Chapter 5

Evaluating Financial Sector Supervision: Banking, Insurance, and Securities Markets

This chapter looks at the legal, institutional, and policy framework needed to ensure effectiveness of financial sector supervision. It focuses on banking, insurance, and securities markets. Effective supervision, however, depends on a legal and institutional environment that provides the necessary preconditions. Those preconditions include the following:

- The provision and consistent enforcement of business laws—including corporate, bankruptcy, contract, consumer protection, and private property laws—and a mechanism for fair resolution of disputes
- Good corporate governance, including adoption of sound accounting, auditing, and transparency procedures that carry wide international acceptance and that promote market discipline
- Appropriate systemic liquidity arrangements, including secure and efficient payment clearing systems that enable adequate control of risks and efficient management of liquidity
- Adequate ways to minimize systemic risk, including appropriate levels of systemic protection or safety nets and efficient procedures for handling problem institutions

The preconditions complement the legal and institutional framework governing the specific sectors of the financial system (banks, nonbank financial institutions, rural and microfinance entities, securities markets, and insurance providers) and their supervision, which is discussed in section 5.1. The broader legal framework governing the preconditions is covered in chapter 9. Section 5.2 in this chapter focuses specifically on the legal and institutional aspects of financial sector safety nets, one of the key preconditions affecting governance and stability of banking institutions. The scope and content of inter-

national standards on financial sector supervision in banking, insurance, and securities markets and the issues in assessing compliance with these standards are taken up in detail in the subsequent sections of this chapter (sections 5.3–5.5).

5.1 Legal and Institutional Framework for Financial Supervision

The legal framework empowering and governing the regulator and the rules used to regulate the various markets and institutional types form the cornerstone of the orderly functioning and development of the financial system. In this respect, the key laws are the law governing the central bank, banking and financial institutions, capital market laws, and insurance laws, and those laws are backed by adequate provisions on the efficient and reliable payment system infrastructure. The provisions are sometimes embedded in the laws or else are governed by separate legislation. The key elements of sound financial sector laws are already part of the existing international standards on supervision. Effective supervision also requires certain preconditions that are embedded in a broader range of laws such as laws on bankruptcy; company laws; contracts laws; and laws governing accounting, auditing, and disclosure, and so forth.

The legal and institutional framework for financial supervision should cover (a) the identity of the supervisor (central bank or separate agency), terms of reference, powers, and authority of the supervisory agency; (b) the authority and processes for the issuance of regulations and guidance; (c) the authority and tools to monitor and verify compliance with the regulations and principles of safe and sound operations; (d) the authority and actions to remedy, enforce, take control, and restructure; and (e) the procedures to delicense and liquidate problem institutions that cannot be restructured.

The legal framework should clarify the roles and responsibilities of different agencies involved in financial supervision. The central bank laws, banking laws, and other laws governing financial sector supervision need to specify the relationships among the supervisory agency, any deposit insurance agency, and other financial sector supervisors. In addition, the relationship with the Ministry of Finance needs to be clear and to provide sufficient operational autonomy to the supervisor. If a country has put in place a unified financial supervisory agency, then this arrangement needs to be laid down in a law, and its autonomy and powers need to be explicit.

The legal and regulatory basis of financial supervision should also support the core components of all financial supervisory standards. Those components consist of the following categories:

- Regulatory governance, which refers to the objectives, independence, enforcement, and other attributes that provide the capacity to formulate and to implement sound regulatory policies and practices
- Regulatory practices, which refer to the practical application of laws, rules, and procedures
- Prudential framework, which refers to internal controls and governance arrangements to ensure prudent management and operations by financial firms
- Financial integrity and safety net arrangements, which refer to (a) the regulatory policies and instruments designed to promote fairness and integrity in the opera-

Figure 5.1. Financial Standards and Their Four Main Components

Regulatory Governance[a]

- Objectives of regulation
- Independence and adequate resources
- Enforcement powers and capabilities
- Clarity and transparency of regulatory process
- External participation

Prudential Framework[b]

- Risk management
- Risk concentration
- Captial requirements
- Corporate governance
- Internal controls

Regulatory Practices[c]

- Group-wide supervision
- Monitoring and on-site inspection
- Reporting to supervisors
- Enforcement
- Cooperation and information sharing
- Confidentiality
- Licensing, ownership transfer, and corporate control
- Qualifications

Financial Integrity and Safety Net[d]

- Markets (integrity and financial crime)
- Customer protection
- Information, disclosure, and transparency

a. Includes BCP 1 and 19; ICP 1; IP: 1, 2, 3, 4, 5, 6, and 7.
b. Includes BCP 2, 3, 4, 6, 16, 17, 18, 20, 22, 23, 24, and 25; ICP 2, 3, 4, 5, 12, 13, 15, 16, and 17; IOP 8, 9, 10, 11, 12, 13, and 29.
c. Includes BCP 5, 6, 7, 8, 9, 10, 11, 12, 13, and 14; ICP 6, 7, 9, and 10; IOP 17, 18, 20, 21, 22, 23, 25, and 27.
d. Includes BCP 15 and 21; ICP 11 and 16; IOP 14, 15, 16, 19, 24, 26, 28, and 30.

BCP—Basel Core Principles
ICP—Insurance Core Principles of International Association of Insurance Supervisors
IOP—International Organization of Securities Commission's Objectives and Principles of Securities Regulation

Note: This four-component framework is based on the paper "Financial Sector Regulation: Issues and Gaps" (IMF 2004a). The allocation of insurance principles into various components is based on the 2000 IAIS standard. For a discussion of specific core principles under each standard, see chapters 5.3–5.5.

tions of financial institutions and markets and (b) the creation of safeguards for depositors, investors, and policyholders, particularly during times of financial distress and crisis

Those four components are illustrated in figure 5.1. For example, in the area of regulatory governance, Insurance Core Principles (ICPs) relating to supervisory objectives and supervisory authority require that insurance legislation include a clear statement on the mandates of the supervisory authority and give authority to issue and enforce rules by administrative means. Many of the other criteria and core principles—such as those relating to independence and accountability—could be part of primary legislation or part of regulations and bylaws issued pursuant to the legislation.

The institutional framework for supervision—and the laws that support it—needs to reflect the financial market structure and the broader institutional and policy environment. The institutional framework should be flexible enough to adapt to the shifts in market structure and in the broader environment to avoid regulatory gaps and to support financial innovation and development. For example, a poorly structured organizational

framework for supervision could impede financial innovation or cause overregulation that stifles development. Similarly, an inappropriate organizational structure may cause regulatory gaps and regulatory arbitrage that may allow excessive risk taking and financial instability. An institutional framework for financial stability is, however, quite broad and goes beyond the institutions conducting financial supervision (such as the sectoral supervisor or integrated supervisor or central bank with supervision responsibilities). It includes other institutions and policy authorities that have jurisdictions over the broader financial infrastructure and macroeconomic policies. For example, accounting policies, competition policies, and insolvency regimes are matters outside the jurisdiction of supervision but are critical for financial stability. The broader institutional framework also includes the specific coordinating arrangements to ensure information exchange and policy coordination among all these policy components—supervisory, infrastructure, macroeconomic, and macroprudential—that interact to produce financial stability and financial development. In most cases, the Ministry of Finance will have the overall coordinating powers, and in some cases, there could be specific coordinating committees that bring together representatives of different policy authorities.

The appropriate design of the institutional structure of financial regulation and supervision has become a major issue of policy and public debate in several countries. Although many countries have moved in the direction of a unified agency for prudential regulation and supervision, the case for integrating conduct-of-business regulation and prudential supervision within the same agency is less powerful and considerably less common. Also, the issue of how to tailor the structure of regulation to specific features—operational complexities and transaction characteristics—of regulated institutions has become a pressing issue, for example, in the context of expanding access to the poor or in managing large and complex financial institutions (LCFIs). The issues in assessing the institutional structure are taken up in greater detail in appendix F (Institutional Structure of Financial Regulation and Supervision).

5.2 Aspects of Financial Safety Nets

Financial safety nets consist of three main elements: (a) a framework for liquidity support, (b) deposit insurance plus investor and policyholder protection schemes, and (c) crisis management policies. Each element of the safety net is designed to prevent situations in which the failure or potential failure of individual financial institutions disrupts the intermediation function of financial markets and, thus, the broader economic activity. Facilities for liquidity support attempt to prevent liquidity difficulties in one institution (or market) from being transmitted throughout the financial system. Deposit insurance and other protection schemes are designed to provide confidence to the least-informed depositors and investors with respect to the safety of their funds and thereby avoid spillovers from runs. Crisis management policies are established to minimize the disruption caused by widespread difficulties in the financial sector and thus avoid those difficulties from spilling over into broader economic activity. Therefore, in assessing the adequacy of the financial sector safety net, all three elements, including their legal underpinnings and their interconnections, should be considered.

5.2.1 Frameworks for Liquidity Support

Liquidity support is a key element of the financial sector safety net. Two somewhat distinct functions—one operating at normal times and another in times of crisis—need to be identified. The first is the lender-of-last-resort (LOLR) function, which typically operates in the normal course of day-to-day monetary policy operations. Nearly all central banks have the authority to provide credit to temporarily illiquid, but still solvent, institutions. This kind of support can provide an important buffer against temporary disturbances in financial markets. LOLR actions may help to prevent liquidity shortages in one bank from being transmitted to other financial institutions, for example, through the payment system. LOLR actions are not intended to prevent bank failures but, rather, to prevent spillovers associated with liquidity shortages—particularly in money and interbank markets—from interrupting the normal intermediation function of financial institutions and markets.

All central banks have a LOLR facility in place, but conditions and modalities are often not well defined.[1] Ill-defined conditions may give rise to moral hazard and forbearance, with adverse consequences for the financial system. Thus, an important component in understanding the adequacy of the financial safety net is assessing the adequacy of the central bank's operational procedures for LOLR support.

