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Crisis Prevention and Crisis Management: The Role of Regulatory Governance

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Abstract

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Good regulatory governance in the financial system is a critical component of financial stability. Research on the topic has not been very systematic and deep. This paper first defines four key components of regulatory governance— independence, accountability, transparency, and integrity. It explores the quality of regulatory governance based on the financial system evaluations under the Financial Sector Assessment Programs (FSAPs), which are the first and most comprehensive effort to analyze regulatory governance issues. In terms of independence, banking supervisors are ahead of the others, while securities regulators perform better on transparency. Insurance regulators are weak in all the regulatory governance components. On the whole, regulators still have a long way to go in terms of practicing good governance. The paper also discusses governance issues specific to crisis management and concludes with an agenda for further research.

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GLOSSARY

AMC	Asset management companies
BCP	Basel Committee's Core Principles for Effective Banking Supervision
CPSIPS	CPSS's Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
FSAC	Financial Sector Action Committee
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
IBRA	Indonesia Bank Restructuring Agency
ICP	Insurance Core Principles
IFIs	International financial institutions
IOSCO	International Organization of Securities Commissions
OECD	Organization for Economic Cooperation and Development
MFP Code	IMF's Code of Good Practices on Transparency in Monetary and Financial Policies
PIN	Public Information Notice
ROSCs	Report on Observance of Standards and Codes

I. INTRODUCTION

A financial system is only as strong as its governing practices, the financial soundness of its institutions, and the efficiency of its market infrastructure. Instilling and using sound governance practices is a shared responsibility of market participants and regulatory agencies. This has three components. First, market participants bear the ultimate responsibility for establishing good governance practices in their institutions in order to gain and keep the confidence of their clients, counterparties, and the markets. Second, regulatory agencies play a key role in instilling, and overseeing implementation of the use of such good practices. The third layer, the main theme of this paper, is that regulatory agencies themselves need to establish and operate sound governance practices. By failing to apply good governance principles, regulatory agencies lose the credibility and moral authority to promulgate good practices in the institutions under their oversight. This could create a moral hazard problem, contribute to unsound practices in the markets, and, ultimately, accentuate crises in the financial system.

Indeed, recent experiences with systemic or significant financial sector crises have amply underlined the importance of good governance on the part of regulatory agencies. In nearly all financial crises of the past decade—East Asia, Ecuador, Mexico, Russia, Turkey, and Venezuela—political interference in the regulatory and supervisory process, forbearance, weak regulations, and supervision have been mentioned as contributing factors to the depth and size of the systemic crises. Each of these phenomena is a symptom of weak regulatory governance, while some are at the same time manifestations of the lack of public sector accountability and transparency.

The need for good regulatory governance in the context of financial sector policymaking and crisis prevention has begun to receive attention recently. However, more work is needed to enhance good regulatory governance as a key element of a well functioning financial system. Partly as a result of experience in the above-mentioned financial crises, a wide range of initiatives have been taken that, directly or indirectly, are aimed at enhancing good governance in regulatory agencies.

In cooperation with the international standard-setting bodies,² several financial sector standards—some sector-specific, others across sectors—have also been promulgated in recent years to establish international best practices and standards. Since 1999, the main vehicle through which financial sector surveillance work has been brought together is the FSAP, conducted jointly by the IMF and the World Bank. While the FSAP's main focus is on analyzing the strengths and vulnerabilities of the financial system, and on the assessment of financial sector standards, it has also become a key instrument to assess and, where

² Such as, the Basel Committee, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the Committee on Payment and Settlement Systems (CPSS).

necessary, assist in improving good governance of regulatory agencies in IMF-World Bank member countries.

The aim of this paper is to analyze the early outcome of the evaluation of good governance practices in regulatory agencies that has formed part of the FSAP effort and draw some preliminary lessons.³ Since the domain under analysis is relatively new and uncharted, we first attempt to define the concept of regulatory governance. Four main components of regulatory governance practices are identified for analysis—independence, accountability, transparency, and integrity. The analysis of FSAP assessments focuses on how countries stand in establishing good governance practices in regulatory agencies. It is found that in their present form, the various regulatory standards do not provide a complete (and consistent) framework of the “state of the art” in terms of regulatory governance; there are many gaps in implementing the good governance practices based on the four identified components. Finally, because complete crisis prevention remains an illusion, the paper also devotes attention to regulatory governance issues in crisis management.

The paper is structured as follows. Section II establishes a conceptual framework for regulatory governance that will serve as the guide through the subsequent sections. Section III discusses the role of FSAPs, and of the assessment of financial sector standards therein in instilling good regulatory governance in member countries. It subsequently presents in Section IV the main findings from a cross-sectional analysis of the standards assessments, and gives an overview of the recommendations that were formulated as part of the FSAPs. Section V discusses regulatory governance issues in crisis management, and the extent to which they differ from governance issues in “normal times.” Section VI summarizes the main lessons and offers some concluding observations.

II. REGULATORY GOVERNANCE—CONCEPTUAL FRAMEWORK

A. Defining Regulatory Governance

Adhering to good governance practices by regulatory agencies is a precondition to instilling good governance practices in the supervised sectors. The channel by which regulatory governance leads to good governance by firms and markets runs through credibility. Good and consistently applied governance practices help build an agency’s credibility, and credible institutions are able to enforce their actions or sanctions, and instill good governance practices in the supervised sectors.

It is necessary to define what is meant by regulatory governance, and outline a conceptual framework based on which implementation of good regulatory governance can be evaluated.

³ The analysis covers approximately 46 countries that participated in the FSAP effort between 1999 and 2001.

For the purposes of this paper, regulatory governance applies to those institutions that possess legal powers to regulate, supervise and/or intervene in the financial sector.⁴ Regulatory governance can therefore be seen as a somewhat narrower, more specific concept than **public sector governance**.⁵ While the principles of good regulatory governance apply obviously to all of the above institutions, it is worth bearing in mind that the (legal) scope of their actions could vastly differ, depending on legal, institutional, and political traditions. To give a few examples, at one end of the spectrum, a deposit insurance agency may have a fairly narrow mandate (pay out depositors in case of a bank failure); although good governance practices are also important in such an institution, there are fewer critical issues. At the other end of the spectrum, bank supervisors typically have “the coercive power of the state against private citizens” when they are involved in revoking bank licenses as Lastra and Wood (1999) note. This is a power that has no equivalent in the powers given to any other financial agency, including central banks. Exercising such far-reaching powers requires high governance standards.

Kaufmann, Kraay, and Zoido-Lobaton (2000, p. 10) define public sector governance as “the traditions and institutions that determine how authority is exercised in a particular country. This includes (1) the process by which governments are selected, held accountable, monitored, and replaced; (2) the capacity of governments to manage resources efficiently and to formulate, implement, and enforce sound policies and regulations; and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them.” This definition is, by extension, also applicable to appointed bureaucracies and official agents, such as financial sector regulators.

A somewhat adapted and more specific definition of regulatory governance, building upon the one above, would probably emphasize elements (2) and (3):

- the capacity to manage resources efficiently and to formulate, implement, and enforce sound policies and regulations—to be seen as the duty to meet the delegated objectives;
- the respect of citizens and the state for the institutions that govern economic and social interactions—protection from industry capture and political interference—complemented by an important element of the principal-agency theory of regulation; and

⁴ Thus, the term “regulatory agency” will be used to cover all institutions involved in financial sector regulation and oversight. This includes the central bank, sectoral regulators and supervisors, deposit insurance agencies, and, in systemic crisis situations, restructuring agencies and asset management companies. As and when necessary, the paper will distinguish between these types of institutions.

⁵ See Carmichael (2002). Our paper takes his definition also as the starting point.

- the respect of the agency for the broader goals and policies of the (elected) legislature.

The principal-agent theory assumes that information is asymmetrically distributed, with agents typically having more information than their principals. A related problem could be that the agent may have a different objective function than the principal. Thus, to avoid that (independent) regulatory agencies become a “fourth branch of the government” outside the normal channels of political control, it is important as a principle of good governance, that they “stay in touch” with the political realities while pursuing their mandate.

Evidence suggests that independent regulatory agencies do not behave as an irresponsible or headless fourth branch. One of the currently prevailing theoretical models on the interaction between political authorities and independent agencies is the “dialogue model”—largely inspired by the agency theory and the new institutionalism—that supports the view that statutory independent agencies in fact do their best to be informed about the intentions, wishes, and opinions of the political leadership and to anticipate their reactions to new policy proposals (Majone, 1993). In other words, the model indicates that independent regulatory agencies are subject to some form of political control—almost self-imposed censorship.

Reassuring though this view of good governance is, many authors are of the view that it is too informal and needs to be supplemented with more formal arrangements. Such formal arrangements bring us to the components of good governance.

B. Components of Good Regulatory Governance⁶

How can the quality of regulatory governance be analyzed with a view to improving it? To answer this question, we need to define its components. Four components can be identified, which bring together most of the elements that can ensure good regulatory governance. These are accountability, independence, integrity, and transparency.

Independence

Agency independence has been practiced, discussed, and accepted for a much longer time in the United States than in Europe or any other part of the world. There is a growing consensus worldwide that good regulatory governance can be best achieved by giving the agency a fair degree of **independence**—that is, independence from the political sphere and from the super-

⁶ This paper takes the need for regulation and supervision of the financial system for granted. For arguments in favor of regulation and supervision (see for instance Goodhart and others (1998), Lastra (1996), and Quintyn and Taylor (2002)).

vised entities.⁷ In the specific area of financial sector oversight, central bank independence is now much more widely accepted than independence of other agencies.⁸

Two main arguments have been offered in favor of delegating to independent agencies—as opposed to a government agency, a specific ministry, or a local body—the tasks related to economic and social regulation: the advantage of resorting to and relying on expertise, particularly when responses are needed for complex situations; and the advantage of potentially shielding market intervention from political interference, thus improving transparency and stability of the output. As such, agency independence increases the possibility of making credible policy commitments.

The issue of credible policy commitments needs to be taken a little further. The time-inconsistency literature tells us that it is indeed very difficult for political executives to commit themselves credibly to long-term strategies and solutions. Politicians live with the short-term cycles of elections and their horizons usually do not go beyond the next election. In addition, politicians face another commitment problem in that they cannot bind a subsequent legislature and government, making public policies vulnerable to reneging and therefore a lack of credibility (Majone 1997).

Hence, referring back to principle (2) of Kaufmann and others (cited above) delegating the authority of regulation to an independent agency not only resolves the government's credibility problem, but it would be proof of good governance by the politicians—and would address one of their key governance problems.

Accountability

It is also increasingly recognized in theory (but not always implemented in practice) that independence goes hand in hand with accountability. One of the underlying premises of this

⁷ Independent regulatory agencies have existed in the United States since the 1890s (the first one was the interstate commerce commission, which became the model for other similar bodies, including the securities and exchange commission), even though their actual degree of independence has varied over time, in line with political moods. In other Organization for Economic Cooperation and Development (OECD) countries, such bodies have been established in more recent years, fueled by such factors as privatization of formerly publicly-owned utilities, reform in Europe inspired by the Single Market, World Trade Organization agreements, and by policy advice from the international financial institutions (IFIs).

⁸ Central bank independence has been discussed widely. Independence of regulatory and supervisory agencies has not been discussed widely until recently. See Quintyn and Taylor (2002) for arguments. Carmichael (2002) also provides arguments for regulatory and supervisory independence.

paper is that there is no trade-off between independence and accountability, but rather they are complimentary. Independence cannot be achieved without accountability.

Accountability is essential for the agency to justify its actions against the background of the mandate given to it. Agencies should give the reasons for their decisions. Independent agents should be accountable vis-à-vis those who delegated the responsibility—the government or the legislature—but also vis-à-vis those who fall under their functional realm, and the public at large.

While the principle of accountability has been generally accepted—both as a complement of independence and as a component of good governance—implementing it in practice has met with difficulties. In general, proper accountability requires a complex combination of approaches. Majone (1993) argues that "[A] highly complex and specialized activity like regulation can be monitored and kept politically accountable only by a combination of control instruments: legislative and executive oversight, strict procedural requirements, public participation, and, most importantly, substantive judicial review." In many countries, this mix has not yet been achieved. Moreover, the ultimate objective of the agency also matters. Accountability is easier to implement when the agency has a clearly defined and measurable objective. Central banks, pursuing an inflation target can be held accountable for reaching this target. Supervisors on the other hand, typically have broader objectives, such as preserving financial stability or consumer protection. Holding them accountable for achieving such objectives is much more tricky than in the case of a central bank's monetary policy mandate.⁹

Transparency

Making the structure and the actions of the regulatory agency transparent is the third component of good governance. Transparency in monetary and financial policies refers to an environment in which objectives, frameworks, decisions and their rationale, data, and other information, as well as terms of accountability, are provided to the public in a comprehensive, accessible, and timely manner (IMF 2000b).

Transparency has increasingly been recognized as a "good" in itself, but it also serves other purposes related to the other components of governance. As a "good" in itself, policy makers have been recognizing that globalization in general and the integration of financial markets and products in particular require a greater degree of transparency in monetary and financial policies, and in regulatory regimes and processes, as a means of containing market uncertainty. In addition, transparency has become a powerful vehicle for countering poor operating practices and policies. Indeed, it is one thing to be transparent **in** policies, but it is another thing to be transparent **about** bad policies. As such, efforts to enhance transparency—mainly driven by the IMF's Code of Good Practices on Transparency in Monetary and Financial

⁹ See Goodhart (2002) on this topic.

Policies (MFP Code)—are helping to focus on the need for enhanced disclosure of monetary and financial policies and their operating framework.

Increased transparency also supports the achievement of other components of regulatory governance, and as such supports credibility. First, it directly supports accountability by making the actions of the agency clear to the outside world (governments and markets). Second, it protects the independence of the agency by demonstrating when and under which form interference is taking place. Supervision, for instance, is a highly invisible function that makes it vulnerable to interference—both by politicians and the supervised entities—and such interference can be very subtle too. Thus, transparency—balanced by the need for commercial confidentiality, which is also a need typical for the supervisory function—may discourage politicians and supervised from interfering in the process (Quintyn and Taylor 2002). Furthermore, transparency may limit self-interest on the part of supervisors (the Kane criticism). Finally, going back to one of the premises of this paper, transparency in regulation and supervision may also be instrumental in increasing the commitment of bank managers, directors, and owners to prudent behavior and risk control of the financial business.¹⁰

Integrity

This final component of regulatory governance reflects the mechanisms that ensure that staff of the agencies can pursue institutional goals of good regulatory governance without compromising them due to their own behavior, or self-interest. Integrity affects staff of regulatory agencies at various levels. First, procedures for appointment of heads, their terms of office, and criteria for removal should be such that the integrity of the board-level appointees (policy making body) be safeguarded. Second, the integrity of the agency's day-to-day operations also needs to be ensured. Effective internal governance implies that internal audit arrangements are in place to ensure that the agency's objectives are clearly set and observed, that decisions are made, and accountability is maintained. Thus, ensuring the quality of the agency's operations will maintain the integrity of the institution and strengthen its credibility to the outside world. Third, integrity also implies that there are standards for the conduct of personal affairs of officials and staff to prevent exploitation of conflicts of interest. Fourth, assuring integrity also implies that the staff of the regulatory agency enjoy legal protection while discharging their official duties. Without such legal protection, objectivity of staff would be prone to contest—and staff to bribery or threat—and the overall effectiveness and credibility of the institution would suffer greatly.

