentive could be justified by IOSCO's *Objectives and Principles of Securities Regulation*, which states that "Investors should be provided with the information necessary to make informed investment decisions on an ongoing basis. The principle of full, timely and accurate disclosure of current and reliable information material to investment decisions is directly related to the objectives of investor protection and fair, efficient and transparent markets."
Benefits	⇨ by encouraging only that material information on observance of relevant standards be made available, this incentive places the burden of pricing this information on the market and helps foster market discipline: it is thus conducive to fostering market incentives ⇨ encourages economies intending to issue international bonds in other jurisdictions to undergo external assessments of the relevant standards ⇨ helps promote public/market awareness of standards
Considerations	⇨ jurisdictions that do not apply this incentive could offer themselves as more attractive markets for issuing sovereign bonds, thereby leading to regulatory arbitrage

	⇨ this incentive may be expressed with reference to existing disclosure standards for cross-border bond offerings ⇨ encourage implementation among the major financial centres so as to minimise regulatory arbitrage and ensure a level playing field ⇨ it may be necessary in many instances to update outstanding prospectuses following external assessments of observance of standards ⇨ requires credible and timely information on observance of standards (from Fund/Bank ROSC assessments) to be made available to the issuing bank for the sovereign bond; where such information is unavailable or an assessment not completed, the prospectus could reflect this ⇨ jurisdictions in which sovereign international bonds are being issued can only verify that information on observance of standards is included in the prospectuses; responsibility for ensuring the accuracy of the information must rest with the sovereign issuing the bonds and the issuing bank.
Recommendation	National authorities represented on the FSF should encourage the voluntary disclosure of material information on observance of relevant standards in bond prospectuses for international sovereign bond issues..
6 (a). INCORPORATION IN RISK ASSESSMENT: Internal Credit Ratings	
Incentive	Encourage domestic financial institutions dealing with counterparties registered in foreign jurisdictions consider in their ***risk assessments*** (e.g. internal credit ratings in the case of banks) material information on the observance of relevant standards in these jurisdictions.
Why applied	To encourage economies to: ⇨ undertake external assessments of observance of standards ⇨ disclose information on external assessments of observance of standards To promote market discipline on economies to observe standards
Who applies	National supervisory/regulatory authorities in *home* jurisdictions
Whom applied to	Domestic financial institutions with operations in jurisdictions which have weak observance of standards or have not undertaken external assessments
Which standards	For sovereign credits: ⇨ Code of Good Practices on Transparency in Monetary and Financial Policies ⇨ Code of Good Practices in Fiscal Transparency ⇨ Special Data Dissemination Standard For credits to / dealings with financial institutions: ⇨ The Forty Recommendations of the Financial Action Task Force on Money Laundering (for bank counterpartiess) ⇨ Core Principles for Effective Banking Supervision (for bank counterparties) ⇨ Insurance Supervisory Principles (for insurance company counterparties) ⇨ Objectives and Principles of Securities Regulation (for investment bank/securities house counterparties) For credits to / dealings with non-financial corporates:

	⇨ Principles of Corporate Governance ⇨ International Accounting Standards ⇨ International Standards on Auditing
Benefits	⇨ Consistent with existing regulatory/supervisory practices and the internal ratings approach being developed within the New Basel Capital Accord ⇨ relies on market discipline rather than direct regulatory/supervisory actions to exert pressure on weak jurisdictions, especially by encouraging market participants to internalise and price the risks inherent in transactions with institutions from such jurisdictions
Considerations	⇨ requires implementation among the major financial centres so as to ensure a level playing field ⇨ requires credible and timely information on observance of standards (from Fund/Bank ROSC assessments and FATF evaluations) to be made available to national supervisory and regulatory authorities as well as financial institutions
Recommendation	National authorities represented on the FSF should encourage domestic financial institutions dealing with counterparties registered in foreign jurisdictions to consider in their risk assessments (e.g. internal credit ratings in the case of banks) information from external assessments of observance of standards in these jurisdictions.
6 (b). INCORPORATION IN RISK ASSESSMENT: Informational Advisories	
Incentive	Issue ***informational advisories*** to domestic financial institutions urging caution in dealing with counterparties registered in jurisdictions, or transactions involving jurisdictions, which have serious gaps in observance of standards or refused to undertake external assessments.
Why applied	To encourage economies to: ⇨ undertake external assessments of observance of standards ⇨ disclose information on external assessments of observance of standards To promote market discipline on economies to observe standards
Who applies	National supervisory/regulatory authorities in *home* jurisdictions
Whom applied to	Domestic financial institutions with operations in jurisdictions which have weak observance of standards or have not undertaken external assessments
Which standards	For sovereign credits: ⇨ Code of Good Practices on Transparency in Monetary and Financial Policies ⇨ Code of Good Practices in Fiscal Transparency ⇨ Special Data Dissemination Standard For credits to / dealings with financial institutions: ⇨ The Forty Recommendations of the Financial Action Task Force on Money Laundering (for bank counterparties) ⇨ Core Principles for Effective Banking Supervision (for bank counterparties)