Somewhat distinct from the normal LOLR function is central bank emergency lending. It is important for central banks to have procedures in place to provide emergency lending, with different modalities and conditions, in times of (imminent) crises. In cases of emergencies, a number of central banks have the legal authority to provide liquidity over and above what is allowed within the normal facility. Having those types of procedures available can be very useful to provide temporary support to the system in times of severe disruptions. However, the very existence of those procedures might lead to moral hazard in banks, causing them to hold less liquidity than they otherwise would do and to take other risks. As a result, the providing of emergency credit is typically at the discretion of the central bank (constructive ambiguity). Nonetheless, internal procedures and policies—a form of contingency planning—should be in place for emergency lending, which should follow sound practices. In particular, the broad principles and the procedures governing the decisions on emergency lending could be established and made transparent.

Key features of emergency lending procedures that should be considered include the following:[2]

- Resources should be made available only to banks that are considered solvent but are coping with liquidity problems that might endanger the entire system (e.g., too-big-to-fail cases).
- Lending should take place speedily.
- Lending should be short term; even then, it should be provided conservatively because the situation of a bank might deteriorate quickly.
- Lending should not take place at subsidized rates, but the rate also should not be penal because it might then deteriorate the bank's position.
- The loan should be fully collateralized, and collateral should be valued conservatively. However, at times of severe crisis, it might be necessary for the central bank

to relax this criterion or to organize government guarantees or to arrange government credit, even if the loan is executed from the central bank's balance sheet.
- Central bank supervisory authorities and the Ministry of Finance should be in close contact and should monitor the situation of the bank.
- Supervisory sanctions and remedial actions should be attached to the emergency lending.

5.2.2 Deposit Insurance

A second key element of the financial safety net is a deposit insurance system (DIS). Although deposit insurance can cause excessive risk taking, a careful design of deposit insurance—complemented by a larger policy package that includes effective supervision, prompt bank resolution methods, and well-designed LOLR procedures—should provide incentives for economic agents to keep the financial system stable.[3]

Good practices that contribute to a proper operation of a DIS include the following:

- The DIS should be explicitly and clearly defined in laws and regulations that are known to, and understood by, the public so bank customers can protect their interests.
- If one is to reduce the probability of moral hazard in banks and to provide incentives for large depositors and counterparty banks to monitor the bank conditions, "large" deposits, including interbank liabilities, should not be covered.
- Ex ante funding schemes are preferable to ex post schemes.
- Membership should be compulsory; insurance premiums should be risk-adjusted, if possible, to moderate the subsidy provided by strong institutions to weaker ones.
- If depositors are to have confidence in the system, the DIS must pay out insured deposits promptly, and it must be adequately funded so it can resolve failed institutions firmly and without delay.
- The DIS should act in the interests of both depositors and the taxpayers who back up the fund. Consequently, it should be accountable to the public, but independent of political interference.
- The DIS should be complemented by effective supervision and well-designed LOLR policies.
- Because the roles of the LOLR, the supervisor, and the DIS are different, it is often advisable in large countries (but impractical in countries facing a shortage of financial skills) to house them in three separate agencies. Regardless, those agencies need to share information and coordinate their actions.
- If the DIS is to avoid regulatory capture by the industry it guarantees, then placing currently practicing bankers in charge of decision making is typically not advisable. However, bankers should be given the opportunity to serve on an advisory board, where they can offer useful advice.
- If a country operates insurance schemes for financial instruments other than (narrowly defined) deposits—including capital market instruments and possibly insurance—then those types of investor and policyholder compensation schemes should

conform broadly to the same standards as deposit insurance, as described in this chapter.

- Although the inclusion or exclusion of foreign currency deposits in deposit insurance would depend on the features of dollarization, adequacy of foreign exchange reserves, and capacity to manage foreign exchange risks, a decision to include foreign exchange deposits should be based on a clear and transparent legal and regulatory framework that specifies who bears the exchange risk.[4]

In a systemic crisis, limited deposit insurance may become ineffective. Other measures such as an extended guarantee (blanket guarantee) could be considered in those circumstances. However, as country experience in systemic crises indicates, a blanket guarantee (a government guarantee for all depositors and certain bank creditors) should be provided only if circumstances are favorable for that guarantee to restore confidence and to stop the crisis from spreading and if there is a credible time-bound exit strategy toward limited guarantee.[5] One crucial condition to restore confidence is that the government's fiscal situation be sustainable.

5.2.3 Investor and Policyholder Protection Schemes

Related to the second element of safety net, deposit insurance, are investor and policyholder compensation schemes, which are designed to promote investor confidence in the functioning of financial markets and to protect policyholders from the failures of financial institutions. They are present in many jurisdictions and form one component of the range of measures adopted by industry associations, self-regulatory organizations (such as stock and futures exchanges), and national authorities. Most schemes are designed to provide some degree of compensation for investors who incur losses from the insolvency or other failure of a member firm; some schemes also provide compensation for losses arising from fraud or other malfeasance on the part of the intermediary or its employees. All schemes have a cap on claims—in absolute terms or as a proportion of the loss incurred or both.

Investor compensation schemes generally cover customer accounts in which a range of investment activities—defined in the respective licensing laws and broader regulatory regimes—take place. Compensation schemes generally do not cover losses on the part of the investor as a result of poor investment advice or management by member firms, although in some schemes, compensation may be available where a causal relationship is established between the poor investment advice or management and the inability of the firm to meet claims made by clients.

In most jurisdictions, the compensation scheme is statutory in nature; however, it may take a variety of forms. Although compensation funds are set up by contract, the obligation to set up and to be a member of one are often in statute. In some cases, schemes are constituted as nonprofit member organizations, whereas, in other cases, the scheme is arranged on the basis of a company operating a fund on behalf of an exchange, the exchange being the principal shareholder of the company. In certain jurisdictions, there are schemes in which trusts—organized on behalf of the various dealer associations and exchanges that are acting as the trust's sponsoring organizations—provide for compensation arrangements. The compensation fund also may be established as a separate company administered by the regulator.

The majority of investor compensation schemes are tailored to individual investors and small business; in some cases, institutional investors are afforded equitable treatment under the terms of the scheme. Generally, the claims cap of the scheme is consistent with the type of investor covered by the arrangements; jurisdictions that provide for both retail and institutional claimants in their schemes have caps that are generally higher than those for compensation schemes that are targeted at retail and small business investors. Some schemes provide for a minimum level of compensation, although the majority set limits on the maximum payment in the event of a successful claim.

Funding arrangements for investor compensation schemes rely to a large extent on levies on member firms. Where levies are imposed, they are generally calculated according to factors such as the gross revenue and net capital of member firms. Other factors may also be taken into account in assessing contributions, including the risk profile and level of activity of the firm. Some schemes set a minimum balance for the fund and have specific arrangements to ensure that the minimum balance is maintained. In some jurisdictions, the scheme does not provide for a reserve fund; rather, levies are raised according to projected costs of the scheme in a given year and calculated on an annual basis. Provisions are usually made in the scheme's rules to ensure that additional funds can be raised in the event of a major default or likely shortfall in funds caused by increased claims.

The adequacy of investor protection measures depends on the full range of regulatory responses in place to minimize investor losses and to protect customer assets in the event of the failure of an intermediary. Those measures include (a) procedures to effect the orderly winding up of a failed intermediary, (b) provisions for the regulator to restrain conduct on the part of a failing or failed firm and to direct the appropriate management of assets held by the intermediary, and (c) capital adequacy requirements that are sufficient to facilitate the protection of customer assets in the event of a firm becoming insolvent. Adequate transparency of the regulator—with respect to the steps taken to deal with the failure of market intermediaries—can promote investor confidence.

Some of the emerging good practices of compensation schemes are noted here. Compensation schemes should be independent and transparent in their operations. They should have open and constructive relations with related agencies or functions—such as a supervisor or an ombudsman or any relevant part of the dispute resolution mechanism—and industry representatives. Compensation schemes should be industry-funded to emphasize that prudential and fiduciary responsibility lies with industry participants. The degree of government backing is likely to vary between jurisdictions, but such backing may increase moral hazard to market participants. Prefunded schemes offer greater certainty of compensation, but pay-as-you-go schemes may be perfectly adequate in disciplined markets. The latter type of scheme (and to a lesser extent, the former) may be required to borrow from time to time. The terms and conditions of this borrowing should be subject to clear limits. Funding levies are usually set at a flat percentage of income. The rate may vary from sector to sector, by size of contributor, or by the degree of financial health of the contributor.

Compensation is made on the defined event of failure or almost certain failure of a financial service provider. Compensation is typically subject to an upper limit that is appropriate for the type of product or market and commensurate with the level of funding. Compensation could be limited to retailers or small, unsophisticated commercial consum-

ers, and the extent to which foreign consumers of domestic products should be compensated should be appropriate to the type of market. Most notably, if a market purports to offer products on an international basis, then compensation should be payable to foreign consumers. Finally, the scheme should adhere to good corporate governance practices, follow strict investment guidelines, and be subject to audit.

Policyholder protection funds act as a financial safety net, often after other avenues for redress have been exhausted (e.g., the bankruptcy process). These funds act to maintain public confidence in the industry by protecting the interest of small entities or uninformed customers and by ensuring a smooth exit mechanism for failing companies. Finally, protection funds help to level the playing field across different sectors.[6]

5.2.4 Crisis Management

A third key element of the financial sector safety net includes the policies and procedures in place to manage crises. An assessment of the adequacy of the safety net should consider the readiness of the national authorities to tackle a systemic banking crisis (ideally, to have in place a contingency plan) in case a crisis occurs. Many country authorities may view the prospects for a crisis as highly remote, and thus, assessments of readiness may help raise awareness of the need to have policies and procedures in place to address a crisis.

Some key considerations in assessing the crisis management framework include the following:

- Is the legal framework during "normal times" robust enough to ensure a smooth banking sector restructuring once a crisis has been contained? This question encompasses a wide range of areas, including the banking law, the bankruptcy procedures, the laws on foreclosing assets, and the quality of the judicial system. Adequate bank insolvency law in normal times is critical to ensure smooth bank restructuring in crisis times.
- A high-level policy committee is needed as soon as it is clear that the crisis has taken on systemic proportions. At that point, it is important to act swiftly and decisively, which requires a high-level body. This body should be at the prime ministerial level (or ministerial level) and should include the head of the central bank and the supervisory agency.
- Although it is impossible to have a contingency plan that covers all contingencies (crises come in different shapes and forms), the authorities should have some views with respect to the types of measures that could be taken to contain an emerging crisis. Time is of the essence at that point, and the measures should be of the type to show that the authorities are in control so confidence will return. Some countries occasionally organize crisis management simulations to increase awareness of potential issues and to resolve logistical impediments to the smooth handling of crises.