¹⁰ Halme (2001). Halme also discusses the need for, and difference between *ex ante* and *ex post* disclosure practices. She notes that supervisory agencies with well-established disclosure procedures (such as the Financial Supervisory Authority in the United Kingdom) typically have *ex post* disclosure requirements. *Ex ante* disclosure requirements are recognized to be more problematic as they can create more ambiguity.

As illustrated above, independence, accountability, transparency, and integrity interact and reinforce each other. The previous paragraphs provided some examples of how the components interact with each other. Independence and accountability represent two sides of the same coin. Transparency is a vehicle for safeguarding independence; it is also a key instrument to make accountability work. Transparency also helps to establish and safeguard integrity in the sense that published arrangements provide even better protection for staff of the regulatory agencies. It can also be argued that independence and integrity reinforce each other. For instance, legal protection of agency staff, as well as clear rules for appointment and removal of agency head support both their independence and their integrity. Finally the pair accountability-integrity is also mutually reinforcing. Because of accountability requirements, there are additional reasons for heads and staff to keep their integrity. The preconditions for meeting these four components are discussed in the next section, as part of the discussion of the various standards used to analyze regulatory governance.

III. REGULATORY GOVERNANCE AND CRISIS PREVENTION

A. Financial Stability, Regulatory Governance, and the Role of the FSAP

Promoting good governance has become an area of key importance for the IMF and IFIs in general (Box 1). Limiting itself to the economic aspects of governance, the IMF promotes good regulatory governance through the use of several instruments. These include (i) advice and technical assistance to strengthen policy making institutions (central banks and regulatory bodies); (ii) strengthening the integrity and transparency in financial transactions (safeguards assessments,¹¹ implementation of good transparency practices in fiscal, monetary and financial policies,¹² evaluating the anti-money laundering supervisory regime, and the steps put in place to combat financing of terrorist activities by financial intermediaries).¹³ These governance strengthening efforts are based on the view that well functioning and credible

¹¹ The safeguards assessments fulfill an “assurance role,” by identifying vulnerabilities in a central bank’s control, reporting, auditing systems, and legal structure that may impair the integrity of a central bank, and affect its operations.

¹² The IMF has identified desirable transparency practices relating to fiscal, monetary, and financial policies (banking, insurance and securities regulation, payment systems oversight, and others). While not offering judgments on the appropriateness of specific fiscal, monetary, and financial policies, it regards transparency to be a compliment to good policies.

¹³ Money laundering and the financing of terrorism have been recognized as global problems that affect not only security, but can harm the transparency, efficiency, and overall stability of financial systems. In evaluating the framework for anti-money laundering and combating terrorist financing, an assessment is also made of the organizational and administrative arrangements of relevant agencies.

Box 1. The IMF and Promotion of Good Governance 1/

- The IMF is concerned about poor governance because it is an obstacle to growth and a threat to economic stability. During their review of governance in February 2001, the IMF Executive Board welcomed the proactive role of the Fund in this area, and reaffirmed that this role is founded on the Fund's mandate which is to promote macroeconomic stability and sustained noninflationary growth among its members.
- The Fund contributes to good governance through its policy advice, technical assistance, and program conditionality. It does so within its areas of expertise that cover the effective and transparent management of public resources and the maintenance of a stable, economic, regulatory and legal environment.
- In the monetary area, the Fund has a policy for strengthening the accounting and auditing of central banks of program countries, in the interest of safeguarding Fund resources. The Fund's *Code of Good Practices on Transparency in Monetary and Financial Policies* also constitutes an important governance initiative. The Fund's *Code of Good Practices on Fiscal Transparency* is also an important governance-related initiative. The code emphasizes the need for clarity of roles and responsibilities of the government; public availability of information; open budget preparation, execution, and reporting; and assurances of integrity.
- The IMF's approach rests heavily on initiatives across the membership, especially the codification of best practices in policy transparency and accountability. However, the Fund also addresses individual instances of poor governance or corruption—in advice or conditionality—when they are of macroeconomic importance. The Fund's Executive Board has been highlighting governance as an issue of concern in roughly one third of its country discussions, as reflected in the Public Information Notices (PINs) issued afterwards.

1/ See IMF (1997) and Van Houtven (2002) on the IMF's role in promoting good governance and its own governance structure. For detailed information on the World Bank's governance, anticorruption, and public sector reform programs, see *Helping Countries Combat Corruption: Progress in the Bank since 1997*, September 2000, and *Reforming Public Institutions and Strengthening Governance: A World Bank Strategy*, November 2000.

economic and financial institutions are essential to maintaining the confidence of the financial markets, and the public (depositors, investors, household savers). Globalization in general, and the trend towards integration of financial markets and products in particular, require stronger governance arrangements so as to enhance the credibility of financial

policies and of regulatory regimes. These issues are also coming up in the context of the discussions relating to general agreement on trade and services and the conduct of financial services.

The main vehicle for evaluating regulatory governance practices in the overall context of macroeconomic stability is the joint IMF-World Bank FSAP.¹⁴ Aimed at identifying the risks, vulnerabilities, and development needs in the financial system, one of the main principles underlying the FSAP is that quality and efficacy of regulatory governance impacts on the overall governance practices within a financial system, and hence on its functioning and stability. Shortcomings in the regulatory governance framework are considered a source of risk that could potentially prove to be inadequate to prevent the occurrence of a financial crisis, or to help contain the magnitude of the problems and demonstrate resilience in managing a crisis situation. The FSAP recognizes the importance of good regulatory governance in the manner in which the business and affairs of a regulator are governed by its board, managers, and staff and the control functions that provide public assurance to regulatory oversight. The FSAP thus integrates regulatory institutions into its analysis, based on the premise that they are fundamental to the structure of financial systems, and that the manner in which regulatory functions are conducted, influences the performance characteristics of the financial system.

The evaluation of governance issues under the FSAP takes place in the context of a comprehensive assessment of the overall risks, vulnerabilities, and development needs.¹⁵ The FSAP undertakes an analysis of the entire financial sector, and measures the likely impact of macroeconomic and structural factors. In this context, the assessment of regulatory governance issues supports a more complete evaluation of the financial system, allowing an examination of the relative importance of various types of financial institutions in the overall policy, regulatory, and institutional context (Box 2). Drawing upon the expertise of the IMF-World Bank staff, and experts from Cooperating Official Institutions, the FSAP provides an assessment framework that offers “peer review” of national financial systems, and a common platform for policy advice and technical assistance from the IMF and the World Bank.¹⁶

¹⁴ For a more detailed description of the FSAP, together with a review of experience with the program, see *FSAP—A Review: Lessons from the Pilot and Issues Going Forward*, International Monetary Fund and World Bank, November 2000 (<http://www.imf.org/external/np/fsap/2001/review.htm>), together with the associated PIN (<http://www.imf.org/external/np/sec/pn/2001/pn0111.htm>).

¹⁵ The regulatory governance assessments under the FSAP do not go into aspects such as control of corruption in the financial system, unrest in the financial system, and rule of law.

¹⁶ There are over 50 Cooperating Official Institutions under the FSAP, comprising central banks, regulatory and supervisory agencies, standard setting bodies and multilateral development banks. This support has been particularly useful in the peer assessment of

Box 2. How Does the FSAP Help to Assess Regulatory Governance?

Good governance within a financial system is predicated on good regulatory governance. The evaluations made under the FSAP thus help to:

- understand how the regulatory authority is exercised in a country, including the processes through which regulators are selected, held accountable, monitored, and whether shortcomings with respect to these are leading to vulnerabilities in the domestic financial system;
- assess the level of observance of good governance practices required under the various financial sector standards;
- determine whether or not the regulatory resources are being properly managed so as to ensure the pursuit of consistent and effective regulatory and supervisory policies;
- assess if the governance framework is conducive for preserving policy continuity, which is a necessary pre condition for policy credibility;
- determine the extent to which regulatory governance is risk-oriented, (operational risk) and whether adequate systems are in place to identify, disclose, and manage the risks;
- ascertain the credibility and integrity of the regulatory body as a policymaking and enforcing body; and
- prioritize financial sector reform to enhance the governance framework and provide support through technical assistance.

The main instrument through which regulatory governance practices are assessed under the FSAP is through the assessment of the key international financial sector standards.¹⁷ Since the inception of the FSAP in 1999, public sector governance issues have been assessed in 46 countries, through over 200 standards assessments (Figure 1 and Table 1).¹⁸ The

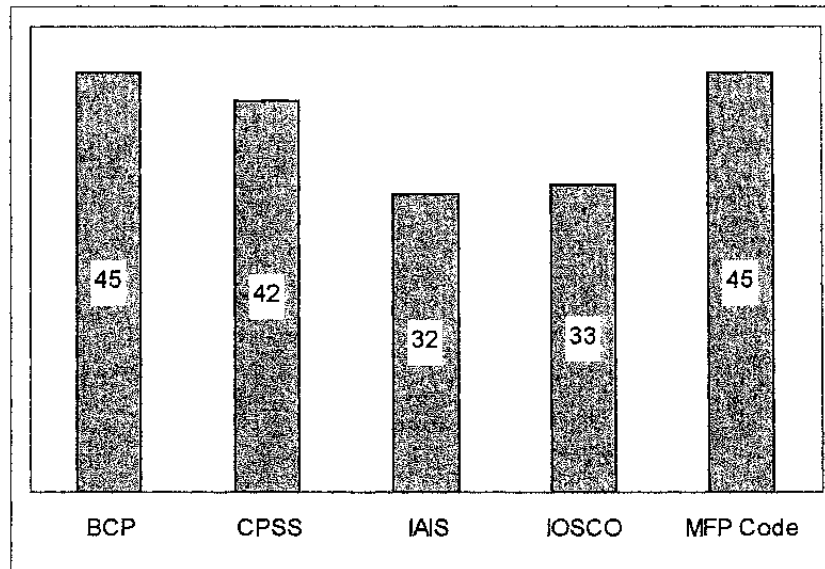
observance of financial sector standards that is undertaken as part of the FSAP work, although it also has covered various areas of central bank operations.

¹⁷ Standards assessments under the FSAP are used to support the broader assessment of the macroeconomic and structural risks affecting domestic financial systems. They help to identify shortcomings in financial sector regulation, supervision, and market infrastructure, thus providing input into the determination of financial system reform and development priorities. The assessment findings also help countries evaluate their systems against international benchmarks.

¹⁸ The assessments under the FSAP result in the production of the financial sector Report on Observance of Standards and Codes modules (ROSCs). As of end-December 2001, 201

Figure 1. Number of Countries in Which Financial Sector Standards Were Assessed Under the 46 Completed and Ongoing FSAPs

(As of end of January, 2002)



Note: Assessments done in countries members of multilateral central bank arrangements and applicable across all members of that arrangement are counted as having been conducted only in those countries that participated in the FSAP program.

standards routinely assessed under the FSAP covering regulatory governance issues are: (i) the IMF's MFP Code; (ii) Basel Committee's Core Principles for Effective Banking Supervision (BCP); (iii) CPSS Core Principles for Systemically Important Payment systems (CPSIPS); (iv) IOSCO Principles; and (v) IAIS Insurance Core Principles (ICP).^{19,20}

The assessments of key international financial sector standards are a crucial instrument in drawing worldwide attention to regulatory governance issues, which have thus far been

ROSC modules in different areas had been completed (for 67 economies), of which 141 have been published (for 45 economies). Of the total ROSC modules completed, 58 percent relate to the financial sector and have been derived from the FSAPs.

¹⁹ For the purposes of this paper, 'regulatory standards' cover the BCP, the ICP, the CPSIPS, and the IOSCO Principles.

²⁰ The OECD Principles of Corporate Governance are also being assessed on a selective basis under the FSAP. They are used as a diagnostic tool for assessing the strengths and weaknesses of the corporate governance framework.

largely understudied. Comparative information across sectors and among countries is very limited. While the evaluation of financial sector governance issues under the FSAP is mainly based on qualitative measures of governance prescribed under the financial sector standards, steps are underway to integrate governance issues covered by the FSAP into its quantitative framework. The work on developing quantitative tools and techniques for stress testing and vulnerability evaluation takes into account measures of regulatory compliance as one of the key components. As this develops, the FSAP findings would help in shedding more light on issues such as the extent to which good regulatory governance is correlated to financial stability or improved performance of the banking system, or in finding causal relationships between good regulatory governance and growth and development of financial systems.

B. Financial Sector Standards and Regulatory Governance

The regulatory standards focus almost exclusively on the independence of the regulatory agency as a starting point for their governance and subsequently, shift their focus to how regulatory agencies should instill good governance principles in the regulated entities. This approach, while useful, seems to be based on the straightforward “agency” perspective, requiring a separation of ownership (by the government or legislature) and control. The regulatory standards, therefore, do not provide a comprehensive overview of regulatory governance and its four components: **independence, accountability, transparency and integrity**.

The MFP Code, on the other hand, focuses more directly on transparency arrangements, mainly as a prerequisite for the practice of good governance. Good governance calls for financial agencies to be transparent, particularly where the financial authorities are granted a high degree of autonomy. In cases when conflicts might arise between or within government units (e.g., if the central bank or a financial agency acts as both owner and financial supervisor of a financial institution) transparency in the mandate and clear rules and procedures in the operations of the agencies can help in their resolution. Thus, the four components of regulatory governance mentioned in Section II cannot be analyzed directly in a meaningful way. The analysis of the assessment findings of governance practices requires that we bring together the different governance-related elements from the regulatory standards and the MFP Code in an attempt to distil an overview.

Regulatory standards and regulatory governance

The view taken by the regulatory standards is that effective regulation and supervision of the financial system is dependent upon several factors that lie outside the regulatory and supervisory framework. In recognition of the importance of the “preconditions” for effective supervision, these standards emphasize the importance of a proper governance structure within which the regulatory bodies operate. This is regarded as an important prerequisite given the regulatory objectives, such as the preservation of systemic stability, or ensuring that the regulated markets operate on a fair and efficient basis. Based on a comparative analysis of the regulatory standards undertaken by the Joint Forum (2001) (see Appendix I) the following governance-related components can be identified:

- All regulatory standards require that the regulators have **operational independence** and that the rules and regulations are applied in a consistent manner to all regulated entities. This is essential to ensure that the regulatory objectives are pursued without interference from the political and the executive process, as well as the regulated entities. While independence is considered essential for operational objectivity and efficiency, good regulatory governance practice also requires that the regulators maintain open communication with the regulated entities and markets, and consult with them in the formulation of regulations and oversight mechanisms.
- Another good regulatory governance requirement relates to adequacy of minimum staff resources, legal protection for the regulatory staff, and that the staff maintains highest professional standards. These hint at the integrity aspects of regulatory governance. In turn, the regulatory agencies should be accountable for their actions, through mechanisms such as reports to the legislature, annual reports, and audited financial accounts.
- Effectiveness of the governance framework is integrally connected with the enforcement powers and capabilities of the regulator. The internal and external governance structure should allow regulators to take remedial action on a timely basis to deal with impending and actual problems. While regulators in all three sectors have the authority to investigate possible violations and take legal action against regulated institutions and associated individuals, securities regulators are required to have wider authority to take action against non-supervised entities and individuals for violations of securities laws.
- The regulatory standards suggest clarity and transparency of the regulatory process as another element of good regulatory governance. Regulators should adopt clear policy making processes, and the practices must be transparent in a comprehensible manner to the interested institutions and individuals. Such clarity allows regulated entities to be certain of the rules to which they must adhere when undertaking their business activities. It also facilitates regulatory accountability to the public.