	⇨ Insurance Supervisory Principles (for insurance company counterparties) ⇨ Objectives and Principles of Securities Regulation (for investment bank/securities house counterparties) For credits to / dealings with non-financial corporates: ⇨ Principles of Corporate Governance ⇨ International Accounting Standards ⇨ International Standards on Auditing
Status	Some jurisdictions have issued advisories. ⇨ The FATF has recently called on its members to request financial institutions within their jurisdictions to give special attention to transactions with jurisdictions identified as non-cooperative. A number of its members have followed up with the issuance of advisories to their financial institutions.
Benefits	⇨ relies on market discipline rather than direct regulatory/supervisory actions to exert pressure on weak jurisdictions, especially by encouraging market participants to internalise and price the risks inherent in transactions with institutions from such jurisdictions ⇨ helps disseminate information to market participants on observance of standards and has potentially powerful "announcement effect" on market views. ⇨ gives scope to convey qualitative information on observance of standards instead of offering just binary choices as is the case with regulatory/supervisory actions
Considerations	⇨ it might not be appropriate to issue advisories solely on the basis of a foreign jurisdiction's weak observance of standards. ⇨ requires implementation among the major financial centres so as to ensure a level playing field ⇨ requires credible and timely information on observance of standards (from Fund/Bank ROSC assessments and FATF evaluations) to be made available to national supervisory and regulatory authorities as well as financial institutions
Recommendation	National authorities represented on the FSF should consider the desirability and feasibility of using informational advisories to urge caution in dealing with counterparties based in jurisdictions, or transactions involving jurisdictions, with material gaps in their observance of standards.
7. MARKET ACCESS MEASURES	
Incentive	Apply market access measures in the following ways: (a) A *host* jurisdiction could take into account in deciding whether, and if so under what conditions, it will allow a foreign institution to operate in its markets, the degree to which that institution's home jurisdiction observes relevant standards. (b) Where regulatory approval is required, a *home* jurisdiction could place restrictions on its domestic financial institutions' operations in foreign jurisdictions with material gaps in observance of relevant standards.
Why applied	To encourage jurisdictions to: ⇨ Implement and observe standards

	⇨ Undertake external assessments of observance of standards ⇨ Disclose information on external assessments of observance of standards
Who applies	National supervisory/regulatory authorities
Whom applied to	(a) Foreign financial institutions whose *home* jurisdictions have weak observance of standards (b) Domestic financial institutions with operations in jurisdictions with weak observance of standards
Which standards	⇨ The Forty Recommendations of the Financial Action Task Force on Money Laundering (for branches and subsidiaries of banks) ⇨ Core Principles for Effective Banking Supervision (for branches and subsidiaries of banks) ⇨ Insurance Supervisory Principles (for branches and subsidiaries of insurance companies) ⇨ Objectives and Principles of Securities Regulation (for investment banks/securities houses)
Status	In many jurisdictions, there is some implicit consideration of home supervisory authorities' observance of standards when assessing applications by foreign institutions although this is not an independent criterion. ⇨ In the case of banks, a key criterion in many jurisdictions is whether the branch or subsidiary would be subject to effective consolidated supervision by the home jurisdiction, and consideration of observance of standards could be part of this assessment ⇨ In the case of applications to place trading terminals in the domestic market, observance of the relevant IOSCO standards is a criterion in several jurisdictions ⇨ In many jurisdictions, there is also implicit consideration of the potential host jurisdiction's observance of standards when assessing applications by domestic institutions to set up operations in these jurisdictions.
Benefits	⇨ consistent with existing regulatory/supervisory practices ⇨ provides clear motivation for implementing standards given tangible returns for doing so
Considerations	⇨ while the affected institutions could be expected to exert pressure on their home jurisdictions to implement standards, this could take time ⇨ not an effective lever on economies whose institutions already enjoy wide access to foreign markets (unless retrospective action is being contemplated) or do not aspire to have such access ⇨ could be used (or seen) as a protectionist policy to keep out foreign institutions ⇨ jurisdictions that do not apply this incentive could offer themselves as more attractive destinations for foreign institutions, thereby leading to regulatory arbitrage

	⇨ requires implementation among the major financial centres so as to minimise regulatory arbitrage and protectionism ⇨ requires credible and timely information on observance of standards in home jurisdictions (from Fund/Bank ROSC assessments and FATF evaluations) to be made available to supervisory and regulatory authorities in host jurisdictions ⇨ observance of standards would need to be considered within the broader assessment that regulators and supervisors have to make on whether to allow market access to a foreign financial institution
Recommendation	⇨ National authorities should be encouraged to give greater consideration to a foreign jurisdiction's observance of relevant standards as one of the factors in making market access decisions.
8. REGULATORY AND SUPERVISORY ACTIONS	
Incentive	Consider tightening supervision and regulation of: (a) *subsidiaries or branches of foreign financial institutions* registered in jurisdictions with weak observance of standards (b) *domestic financial institutions* dealing with counterparties registered in foreign jurisdictions with weak observance of standards ⇨ conduct more intensive examinations ⇨ impose higher public disclosure requirements (for listed entities) ⇨ increase regulatory reporting requirements ⇨ require more extensive external audits ⇨ restrict inter-affiliate transactions ⇨ increase scrutiny of customer identification ⇨ strengthen oversight of payment system providers
Why applied	To encourage jurisdictions to: ⇨ implement and observe standards ⇨ undertake external assessments of observance of standards ⇨ disclose information on external assessments of observance of standards
Who applies	General National supervisory/regulatory authorities Strengthening oversight of payment system providers: Central banks
Whom applied to	General (a) Foreign financial institutions whose *home* jurisdictions with serious gaps in observance of standards (b) Domestic financial institutions with operations in jurisdictions with serious gaps in observance of standards Strengthening oversight of payment system providers: Payment system providers