Additional discussion of those issues is provided in Hoelscher and Quintyn (2003), Lindgren and others (2000), and World Bank and IMF (2004), especially with respect to

the legal, institutional and regulatory framework to deal with insolvent banks. See also section 5.3.5 for a more detailed discussion of bank insolvency issues.

5.3 Assessment of Banking Supervision

This section presents the core principles that form the basis for assessing the effectiveness of banking supervision, explains the assessment methodology, outlines the recent assessment experience, and discusses selected key issues in supervision: new capital adequacy standards (Basel II), bank insolvency procedures, supervision of large and complex financial institutions (LCFIs), consolidated supervision, and unique risks in Islamic banking.

5.3.1 Basel Core Principles—Their Scope and Coverage, and Their Relevance to Stability and Structural Development

The Basel Core Principles (BCPs) for Effective Banking Supervision, developed by the Basel Committee on Banking Supervision (BCBS), are the key global standard for prudential regulation and supervision of banks. The BCPs provide a benchmark against which the effectiveness of bank supervisory regimes can be assessed. The BCPs consist of a set of five preconditions for a robust financial system and 25 principles governing aspects of supervision (see box 5.1). The 25 core principles cover various aspects of objectives, autonomy, powers, and resources (Core Principle 1); licensing and structure (Core Principles 2–5); prudential regulations and requirements (Core Principles 6–15); methods of ongoing supervision (Core Principles 16–20); information requirements (Core Principle 21); remedial measures and exit policies (formal powers) (Core Principle 22); and cross-border banking (Core Principles 23–25).

The purpose of the BCPs is to strengthen individual banks by ensuring a sound supervisory framework. Assessments of observance of the BCPs help identify areas that need strengthening and that contribute to stability of the financial system (a) directly by improving good supervision and (b) indirectly by promoting a robust financial infrastructure. The BCPs seek to ensure that the supervisor can operate effectively and that banks operate in a safe and sound manner. The BCPs also define the necessary preconditions, including the legal, accounting, and auditing infrastructure; effective market discipline and resolution of problem banks; public safety nets; and sound macroeconomic frameworks that should be in place for effective supervision. The BCP assessments provide useful qualitative information on the risk environment, on the responsiveness of the supervisor, and on the overall effectiveness of risk management.

The BCPs highlight a set of prerequisites relating to regulatory governance and spell out principles and criteria to govern sound regulatory practices, a prudent operational framework, and financial integrity in regulated firms (box 5.1). In particular, Core Principle 1 lays down a number of prerequisites to the effective exercise of supervision such as clear and legally determined terms of reference, independence of supervisor, powers to address deficiencies, information sharing, and confidentiality and legal protection of the supervisor. What is needed to define the scope of banking supervision is a definition of banking and a licensing system to ensure that only the best-qualified institutions are

Box 5.1 Basel Core Principles for Effective Banking Supervision

The Basel Core Principles comprise 25 basic principles that need to be in place for a supervisory system to be effective. The core principles (CPs) relate to the following:

- Objectives, Autonomy, Powers, and Resources
  - CP 1.1* deals with the definition of responsibilities and objectives for the supervisory agency.
  - CP 1.2 deals with skills, resources, and independence of the supervisory agency.
  - CP 1.3 deals with the legal framework.
  - CP 1.4 deals with enforcement powers.
  - CP 1.5 requires adequate legal protection for supervisors.
  - CP 1.6 deals with information sharing.
- Licensing and Structure
  - CP 2 deals with permissible activities of banks.
  - CP 3 deals with licensing criteria and the licensing process.
  - CP 4 requires supervisors to review—and have the power to reject—significant transfers of ownership in banks.
  - CP 5 requires supervisors to review major acquisitions and investments by banks.
- Prudential Regulations and Requirements
  - CP 6 deals with minimum capital adequacy requirements. For internationally active banks, the requirements must not be less stringent than those in the Basel Capital Accord.
  - CP 7 deals with the granting and managing of loans and the making of investments.
  - CP 8 sets out requirements for evaluating asset quality and the adequacy of loan-loss provisions and reserves.
  - CP 9 sets forth rules for identifying and limiting concentrations of exposures to single borrowers or to groups of related borrowers.
  - CP 10 sets out rules for lending to connected or related parties.
  - CP 11 requires banks to have policies for identifying and managing country and transfer risks.
  - CP 12 requires banks to have systems to measure, monitor, and control market risks.
  - CP 13 requires banks to have systems to measure, monitor, and control all other material risks.
  - CP 14 calls for banks to have adequate internal control systems.
  - CP 15 sets out rules for the prevention of fraud and money laundering.
- Methods of Ongoing Supervision
  - CP 16 defines the overall framework for onsite and offsite supervision.
  - CP 17 requires supervisors to have regular contacts with bank management and staff and to fully understand banks' operations.
  - CP 18 sets out the requirements for offsite supervision.
  - CP 19 requires supervisors to conduct onsite examinations or to use external auditors for validation of supervisory information.
  - CP 20 requires the conduct of consolidated supervision.
- Information Requirements
  - CP 21 requires banks to maintain adequate records reflecting the true condition of the bank and to publish audited financial statements.
- Remedial Measures and Exit
  - CP 22 requires the supervisor to have—and promptly apply—adequate remedial measures for banks when they do not meet prudential requirements or when they are otherwise threatened.
- Cross-Border Banking
  - CP 23 requires supervisors to apply global consolidated supervision over internationally active banks.
  - CP 24 requires supervisors to establish contact and information exchange with other supervisors involved in international operations, such as host country authorities.
  - CP 25 requires (a) that local operations of foreign banks are conducted to standards similar to those required of local banks and (b) that the supervisor has the power to share information with the home-country supervisory authority.

* CP 1 is divided into six parts.
Source: BCBS (1999).

permitted into the market. The public needs to be aware of which financial institutions are banks and that, as banks, they are subject to supervision. Consequently, the use of the word "bank" needs to be limited to licensed institutions. Those issues are dealt with in Core Principles 2 and 3.

The quality and integrity of the bank's owners and management are crucial elements in longer-term safety and soundness of the bank, and they need to be vetted by the supervisory authorities. Without clear insight into the structure of the group to which a bank belongs and its acquisitions of interests in other companies, supervisors may not be able to adequately monitor the risks. Core Principles 3, 4, and 5 address those questions. Core Principle 6 requires that banks be subject to rules regulating the adequacy of their capital buffer against risks in the asset portfolio, a key requirement for safe and sound banking. Core Principles 7–11 broadly relate to the quality of lending procedures, the adequacy of provisions (without which capital adequacy figures are overstated), the concentration risks, the risks in lending to connected parties against which contract enforcement may be difficult, and the risks in lending abroad. Core Principles 12 and 13 relate to risks with respect to open positions in securities, currencies, and fixed-income instruments. Good internal systems to monitor and manage risks, as required in Core Principle 14, are also of key importance because bank management is primarily responsible for the stability of the institution and needs to be able to rely on its own information and control systems. Core Principles 16–20 relate to the need for the supervisory authority to have reliable and comprehensive information on the operations and financial condition of a bank. Without this information, monitoring and timely corrective action are not possible. Related to this need, but with a broader objective of informing the markets and the public, is the requirement in Core Principle 21 to disclose audited consolidated annual financial statements that are prepared according to internationally acceptable accounting standards. The supervisory authority must have the means to preempt threats to the stability of financial institutions through timely corrective actions, as envisaged in Core Principle 22. The remaining Core Principles 23–25 relate to the effective monitoring of groupwide risks, the creation of an overview of the financial condition of the group as a whole, and the associated cross-border supervisory cooperation.

Transparency of supervisory framework and policies can contribute to effective supervision. Although the transparency of supervision is not explicitly covered in the BCPs, good transparency practices are covered in IMF Code of Good Practices on Transparency in Monetary and Financial Policies (IMF 2000). Supervisory policies and their implementation need to be disclosed to the public, for instance, through annual reports of the supervisory agency or through dedicated chapters in central bank annual reports. Web sites of supervisory agencies can be used to disseminate annual reports and other periodicals and can serve as a repository for banking laws and regulations. For additional suggestions and guidance on transparency practices, reference is made to the "Supporting Document" of the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies* (IMF 2000).

Good BCP observance has a clear and positive effect on financial sector stability because it helps to ensure that the risks in the banking system—which, in many countries, is by far the most important component of the financial system—are adequately monitored and that tools are in place to manage the risks. If the BCPs are properly implemented and

if the preconditions are satisfied, then supervisory authorities have the means to remove weak institutions from the market and to preempt more extensive damage to the banking system. Although risks in banking institutions may also arise from macroeconomic and external shocks (e.g., liberalization-induced credit booms or a foreign exchange crisis), good BCP observance can help manage the effect of the shocks by constraining excessive buildup of exposures to risk factors.[7]

The links between observance of the BCPs and financial development are complex and multifaceted. At one level, the preconditions for observing the BCPs (discussed in section 5.3.2) are also conditions that facilitate financial stability and help to promote financial development. Beyond the preconditions, the observance of best practices of supervision and regulation can also promote strong governance and better risk management, as well as generate more efficient and robust institutions, markets, and infrastructure. In turn, this strengthening of institutions can help promote sustained economic growth. However, the precise mechanism through which this effective operation can occur is far from clear because it also can be the case that developments in the regulatory infrastructure arise in response to financial development. This situation can arise when market participants see that the public good aspects of financial stability outweigh the compliance costs of a stronger regulatory framework so a constituency in favor of a strong regulatory framework emerges.

The key area in supervision that is directly relevant to the ability of banks to contribute to sustainable economic growth relates to implementation of capital adequacy standards and appropriate loan evaluation, as well as provisioning policies and practices. The rules on capital adequacy in a jurisdiction determine the relationship between banks' capital and their loan and investment portfolios and, therefore, limit the amount of loans and investments banks can make against the amount of regulatory capital they hold. When provisions for losses on assets are not adequate, a bank will overstate its capital and thus its capacity to intermediate funds. When a correction needs to be made, the action will instantly decrease the intermediation function of the institution. If this dynamic occurs on a large scale, for instance, as a result of more widespread banking sector problems in an economy, then the result can be a credit crunch, which can have fiscal consequences related to costs of bank resolution, including deposit protection.