Transparency code and regulatory governance

The MFP Code emphasizes the desirable set of transparency procedures (Table 2). Transparency, in itself, is not an end. However, through public accountability mechanisms, disclosing and explaining the governance structure, and clarifying the decision making process, the regulatory body gains market credibility, which in turn, should contribute to policy effectiveness. The release of adequate information to the public on the activities and financial operations of financial agencies provides an additional mechanism for enhancing the credibility of their actions. There may also be circumstances when public accountability of decisions by financial agencies can reduce the potential for moral hazard. Financial market participants are better able to assess the actions of the regulator, and the context of financial

policies. The element of uncertainty is considerably reduced, thus helping promote financial system stability.

The MFP Code addresses governance-related aspects of transparency (see Table 1) as follows:

- **Accountability**, consisting of (i) **general**—encompassing the availability of regulatory agencies’ officials to explain their institution’s objectives and performance to the public; (ii) **published**—where the financial agencies issue periodic public reports on the policies used in the pursuit of their overall objectives and the developments in the financial sectors under their jurisdiction; and (iii) **financial**—disclosure of financial agencies’ audited financial statements and of the underlying accounting policies, aggregate market transactions, and operating revenues and expenses.
- **Integrity of the regulator**—public disclosure of procedures for appointment, terms of office, and dismissal of financial agencies’ officials; of codes of conduct regulating staff’s personal financial affairs and conflicts of interest; and of any legal protections for officials and staff of financial agencies.
- **Regulatory policy transparency**, comprising: (i) **general**—encompassing the public disclosure and explanation of the regulatory framework and financial agencies’ operating procedures, of significant changes in financial policies, and advocating public consultations of proposed substantive changes in financial regulations; and (ii) **oversight of consumer protection and client asset protection schemes**—specifically requiring public disclosure of the nature, form, source of financing, and performance of client asset protection schemes, and of information on any consumer protection arrangements operated by financial agencies.
- **Transparency of regulatory operations**, consisting of (i) **general**—requiring clear definition of the broad objectives and institutional framework of financial agencies, public disclosure of their responsibilities, and procedures for appointment, terms of office, and dismissal of financial agencies’ officials; and (ii) **cross regulatory**—interaction with other financial agencies, covering public disclosure of the relationship between various financial agencies, including formal procedures for information sharing and consultation, and between financial agencies and any self-regulatory organizations under their oversight.

Prerequisites for the conduct of good regulatory governance

The regulatory standards describe several prerequisites, or “preconditions” that are essential for the conduct of good regulatory governance. The prerequisites consist of two areas: (i) macroeconomic framework; and (ii) market infrastructure. As regards macroeconomic prerequisites, the regulatory standards require the existence of sound and sustainable macroeconomic policies that are conducive to intermediation of household savings and investment. Volatile conditions in the money market, or the foreign exchange markets, and uncertain

inflationary tendencies create conditions under which the consistency of application of regulatory principles becomes difficult, thus undermining the objective pursuit of regulatory objectives.

Creation of the essential market infrastructure is also important for a well-governed regulatory agency. These include, inter alia, a fair and effective legal and judicial system, tax, and accounting framework.²¹ These are regarded as being essential for the regulatory body to be able to perform its functions in a coherent, credible, and consistent fashion. In the absence of these prerequisites, “regulatory forbearance” becomes relatively easy to conceal or disguise. The objectivity and credibility of the regulatory agency can also be concealed, especially when the regulator and the regulated entity believe that hiding the regulatory actions is in their mutual interest, couched under the pretext of “confidentiality considerations” or “systemic concerns.”

The above approach adopted by the regulatory standards and the MFP Code towards regulatory governance can be summarized in ten main elements (Box 3). Most of the elements, in turn, can be related to the four components set forth in Section II.

Relationship between regulatory and financial sector corporate governance

All the regulatory standards require that the regulators encourage sound corporate governance within the supervised entities. Wherever legally permissible, the regulators are required to regulate the corporate governance requirements. The standards thus provide a balance between the governance requirements for the regulator and for the regulated entities. This is based on the premise that improved public sector governance is a critical foundation stone for implementing a system of strong corporate governance (see Appendix I for a comparison of the corporate governance requirements across sectors by the regulatory standards).

Corporate governance mechanisms, however, vary across the financial sectors and among economies. There is growing awareness that good corporate governance practices at the level of the regulated entity is important both to the firm itself and the economy as a whole. Financial sector supervisors have long recognized the importance of good governance in the manner in which the business and affairs of an institution are governed by its board and managers and the control functions that provide assurance to the monitoring processes. The respective roles and responsibilities of the board, management, auditors, and actuaries (in insurance) in the risk management process are of particular interest.

²¹ The importance of preconditions for effective governance is increasingly being emphasized. Kane (2001), for instance, in an analysis of financial safety nets emphasizes that the implementation of international best practices does not necessarily lead to the desired policy effectiveness, but that more attention needs to be given to the existing preconditions which he summarizes under three headings: the existing degree of transparency, deterrence, and accountability in the society.

**Box 3. Regulatory Governance Framework Based on the Financial Sector Standards:
Ten Main Elements**

Independence

- Regulatory bodies have a well-founded and modern legal and institutional structure for licensing, regulating, and overseeing financial intermediaries and financial markets.
- Regulatory bodies are empowered to enforce legal and regulatory provision relating to corporate governance among the regulated financial firms.
- Regulatory bodies have freedom from politically motivated interference, ensuring independence of decision making.
- Regulatory bodies have adequate regulatory capacity with competitive pay scales to allow professional conduct of regulatory functions.

Accountability

- Formal mechanisms exist for collaborative partnerships, interagency coordination among regulatory bodies, and in areas of overlap, accountability in decision-making is clearly established.
- Clearly defined accountability frameworks (of the Board and the regulatory staff) consist of reporting relationships, powers to appoint and remove regulators, liability, independence, business ethics.

Integrity

- Formal systems exist, including a code of conduct for regulators (including the members of the regulatory board).
- Consultative processes are established through which the regulated firms, and users of financial services participate in the formulation of rules, regulations, and legal reform.
- Mechanisms for regulated firms and consumers are in place to seek redress in cases of violation of their rights.

Transparency

- Adequate regulatory disclosure exists of information on the governance structure of the regulator and its policies, performance, regulatory objectives, and disclosure of internal policies relating to internal audit and control and mechanisms through which frauds and conflict of interest situations are avoided.

The primary responsibility for the conduct of business of the entity lies with the board and management of the firm. In particular, their responsibilities include establishing and maintaining policies and procedures regarding risk management and internal controls and to ensure the firm complies with the statutory and supervisory obligations imposed on it. Supervisors in all three sectors devote a great deal of time and attention to these areas.

Persons filling key roles should have the necessary skills and experience to carry out their tasks appropriately and the supervisor has a role in assessing the qualifications and integrity of these key personnel. The participation of board members who can exercise objectivity, independent of management, is recognized good practice. Internal audit, external audit, and the oversight function of the board in the financial area (directly or through a committee such as the audit committee) support the effective operation of supervised firms.

However, while there are a large number of commonalities in supervisory expectations on this topic, regulators often use different methods to encourage good corporate governance. For example, several countries have issued guidance to their firms, while others use a common supervisory program to be applied during on-site inspections in all three sectors. Other methods used include setting out detailed mandatory statutory requirements, publishing a reference document for supervisors or entering into tripartite contracts among the supervisor, the external auditors, and the company. There is a clear trend towards both greater emphasis on corporate governance issues and on increasing the transparency of the supervisors' and other standard setters' expectations regarding what constitutes a good or appropriate corporate governance framework at a supervised firm.

IV. REGULATORY GOVERNANCE IN PRACTICE—MAIN FINDINGS FROM COUNTRY ASSESSMENTS

In this section, we present the main findings relating to observance of good regulatory governance practices by regulatory bodies in banking, insurance, securities, and payment systems oversight areas. The assessment findings are helping national authorities to focus on issues of accountability, independence, and integrity, within a transparent framework, thus enhancing the regulatory governance framework.

A factor limiting these assessments, however, is the fact that the concept of regulatory governance has been expressed in general terms under the regulatory standards. These standards are broader than just on principles and practices on governance aspects of the regulatory body. This leaves the assessment of governance practices open to considerable scope for interpretation. Moreover, several assessments have been carried out in the absence of a fully developed assessment methodologies, which, so far, has constrained the evaluation of the implementation issues.²² Consequently, valid and statistically well-founded conclusions are difficult. Nonetheless, the findings provide several useful insights and indications of the overall trends in regulatory governance.

²² Assessment methodologies are being developed for the assessment of securities regulation and monetary and financial policy transparency.

A. General Observations

- Many regulatory bodies promote good governance across a full range of internationally accepted principles and practices, while others are more selective. Some regulatory agencies appear to be operating in an environment that has a tradition and culture for more openness than others do.
- The governance framework is influenced by institutional factors, the underlying legal framework, and country specific circumstances. Some regulatory agencies are “composite” and responsible for more than one financial sector; some are independent agencies, while others are part of a larger government unit. These differences, in turn, explain the divergent approaches towards regulatory governance. The creation of composite financial regulatory agencies in a number of countries has led to an enhanced focus on the role and form of governance arrangements, although the governance practices that have been adopted are relatively recent, experimental, and not yet fully tested.
- In several countries, the governance framework is applicable on a government-wide basis. These requirements form part of legislation or regulation that apply to all units of government and to all or identified public servants. The regulatory agency is typically subject to these government-wide provisions and follows the same practices as other units of government. In some cases, however, regulatory agencies reconfirm or supplement the government-wide governance practices in their publicly available bylaws or a similar document.
- Substantial effort is needed to build public understanding of the need and objectives for good regulatory governance. In many cases the rationale for an independent, and accountable regulator is not always clear, hence influencing the approach towards good governance practices.
- Differences also exist with regard to the governance framework within which enforcement of regulations takes place. In the banking sector, supervisory remedial actions of a prudential nature are not always publicly announced for fear that in so doing problems could be compounded, thus reducing the chance of the action being effective. Similar considerations apply to prudential issues in the insurance sector, although insurance supervisors in some jurisdictions favor disclosure of remedial action in respect of conduct of business issues. In the case of securities regulators, while investigations conducted are not public, enforcement proceedings are generally public proceedings. Securities supervisors generally publish the results of proceedings and sanctions imposed to warn customers of particular entities or schemes.
- The transparency aspects relating to regulatory governance are mostly weak and require considerable strengthening. This shortcoming is made worse through

technical or complex legislative or regulatory requirements and poor public accessibility of texts of laws and regulations. Accountability documents such as memoranda of understanding among the regulatory bodies, or with the government for exchanging information, are often treated as (sensitive) internal documents. Similarly, delays in publishing documents such as the *Annual Report*, which provide a good basis to report on the practice of governance, can better serve as a document of record than as a timely source of information.

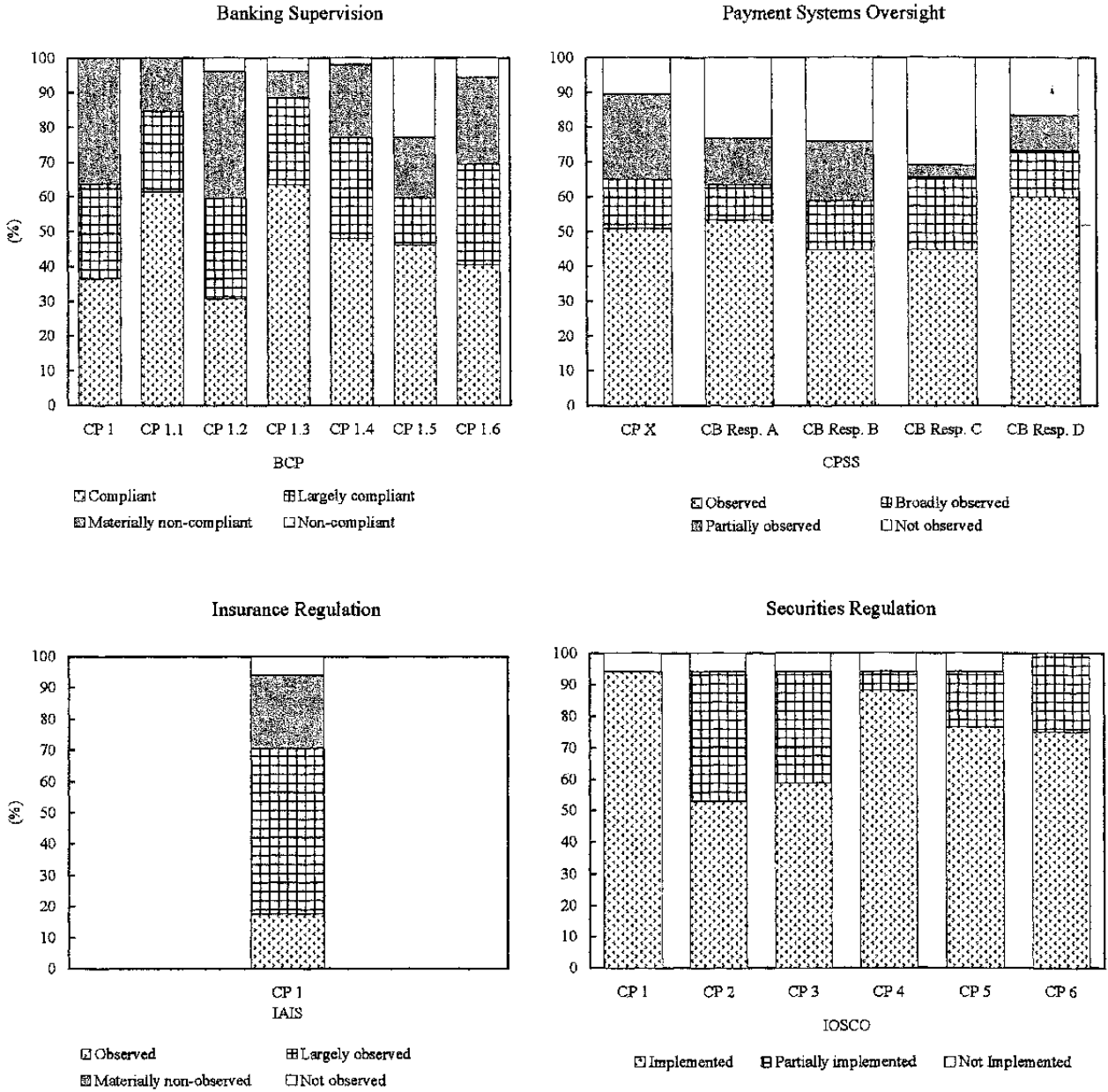
- The content of governance-related disclosure also varies. In many instances, the focus is less on the materiality and relevance of the information that is being provided. Performance relating to governance-related requirements are often explained in very general terms and often through contradictory assessments. Similarly, in some cases the governance framework is not applied consistently (e.g., reversals of previously applied practices when developments are unfavorable), thus going against the spirit and intent of good governance.
- An important use of the assessments of regulatory governance is that they provide a basis for making recommendations for strengthening the governance framework. Recommendations arising out of assessments carried out in the context of the broader macroeconomic and macro prudential considerations are helping the regulatory bodies to focus on governance-related issues and strengthen the institutional arrangements in the overall context of risk and control environment.
- Finally, the approach towards good regulatory governance appears to be evolving, reflecting changes in the international environment. Considerations are also being given to benefits and costs of good governance, transition issues of enhancing the governance framework, the notion of for whom good governance is being directed, and the domestic versus international dimensions of governance. The notion of improved regulatory governance is gaining greater public attention, alongside the emphasis being given to enhanced corporate governance on the part of the regulated entities.