Which standards	⇨ Core Principles for Systemically Important Payment Systems (for payment system providers) ⇨ The Forty Recommendations of the Financial Action Task Force on Money Laundering (for banks) ⇨ Core Principles for Effective Banking Supervision (for banks) ⇨ Insurance Supervisory Principles (for insurance companies) ⇨ Objectives and Principles of Securities Regulation (for investment banks/securities houses)
Status	Many host supervisors (in banking and insurance) take into account the quality and reliability of home supervision, including implicitly the observance of relevant international standards, when considering more intensive supervision and regulation of foreign institutions operating within their jurisdictions. But practices vary considerably. Similarly, many home supervisors (in banking and insurance) take into account the quality and reliability of supervision in the host jurisdiction, including implicitly the observance of relevant international standards, when considering more intensive supervision and regulation of domestic institutions operating in foreign jurisdictions <u>Imposing higher capital charges and/or provisioning requirements</u>: Given the operational difficulties of applying this principle in an objective manner, the BCBS has decided that observance of standards would not be among the criteria for determining capital adequacy ratios under the New Capital Accord. The application of this incentive would therefore have to made on a case-by-case basis under the second pillar of the Capital Accord, namely ongoing supervisory review of banks' capital adequacy. <u>Strengthening the oversight of payment system providers</u>: The G10 and EU central banks share the view that oversight of payment systems is an essential function of central banks; laws establishing a country's central bank or other national laws are often the basis for these oversight activities. The Treaty establishing the European Community and the Statute of the ESCB and the ECB recognises oversight as one of the basic tasks of the Eurosystem.
Benefits	⇨ provides clear motivation for home and host jurisdictions to implement standards given that not doing so generates tangible costs and inconvenience on their institutions ⇨ broadly consistent with existing regulatory/supervisory practices
Considerations	<u>General</u> ⇨ jurisdictions that do not apply this incentive could offer themselves as more attractive destinations for foreign institutions, leading to regulatory arbitrage ⇨ not an effective lever on economies whose institutions do not have or do not aspire to have significant operations in foreign jurisdictions ⇨ while the affected foreign institutions could be expected to exert pressure on their home jurisdictions to implement standards; this could take time ⇨ could be used (or seen) as a tool to put foreign institutions at a disadvantage vis-à-vis domestic institutions ⇨ in the absence of specific problems at an institution, this may not be an effective use of scarce supervisory resources ⇨ some of these measures, e.g. on-site examinations and external audits, are not part of the supervisory regime in many jurisdictions.

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⇨ requires implementation among the major financial centres so as to minimise regulatory arbitrage and ensure a level playing field
⇨ requires credible and timely information on observance of standards (from Fund/Bank ROSC assessments) to be made available to national supervisory and regulatory authorities
⇨ in deciding an appropriate supervisory/regulatory strategy with respect to foreign financial institutions, observance of standards would have to be considered as one among many factors within the broader assessment that host regulators and supervisors have to make of the overall risk profile of these institutions
⇨ the additional information or external audits being required of foreign institutions must be relevant for the fair and proper regulation of these institutions
<u>Imposing higher capital charges and/or provisioning requirements:</u>
⇨ this could be seen as second-guessing the risk management systems and credit policies of the regulated domestic institutions, with possible distortions to the credit-granting process.
⇨ this could create a moral hazard: if higher capital charges or provisioning requirements were not imposed with regard to certain jurisdictions, it could lead some domestic financial institutions to view this as an official seal of approval and encourage them to take risks without applying full due diligence
⇨ given that assessments of observance of standards are necessarily qualitative in nature and that capital charges are precise and quantitative, it is difficult to map the former onto the latter
⇨ given that capital charges are specifically targeted at addressing credit risk and that not all standards (or even elements of standards) have particular relevance to credit risks, it would be inappropriate to link capital charges to observance of standards.
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<u>Strengthening the oversight of payment system providers:</u>
⇨ requires cross-border information exchange on relevant payment systems participants
⇨ rules for the flow of information between central banks and supervisory authorities, including appropriate co-ordination channels, would need to be set up.
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<tr><td>Recommendation</td><td>National authorities should be encouraged to give greater consideration to a foreign jurisdiction’s observance of relevant standards as one of the factors in supervision and regulation of (a) subsidiaries or branches of foreign institutions from that jurisdiction; or (b) domestic institutions dealing with counterparties in that jurisdiction.</td></tr>
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