Specific institutional features of the banking system need to be taken into account in applying the BCPs and in designing regulatory policies. For example, increasingly, the presence of LCFIs with significant international operations requires an analysis of cross-border exposures to risks and an integrated management of risks across business lines. In some countries, state-owned commercial banks play an important role in the countries' financial systems. In many cases, the weak profitability, governance, and efficiency of those institutions become a cause for concern. The factors may not immediately pose a risk to the banking sector insofar as the implicit guarantee of their liabilities serves to maintain confidence, but they can distort incentive structures and can slow down the growth of a viable commercial banking sector with more rigorous risk-management policies. Better risk-management policies with strong underwriting standards also impose discipline on banks' borrowers to the benefit of the overall quality of the assets portfolio. Also, the balance between the scope of official supervision and the extent of market discipline would vary among countries. The approaches and tools to observe the BCPs

may be strongly influenced by the extent to which the overall policy environment and the supervisory policies themselves tend to harness market forces and bring about good governance of banks. For an analysis of the importance of bank supervisory and regulatory policies that facilitate market discipline, see Barth, Caprio, and Levine (2004). In addition, the appropriate balance between official supervision and market discipline could change over time, depending on the extent of stress in the banking system, which might affect the incentives for risk taking.

5.3.2 Preconditions for Effective Banking Supervision

The BCPs include five preconditions for effective supervision. Although preconditions are not formally part of the BCPs because they are normally beyond the jurisdiction of bank supervisors, "weaknesses or shortcomings in these areas may significantly impair the ability of the supervisory authority to implement effectively the Core Principles" (BCBS 1999), the preconditions are as follows:

- Sound and sustainable macropolicies (the precondition that has the most significant effect on risk exposures and capital adequacy)
- A well-developed public infrastructure that covers contract enforcement, a general insolvency regime, an accounting framework, and a corporate governance (all of which affect supervisory powers and enforcement)
- Effective market discipline that is based on transparency and disclosure (which affects the quality of prudential framework)
- Procedures for effective resolution of problem banks
- Mechanisms for providing either an appropriate level of systemic protection or a public safety net (which, along with the preceding precondition above, affects supervision of market conduct and enforcement of corrective actions)

The 2002 evaluation of the experience with the Financial Sector Assessment Program (FSAP) in 60 countries[8] drew attention to the importance of effective preconditions for bank supervision during recent banking crises. In many of the countries experiencing crises, these preconditions were not sufficiently met. It is also noted that "compliance with the BCP is positively correlated to compliance with the preconditions and the stage of development of the financial sector"(IMF and World Bank 2002b). It was stated that developing countries generally are characterized by less favorable preconditions, including unstable macroeconomic conditions, inadequacies of the laws and judicial systems, weak credit culture and accounting systems, low disclosure, and incipient or nonexistent safety nets.

In view of these arguments, the evaluation emphasized the need for assessing the preconditions for effective banking supervision more explicitly in the context of an FSAP process and the BCP assessment. It continued to explain that a more structured approach to their evaluation could improve the analysis of the BCPs. It could furthermore enhance the discussion within an FSAP of linkages between the macroeconomy, the condition of the banking sector and the effectiveness of supervision.

Although an in-depth assessment of some of the preconditions may be beyond the scope of a BCP assessment, an effort should be made to present not only the weaknesses

and shortcomings with respect to those preconditions but also the effect they may have on the effectiveness of supervision and on the soundness of the financial system. Emphasis could be placed on the following issues:

- Although the assessment of macroeconomic policies remains in the purview of the broader surveillance, the assessor can focus on identifying vulnerabilities and risks associated with macroeconomic policies both for the financial system and for the effectiveness of bank supervision. Assessors should note whether supervisors have the capacity to assess those vulnerabilities and risks and to what extent the risks can be controlled by supervisors or by banks.
- To assess the adequacy of public infrastructure, the BCP assessors can draw from the conclusions of assessments of financial infrastructure, where available. Using that information, the assessors could note weaknesses in the credit culture, the level of creditor protection, the effectiveness of the judicial system, the bankruptcy procedures, the accounting standards, the auditing profession, and the level of information disclosure to the public.
- An assessment of the strength of market discipline needs to consider (a) issues of transparency, including quality, timeliness, and clarity of the information available to the public; (b) issues of corporate governance; and (c) the role of the government in the financial system and the set of incentives that may weaken market discipline.
- The adequacy of procedures to address problem banks and the effectiveness of the safety net fall within the scope of the BCP assessment and should be examined while assessing Core Principles 1 and 22. In this regard, the assessor should focus on whether supervisors have a sufficient and flexible range of procedures to achieve the efficient resolution of problems in banks, including the capacity to conduct an orderly resolution with respect to problem banks. For the assessment of the safety net, examiners should focus on the existence and design of the deposit insurance and lender-of-last-resort facilities.

In many cases, assessing the weaknesses and shortcomings in the preconditions for effective bank supervision may be time consuming and difficult, demanding a high degree of coordination of different agencies and branches of the government. Important issues of priorities and sequencing arise when trying to prepare a road map to address weaknesses in prudential aspects and preconditions for effective supervision. The question of whether shortcomings in preconditions should be addressed before addressing prudential weaknesses is not a trivial one. Coordination, prioritization, and sequencing of various reforms of infrastructure, supervision, and market and institutional development require careful consideration of the effect on financial stability and the technical interlinkages among various reform components that affect implementation.[9]

5.3.3 Assessment Methodology and Assessment Experience

BCP assessments are a form of peer review that helps to (a) identify regulatory strengths, risks, and vulnerabilities; (b) assess the level of observance of financial sector standards; (c) ascertain the financial sector's developmental and technical assistance needs; (d)

prioritize financial sector policies; and (e) provide a reform agenda for improving the supervisory system.[10] Furthermore, standards assessments support the analysis in the context of an analysis of the macroeconomic and structural risks affecting domestic financial systems.

A BCP assessment involves an examination of the adequacy of the legislative and regulatory framework and a determination of whether supervisors are effectively supervising and monitoring all of the important risks taken by the banks. The assessment should follow the guidance provided in the Core Principles Methodology by the Basel Committee on Banking Supervision (BCBS 1999).[11] To achieve full objectivity, compliance with each principle is best assessed by a suitably qualified outside party consisting of at least two individuals with varied perspective so as to provide checks and balances.

Each principle is assigned criteria that are relevant for compliance with it. Two categories of criteria are used: "essential criteria" and "additional criteria." The essential criteria are those elements that should be generally present in individual countries for supervision to be considered effective. Typically, essential criteria specify certain policies and procedures that supervisors are expected to follow to comply with a core principle. The additional criteria are elements that further strengthen supervision and that all countries should strive to implement to improve financial stability and effective supervision. Additional criteria may be particularly relevant to the supervision of more sophisticated banking organizations or may be needed in instances where international business is significant or where local markets tends to be highly volatile.

If one is to achieve full compliance with a core principle, the essential criteria generally must be met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the core principle has been achieved through different means. Conversely, because of the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the principle. Therefore, additional criteria or other measures may also be needed for the particular aspect of banking supervision addressed by the principle to be considered effective. Altogether, there are 227 essential and additional criteria.

As an example of the assessment process and the role of different criteria, consider the case of Core Principle 1. For this principle, each subprinciple is assessed separately. A "compliant" grading for Core Principle 1, for instance, requires that the essential criteria mentioned in the methodology be met, namely, that laws are in place and that responsibilities are clearly defined, that minimum prudential standards are in place, that defined mechanisms exist for coordination, and that those mechanisms are actually used.[12] Furthermore, supervisors should have a role in deciding on resolution of banks, and laws should be updated as needed. Assessment of compliance with those criteria would, for instance, require obtaining and reading the texts of the relevant laws and including the citations in the assessment report. If one is to assess whether responsibilities are, in fact, clear, then information could be obtained on whether agencies cooperate effectively or whether turf issues arise frequently. Do annual reports of various agencies cover the same ground, or are they complementary? Are prudential regulations readily accessible, and do they cover the main prudential areas? If one wishes to review which areas are essential, the list of publications on the Basel Committee's Web site could be consulted to obtain an impression of which areas have been considered important. Coordination mechanisms

should be established by a formal decision of the authorities and laid down in some form of decree or similar instrument. This decree should also define the mechanics of coordination, the exchange of information, the procedures for dealing with confidentiality issues, and similar issues. The authorities should provide to the assessors descriptions of how recent bank resolutions were handled, showing, in particular, what role the supervisory authorities had played.

5.3.3.1 Key Considerations in Conducting an Assessment

Consistency to the extent possible, fairness, and objectivity are key, but the primary objective of the assessment remains, not to compare a country's performance with others, but to identify and to address individual countries' strengths and weaknesses. Consistency—defined as a uniform approach to assessments and avoidance of contradictions in assessment grading—is reinforced through the use of assessment methodologies and assessment guidance notes and through the review of draft assessments by other experts. "Calibrating" the BCPs or modifying the assessment criteria to country-specific factors would, however, be contrary to the Basel Committee's intended objective of viewing the BCPs as a standard to be universally adopted and implemented. The quality of the assessment is enhanced when the "four eyes" approach is used—that is, the reliance on two experts with a mix of skills and backgrounds—because it helps mitigate the risk of individual bias.

A well-prepared self-assessment—including the summaries of the relevant legal and regulatory texts, as well as a thorough description of the institutional framework and supervisory practices—is essential. The assessors should meet with the authorities, banks, and other agencies and private sector counterparts. Relevant issues should be discussed not only with the supervisors but also, for instance, with other regulators, the Ministry of Finance, and the representatives from the central bank, as well as from the private sector (e.g., bankers, insurance companies, securities market participants, external rating agencies, and external auditors).[13]

The assessor may need to take into account the countries' level of development while assessing the supervisory prerequisites (Core Principle 1). Differences in prerequisites are likely to have a bearing on the detailed principle-by-principle assessment. For example, when assessing how the collateral value is accounted for in prudential regulations, assessors will have to consider the efficacy of the legal system and whether or not enforcement of regulatory and judicial decisions is problematic. Assessors should reflect the country-specific factors in the "comment" section of the assessment template, and deficiencies can be incorporated in a forward-looking, sequenced action plan. Any considerations relating to the level of development and country-specific circumstances should be reflected fully in the "comments" section of the assessment templates and in the "recommended action plan."