B. Regulatory Governance Across Sectors

Governance frameworks differ across financial sectors based on the primary objectives of regulation. For securities regulatory agencies, the emphasis is mainly on market efficiency considerations, while for banking supervisory and payment systems oversight agencies the focus is on market and systemic stability. For insurance regulators the principal consideration is policyholder protection.

Figure 2 brings together the regulatory governance-related components of the financial sector standards assessments in the four areas of banking, insurance, securities, and payment systems oversight. Each of the regulatory governance-related principles was assessed on the

Figure 2. Regulatory Standards and Observance of Good Practices in Regulatory Governance



Sources: Country assessments of observance of the BCPs, CPSIPS, ICPs, and IOSCO Principles. Distribution of assessment grades in percents among assessed countries.

grading scale suggested by individual standard setter. The assessment for each principle or practice was then aggregated across the assessed countries. The main observation that stems for this comparison is that securities regulators have a better-founded governance structure than the other sectoral regulators, while the insurance regulators, need to carry out more work to strengthen their governance framework (see Tables 3–7 for a detailed breakdown of the assessment outcome).²³

Governance practices of banking supervisors²⁴

The assessments indicate several instances of regulators encountering political interference. These include interference in the decision-making process, budgetary independence, and arbitrary removal of the senior management. Apart from political interference, there are shortcomings relating to operational independence coupled with the existence of agencies with overlapping regulatory responsibilities. The lack of clear separation of functions (or the mechanisms for regulatory coordination) is among the main reasons for this lack of authority highlighted by the assessments.

The governance framework of the banking regulators is also impaired in many cases by the lack of trained supervisors. Adequacy of supervisory resources (staff and budgetary) is important from the viewpoint of ensuring proper implementation of the regulatory framework and enhancing supervisory credibility through consistent and transparent application of rules and regulations. In this regard, assessments have brought out that where legal protection for supervisors does not exist, legal action against them, or the threat of such actions, has come in the way of consistent application of supervisory measures. In this regard, regulatory practice differs across the countries reviewed—ranging from explicit provisions in the banking law to administrative provisions, to nothing at all.

Effectiveness of banking regulatory governance is also affected by inadequate enforcement powers given to the banking supervisors. This inadequacy often undermines the credibility and integrity of the banking supervisor vis-à-vis institutions typically found to be noncom-

²³ These have been presented according to the WEO country classification so as to bring out the difference across various groups of countries. However, given the limitations of the assessment sample, less than comprehensive treatment of regulatory governance by the respective standards, and some of the assessment methodological problems, any inference of which type of countries have high or low degree of regulatory governance needs to be approached with caution. In all the WEO based groupings, there are both weak and strong regulatory governance practices.

²⁴ Also see IMF review of the “Experience with the Assessment of Basel Core Principles” available at <http://www.imf.org/external/np/mae/bcore/exp.htm>, and the IMF-World Bank paper “Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives” (forthcoming).

pliant with the prudential regulations. A related problem is that banks in some countries do not comply with the regulatory directives or orders and enforcement is weak (delays or other shortcomings in the judicial system, political interference, lack of decision taking or low staff morale).

In addition, the assessments are bringing out shortcomings relating to the “preconditions” (on basic requirements), often being the origin of governance-related shortcomings. In many cases improvements in the macroeconomic framework are also necessary for well functioning regulatory governance. For some of the regulators, many changes (such as relating to the legal and the court system) are beyond their direct purview and require time and political will to be corrected.

In order to address the governance-related weaknesses, priority recommendations include (i) improving the functioning and independence of the banking supervisor; (ii) addressing the organizational weaknesses; and (iii) strengthening the legal framework and supervisory powers to take prompt corrective action in a transparent and accountable manner. Other recommendations are: the need for legal protection for the regulators and the strengthening of the formal mechanisms for the exchange of supervisory information.

Governance practices of insurance supervisors²⁵

Assessments reveal that several shortcomings exist with regard to the overall governance of the insurance sector. The governance-related areas where weaknesses have been identified are: (i) weak institutional capacity of insurance supervisors characterized by inadequate supervisory skills and staff; (ii) lack of financial resources and operational independence; and (iii) a nontransparent accountability framework.

Governance arrangements that can provide assurances of integrity of the insurance supervisor are deficient. The most commonly identified shortcomings include (i) internal governance procedures are not documented; (ii) cooperation and information-sharing agreements with other supervisory agencies are not in place; (iii) financial statements of the insurance supervisor are not audited on a preannounced schedule; and (iv) some of the procedures for appointment, terms of office, and removal of insurance supervisory officials are not clearly defined.

In several cases, the legal powers for carrying out insurance regulation were inadequate. For instance, with respect to corporate governance and internal controls, there was a lack of description of the role and responsibilities of the board of directors of insurance companies in relevant legislation and regulations; and supervisors did not have the authority to define the

²⁵ Also see IMF-World Bank paper “Experience with the Insurance Core Principles Assessments Under the Financial Sector Assessment Program,” (<http://www.imf.org/external/np/mae/ins/2001/eng/>).

role of directors. Similarly, powers relating to enforcement and taking prompt action against problem insurers, or for ensuring an orderly wind-up of insolvent insurers were missing.

Assessments of the preconditions for effective insurance supervision reveal that some countries partially met the preconditions for effective insurance supervision, with qualifications related to the fact that while good laws were either in the process of being adopted or recently passed, they have not been tested in practice, or that the familiarity with the laws was weak. In some countries, assessors concluded that the judiciary system was weak, laws were outdated, and there were few qualified professionals (i.e., accountants, actuaries, auditors, and financial analysts). In a few cases, while the laws were outdated, the judiciary system was found to be satisfactory and some qualified professionals were present.

When analyzed based on the “insurance penetration” as a proxy for the stage of development of the insurance industry relative to the global trends in the insurance business, the results indicate that the governance practices of the insurance supervisors in the most developed insurance sectors was significantly higher than that in countries with least developed insurance sectors. The governance practices of insurance supervisors in countries in different intermediate stages of development of the insurance industry is quite similar, but significantly lower than that of countries with the more-developed insurance sectors.

The main recommendations to strengthen the governance arrangements have consisted of (i) building the organization of an insurance supervisor through an increase in the number of staff in the authority; (ii) budgetary independence so as to safeguard its independence and effectiveness; (iii) improvement of the quality of staff conversant with actuarial knowledge and contract law (training and recruiting) and the supervisory framework; (iv) enhancement of the independence of the supervisor (be independent from government, legislature, and regulated insurers); and (v) strengthening indemnity of the supervisory staff. In addition, recommendations have also been made to strengthen some of the governance-related prerequisites such as the legal infrastructure, accounting, and disclosure practices.

Governance practices of securities regulators²⁶

The assessments reveal that while the governance-related practices are well in place, weaknesses exist with respect to some of the key elements relating to good governance. In particular, operational independence and its accountability are being impaired by inadequacy of financial and staff resources. Similarly, the objectives of the securities regulator in terms of the scope of responsibility and independence were weak.

²⁶ Also see IMF-World Bank review of the “Experience with the Assessments of the IOSCO Objectives and Principles of Securities Regulation under the Financial Sector Assessment Program” available at <http://www.imf.org/external/np/mae/IOSCO/2002/eng/041802.htm>.

As regards adequacy of resources, several securities regulators, particularly in developing markets, were assessed as having resources that were less than needed to discharge the functional responsibilities assigned to the agency. In terms of scope of responsibility, the assessments reveal a spread of regulatory responsibilities across several agencies or the lack of clarity of roles (particularly between a self regulatory organization and the regulator). This tended to dilute the overall effectiveness of the regulatory regime and often resulted in the use of informal administrative arrangements to ensure that appropriate oversight was maintained.

As regards regulatory independence, the administrative control of the regulator's budget by the ministry of finance or other governmental body was viewed in some jurisdictions as having the potential to compromise operational independence. The manner in which the head of the agency was appointed, and the nature of the appointment, was also seen as having the potential to lead to unnecessary political intervention in the operations of the regulator.

Another assessment finding (similar to that of banking and insurance regulators) relates to inadequacy of enforcement powers vested in the regulator. While comprehensive powers of inspection, investigation, and surveillance exist, several shortcomings were found with regard to enforcing compliance and prompt corrective action. In some cases, the effectiveness of oversight is constrained by limited availability of sanction powers, or due to an inefficient judicial system through which sanctions have to be applied.

Recommendations have therefore consisted of (i) strengthening the independence of the regulator, and assigning adequate budgetary and staff resources; (ii) expansion of inspection programs, and market surveillance operation; (iii) greater enforcement and sanction powers; and (iv) establishing mechanisms through which cooperation and information sharing among domestic regulators can be enhanced. In cases where securities regulatory reforms were underway, governance-related aspects were integrated in the planned reform.

Governance of payment systems²⁷

In the governance structure relating to payment systems, assessments reveal significant deficiencies in terms of the effectiveness of the governance structure. It is notable that more than half of the systemically important payment systems that are operated by the national central bank are not subject to adequate oversight by that institution. That ineffective governance structure itself reflects failure by a majority of the central banks to observe in full their responsibilities relating to the payment systems oversight.

²⁷ Also see IMF-World Bank review of "Financial Sector Assessment Program—Experience with the Assessment of Systemically Important Payment systems" available at <http://www.imf.org/external/np/mae/pay/2002/eng/041902.htm>.

The central banks do not fully observe their responsibilities to ensure adequate oversight arrangements, or to cooperate with other relevant authorities, domestic or foreign. In some countries the central bank lacks the statutory authority to oversee those payment systems that it does not itself operate. Independence and functional clarity relating to the central banks oversight objectives are also weak.

Considerable divergence in governance practices has emerged among different groups of countries based on these assessments. The assessments suggest that in a significant majority of developing countries currently operating payment systems governance of the payment systems is an important weakness. Similar trends have been assessed in countries in transition. While the payment systems of these countries appear in general to be markedly less vulnerable than those of the developing countries to systemic shocks arising from their payment systems, weaknesses remain with respect to their governance and oversight, including the oversight of the payment systems operated by the central banks themselves. With regard to advanced economies, the payment systems related governance structures appear generally robust.

Most of the governance-related recommendations have pertained to the central bank oversight of the systems. These have included (i) strengthening the oversight power of the central bank and providing it a statutory base; (ii) improving the staff resources and expertise for the oversight function; (iii) separate the function from other central bank tasks, including banking or payment systems operational areas and, where applicable, banking supervision; (iv) clarify the respective roles and responsibilities of the central bank and the banking supervisors in respect of the payment systems and its participants; and (v) develop a co-operative arrangement with the banking supervisor, including a formal protocol or memorandum of understanding.

C. Transparency of the Governance Framework

Transparency of the governance framework is strongest among security markets regulators, followed closely by their counterparts in banking and payment systems. Among all regulatory bodies, governance-related transparency practices are well in place in the area of disclosure of the regulatory and policy framework, followed by those related to general accountability, and disclosure of their objectives, institutional framework, and responsibilities. Transparency of the governance framework is the weakest in the areas of financial accountability and assurances of integrity, and disclosure of the relationship between regulatory agencies.

General observations

- In most countries the broad governance framework (objectives and institutional framework) of the financial agencies are specified in legislation or regulations. In some countries, however, this is not the case for one or more of the following: procedures for appointment, terms of office, and criteria for removal of members of the governing body of the regulatory agency.

- Transparency is markedly inadequate in the area of public disclosure of the relationship and formal procedures for information sharing and consultation between financial agencies,²⁸ and is lacking in the areas of financial accountability, particularly of insurance supervisors, and disclosure of integrity safeguards.
- Whereas almost all independent financial agencies publish audited financial statements, deficiencies in financial accountability of supervisory authorities that are either entirely or partly funded by the state budget were frequently noted. In these cases, either the transparency of the budgetary process was deemed inferior to direct disclosure of financial statements, or audits were performed internally and not by an independent audit agency.
- Significant shortcomings in the public disclosure of internal governance procedures for insuring integrity of operations including internal audit arrangements were found in all areas of financial policies, but were most pronounced among insurance and securities regulatory agencies. In many of these cases, internal governance arrangements were not disclosed at all, and/or existing codes of conduct guidelines were not published or were only available upon request.