5.3.3.2 Assessment Experience[14]

A review of FSAP experience with BCP assessments reveals areas of strengths and weaknesses (see table 5.1). Notwithstanding better overall performance of industrialized

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Table 5.1. Observance of Basel Core Principles for Effective Banking Supervision

Core principle (number and main topic)	*Issues raised by assessors*
1.1 Framework for supervisory authority/ objectives	Fragmented responsibilities; unclear role of external auditors
1.2. Independence	Political interference in licensing and remedial measures; forbearance; insufficient legal protection; weak autonomy; insufficient staffing.
1.3. Legal framework	Insufficient basis for cooperation and information exchange, also with foreign supervisors.
1.4. Enforcement powers	Legal basis inadequate or overly rigid; forbearance, court intervention, need to consult political authorities.
1.5. Legal protection	Rules on legal protection not explicit, inadequate or absent; no rules on legal expenses; accountability concerns.
1.6. Information sharing	Lack of legal basis or formal agreements; rigid confidentiality constraints, MOUs not implemented in practice.
2. Permissible activities	No authority to act against unauthorized banks; laws unclear on licensing requirements; no protection of the word "bank."
3. Licensing criteria	Reputation of managers not tested; inadequate fit and proper tests, refusal to grant license can be appealed at Ministry of Finance; foreign supervisors not contacted; political interference.
4. Ownership	Prior supervisory approval not required; no fit and proper test for shareholders; no definition of significant ownership, nor qualitative criteria to determine ownership.
5. Investment criteria	No approval authority; inadequate definitions of investments requiring approval; no criteria for impairment of supervision resulting from acquisitions.
6. Capital adequacy policies	No calculation on a consolidated basis; no market risk charges, inadequate risk weightings, inappropriate capital components.
7. Credit policies	Insufficient supervisory guidance on credit policies; no rules on arm's length lending; unclear board and management responsibility for credit policies; no dissemination of policies to staff; insufficient supervisory monitoring.
8. Loan evaluation	Insufficiently rigorous loan classification and provisioning rules, insufficient monitoring, no cash flow based assessment, rules too lenient on use of collateral, restructured or evergreened loans, no tax deductibility for specific provisions, off–balance sheet items not included.
9. Large exposures	Exposures not reported/monitored on a consolidated basis, inadequate and/or overly rigid criteria to establish group connections.
10. Connected lending	Regulations absent or without sufficient legal basis; inadequate/overly rigid definitions of connectedness.
11. Country risk	Absence of regulations, usually because banks have little or no exposure.
12. Market risk	Absence of regulations, or inconsistency with Basel guidance, usually because banks have little or no exposure; no supervision on a consolidated basis, weak or no enforcement.
13. Other risks	Absence or inadequacy of rules on risk management, absence of guidelines on interest rate, liquidity and operational risk; inadequate supervisory capacity.
14. Internal control	Inadequate or no standards, unclear responsibilities of management for internal controls, examination mandate inadequate, no rules on corporate governance.
15. Anti-Money laundering	Inadequate or no legal framework.
16. On-site and off-site supervision	Inadequate frequency of visits, staff shortages, insufficient skills, no risk-based supervision, unclear objectives.
17. Contacts with bank management	Insufficient frequency, no clear procedure to maintaining contact.
18. Off-site supervision	No supervision on a consolidated basis, reporting framework not set by supervisor, non-bank affiliates not covered, inaccurate reporting.
19. Validation of information	Inadequate response to weak audits, no control over external auditors, insufficient frequency of inspections.
20. Consolidated supervision	No requirements on consolidation or consolidated supervision, no legal basis to require consolidated reporting, scope of consolidation too limited, e.g., not covering non-bank affiliates, no reporting of related interests.

Table 5.1. (continued)

Core principle (number and main topic)	Issues raised by assessors
21. Accounting	Standards do not comply with IAS, supervisor has no authority to set bank accounting standards.
22. Remedial measures	Insufficient legal basis, enforcement ineffective, forbearance, limited range of measures, proactive action not possible, court intervention.
23. Global consolidation	Scope too limited, no supervision on a consolidated basis, insufficient authority to oversee foreign banks, insufficient information exchange and MoUs.
24. Host country supervision	No formal arrangements for contacts with home supervisors, little contact in practice, confidentiality constraints.
25. Supervision of foreign establishments	Insufficient exchange of information, insufficient MoUs, no inspection authority for foreign supervisors.

Source: IMF 2004a.

countries, similarities in relative strengths and weaknesses exist across all country income groups (industrialized, developing, and emerging). It is significant to note that, in all countries, the broad area of credit risk management has relatively low rates of compliance. Principles relating to the overall foundation for supervision (i.e., the legal and regulatory framework, licensing, and supervisory practices) are relatively well observed when compared with the principles on credit policies, loan evaluation, and risks related to country, market, and other variables. These are areas that affect banks' condition most directly, and their relatively low observance is a matter of concern.

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

The experience of assessments to date indicates that developing countries generally show lower levels of compliance with the BCPs, whereas many transition countries have intermediate levels of compliance. Advanced economies generally satisfy the preconditions more robustly and achieve the highest level of compliance overall. Compliance with the BCPs is positively correlated with observance of the preconditions and the stage of development of the financial sector.

In general, the main areas of weakness identified by assessments of observance of the BCPs relate to supervisory independence, legal protection for supervisors, and information sharing with other supervisors. Compliance with respect to the principles on credit policies and connected lending, as well as the practices relating to loan classification and provisioning, also appears to be low. Consolidated supervision, especially for large complex financial institutions, is another area of weakness that has been identified in

assessments performed to date. The rules on anti-money-laundering and combating the financing of terrorism (AML–CFT) need to be more strongly implemented, as do prompt and effective remedial measures. Finally, systems for managing country risk and market risk were identified as needing improvement in many countries that were assessed.

5.3.4 Basel II

The 1988 Capital Accord (Basel I) introduced capital adequacy measures for credit risk that were based on risk weights assigned to different classes of bank exposures. It was originally intended to be applicable to internationally active banks in the G-10 and other member countries (Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom, and United States) of the Basel Committee on Banking Supervision. However, the framework was quickly adopted by national supervisors almost universally, making it an international standard. Subsequently, a capital measure for market risk introduced in 1996 has also met with wide acceptance, though it has not been as widely implemented. Nevertheless, significant deficiencies began to surface in the application of Basel I. The use of a uniform 100 percent risk weight for all commercial credits regardless of the risk profile of individual exposures led to distortions. Similarly, the treatment of cross-border and interbank claims also caused biases in credit allocation. Moreover, rapid changes in risk-management technology, including the increasing use of credit risk transfer instruments, needed to be recognized. The factors were among those that led to the development of a new capital accord.

The New Capital Framework (Basel II) represents a significant improvement over the original accord and seeks to provide more risk-sensitive methodologies to align capital requirements with riskiness of banks assets. Under Basel II, the risk weights can be determined using different approaches based on ratings either assigned to bank exposures by external agencies (standardized approach) or internally assigned through supervisor-validated, value-at-risk (VAR) approaches using default probabilities (internal-ratings-based [IRB] approaches). Extensive guidance has also been provided on the expanded credit risk mitigation techniques and their application, as well as on the treatment of securitization and specialized lending. The methodology for market risk capital has been kept almost unchanged while a new capital charge for operational risk has been introduced. Apart from laying out different approaches of varying degrees of sophistication, the Basel II framework also provides for a high degree of national discretion. In addition to laying out methodology to compute minimum capital requirements (Pillar I), the new Basel framework also incorporates guiding principles on the supervisory review of bank risk management (Pillar II) and promotes market discipline through enhanced disclosure requirements (Pillar III).

Member countries of the Basel Committee are expected to implement the Basel framework beginning at the end of 2006. Both the existing and new systems will be run in parallel for a year. While most European Union (EU) countries are expected to implement Basel II in full for their banking systems, many other countries can be expected to implement a mixture of Basel I and Basel II for different parts of their banking systems. Thus, after 2007, assessors can expect banking systems to be applying a bifurcated stan-

dard. The assessment of this bifurcated standard will be made further challenging by the fact that there are several different approaches in Basel II for both credit and operational risk, as well as for several areas of national discretion in Pillar I, which could affect cross-institution and cross-country comparisons of capital regimes.

In the period before implementation, national authorities are beginning to examine more closely the various options, as well as the necessity and possibility of applying them. National authorities are also under pressure from the banks in their jurisdictions to refrain from taking actions that would raise capital requirements or increase costs for the system; the banking supervisors are worrying about the lack of capacity to deal with the technical issues in the new Basel framework. International banks face the possibility of being subject to multiple capital regimes through national requirements in different jurisdictions, the resolution of which will require the development of effective systems for cooperation between home and host country supervisors. In contrast, local banks in developing countries are apprehensive about competitive concerns because they fear that foreign banks could gain advantage from using the more advanced approaches that could lower groupwide capital requirements.

Effective implementation of the new capital framework will promote better risk-management practices, more risk-focused bank supervision, and stronger market discipline. However, the framework has been written with the internationally active G-10 banks in mind. Many jurisdictions may not find the proposals easy, or even relevant, to implement. Further, there are other supervisory priorities to be addressed in many countries, and weak implementation may not provide the required comfort but, instead, may divert scarce supervisory and other resources. For this reason, a good level of compliance with the BCPs is considered to be a precondition to considering Basel II implementation.

The Fund, together with the Bank and other international donors, would develop technical assistance programs for countries that seek assistance to implement some or all parts of the new Basel framework within the constraints of available budgets. Finally, countries will not be assessed under the BCPs on the basis of whether or not they have chosen to implement Basel II, but will be assessed against the standard that they have chosen to apply, be it Basel I or Basel II.

5.3.5 Bank Insolvency Procedures: Emerging Bank-Fund Guidelines

Effective bank insolvency procedures form an essential part of the supervisory framework and are also part of a proper financial safety net. Effective procedures help in reducing moral hazard. An analysis of the effectiveness and appropriateness of bank insolvency procedures and exit policies is an important part of BCP assessment. Experience indicates that, in many countries, those types of procedures are weak, opening the door to interference and forbearance.

The World Bank and the IMF have developed a (draft) document titled "Global Bank Insolvency Initiative," (IMF and World Bank 2004),[15] which documents practices around the world in the area of insolvency procedures. Although not a "best practices" document (given the diversity of judicial approaches around the globe, it is premature to develop best practices), this document could certainly be used to check country practices and to provide advice.

When authorities face problem banks, the general principle is that the authorities should take prompt action to restore them to health. The supervisors should have the authority to identify unsafe and unsound banking practices and then to require that those practices be halted. Supervisors should be able to apply a series of corrective measures and penalties with increasing severity. If deterioration continues, supervisors should close, merge, or otherwise resolve issues in troubled banks expeditiously before they become insolvent. Increasingly, countries are basing supervisory corrective action on a legal obligation to take specific actions ("prompt corrective action" specifically identified in the law) against a bank as capital levels fall below values established in the law. Prompt action reduces the likelihood that a failing bank will engage in risky and potentially expensive gambles for redemption.

Supervisors need good information on the condition of individual banks so they can take appropriate action. Appropriate disclosure of information to the public would support market discipline. These general issues should come out of the BCP assessment, particularly in Core Principle 22. However, the core principles do not deal specifically with insolvency proceedings other than in the preconditions. That is where the Bank-Fund document on bank insolvency (IMF and World Bank 2004) becomes useful. When making an assessment, assessors should bear in mind that legal and judiciary systems and traditions differ widely among countries. When a bank develops severe financial difficulties, it will have to be either restructured or liquidated. The legal and institutional features that should be in place to allow for orderly restructuring or liquidation are discussed in appendix G (Bank Resolution and Insolvency) and are summarized next. The broader legal environment for effective insolvency procedures is outlined in Annex 5.A.

A special bank insolvency regime, or suitable modifications of a general corporate insolvency regime, is needed to reflect the potential systemic effects of bank failures that call for prompt actions, effective protection of bank assets, and the key role of the banking authorities in bank insolvency proceedings. A typical immediate first step is to have an official authority assume direct managerial control of an insolvent bank (insolvent either in a regulatory sense or in a balance-sheet sense) with the goal of protecting its assets, assessing the true condition, and arranging or conducting either restructuring or liquidation. Official administration continues until the institution has been restored or placed in liquidation. The key principles governing official administration, bank restructuring, and bank liquidation are further discussed in appendix G. One of the key principles is that the authorities should choose the bank resolution option that costs the least. In particular, the cost of bank restructuring should be viewed in terms of net outlays on recapitalization and other assistance operations after deducting the proceeds from reprivatization and asset recoveries. When restructuring is not feasible or when it involves spinning off the viable operations of the bank and, thus, leaving behind only the nonviable part, then the bank will have to be liquidated.

In this process, the supervisory (licensing) agency should have the authority to withdraw a bank's license on the basis of clearly defined criteria. Such criteria include (a) noncompliance with the conditions under which the license was initially granted (in particular, when management is no longer fit and proper), (b) failure to meet prudential requirements, (c) failure to make payments, (d) following of unsafe and unsound banking

practices, and (e) criminal activities by the bank. The supervisor could also be given the responsibility to establish the list of qualified liquidators.

Unless the supervisory authorities or some other government agency (such as a deposit insurance fund) is responsible for resolving the problems of insolvent banks, the liquidator will be appointed by the courts, which oversee liquidation. Any deficiency in the court process that could impede bank liquidation should be identified. The authorities should have contingency plans to deal with the emergence of systemic banking problems or large-scale bank closures. Plans should include ways to protect the payments system and to maintain basic banking services. The authorities should also have an idea of how to organize the restructuring efforts, including which institutions would be charged with guiding the restructuring efforts. In addition, the authorities should evaluate the legal framework for bank supervision and regulation to ensure that the authorities have the necessary powers to act quickly and efficiently in the face of a systemic crisis.

5.3.6 Large and Complex Financial Institutions[16]

The activities of large and complex financial institutions (LCFIs)[17] raise issues of cross-sectoral and cross-border transfer of financial risks that are especially relevant to a comprehensive assessment of the strengths and weaknesses of financial systems and their supervision. An LCFI is likely to have the following characteristics:

- An LCFI will be an important player in both wholesale and retail financial markets and in substantial international operations, regionally or globally. In some cases, these operations could dwarf its business in the country under consideration.
- The group may have its headquarters in the country or may be based abroad. In the latter case, it will have a significant local presence in the form of branches or locally incorporated subsidiaries (perhaps including local holding companies). The legal form of its local presence may have important implications for the way it is regulated.[18]
- The group's international and domestic business will span a number of financial activities including commercial banking and other lending, such as the origination and securitization of credit; securities trading, dealing and underwriting, mergers and acquisitions, and other capital market activity; life and general (property and casualty) insurance; and custody and asset management. In some cases, the operations of the wider group may include significant industrial and other nonfinancial activities.
- The group is likely to be prominent in the local payments, clearing, and settlements structure.

As a consequence of the characteristics of an LCFI, the group's liabilities will reflect very diverse sources of local and cross-border funding and reserves, while its assets will include a full range of marketable and nonmarketable financial instruments held locally and abroad. Off-balance sheet items are likely to be particularly prominent and to reflect complex funding, plus hedging and speculative trading strategies, all of which are carried out in both over-the-counter (OTC) markets and on organized exchanges. The group is likely to comprise many different legal entities, and the link between those entities and

its internal management structure may appear complicated or even opaque. Complexity or opaqueness in organizational structures could be a potential source of risk, as well as raising issues for supervisory and central bank coordination.

The group's activities may be subject to numerous different national legal and insolvency, accounting, tax, and regulatory regimes, which will influence the management of its business and balance sheet. The group may or may not have an overall lead supervisor monitoring its activities on a consolidated basis. At the host country level, responsibility for supervision of an LCFI's local affiliates may reside within a single regulator or several functional regulators. The size of the group and of its geographical diversification has the potential to threaten financial stability in several countries and markets. Its operations will thus be of concern both to its many financial regulators and also to the central banks and guarantee agencies that could be involved in providing or facilitating liquidity or other official financial support.

The presence of foreign-owned LCFIs in the domestic financial market may not raise particular issues for local financial stability, when their share of local banking, securities, and insurance markets is small and when the nature of their local business is straightforward. While local and foreign affiliates of wider LCFI groups may well be counterparties in foreign exchange and OTC derivatives transactions of local financial institutions, this need not warrant any special analysis, absent any significant concentrations of exposure. Conversely, there may be cases where an internationally active institution has such a large share of the local market or is such a significant counterparty of local financial institutions that its failure could constitute a serious local systemic risk. In such instances of high concentration, an understanding of the wider operations of the group, its reputation, and the risks of its business should be important in assessing potential threats to financial stability.

In relation to LCFIs, there are clearly limits to the scope of assessments at the level of individual countries. Country assessments can be expected to cover only part of the activities of LCFIs, given the international nature of such. Even if local supervision of an LCFI is effective in identifying and mitigating local risks as far as possible and if there is good cooperation with the LCFI's home regulator(s), a host country is unlikely fully to escape the effects of a failure. The assessment process should focus mainly on those aspects over which the countries' authorities can reasonably be expected to exert an influence.

An examination of LCFIs can be approached in three stages, followed by a summary of the main risks identified and recommendations to the authorities:

- Stage I involves the identification of the scope and scale of LCFIs' activities within the local financial system. An assessor will want to seek data on market shares of prominent, internationally active, financial institutions to determine if a focus on LCFI activities is warranted. Where one or more LCFIs have been identified as having particular significance for local systemic stability, more detailed firm-specific information on the legal entity and organizational structures, the nature of intra-group exposures, the main sources of earnings, and so forth may then be needed to provide a sufficiently detailed map of their activities to identify the main channels of systemic risk. For some internationally prominent LCFIs, it may

be possible to draw on information gathered from other assessments conducted for other countries.

- Stage II involves an assessment of the major systemic risks arising from the activities of LCFIs. Emphasis should be placed on the extent and nature of both intragroup transactions and the exposures of other domestic institutions to LCFIs. Key concerns will be not only potential direct losses in the event of an LCFI failure but also contagion risks. The approach suggested here is that this assessment be built up by considering credit, technical,[19] liquidity, market, and operational risks from the different businesses of the group. LCFIs' participation in local payment and settlement systems should also form a significant part of the analysis. Drawing on the preceding qualitative identification of risks, the assessor may also want to quantify the risks by considering further stress testing or scenario analyses.
- Stage III involves an assessment of the effectiveness of the authorities' policies and practices in addressing the risks. This stage should include a review of group capital adequacy, the regulation of large exposures and of intra-group transactions, and the extent and effectiveness of information sharing between local and foreign supervisors. Oversight of the role of LCFIs in local payment and settlement systems should also be considered.

Given the potential of LCFIs to be a conduit in the transmission of internal and external shocks, the authorities' approach to surveillance—the identification of potential systemic risks from the activities of LCFIs—should be a prominent part of the assessment. The assessment team may want to assess the effectiveness of stress testing and scenario analyses that are conducted by the authorities and that may be complemented by work conducted by the team itself as part of Stage II. The state of preparedness for managing a crisis arising from a domestically headquartered LCFI that is in difficulties or from the failure of a major foreign, internationally active institution that threatens local financial stability is an important issue for supervisors to consider.

5.3.7 Consolidated Supervision

Consolidated supervision is a supervisory tool that was developed in response to the growing trend in financial institutions of diversifying their activities across national borders and sectoral boundaries through ownership linkages. The creation of diversified financial groups raises additional supervisory concerns, including contagion, conflicts of interest, lack of transparency, and regulatory arbitrage. Supervisory and regulatory arrangements are geared at mitigating those concerns to ensure that risks are properly managed and that they do not threaten the safety and soundness of the financial system.