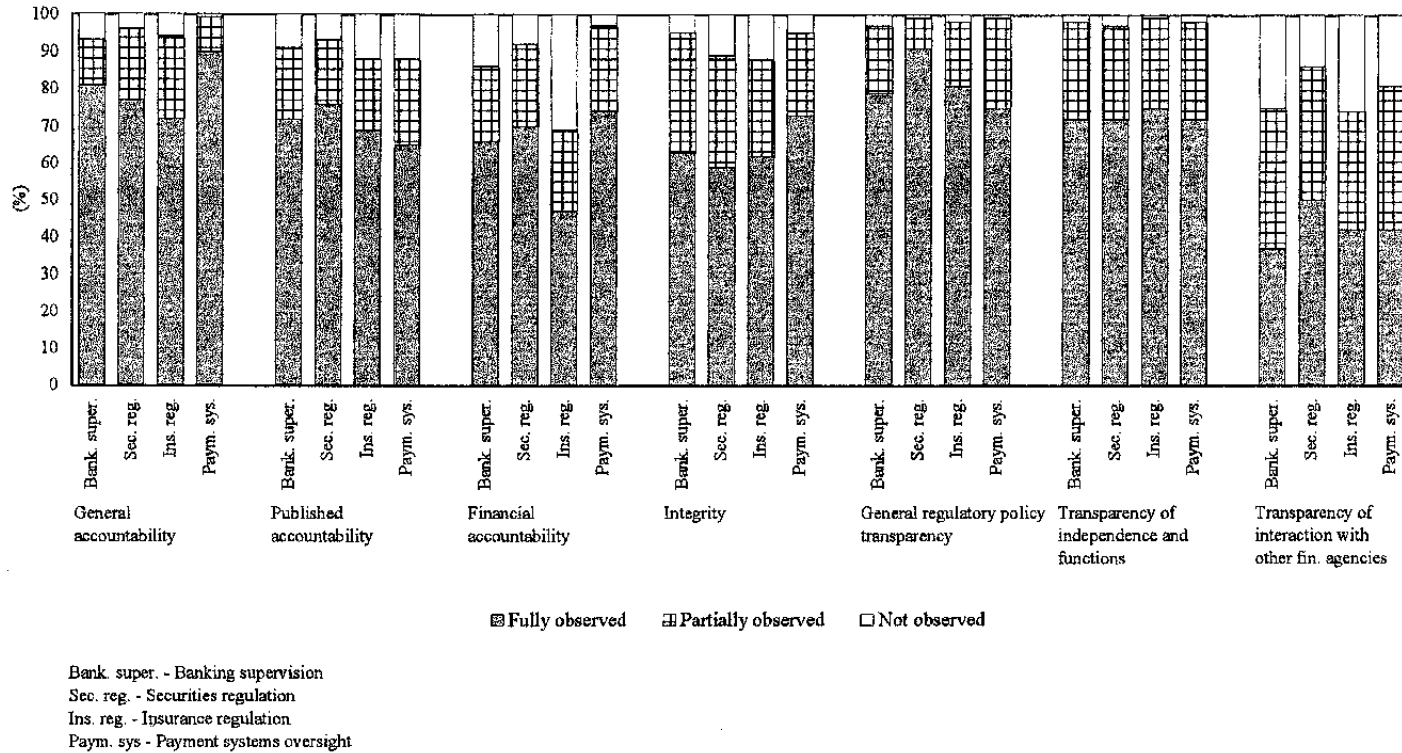
Findings across countries

Analysis of the average degree of observance of governance-related transparency practices by supervisory agencies from countries with different socio-economic characteristics²⁹ shows that developing countries are significantly lagging behind advanced countries, especially in the areas of published and financial accountability, and in the public disclosure of the relationship between financial agencies (Figure 3 and Table 7). The latter aspect of transparency is also weak in transitional countries, where transparency practices are otherwise at par with advanced countries. Transparency practices of banking and payment systems supervisors in transition countries in the area of public disclosure of their broad objectives, institutional framework, and responsibilities, are strongest among all countries. This might have resulted from the fact that these countries' legal systems are relatively new and have benefited from the collective experience of other countries. The relatively high average degree of observance of governance-related transparency practices by supervisory agencies masks an underlying deep transparency divide between advanced and transition economies on the one hand and developing countries on the other.

²⁸ Assessments have noted that while procedures for information sharing and cooperation agreements exist, they are not publicly disclosed; only the partial text of the memoranda of understanding between agencies is published; the relationship between financial agencies remains informal and confidential; and the law does not clearly delineate the roles and responsibilities of agencies.

²⁹ Based on IMF's World Economic Outlook categorization of member countries in three groups: advanced, developing, and transitional.

Figure 3. Observance of Transparency of Regulatory Governance



Note: Numbers shown represent the average percentage shares (across the MFP Code assessments) of the transparency practices related to regulatory governance (see note in Table 7), categorized as being observed, partially observed, and not observed.

Transparency across sectors

Banking supervision

With some exceptions, the good relative standing of banking supervisors is due in part to the fact that in many countries this function is carried out by the central bank that tends to be stronger institutionally and better funded. Banking regulators demonstrate a strong ability to publicly disclose their supervisory objectives and responsibilities, the regulatory framework and operating procedures, financial reporting requirements based on which regulatory oversight and surveillance is conducted, and to consult market constituents on changes in the regulatory or the operational framework.

Accountability and integrity of banking supervisors, on the other hand, is weak and needs strengthening. The accountability framework is particularly strong in cases where the supervisory function is a responsibility of the central bank. However, the assessments also reveal that while disclosing information on the annual operating expenses and revenues relating to banking supervision, there are several shortcomings in the content and scope of information provided. For instance, the operating costs and expenses relating to banking regulation and supervision are consolidated with the overall accounts of the central bank; or, information on total revenue and expenses is available only through the Annual Report, but with no details on these data. Common weaknesses in published accountability are the lack of any periodic public report on major developments in the sector and the long and variable delays in its publication.

Another element relates to the institutional and accountability arrangements amongst the different financial agencies. Assessments are revealing that the clarity in defining the rules governing the exchange of information and the relationship between financial agencies remains informal and confidential. Accountability as it relates to the activities of these agencies in the areas of overlap, discussions, and agreements are also weak. In almost all countries, while procedures for information sharing exist, they are not publicly disclosed. Most developing and transition economies were still working out the details regarding the information-sharing arrangement with the various domestic and international supervisory bodies.

Recommendations on enhancing transparency aspects of regulatory governance have supplemented some of the findings of the Basel Core Principles assessments. These relate to disclosure issues, and transparency practices in the areas of open process for formulating and reporting of banking supervision policies. Recommendations have emphasized increased and timely disclosure of statistical data for the banking sector and emergency financial support (see also Section V below), publication of formal information sharing agreements between financial agencies, disclosure of the results of banking sector operations on an annual basis, and public dissemination of regulatory texts.

Insurance regulation

Insurance supervisors' transparency practices are strongest in the public disclosure and explanation of the regulatory framework and operating procedures governing their activities, and in involving market participants in the making of policy changes. As in the case of banking supervisors, considerable weaknesses remain with respect to accountability and assurances of integrity by insurance supervisors.

Problems identified in the assessments include:

- insurance law does not prescribe any formal accountability mechanism;
- accountability hindered by legislative provisions that make one part of the government responsible for appointing the head of the agency, whereas its supervision is conducted by another agency;
- limited dissemination of information on regulatory activities, sometimes only to other government agencies;
- officials are not required by law and are not available to appear before a public authority or there is no such established practice; and
- internal governance procedures exist but are not disclosed to market participants; one or more elements of the procedures for appointment, terms of office, and removal of officials are not specified in legislation.

Similarly, practices relating to public disclosure of formal procedures for information sharing and consultation with market participants were weak. In several instances, only the partial text of the memoranda of understanding between agencies is published or the cooperation agreements are not publicly disclosed at all. Public availability of audited financial statements was assessed to be irregular, often lacking any preannounced schedule based on which the market can expect such information.

On transparency of the insurance governance framework, recommendations have focused on transparency practices in the area of open process for formulating and reporting of insurance regulatory policies. In particular, improvements in transparency of the relationships between the insurance, banking, and securities regulatory agencies and of the formal information sharing arrangements with other insurance regulators have been sought.

Securities regulation

The strength of securities regulators' governance-related transparency practices is based on their success relative to other financial agencies in the public disclosure and explanation of their regulatory framework and operating procedures, in involving market participants in

determining future courses of action, and in disseminating information on consumer protection and client asset protection schemes.

Weaknesses in the transparency of the securities regulatory governance framework consist of:

- As in the case of banking and insurance supervisors, governance arrangements were inadequate in terms of the regulatory responsibilities relating to securities regulation and the overlapping areas pertaining to the banking and insurance regulators. There was therefore insufficient public disclosure of formal procedures for information sharing and consultation between regulatory agencies. In most cases, information sharing between regulatory agencies is carried out; however, the cooperation agreements are not made sufficiently clear to the public or are not publicly disclosed at all.
- Nondisclosure of procedures for appointment, terms of office, removal of officials, internal governance procedures, and audit arrangements.
- Deficiencies in the accountability framework, such as periodic reports on securities regulators activities are either not produced or are submitted only to an oversight body (legislature) and when such reports are released, they are found to be lacking in quality and coverage, such as the activities of the stock exchange.
- Lack of explicit procedures for holding the organs of the stock exchange accountable.
- Officials are not required by law and are not available to appear before a public authority or there is no such established practice.

The main recommendations in the area of securities regulatory governance transparency relate to the area of open process for formulating and reporting of securities regulatory policies, and accountability and assurances of integrity by the securities regulators. They have focused on improving the transparency of the relationship between regulatory authorities and among national and lower-level securities agencies, as well as of the formal information sharing arrangements. Improvements have also been suggested in making transparent rules for the terms of office of the chief executive of the securities regulatory agency and the general criteria for removal of the governing body members.

Payment systems oversight

The transparency of the governance framework of payment systems oversight agencies appears strong in the area of transparency of general accountability that encompasses the availability of officials to explain their institution's objectives and performance to the public. This is due to the fact that in many countries payment systems oversight is the responsibility of the central bank.

On the other hand, a frequently noted weakness in public accountability is that payment systems oversight agencies (mostly being central banks) report on performance on macro-financial issues, with relatively little reporting on the actual operations, risks, and how they are being managed in the payment systems. Other disclosure deficiencies relate to availability of information on operating expenses and revenue. Often the details of the operating expenses and revenues of the oversight agency are not available separately from the overall accounts of the central bank; existing data is dated and published irregularly.

Furthermore, reporting on developments in the payment systems is often on an ad hoc basis; and no official data on the sector is published. Most of all, the disclosure of general policy principles for agencies overseeing the payment systems is often incomplete, especially those related to risk management policies, which are either nonexistent or not disclosed. Another important governance issue relating to payment systems oversight relates to its relationship and accountability vis-à-vis the banking supervisor. In most cases the relationship was not clearly defined despite the existence of a potential conflict of interest and, where stated to exist, it was either lacking a legal or a regulatory basis, or was not disclosed.

Recommendations on payment systems oversight have complemented the assessments of observance of the CPSIPS, and have focused on public availability of information on payment systems policies and clarity of roles, responsibilities, and objectives of the payment systems oversight agency. They emphasize the need for better communication of general principles of payment systems policy to the public (including risk management policies), clarity in the law separating the roles and responsibilities of the central bank and other agencies as they relate to payment systems, and clarifying the role of the clearinghouse, the central bank, and clearinghouse member banks.

D. Regulatory Agencies Versus Central Banks

The larger part of this paper on regulatory governance has been devoted to regulators and supervisors, even though at the beginning of the paper we included central banks as a key agency for financial sector oversight. The main reason was that, while the subject of central bank governance, independence, and accountability is fairly well documented, very little has been written about regulators and supervisors. However, to provide a full perspective on regulatory governance issues in the context of financial stability, it is useful to compare regulatory agencies with the central banks.

There is no internationally recognized standard on central banks' monetary policy operations, equivalent to, for instance, the BCP (the IMF, though, has come out with guidance and good elements relating to various aspects of central banking, including central bank organization, and accounting practices). While this limits a discussion of the components of central bank governance along the lines presented in this paper, we have based the discussion below on the MFP Code and the extent to which it covers accountability and integrity aspects of the central bank governance framework.

Sundararajan, Das, and Yossifov (2002) define a policy transparency index in which they compare all agencies, including central banks.³⁰ They conclude that the average degree of observance of the MFP Code is the highest for monetary policy. For advanced countries the index reaches 90 percent, over 80 percent for transition countries, and 73 percent for developing countries. These percentages are significantly higher in each country grouping than the indices for all other agencies (Figure 4).

These findings, in conjunction with the well-documented fact that central banks across the world have also reached a higher degree of independence from the political sphere, **indicate that central bank governance practices are better established than good governance practices of other regulatory agencies.** This should not come as a complete surprise if one takes into account that the international effort for central bank independence and accountability—and with it good governance—is more than two decades old. The call for good governance practices in regulatory agencies is of a much more recent date and is certainly still not as widely accepted as in the case of central banks, indicating that it will take some time before politicians generally accept the idea.

It is hoped that the country assessments under the FSAP, and research along the lines of this paper, expedite this process at a time that financial stability is generally accepted as a public good and the key role of regulatory agencies in achieving this objective is firmly accepted.

V. GOVERNANCE ISSUES IN CRISIS MANAGEMENT

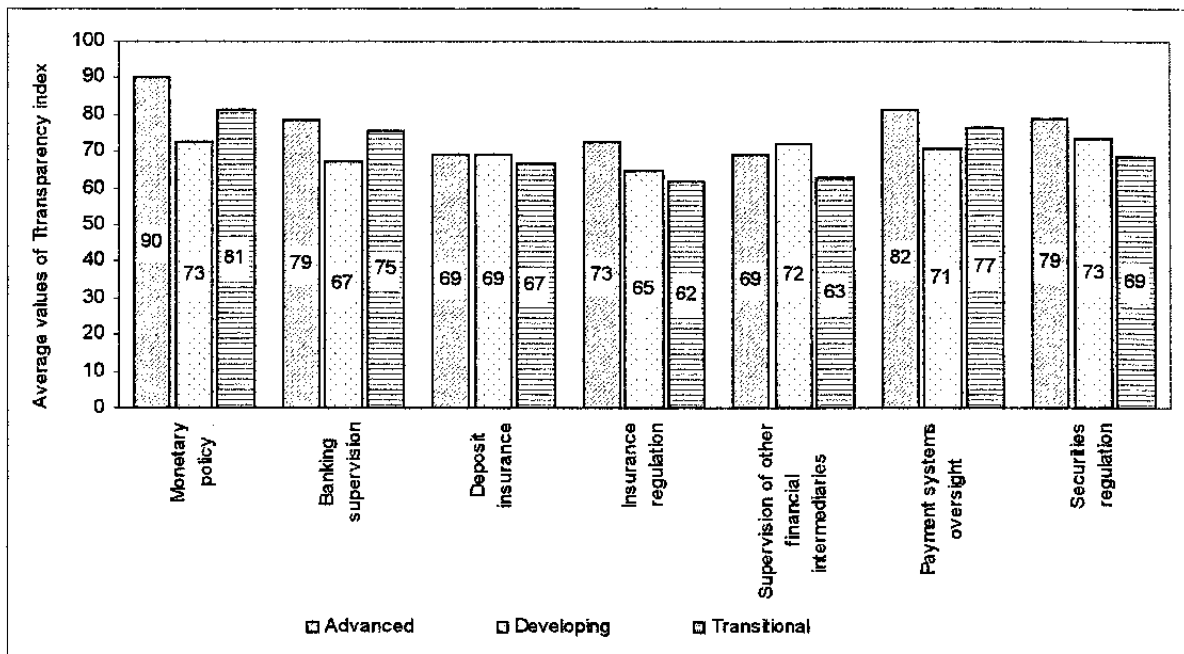
A. The Specific Nature of Systemic Banking Crises

The question as to whether a paper like this one needs a separate section on governance issues in crisis management is legitimate. Indeed, on the one hand it can be argued that good governance frameworks established for, and in, normal times should also, and perhaps even more, show their value in crisis management. Therefore it should not be necessary to devote special attention to these issues in times of a deep crisis. On the other hand—and that is the view taken in this paper—the management of systemic, or significant, banking crises brings

³⁰ The index measures the degree of observance of the MFP Code by IMF member countries in the areas of monetary policy, and financial sector policies. The value of the index for each sector of the financial system in a given country is computed as unweighted averages of the overall scores assigned to the country's implementation of four dimensions of transparency: (1) means of disclosure; (2) timeliness of disclosure; (3) periodicity of disclosure; and (4) observance of requirements related to the form and content of disclosure set forth in the MFP Code. The data used in the construction of the transparency index is derived from a 1999 survey on the implementation of the MFP Code by IMF member countries. The survey asked IMF member countries to describe the modalities of implementation of the MFP Code, not to grade their observance. The values of the index are derived based on detailed analysis of countries' responses.

up a set of specific, or exceptional, issues which government agencies might be unfamiliar with. Therefore it might be useful to explore those unfamiliar sides and highlight what type of governance issues might come up. So, this section intends to highlight those exceptional circumstances and discuss the specific issues that need special attention. It should nevertheless be borne in mind that there should be a continuum between governance in normal times and crisis times, in other words that crisis governance is predicated on governance practices in normal times.