Consolidated supervision may be broadly defined as a qualitative and quantitative evaluation of the strength of a financial group that consists of several legal entities under common ownership or control. The objective of consolidated supervision is (a) to ensure the safety of the financial system through monitoring and evaluating the additional risks posed to the regulated financial institutions by the affiliated institutions in the financial group and (b) to assess the strength of the entire group. Consolidated supervision should have both quantitative and qualitative elements:

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- Quantitative consolidated supervision focuses on issues such as asset quality, capital adequacy, liquidity, and large exposures that are measured on a consolidated basis. There is clearly a requirement that the group be able to produce (a) comprehensive on-balance sheets and off-balance sheet data and (b) counterparty information. This input should be in a form sufficient for reliable capital adequacy, liquidity, and exposure concentration calculations to be made. Because different entities in the group may be subject to different accounting regimes, the results of accounting consolidation may need to be treated with caution.
- Qualitative consolidated supervision is closely identified with comprehensive risk-based supervision, which is designed to assess how well management identifies, measures, monitors, and controls risks in a timely manner. This supervision will involve an assessment of the wider risks posed by other group companies in terms of their effect on the regulated entity. This assessment is likely to involve the

Box 5.2 Unique Risks in Islamic Banking

Islamic banking poses unique risks to the financial system because of the profit-and-loss-sharing (PLS) modes of financing and specific contractual features of Islamic financial products.[a] PLS not only shifts the risks in the institution to investment depositors to some extent but also makes Islamic banks vulnerable to a range of risks (including those normally borne by equity investors) because of the following features:

- Administration of PLS is more complex, requiring greater auditing of projects to ensure proper governance and appropriate valuation.
- PLS cannot be made dependent on collateral or guarantees to reduce credit risk.
- Product standardization is more difficult because of the multiplicity of potential financing methods, the increasing operational risk, and the legal uncertainty in interpreting contracts.
- Liquidity risks are substantial because of the inability to manage asset and liability mismatches as a result of the absence of Sharia-compliant instruments such as treasury bills and lender-of-last-resort facilities.

The presence of commodity inventories in Islamic bank balance sheets adds to operational and price risks. In addition, for contracts with deferred delivery of products, significant additional price risks arise.

Unique Risks of Islamic Banking

Addressing the unique risks of Islamic banking requires adequate capital and reserves, as well as appropriate pricing and control of risks in a suitable disclosure regime. Because information asymmetries are particularly acute in Islamic banking, the need for strong rules and practices for governance, disclosure, accounting, and auditing rules is paramount. The development of an infrastructure that facilitates liquidity management is also a key priority. The challenge for supervisors in ensuring that this type of framework is in place is made more difficult by the absence of uniform prudential and regulatory rules and standards. Currently, there is no uniformity in income-loss recognition, disclosure arrangements, loan classification and provisioning, treatment of reserves, practices in income smoothing, and so forth, although standards for those elements have been developed—and are in increasing use—by accounting and auditing organizations for Islamic financial institutions.

a. The Islamic Financial Services Board (IFSB) was established to adopt regulatory practices and policies to the specific features of Islamic finance and to promote its development. Establishment of IFSB was facilitated by IMF so it can develop prudential standards for Islamic banking and can foster effective risk management. Several IFSB working groups are developing standards and guidelines on capital adequacy, risk management, corporate governance, Islamic money markets, and market discipline and transparency; in addition, draft standards on capital adequacy and risk management have been issued for public comments.

identification of significant activities or business units and an understanding not only of their role within the group but also of the risks to the group posed by their activities.

Some of the key issues and principles governing consolidated supervision are summarized in Annex 5.B.

5.3.8 Unique Risks in Islamic Banking

Islamic banking can be defined as the providing of and use of financial services and products that conform to Islamic religious practices.[20] Islamic financial services are characterized by a prohibition against the payment and receipt of interest at a fixed or predetermined rate. Instead, profit-and-loss-sharing (PLS) arrangements or purchase and resale of goods and services form the basis of contracts. In PLS modes, the rate of return on financial assets is not known or fixed before undertaking the transaction. In purchase-resale transactions, a markup is determined on the basis of a benchmark rate of return, typically a return determined in international markets such as LIBOR (London interbank offered rate). Islamic banks are also prohibited from engaging in certain activities such as (a) financing production or trade in alcoholic beverages or pork and (b) financing gambling operations. A range of Islamic contracts is available, depending on the rights of investors in project management and the timing of cash flows. Special risks in Islamic banking arise because of the specific features of Islamic contracts and the weak environment for effective risk management, thereby reflecting the absence of risk-management tools that are Sharia compatible. Box 5.2 contains further details.

5.4 Assessment of Insurance Supervision

The International Association of Insurance Supervisors (IAIS) has developed the *Insurance Core Principles* (IAIS 2000) as the key global standard for prudential regulation and supervision for the insurance sector. The objective of the Insurance Core Principles (ICPs), from the perspective of the standard setters, is to act as a diagnostic tool to assist in improving supervision globally. To this end, the assessment of ICPs should include prioritized recommendations that can serve as a roadmap for a reform agenda. Fundamentally, insurance supervisors around the world have been concerned about improving insurance supervision and bringing about a basic level of effectiveness in all jurisdictions by facilitating assessments (both internal and external) that are consistent and comprehensive. The global nature of insurance markets (particularly the presence of conglomerates), the expansion of cross-border transactions, the global nature of reinsurance markets, and the presence of active offshore centers all call for some convergence of regulatory practices and norms to ensure effectiveness of regulations and a level playing field.

The ICPs were updated through an extensive process culminating in a new version in October 2003 (IAIS 2003a). This version sets out the key elements of effective regulation and supervision for the insurance sector and elaborates the requirements on the law, the supervisory process, and the functions and operations of market participants so as to deliver an effective and positive contribution from the insurance sector to the wider

economy and to the long-term well-being of the population. The October 2003 version of ICP incorporates additional core principles, including adequacy of risk-management operations, AML–CFT (the subject of a separate standard; see later parts of this Handbook), and transparency of insurance supervision policies (also the subject of a separate standard; see later parts of this Handbook). Moreover, the new version contains additional, more specific criteria for assessment purposes as it draws on earlier assessment experience under the Financial Sector Assessment Program and other previously issued guidelines by IAIS outside of the ICPs. For example, the principles also address issues such as management of risk and consumer protection, and they incorporate as essential criteria "principles on capital adequacy and solvency" (IAIS 2002), which was adopted in 2002. The relevance of effective regulation and supervision of insurers for stability and development, the scope of the new ICPs, and their use in assessments and lessons of assessment experience are summarized in the following sections.

5.4.1 Relevance to Stability and Development

Sound and effective regulation and supervision is important in sustaining a sound operating sector that protects and maintains the confidence of policyholders and, therefore, plays an effective role in overall economic development. Supervision of the insurance sector is not an end in itself. Rather, insurance supervision, when properly conducted, plays a critical role in facilitating that sector's contribution to the effective management of risks for the wider economy; the mobilization of long-term savings, particularly in the life insurance sector; and the allocation of investment in long-term fixed interest and equity markets, as well as in infrastructure and venture capital.

Sound regulation and supervision can also guard against the consequences of insurer failure for policyholders. The traditional focus of supervision on policyholder protection is increasingly giving way to broader financial stability concern as activities of insurers in financial markets expand. Failure can have catastrophic consequences for the individual policyholder, particularly because the choice of insurer may not be subject to market forces in all cases (e.g., third-party claimants) and may not be easily diversified. Some insurance contracts are not suitable for the insured party to take out contracts with several providers—in the same way that many hold deposits with several institutions. The ICPs seek to protect policyholders, both as a group (by focusing on the institutional integrity of the insurance companies) and individually (by promoting good marketing practices, adequately disclosing information about contracts to customers and potential customers, and handling consumer complaints). At the same time, the increasing financial market activities of insurers, including a growing role in credit risk transfer, has raised a question about the implications for financial stability arising from insurer's failures and the implications for insurance supervision (see IMF 2002, 2004b).

Insurers have a role to play in guarding against fraud, money laundering, and terrorism financing. The ICPs recognize this role through a comprehensive set of requirements and good practices in the custody and management of assets, corporate governance, and internal controls. Specific obligations with respect to the fitness and propriety of those who act as custodians (in a legal sense or otherwise) of the community's savings are recognized as critical to the maintenance of a sound insurance sector.

5.4.2 The Structure of the ICPs

The ICPs consist of 28 principles in total, grouped into seven categories.[21] The principles cover all aspects of a supervisory framework—from licensing to closure of activities. The seven groupings reflect commonality of purpose among the principles in each group, ranging from preconditions to prudential requirements and market conduct. See Annex 5.C for a summary of the scope of each of the principles.

The first ICP addresses the general conditions needed for effective supervision and is similar in nature to the BCP "preconditions." This ICP addresses elements that are most usually not the direct responsibility of the insurance supervisory authority. The elements relate to the overall policy settings for the financial sector, as well as the infrastructure of financial markets and their efficient operation. Effective policy settings are critical to the supervisors' task because they provide the backdrop against which the institutional risk is assessed. Infrastructure in markets includes not only the broader financial policy aspects but also the legal and professional services that enable the supervisory process to function. The role of accounting, auditing, and actuarial professions shows examples of particular relevance to insurance supervision. The efficiency of financial markets influences the extent to which institutions are exposed to liquidity risk and market risk, as well as the options they have to address those risks. The first ICP is also concerned with the extent to which companies are able to access statistical data to enable those data to assess market risks and liability risks.

The second group of ICPs (ICPs 2–5) deals with the organizational structure and governance aspects of the supervisory authority. Those ICPs cover the objectives of the supervisor, the legal standing of the supervisory authority, the independence, the confidentiality requirements, and the existence of a transparent supervisory process. Information sharing is also covered in this group of ICPs, which makes it consistent with the issue of confidentiality.

The third group of ICPs (ICPs 6–10) focuses on the establishment and operations of the insurance companies as supervised entities. The fundamental licensing obligation and the effective stewardship of the organization under the continuing control of owners with integrity is emphasized through tests for fitness and propriety, as well as through control of changes in ownership and transfers of portfolios.[22] Overall policies and obligations with respect to corporate governance and internal controls also form part of this group.