Figure 4. Regulatory Agencies Versus Central Banks: Average Degree of Observance based on the Transparency Index



Source: Sundararajan, Das, and Yossifov (2002).

In a deep systemic or significant financial crisis—a crisis whereby a systemically important part of the sector is affected to such an extent that the operation of the payment systems, and therefore of the economy, is at best threatened, or at worst stalls—government intervention is inevitable, because the public good function of financial stability itself is at stake. Such government intervention typically implies two key elements: (i) setting up the appropriate institutional structure and; (ii) taking exceptional measures.

The institutional structure

The demands on intervention posed by a systemic banking crisis go beyond what is commonly known as “intervention,” i.e., intervention by the regulatory agencies in failed or failing banks. There is a role for the government as such to step in, develop, and implement a broad strategic plan to address the crisis. Broader government intervention, better defined as **political leadership**, is justified for several reasons: (a) budgetary resources will be called

upon in the restructuring of financial institutions—a responsibility that goes beyond those of the traditional regulatory agencies; (b) a strategic plan needs to be shepherded through the legislative body, for which strong political support will be needed; (c) a systemic banking crisis involves burden sharing and redistribution of wealth among all layers of society who are all voters in democratic societies; and (d) resolving a systemic crisis typically also implies the breaking of vested interests, a task that also needs political leadership. So, governments are confronted with taking a host of highly technical decisions and measures, but these measures all have a highly politically sensitive content.

The above agenda implies that, to handle the crisis, the authorities need to set up an institutional framework which will cut across the traditional division of responsibilities among regulatory agencies. Setting up such a crisis management framework involves therefore (a) revisiting some of the mechanisms underlying the components of good governance in the individual agencies (independence, accountability, transparency and integrity); and (b) defining the contents of these same components for the (temporary) crisis management structure.

Exceptional measures

This temporary institutional structure will be called upon to **take exceptional measures**—measures typical for deep and systemic crises that often need to be very innovative and creative, but that are therefore, by definition, also unfamiliar to the authorities. Such measures may have outcomes which are perhaps unknown or unpredictable and may not necessarily be completely market-oriented. One of the greatest challenges will be to avoid moral hazard. Appropriate governance mechanisms should prevent this outcome from happening.

Applied to a crisis situation, good governance practices are needed to (a) get as quickly as possible out of the crisis—shorten the “policy lag”; (b) achieve an equitable burden sharing; and (c) ensure proper coordination between government agencies. **The leading principle should be that adequate accountability, transparency and disclosure is needed for each and every step in order to build up or maintain the authorities’ credibility.**³¹

B. Key Governance Issues in Crisis Management³²

This section goes through the different stages of an unfolding systemic crisis. Starting from the stylized facts about the unfolding and resolution of a systemic banking crisis presented in

³¹ See also Sundararajan and Das (2002) who make this point in the broader context of financial sector reform.

³² References to and discussions of the sequencing of systemic banking crises are based on Lindgren and others (1999) and Scott (2001).

the next section, we discuss key governance issues regarding the role of the lender of last resort function, the resort to a blanket guarantee for depositors and some creditors, the use of deposit freezes, the role and establishment of a restructuring agency, and of asset management companies (AMC), and issues pertaining to bank restructuring techniques.

A systemic banking crisis: Stylized facts

As experienced during the 1990s around the world, banking distress typically turns into a banking crisis when triggered by some exogenous shock. Such an event can be closely related to the state of the banking system, or more remotely, such as a political statement that drains the confidence in the (political and) financial system. The beginning of the crisis is then characterized by deposit runs. The problem becomes systemic when the operation of the payment systems is threatened and could break down.

The first task of the authorities faced with such a situation is to contain the crisis, and to try to restore some degree of confidence with the public at large so that the bank runs are contained. During this initial period, the central bank could be called upon to provide emergency liquidity support to all financial institutions that are not clearly nonviable; the authorities should announce a package of macroeconomic measures in their efforts to restore confidence; it might also be useful—depending on the circumstance, see below—to announce a blanket guarantee for some creditors and depositors. Other measures could include the immediate closure of nonviable or fraudulent banks and the imposition of capital controls. Some countries also experimented with deposit freezes to (re)gain control over the situation.

Once this package of measures has succeeded in stopping the run on banks, the crisis enters a second stage—the restructuring stage. This is the time for the authorities to take stock of the situation, put in place an organizational structure that can handle the restructuring and start taking measures. These include valuation of the banks; triage of viable and nonviable entities; strategies to deal with the nonviable ones, to recapitalize and reorganize the viable ones, to deal with the impaired assets; and corporate sector restructuring.

Finally, the third phase concerns the exit strategy. Issues to be dealt with at this point include the exit from the blanket guarantee—if there was one, and from other measures like capital controls; the reprivatization of financial institutions that were deemed to be only temporarily under government control and the design of an efficient safety net, including a limited deposit insurance scheme. These issues are beyond the scope of this paper.

Governance issues in crisis containment

A key issue that could be labeled a governance problem is the **recognition** that a crisis is unfolding. In several recent crises governments and/or regulatory agencies were in denial, thereby allowing the crisis to widen and deepen. Often the problem is situated at the level of the politicians who neglected or overruled alarms from supervisors because of vested

interests.³³ On other occasions, supervisors themselves did not take the necessary steps. With established arrangements for accountability, transparency, and integrity such events should not be allowed to happen.

Once it is clear that a crisis is systemic in nature, the first priority for the authorities is to stop the deposit run, stabilize the financial institutions' liabilities, and keep the payment systems running. Typically at this stage of a crisis, coordination among government agencies is not yet established and the main responsibility, almost by default, lies with the central bank. Its key objective must be to keep the payment systems running through some form of liquidity support.

Emergency liquidity support

The central bank's role in re-establishing confidence in the financial system is crucial at this stage. While it has been argued that substantial liquidity support may delay crisis recognition and increase the macroeconomic costs,³⁴ failure to provide the necessary liquidity will result in a collapse in the payment systems and, therefore, in economic activity. So, central banks have to walk a very fine line.

Good governance under such circumstances should focus on transparency and accountability:

- Under the circumstances, central banks may have to deviate temporarily from their main policy objective (e.g., price stability) in order to “stop the bleeding” and preserve the operation of the payment systems. Clear principles should be established regarding the amounts, forms, and circumstances under which emergency support can be provided. Established **accountability** channels, in combination with full **transparency** in its operations should be used to explain and justify the central bank's actions and to preserve its credibility—or even enhance it.^{35,36}

³³ See Lindgren and others (1999).

³⁴ See for instance Klingebiel and Laeven (2000).

³⁵ A general principle is that central bank liquidity support should be for illiquid but solvent banks. However, the situation faced by the authorities might be so confused and uncertain—and hard data lacking—that some liquidity support in the end may turn out to be solvency support. For such cases transparency is needed because the central bank may later have to explain on which grounds it decided to provide support.

³⁶ Deviation from other stipulations in the central bank law may also be necessary and should be disclosed. For instance, it might be necessary to broaden the definition of acceptable collateral in order to accommodate all institutions that are still deemed viable and, therefore, eligible for emergency support.

- Transparency would also require that, if such loans cannot be repaid by the borrowing institutions, the government should compensate the central bank for its losses. So clear arrangements between the government (budget) and the central bank are needed from the first hours onward.

Blanket guarantees

A blanket guarantee is an announcement by the government that it will ensure that a well-defined set of the banks' (or financial institutions') liabilities will be honored. While such a commitment can improve confidence in the financial system, stabilize the banks' funding, and preserve the operation of the payment systems, it is a far-reaching measure that, if not announced and implemented properly, may create moral hazard.

The key issue is that a successful guarantee requires that the government's promise is credible. This implies, in the first place, that the government has the financial capacity to honor the guarantee, which is directly related to the country's fiscal and public debt situation. However, credibility also depends on how the measure is "governed." **Disclosure and transparency** are the key requirements here: the announcement must be clearly spelled out (parties covered, payment modalities, measures taken to contain moral hazard, the way the exit from the guarantee will be announced);³⁷ in addition, the announcement must be perceived as having the full support from institutions within the government and from all political parties. Any signs of disagreement or dispute will undermine the credibility. So, this is a matter of public sector governance.

Closures of nonviable institutions

It would be proof of sound governance practices if the regulatory agencies—in cooperation with the government—seize the opportunity at the outbreak of the crisis to close institutions that are clearly insolvent (and often fraudulent) and seen by the markets as nonviable. This way, the authorities clearly demonstrate to the markets that poor governance practices in the sector are penalized by imposing losses on uninsured depositors, creditors, and shareholders. Such action gives the authorities some "early wins" that underpin their credibility in containing the crisis, and, ultimately, will also reduce the resolution costs.

Accountability, transparency, and integrity once again surface as the three key elements to the success of such intervention. If banks are to be closed, closures must be based on transparent, uniform, simple, and defensible criteria, and these criteria should be communicated to the public and explained. There should be no exceptions to the specified rule, since the credibility of the entire operation would be only as strong as its weakest link.

³⁷ The exit from the blanket guarantee is a very sensitive issue as has been shown by several country experiences.

Deposit freezes

Deposit freezes, because of the host of negative effects they bring along, should only be used as a last resort, when all else fails. While deposit freezes allow the government time to elaborate a strategy, their negative effects in terms of output loss and loss of confidence in the government and the financial system are difficult to restore. Moreover, exit from a freeze has proven to be highly problematic. Of the measures discussed here, freezes are the least market-oriented measure as they actually interrupt the functioning of the markets.

If imposing a freeze is the only way out for the authorities, the measure should be **transparent**: its rules should be clearly announced, the measure should be fair and equitable, exceptions should be spelled out, but at the same time be limited to avoid circumvention and undermining, the period of the freeze should be as short as possible, and the unfreezing should be prepared carefully and its stages announced in detail.

Governance issues in bank restructuring

Once the acute crisis is contained, the authorities will face a confused and uncertain situation. Coordinated, credible, and rapid action will be needed to move into the restructuring phase. Key areas where the authorities should demonstrate good governance practices include, the establishment of a single accountable authority to coordinate and implement the restructuring plan; a sound legal framework that supports good governance practices; and restructuring practices and impaired asset management that provide the right incentives. All this needs to be done in clear communication with the public at large. These are the areas, where in some recent crises, weaknesses in governance have contributed to the slowdown of the restructuring process.

Need for inter-agency coordination

The establishment of a **single and accountable authority** responsible for coordinating and implementing the bank-restructuring plan is of prime importance for the resolution strategy to gain credibility. The establishment of such an agency would be a clear signal from the political leadership that it stands behind the restructuring.

A restructuring agency is needed because policies that need to be defined and implemented go beyond the mandate or capacity of the regulatory agencies. Hence, the need for an umbrella structure that brings together and coordinates the work of these agencies and counters the build up of the perception that they are operating at counter-purpose or that “turf battles” undermine the entire effort.

The restructuring agency will most likely be established by emergency legislation or decree. It should have a clear (and preferably single) mandate; be awarded a sufficient degree of political autonomy in its day-to-day operations; accountability measures should be established; and the transparency of the agency’s actions should be clearly spelled out.

Communication with the markets and the public at large is critical for the success of the undertaking.

At the same time, the establishment of such a restructuring agency with far-reaching powers may imply that the autonomy and powers of some other institutions be curbed for a limited period of time.³⁸ Given their mandate, this applies in particular to the regulatory authority. For instance, the decision to close an institution or intervene (that is, provide government financial support) should be taken in coordination among agencies involved, and against the background of the overarching strategy. Other agencies may also have to accept limitations to their original mandate. Whatever the limitations, decisions by the restructuring agency should be taken after due consultation with the “specialized” agencies.

There is also a theoretical argument for limiting agency autonomy in times of systemic banking crisis. As Majone (1997) explains, the model of delegating to autonomous agencies is suitable for areas of economic and social regulation, for efficiency reasons. However, it is not suitable for redistributive policies or policies with significant redistributive effects. Such policies should remain directly under the control of the elected political executives. Systemic crisis management has wealth-distributive effects and, therefore, should be closely controlled by the political authorities. Of course this does not mean that day-to-day management of the restructuring agencies should be politically controlled, but regular briefings and debriefings are a necessity—in other words a less than arms’ length relationship should be developed.

The example of the Indonesian Bank Restructuring Agency (IBRA) is unfortunately one of the best examples of poor (public sector) governance in a restructuring effort.³⁹ During the Habibie presidency, the Financial Sector Action Committee (FSAC), comprising a number of ministers of economics and chaired by the coordinating minister, made a number of intrusive interventions into the activities of the operations of IBRA. For example, FSAC intervened to reject shareholder settlements that had been negotiated by IBRA management and to demand that the bank recapitalization scheme favor the indigenous business community over banks that were “Chinese.” These political interventions served to undermine the credibility of the bank restructuring effort, and particularly the requirement of uniformity of treatment. Meanwhile, IBRA has already had eight chairpersons, another sign of political interference in this key institution. Just like day-to-day supervision, the credibility of bank restructuring is significantly enhanced if it is under the direction of an agency with a strong and independent board and a clear mandate.

³⁸ Several countries’ laws stipulate this possibility explicitly.

³⁹ See Enoch and others (2001).

Need for a legal framework that supports good governance practices

Ideally, this topic should not be an issue. A proper legal framework supporting good governance practices in the financial sector should be in place at **all** times. Country experience however indicates that specific provisions or articles, that have been in the laws for years, only come into play in highly exceptional situations, like systemic banking crises. And then, they prove to be inadequate—that is, block a smooth restructuring process—or provide the wrong incentives.

Crucial provisions in legal frameworks in providing the right incentives include the power to write down shareholders' equity and to remove management, as well as proper exit policies.⁴⁰ Legal authority is needed that permits efficient exit policies for banks—especially early action against weak banks and write down of shareholder rights. In many countries exit policies are never brought to a test. In some recent crises, governments have been unable to intervene effectively in insolvent banks and shareholders have retained sufficient power to impede loss recognition and restructuring, thus stalling or even reversing progress in banking system restructuring. Combined with these requirements is the general requirement that the integrity of the supervisors and restructurers be protected, as discussed earlier in this paper. They should be immune from lawsuits as a consequence of discharging their official functions. Without such immunity the entire restructuring process might stall.

Governance issues in bank restructuring

Bank restructuring in a systemic banking context is a comprehensive task. By taking the lead in restructuring, the government takes on a major responsibility. But in addition, as has been demonstrated by several recent cases, governments often become owners-of-last-resort, which in itself poses another set of governance problems.⁴¹ Transparency and accountability with respect to the actions of the restructuring agency and the government will be key factors to the success of the undertaking. By being transparent in its actions, the government will facilitate the decisions of foreign or domestic (strategic) investors to participate in the restructuring effort; of international markets in general to stop, continue, or expand its involvement in the country's financial sector, and of depositors to maintain or rebuild their confidence in the banking system. Following are some of the steps where **transparency** and **accountability** play a crucial role.⁴²

⁴⁰ Proper incentives should also be present in other pieces of legislation, such as the bankruptcy law, contract laws, and laws on collateral and foreclosure. And even the quality of the judiciary becomes a governance issue in crisis management.

⁴¹ Many of these issues are set out in Carmichael (2002) in more detail.

⁴² In some cases ex-ante transparency is desirable or needed. In other cases, ex-post transparency might be more desirable because of confidentiality issues.

- The “triage” process of viable and nonviable banks, following a thorough valuation of the banks, should also be based on clear and transparent criteria and these should be communicated to the markets.
- If the government decides to close a bank, transparency and good communication is needed. Closures can cause uncertainty and concern about the fate of remaining institutions. The authorities should provide clear statements about the reasons for closure also to avoid that inappropriate incentives are given to other banks in the system.
- Recapitalization schemes involving incentives for the markets should be clearly communicated to the markets.
- If the government decides to participate in the recapitalization, proper incentives should be communicated to the private sector to “bail in.” The impact on public finances should also be spelled out clearly.
- If the government decides to take over a bank, shareholders of the banks must be the first to lose their investments. If the shareholders are to retain some equity position in their banks, they must contribute to the recapitalization. Uniform treatment of all institutions in the same situation and clear communication with the public can assist in this process.
- Speed of the recapitalization should be treated transparently to allow the markets to make a sound judgment of the health of the banks.

Asset management companies

A last, but highly important and complex area of bank restructuring is the way the authorities deal with impaired assets. Recent experience had demonstrated several of the problems that can arise if no good governance practices are adhered to.⁴³ Good governance is essential to maximize the value of the impaired assets; minimize the fiscal costs; and stop a deterioration of credit discipline. However, an AMC is not a company like any other. AMC’s are typically meant to be temporary institutions. By achieving their goal, they make themselves redundant. This specific aspect of the AMC-business requires a solid governance structure. AMC managers should be provided with the right set of incentives to achieve the company’s objective(s).

⁴³ See Cooke (2002) for an in-depth overview of governance issues in AMCs, mainly based on the experience in East Asian crisis countries in the late 1990s. Our paper only lists the main issues without too much detail.

We limit ourselves to highlighting the main governance issues to be taken into account when establishing the infrastructure for dealing with impaired assets:

- The governance infrastructure for managing problem assets (centralized versus decentralized; public versus private) should correspond as closely as possible to the conditions in and structure of the market (size of the banking problem; dominant type of impaired assets; structure of the financial system—public versus private).
- When the choice is for a public AMC, good governance is necessary to assure the effective operation of the agency. These principles in many ways do not differ from those discussed for other agencies: AMCs should have a clearly defined goal and a governance structure that is supportive of this goal.⁴⁴ Many AMCs have indeed run into problems because their mandate was not clearly spelled out, or because they had to pursue multiple—often conflicting—objectives. It is important that they be **independent** from day-to-day political interference (and enjoy budgetary independence) in the disposition and restructuring of assets and have the proper incentive structure to achieve their goals. At the same time they should be **accountable** to their (many and diverse) stakeholders for their actions and performance and be transparent. To assure **transparency**, AMCs should be required to publish regular reports describing their performance in pursuing their goals. In addition to making detailed financial information public, the AMCs should be audited regularly to assure that their financial statements are accurate, that representations as to the value of assets are reasonable, and that the AMC has proper internal controls in place to safeguard the assets under its management. Independent auditors chosen by the government should undertake such audits.
- Public AMCs should be given the proper legal powers to expedite loan recovery and bank restructuring;
- Public AMCs should provide the right incentives to the financial institutions. They should attach conditions to purchases of nonperforming loans; they should use the leverage over debtors;
- In order to duly take into account the specific nature of the AMC's (phasing themselves out by meeting their objectives), stakeholders should give incentives for meeting the AMC's objectives, such as providing employee outplacement assistance and compensation incentive programs for rewarding timely and final resolution of assets (see also Cooke, 2002).

⁴⁴ See Klingebiel (2000) for a listing of objectives for AMCs in different countries.

Two additional principles

This section on governance issues in crisis managements leads us to add two principles to the list of ten presented in Box 3 underlining the importance of adhering to all four components of regulatory governance at each and every step to be taken on the (typically) uncharted territory of crisis management, in order to reduce the uncertainty created by the crisis and the concomitant loss of confidence:

- Exceptional measures should be formulated and implemented in a transparent manner and the authorities should adhere to high accountability standards.
- The four components of regulatory governance should underpin all exceptional institutional arrangements.

VI. CONCLUSIONS

Good regulatory governance in the financial system is increasingly being recognized as key to the achievement and preservation of financial stability. Indeed, weaknesses in regulatory governance—or poor public sector governance more generally—are among the factors contributing to all recent systemic crises.

Good regulatory governance is essential for the credibility of regulatory agencies in the discharge of their regulation and oversight functions. As has been recognized by various standard setting bodies, good regulatory governance is a necessity for instilling good governance practices in the financial sector. Despite this linkage, research on issues of regulatory governance in the financial system has thus far not been very systematic or deep. Ways to strengthen regulatory governance have also been very tentative. This paper has therefore tried to contribute to the debate on regulatory governance issues in the context of financial stability and development.

Four components have been identified as being key to good regulatory governance. These include (i) independence of the agency from political and industry interference; (ii) accountability; (iii) transparency; and (iv) integrity. These components interact and reinforce each other in ways that, taken together, lay the foundations for the practice of good regulatory governance.

The FSAP effort is the first, and so far most comprehensive effort to analyze regulatory governance issues. However, more work is needed before a systematic approach can be presented. The assessments of regulatory standards, as part of the FSAPs, provide valuable insights for analyzing regulatory governance issues through the four components of regulatory governance identified above.

This paper has attempted to provide an (early) overview of the “state of the art” of regulatory governance with special reference to banking, insurance, securities and payment systems oversight areas. The following conclusions can be drawn from it:

- In terms of independence as a foundation for good governance, bank regulators seem to be ahead of the other sector regulators. To some extent, this might be the case because many bank supervisors who operate from within the central bank, can “piggy-back” on the central bank’s independence in the conduct of monetary policy.
- As to transparency in objectives, operations, accountability and integrity, securities supervisors score better than the others. One is tempted to say that securities regulators need a high degree of transparency to be credible in securities market where transparency and disclosure is key to the functioning of safe and efficient markets.
- Insurance supervisors score the worst on all counts. For a long time, the insurance sectors in most countries have not received adequate policy and institutional attention. They have mostly grown as an agency or department within the government.
- We also compared these results with some of the results from other work on central banks. The conclusion is straightforward: in general central banks are much more advanced in terms of governance issues. The reason for this better performance is that the quest for central bank transparency, independence, accountability and integrity started approximately two decades before the emphasis on regulatory governance. In other words, regulators and supervisors still have a long way to go.
- The paper also drew the attention to governance issues in crisis management. The main message in this area is that good governance practices, established and applied in “normal times” should help significantly in times of crisis. The exceptional circumstances, however, require exceptional measures and an appropriate institutional setup to take such measures and implement them. Key conditions here are appropriate accountability arrangements for those in charge of the measures and a high degree of transparency of the restructuring strategy to ensure that all parties involved—and in times of a systemic crisis, that is basically the entire society—are well-informed about the authorities’ intentions. Transparency will expedite the process and ensure that the outcome is what the authorities expect.

However, experience from recent crisis episodes around the world seems to indicate that the statement above—that having good governance practices in normal times helps to adhere to good practices in crisis times—is still theory. The reality is, more often than not, that we learn from crisis experiences and, therefore, that the seeds of good governance practices are planted in crisis times.

This finding, then, closes the circle and brings us back to crisis prevention. In this light, the findings of this paper also provide a work agenda for the future, in terms of assessment, analysis, and recommendations:

- Governance practices in central banks as they relate to monetary policy should serve as the leading example for establishing good governance in regulatory agencies. The twelve main elements of regulatory governance identified in this paper can be used to strengthen regulatory governance standards.
- The formation of large financial groups and conglomerates necessitates a further harmonization of regulatory and supervisory approaches towards good governance. Unification of supervisory agencies and enhanced emphasis on exchange of information among the regulators, are providing an opportunity to improve the regulatory governance practices.
- The FSAPs offer the first vehicle to assess regulatory governance practices. The assessment findings need to be further analyzed. It would be useful to build upon the FSAP framework to come to a more comprehensive assessment of governance practices. As this develops, the FSAP findings could help in shedding more light on issues such as the extent to which good regulatory governance is correlated with financial stability or improved performance of the banking system, or in finding causal relationships between good regulatory governance and growth and development of financial systems.
- With more assessments in the pipeline, it will be useful to undertake more cross-sectional analyses; to analyze in more depth the linkages between good regulatory governance and good corporate governance practices—one of the premises of this paper; and to analyze the linkages between good regulatory governance practices and (measures) of financial stability.
- Finally, good regulatory governance can only be effective if it is complemented by good public sector governance. As long as the cost of interference in the regulatory process is low for politicians, interference will continue to exist. This nexus needs to be further explored through a closer analysis of the preconditions for good regulatory governance.

Table 1. Countries in Which Regulatory Standards and MFP Code
Were Assessed Under the 46 Completed and Ongoing FSAPs

(As of end of January, 2002)

FSAP Missions	Year	BCP	CPSS	IAIS	IOSCO	MFP Code
Argentina	2001	X	X	X	X	X
Armenia	2000	X	X	X	X	X
Bulgaria	2001	X	X	X	X	X
Cameroon	2000	X	X	X		X
Canada	1999	X	X	X	X	X
Colombia	1999	X	X			X
Costa Rica	2001	X	X		X	X
Croatia	2001	X	X	X	X	X
Czech Republic	2000	X	X	X	X	X
Dominican Republic	2001	X	X	X		X
El Salvador	2000	X	X			X
Estonia	2000	X	X	X	X	X
Finland	2001	X	X	X	X	X
Gabon	2001	X		X	X	X
Georgia	2001	X	X	X	X	X
Ghana	2000	X	X	X	X	X
Guatemala	2000	X	X			X
Hungary	2000	X	X	X	X	X
Iceland	2000	X	X	X	X	X
India	2000	X	X		X	X
Iran, Islamic Republic of	2000	X	X			X
Ireland	2000	X	X	X	X	X
Israel	2000	X	X	X	X	X
Kazakhstan	2000	X	X	X	X	X
Korea	2001	X	X	X	X	X
Latvia	2001	X	X	X	X	X
Lebanon	1999	X				X
Lithuania	2001	X	X	X	X	X
Luxembourg	2001	X	X	X	X	X
Mexico	2001	X	X	X	X	X
Morocco	2002	X		X	X	X
Nigeria	2001	X	X	X	X	X
Peru	2000	X	X			X
Philippines	2001	X	X	X	X	X
Poland	2000	X	X	X	X	X
Senegal	2000				X	X
Slovenia	2000	X	X	X	X	
South Africa	1999	X	X	X		X
Sri Lanka	2001	X	X		X	X
Sweden	2001	X	X	X	X	X
Switzerland	2001	X	X	X	X	X
Tunisia	2001	X	X	X	X	X
Uganda	2001	X	X			X
United Arab Emirates	2001	X	X			X
Uruguay	2001	X	X			X
Yemen, Republic of	2000	X	X			X
Total	46	45	42	32	33	45

Table 2. Transparency-Related Aspects of Regulatory Governance Addressed by the MFP Code

Transparency-Related Aspects Of Regulatory Governance	MFP Code Practices
I. Accountability	
I.1 General	5.1.3 Where applicable, the broad modalities of accountability for financial agencies should be publicly disclosed.
	7.4.2 Senior financial agency officials should be ready to explain their institution's objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public.
	8.1 Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate, exchange views on the state of the financial system.
I.2 Published	6.3 Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.
	7.1 Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.
I.3 Financial	7.3 Where applicable, financial agencies should publicly disclose their balance sheets on a preannounced schedule and, after a predetermined interval, publicly disclose information on aggregate market transactions.
	8.2 Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a preannounced schedule.
	8.2.1 Financial statements, if any, should be audited by an independent auditor. Information on accounting policies and any qualification to the statements should be an integral part of the publicly disclosed financial statements.
	8.3 Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.
II. Integrity	5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.
	8.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.
	8.4.1 Information about legal protections for officials and staff of financial agencies in the conduct of their official duties should be publicly disclosed.
III. Regulatory policy transparency	
III.1 General	6.1.1 The regulatory framework and operating procedures governing the conduct of financial policies should be publicly disclosed and explained.

Table 2. Transparency-Related Aspects of Regulatory Governance Addressed by the MFP Code

Transparency-Related Aspects Of Regulatory Governance	MFP Code Practices
III.2 Consumer protection and client asset protection schemes	<p>6.1.2 The regulations for financial reporting by financial institutions to financial agencies should be publicly disclosed.</p> <p>6.2 Significant changes in financial policies should be publicly announced and explained in a timely manner.</p> <p>6.4 For proposed substantive technical changes to the structure of financial regulations, there should be a presumption in favor of public consultations, within an appropriate period.</p> <p>7.5 Texts of regulations and any other generally applicable directives and guidelines issued by financial agencies should be readily available to the public.</p> <p>7.6 Where there are deposit insurance guarantees, policy-holder guarantees, and any other client asset protection schemes, information on the nature and form of such protections, on the operating procedures, on how the guarantee is financed, and on the performance of the arrangement, should be publicly disclosed.</p> <p>7.7 Where financial agencies oversee consumer protection arrangements (such as dispute settlement processes), information on such arrangements should be publicly disclosed.</p>
IV. Transparency of operations and functions	
IV.1 General	<p>5.1 The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.</p> <p>5.1.2 The responsibilities of the financial agencies and the authority to conduct financial policies should be publicly disclosed.</p> <p>5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.</p>
IV.2 Transparency of interaction with other financial agencies	<p>5.2 The relationship between financial agencies should be publicly disclosed.</p> <p>5.4 Where financial agencies have oversight responsibilities for self-regulatory organizations (e.g., payment systems), the relationship between them should be publicly disclosed.</p> <p>6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.</p>

Table 3. Summary of Basel Core Principles Assessments' Findings
Related to Regulatory Governance 1/

Governance-Related Core Principles	Distribution Of Assessment Grades 2/			
	Compliant	Largely Compliant	Materially Noncompliant	Non-compliant
1. Framework for supervisory authority				
Advanced	66.7	33.3	0.0	0.0
Developing	16.7	16.7	66.7	0.0
Transitional	50.0	50.0	0.0	0.0
1.1. Objectives				
Advanced	83.3	16.7	0.0	0.0
Developing	58.8	20.6	20.6	0.0
Transitional	58.3	33.3	8.3	0.0
1.2. Independence				
Advanced	83.3	16.7	0.0	0.0
Developing	23.5	29.4	41.2	5.9
Transitional	25.0	33.3	41.7	0.0
1.3. Legal framework				
Advanced	100.0	0.0	0.0	0.0
Developing	55.9	29.4	8.8	5.9
Transitional	66.7	25.0	8.3	0.0
1.4. Enforcement powers				
Advanced	83.3	0.0	16.7	0.0
Developing	41.2	38.2	17.6	2.9
Transitional	50.0	16.7	33.3	0.0
1.5. Legal protection				
Advanced	83.3	0.0	0.0	16.7
Developing	38.2	17.6	23.5	20.6
Transitional	50.0	8.3	8.3	33.3
1.6. Information sharing				
Advanced	83.3	0.0	16.7	0.0
Developing	35.3	26.5	29.4	8.8
Transitional	33.3	50.0	16.7	0.0

1/ IMF, 2001, "World Economic Outlook," (Washington, D.C.: IMF), May, (<http://www.imf.org/external/pubs/ft/weo/2001/01/index.htm>).

2/ In percentage of the number of countries in which CP was found to be applicable and was assessed.

Table 4. Summary of IAIS Insurance Core Principles Assessments' Findings Related to Regulatory Governance 1/

Governance-Related Core Principles Observed	Distribution Of Assessment Grades 2/		
	Largely Observed	Materially Nonobserved	Not Observed
CP 1. Organization of an insurance supervisor			
Advanced	40.0	60.0	0.0
Developing	11.1	44.4	33.3
Transitional	10.0	30.0	50.0

1/ IMF, 2001, "World Economic Outlook," (Washington, D.C.: IMF), May, (<http://www.imf.org/external/pubs/ft/weo/2001/01/index.htm>).

2/ In percentage of the number of countries in which CP was found to be applicable and was assessed.

Table 5. Summary of IOSCO Core Principles Assessments' Findings Related to Regulatory Governance

Governance-Related Core Principles	Distribution Of Assessment Grades 1/		
	Partially Implemented	Not Implemented	Not Implemented
CP1. The responsibilities of the regulator should be clear and objectively stated.	94.1	0.0	5.9
CP2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.	52.9	41.2	5.9
CP3. The regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers.	58.8	35.3	5.9
CP4. The regulator should adopt clear and consistent regulatory processes.	88.2	5.9	5.9
CP5. The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.	76.5	17.6	5.9
CP6. The regulatory regime should make appropriate use of self-regulatory organizations that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.	75.0	25.0	0.0

1/ In percentage of the number of countries in which CP was found to be applicable and was assessed.

Table 6. Summary of CPSS Core Principles for Systemically Important Payment systems Assessments' Findings Related to Regulatory Governance 1/

Core Principle/Central Bank Responsibility	Distribution Of Assessment Grades 2/			
	Observed	Broadly Observed	Partially Observed	Not Observed
CP X. The system's governance arrangements should be effective, accountable and transparent.				
Advanced	84.6	0.0	0.0	15.4
Developing	28.0	20.0	40.0	12.0
Transitional	57.9	15.8	21.1	5.3
A. The central bank should define clearly its payment systems objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.				
Advanced	70.0	0.0	0.0	30.0
Developing	30.0	20.0	30.0	20.0
Transitional	60.0	10.0	10.0	20.0
B. The central bank should ensure that the systems it operates comply with the Core Principles.				
Advanced	66.7	0.0	0.0	33.3
Developing	30.0	20.0	30.0	20.0
Transitional	40.0	20.0	20.0	20.0
C. The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.				
Advanced	50.0	10.0	10.0	30.0
Developing	33.3	22.2	0.0	44.4
Transitional	50.0	30.0	0.0	20.0
D. The central bank, in promoting payment systems safety and efficiency through the Core Principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.				
Advanced	70.0	0.0	0.0	30.0
Developing	40.0	30.0	20.0	10.0
Transitional	70.0	10.0	10.0	10.0

1/ IMF, 2001, "World Economic Outlook," (Washington, D.C.: IMF), May, (<http://www.imf.org/external/pubs/ft/weo/2001/01/index.htm>).

2/ In percentage of the number of countries in which CP was found to be applicable and was assessed.

Table 7. Summary of MFP Code Assessments' Findings Related to Transparency of Regulatory Governance 1/

Governance-Related Aspects Of Transparency 2/	Number Of Relevant Practices	Fully Observed	Partially Observed	Not Observed
I. Accountability				
I.1 General accountability				
Banking supervision				
Advanced	3	90	10	0
Developing	3	74	19	7
Transitional	3	85	6	9
Securities regulation				
Advanced	3	81	19	0
Developing	3	67	28	6
Transitional	3	80	13	7
Insurance regulation				
Advanced	3	81	19	0
Developing	3	71	25	4
Transitional	3	67	22	11
Payment systems				
Advanced	3	95	5	0
Developing	3	78	19	4
Transitional	3	97	3	0
I.2. Published accountability				
Banking supervision				
Advanced	2	100	0	0
Developing	2	39	39	21
Transitional	2	95	5	0
Securities regulation				
Advanced	2	86	14	0
Developing	2	58	25	17
Transitional	2	80	15	5
Insurance regulation				
Advanced	2	100	0	0
Developing	2	44	44	12
Transitional	2	68	14	18
Payment systems				
Advanced	2	100	0	0
Developing	2	33	33	33
Transitional	2	70	30	0
I.3 Financial accountability				
Banking supervision				
Advanced	4	92	8	0
Developing	4	33	36	31
Transitional	4	82	9	8
Securities regulation				
Advanced	4	100	0	0
Developing	4	62	29	8

Table 7. Summary of MFP Code Assessments' Findings Related to Transparency of Regulatory Governance 1/

Governance-Related Aspects Of Transparency 2/	Number Of Relevant Practices	Fully Observed	Partially Observed	Not Observed
Transitional	4	54	34	12
Insurance regulation				
Advanced	4	96	4	0
Developing	4	7	36	57
Transitional	4	45	23	32
Payment systems				
Advanced	4	93	7	0
Developing	4	46	43	11
Transitional	4	81	19	0
II. Integrity				
Banking supervision				
Advanced	3	69	31	0
Developing	3	55	38	7
Transitional	3	70	24	6
Securities regulation				
Advanced	3	79	21	0
Developing	3	47	36	17
Transitional	3	52	33	15
Insurance regulation				
Advanced	3	74	26	0
Developing	3	60	21	19
Transitional	3	56	30	14
Payment systems				
Advanced	3	79	21	0
Developing	3	63	30	7
Transitional	3	78	15	7
III. Regulatory policy transparency				
III.1. General				
Banking supervision				
Advanced	5	89	11	0
Developing	5	67	29	4
Transitional	5	89	9	2
Securities regulation				
Advanced	5	89	11	0
Developing	5	93	7	0
Transitional	5	92	6	2
Insurance regulation				
Advanced	5	91	9	0
Developing	5	75	20	5
Transitional	5	79	21	0
Payment systems				
Advanced	5	86	14	0
Developing	5	58	39	3
Transitional	5	83	17	0

Table 7. Summary of MFP Code Assessments' Findings Related to
Transparency of Regulatory Governance 1/

Governance-Related Aspects Of Transparency 2/	Number Of Relevant Practices	Fully Observed	Partially Observed	Not Observed
III.2 Regulatory policy transparency in areas of consumer protection and client asset protection schemes				
Banking supervision				
Advanced	2	88	12	0
Developing	2	58	42	0
Transitional	2
Securities regulation				
Advanced	2	100	0	0
Developing	2
Transitional	2	81	19	0
Insurance regulation				
Advanced	2	83	17	0
Developing	2	67	33	0
Transitional	2	57	36	7
Payment systems				
Advanced	2	50	50	0
Developing	2	50	0	50
Transitional	2
IV. Transparency of independence and functions				
IV.1 General				
Banking supervision				
Advanced	3	67	33	0
Developing	3	60	38	2
Transitional	3	91	6	3
Securities regulation				
Advanced	3	83	17	0
Developing	3	50	44	6
Transitional	3	77	20	3
Insurance regulation				
Advanced	3	67	33	0
Developing	3	92	8	0
Transitional	3	68	29	3
Payment systems				
Advanced	3	76	24	0
Developing	3	44	52	4
Transitional	3	93	3	3
IV.2 Transparency of interaction with other financial agencies				
Banking supervision				
Advanced	3	74	14	12
Developing	3	21	58	21
Transitional	3	32	32	36

Table 7. Summary of MFP Code Assessments' Findings Related to Transparency of Regulatory Governance 1/

Governance-Related Aspects Of Transparency 2/	Number Of			
	Relevant Practices	Fully Observed	Partially Observed	Not Observed
Securities regulation				
Advanced	3	81	10	9
Developing	3	11	83	6
Transitional	3	52	25	23
Insurance regulation				
Advanced	3	86	7	7
Developing	3	14	64	21
Transitional	3	32	27	41
Payment systems				
Advanced	3	76	17	7
Developing	3	17	69	14
Transitional	3	37	30	33
Overall governance-related transparency				
Banking supervision				
Advanced	25	84	15	1
Developing	25	55	33	11
Transitional	25	81	12	8
Securities regulation				
Advanced	25	86	12	1
Developing	25	60	32	7
Transitional	25	71	20	9
Insurance regulation				
Advanced	25	85	14	1
Developing	25	58	28	14
Transitional	25	59	26	15
Payment systems				
Advanced	25	86	13	1
Developing	25	52	39	10
Transitional	25	81	15	4

Note: Numbers in table represent the average percentage shares (across the MFP Code assessments by country groups) of the applicable and assessed practices, pertaining to each governance-related aspect of transparency, categorized as being observed, partly observed, and not observed.

1/ IMF, 2001, "World Economic Outlook," (Washington, D.C.: IMF), May, (<http://www.imf.org/external/pubs/ft/weo/2001/01/index.htm>).

2/ For a list of MFP Code practices pertaining to each aspect of governance see Table 1.

Regulatory Standards and Regulatory Governance Principles 1/

Issue	CP#	Banking	CP#	Insurance	CP#	Securities
1. Attributes of supervisory systems • Operational independence and adequate resources	Part CP 1	An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources . A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors .	CP 1	In particular, the insurance supervisor should: be operationally independent and accountable in the exercising of its functions and powers; have adequate powers, legal protection and financial resources to perform its functions and exercise its powers; clearly define the responsibility for decision making; and hire, train, and maintain staff with high professional standards who also follow the appropriate standards of confidentiality.	CP 2	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
	CP(1) AC1	The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.	CP 1	The insurance supervisor is operationally independent from both political authorities and the insurance companies that it supervises in the execution of its supervisory tasks and is accountable in the exercise of its functions and powers .	CP 3	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
	EC2	The supervisory agency and its staff have credibility based on their professionalism and integrity .	EC2		CP 5	The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.
					6.2	The capacity of the regulator to act responsibly, fairly, and effectively will be assisted by: a clear definition of responsibilities , preferably set out by law; and adequate legal protection for regulators and their staff acting in the bona fide discharge of their functions and powers.
					6.3	The regulator should be operationally independent from external, political, or commercial interference in the exercise of its functions and powers and accountable in the use of its powers and resources . Independence will be enhanced by a stable source of funding for the regulator. In some jurisdictions

Regulatory Standards and Regulatory Governance Principles 1/

Issue	CP#	Banking	CP#	Insurance	CP#	Securities
						<p>particular matters of regulatory policy require consultation with, or even approval by, a government, minister or other authority. The circumstances in which such consultation or approval is required or permitted should be clear and the process sufficiently transparent or subject to review to safeguard its integrity. Generally, it is not appropriate for these circumstances to include decision making on day-to-day technical matters.</p> <p>Accountability implies a regulator that operates independently of sectoral interests; a system of public accountability of the regulator; and a system permitting judicial review of decisions of the regulator.</p>
<ul style="list-style-type: none"> Enforcement powers and capabilities within law and judicial system 	CP22	Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.	CP1 EC3	The insurance supervisor has adequate powers , legal protection and proper resources and staff, and the capacity to perform its functions and its powers.	CP3	The regulator should have adequate powers, proper resources , and the capacity to perform its functions and exercise its powers.
			CP14	Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified.	Section 12.3	The licensing authority should also have the power to withdraw or suspend the license or otherwise sanction the licensee whenever the entry criteria are not fulfilled. The regulator should be empowered to withdraw a license or authorization where a change in control results in a failure to meet relevant requirements.
	CP 2 EC 2	The permissible activities of institutions that are licensed and subject to supervision as banks are	CP2(2) EC14	The insurance supervisor has the right to withdraw the license on grounds of substantial irregularities, e.g., if the company no longer meets the licensing requirements or seriously infringes the law in force.		

Regulatory Standards and Regulatory Governance Principles 1/

Issue	CP#	Banking	CP#	Insurance	CP#	Securities
		clearly defined either by supervisors, or in laws or regulations.				
2. Clarity and transparency of regulatory process	Part of CP1	An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations.	Part CP 1	Adopt a clear, transparent, and consistent regulatory and supervisory process.	CP 1	The responsibilities of the regulator should be clear and objectively stated.
			CP 1 EC 1	The responsibilities of the insurance supervisor are clear and objectively stated.	CP 4	The regulator should adopt clear and consistent regulatory processes.
	CP1(1) AC1	The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.	CP1 EC4	The insurance supervisor adopts a clear, transparent and consistent regulatory and supervisory process. The rules and procedures of the insurance supervisor are published and updated regularly.	6.3	In some jurisdictions particular matters of regulatory policy require consultation with, or even approval by, a government, minister or other authority. The circumstances in which such consultation or approval is required or permitted should be clear and the process sufficiently transparent or subject to review to safeguard its integrity.
					6.5	In exercising its powers and discharging its functions, the regulator should adopt processes which are: consistently applied; comprehensible; transparent to the public; fair and equitable.
Regulatory Standards and Corporate Governance						
3. Corporate governance	Intro	Corporate governance Supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of responsibilities for a bank's board of directors and senior	Part CP 4	Corporate governance It is desirable that standards be established in the jurisdiction which deals with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the supervisor should	CP 23	Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the
	CP14					

Regulatory Standards and Regulatory Governance Principles 1/

Issue	CP#	Banking	CP#	Insurance	CP#	Securities
		management) and enhancing market transparency and surveillance.		set requirements with respect to: the roles and responsibilities of the board of directors.		intermediary accepts primary responsibility for these matters.
	EC1	Corporate or banking laws identify the responsibilities of the Board of Directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.	CP4 EC1	The insurance supervisor has the authority to require Boards of Directors to clearly set out their responsibilities towards acceptance of and commitment to the specific corporate governance principles for their undertaking.	12.5	<p>The details of the appropriate internal organization of a firm will vary according to the size of the firm, the nature of its business and the risks it undertakes, but generally regulation of market intermediaries should adhere to the following standards:</p> <ul style="list-style-type: none"> • integrity and diligence; • terms of engagement; • information about customers; • customer assets; • market practice; • operational controls; • conflicts of interests; and • proprietary trading.

1/ Joint Forum, 2001.

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