Ongoing supervision is the focus of the fourth group of ICPs (11–17). The principles in this group set out the process for supervision and its key components at a high level and then elaborate on key elements of the supervisory process. First, to establish the basis for sound assessment of individual institutions and prompt supervisory actions, ICP 11 stresses the role of an overall analysis of the market and identifies the potential risks and vulnerabilities that affect insurance firms and markets[23] and that arise as a result of the overall environment in which they operate. The ICPs that follow cover the reporting obligations of companies, including the regular and ad hoc information requirements; the assessment of returns received by the supervisor; the conduct of onsite inspections; the taking of action through preventative measures; the active enforcement and sanction powers; and, if necessary, the closeout of the insurer. In particular, ICP 12, which focuses on reporting, also establishes the main obligations with respect to external audit and

accounting standards. ICP 12 largely focuses on the content and completeness of supervisory reporting[24] and includes a substantive role of offsite supervisory assessment as one of the criteria. ICP 16 includes the definition of insolvency, or at least the point at which intervention is obligated to protect policyholders, and ICP 17 addresses the assessment of groupwide risks.

The group of insurance core principles that cover "prudential requirements" (ICPs 18–23) focuses on insurers' obligations with respect to the key areas of sound risk management, which includes understanding the nature of insurance risks, liabilities, assets, risk instruments, and capital. However, there is no internationally uniform capital requirement or set of rules for assets and liabilities in the insurance sector at this stage. The most important characteristics of a capital adequacy and solvency regime are covered at a fairly high level in the standard. Therefore, a wide range of approaches to capital adequacy and solvency are in use, some of which may be deficient in their ability to identify and require capital for significant risks to financial stability or to the solvency of an insurer. For example, capital required under the regime used in the EU and other jurisdictions does not depend on the composition of the investment portfolio. The IAIS and other organizations are working toward greater uniformity of capital adequacy standard.[25] The ICPs within this group emphasize the need for a sound assessment of risk and adequate resources to meet the risks assessed. The IAIS had already issued other supervisory standards that are relevant and related to these ICPs. Because the ICPs themselves were being revised, the supervisory standards available at the time were incorporated into the ICPs; some guidelines and issue papers were also under preparation at the time of the issuance of ICPs, and those, too, would be relevant for the assessment.[26]

The remaining two groups (ICPs 24–28) deal with markets and consumers (the oversight of insurance intermediaries, customer protection, disclosure to the wider market, and fraud prevention) and with AML–CFT. The oversight of intermediaries (most commonly, insurance agents and brokers) is an important element of insurance sector soundness that does not always have a direct equivalent in other sectors. The failure of an intermediary can have a direct effect on those customers who have dealt with the insurer through the intermediary. The fitness and the propriety of intermediaries are also an important element in the maintenance of a sound system that preserves public confidence in the sector. Customer protection goes beyond the customer's dealings with intermediaries to include (a) the requirements for information disclosure to explain the product and services to the customer and (b) the manner by which a customer may seek to have complaints resolved. Complaint resolution needs to be accessible, to be timely, and not to impose an undue cost, recognizing that customers have relatively limited financial and technical resources available. In some jurisdictions, this role is played by self-regulatory organizations (SROs). In others, it is played by companies with supervisory oversight or even by the supervisors themselves. Wider market disclosure focuses on broader and less-specific disclosure than is involved with individual customers and their individual products. The intent of this wider disclosure is to impose market discipline on companies. Again, it can be more or less effective and needs to reflect the market structures as the system needs to consider all companies, not just those that are publicly listed.

Claims fraud is a key issue in the insurance sector and is addressed in the newly introduced ICP 27. Claims fraud, wherein customers might submit inflated or invalid claims,

has an insidious effect on companies and can ultimately bring the solvency of a company into question. As one addresses this issue, the diligence and integrity of the company is emphasized, as well as the linkages between the supervisory and prosecuting authorities.

The principles themselves have been deliberately drafted at a general level, and those principles should be interpreted according to the additional explanation provided for each principle. Each principle is elaborated with an explanatory note and followed by a set of criteria. The explanatory note is intended to provide elaboration and clarification, setting out the rationale for the particular principle and sometimes referring to specific examples. The criteria are divided between the so-called "essential criteria" and "advanced criteria." Essential criteria are considered necessary for all markets to be fully functional and effective. Advanced criteria are considered either for particularly advanced and complex markets or, more likely, to provide a sense of direction for further improvement as markets and practices evolve.

5.4.3 Assessment Methodology and Assessment Experience

ICP assessments are based on a set of essential and advanced criteria, as well as on an assessment methodology that has been issued as part of the document.[27] The methodology is intended to assist the assessor in his or her goal to be both fair and objective. The document itself speaks of the assessments being "comprehensive, precise, and consistent" (IAIS 2003a). In practice, the methodology and the ICPs themselves include some key nuances that should be understood in carrying out the assessment and in interpreting the results. The following subsections highlight these key issues, without elaborating on every feature of the ICPs and their assessment.

5.4.3.1 Essential and Advanced Criteria—Assessment Process

Assessments are normally carried out against the essential criteria for comparability with other assessments. As noted above, essential and advanced criteria are included in the ICPs. However, it may be necessary or sensible to also consider the advanced criteria in some cases. When considering the advanced criteria, the assessor can prepare the report on the observance of the standards by considering the essential criteria and making further comments or by using the advanced criteria to guide recommendations. Nevertheless, the IAIS methodology indicates that, even where the advanced criteria are considered, the overall assessment of the principle will be based on the essential criteria only for consistency purposes.

There are five categories for the assessment of the criteria. Those categories are defined in the annex to the document as "observed," "largely observed," "partly observed," "not observed," and "not applicable." Procedurally, the assessment process assesses each of the criteria first; only then can the principle be assessed after considering the overall situation with respect to all the underlying criteria. For a principle to be rated as "observed," it needs to have all its related criteria rated as "observed" or "not applicable." Consequently, it is difficult to achieve full observance, particularly for the ICPs that have a larger number of criteria as compared with an ICP that has a smaller number of criteria. Thus, an overall summary that does not identify the criteria but simply summarizes the number

of ICPs at each rating will be misleading. ICP 3 is particularly difficult in this context because it has 17 essential criteria and is wide ranging in scope.

A rating of "largely observed" means that the shortcomings are minor and that the authority would be able to achieve observance without an expectation of concern. For example, a shortcoming is recognized and is being addressed effectively. Thus, the assessor has no reason to doubt its successful implementation. However, in situations where, for example, significant industry or political resistance is to be expected and has not yet been overcome in implementing the reform program, then the observance of the relevant core principle would not be rated as "largely observed."

The rating is akin to a temperature reading at a point in time rather than an indication of a future position. The reports provide the opportunity to recognize work in progress through comments, but the rating has to reflect the actual current situation in fact. Differentiating between a rating of "largely observed" and "partly observed" will mean—because of the definitions—that work in progress is influencing the decision to use one or the other of the two ratings.

The assessor can decide to show more than one rating for an ICP depending on the segment of the insurance industry. It may be the case that segments of the industry show a very different result for one or more ICPs. For example, the life and nonlife sectors may be subject to different regulation, and one may be more complete than the other; similarly, reinsurance may not be subject to a particular element but the direct insurance companies may be comprehensively covered. Showing more than one rating can be a useful way to reflect the positive elements of the situation while identifying the segment that may have a missing element.

5.4.3.2 *Usefulness of a Well-Prepared Self-Assessment*

The authorities should prepare a self-assessment to benefit fully from an independent assessment of observance of ICPs. Self-assessment also helps the authorities to identify the relevant parts of the law and the supervisory practice that will be of interest to the outside assessor.

Sometimes, a supervisory authority may prepare an assessment for another purpose, one that assesses the authority rather than the whole jurisdiction. In those cases, the assessment may rate a particular criterion as "not applicable" where it falls to a different authority in the jurisdiction to undertake that task. Insurance assessment should, however, be carried out in the context of the jurisdiction as a whole rather than for an individual authority. Therefore, the assessor will need to obtain information on the relevant criteria, laws, practices, and oversight from several authorities, including the agency with primary responsibility for insurance supervision. Obtaining this information will require coordinating the assessment process with many agencies.

5.4.3.3 *The Insurance Market Assessment*

The ICPs can be properly assessed only in the context of an overall analysis of conditions in the insurance sector, including an assessment of the performance of and prospects

for the sector. Consequently, it is necessary to analyze and form a view on the adequacy of provisions, profitability, business trends, and capitalization of the sector while using recent data (see chapter 4 for a discussion of sectoral analysis).[28]

A key feature of the assessments made in this context of an overall analysis needs to be the assessment of ICP 1—the conditions for effective supervision. As noted earlier, the elements of this ICP are often outside the control of the supervisor. When a supervisor is doing a self-assessment for other purposes or for an internal examination, then this ICP may be less important. However, within the context of a broader financial sector assessment, it is a critical element because it provides the necessary links to considering development and stability. The ICPs also recognize some steps that the supervisor may take in the face of weaknesses in the conditions.[29] Examples would include the encouragement or sponsorship of statistical studies where they are not being done otherwise. Weaknesses in the asset markets may signal that it is reasonable to impose more onerous or specific obligations on investments. Weaknesses in the legal system may lead to a response to establish separate specific procedures for the sector. Those kinds of steps may be considered in the context of recommendations to strengthen the system as a whole in the face of weak conditions.

5.4.3.4 *Flexibility*

Another feature of the assessment process is that "the framework described by the Insurance Core Principles is general. Supervisors have flexibility in adapting it to the

Box 5.3 Flexibility in Assessments

Core Principle 19 on insurance activity states that "since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums." This principle is elaborated through a set of five essential criteria, including supervisory review of adequacy of reinsurance and the requirement that "the insurer has a clear strategy to mitigate and diversify risks by defining limits on the amount of risk retained."

The level of detail and breadth of such a strategy clearly depend on the nature of the risks that the sector underwrites; therefore, the scope of the strategy is a function of the product mix. The level of exposure to natural catastrophes is relevant to property insurance firms, and the level of sophistication in the identification and measurement of catastrophe risks will vary amongst jurisdictions.

In the case where a company insures significant property risks in a jurisdiction where natural catastrophes are material, then it would be expected that the company would take a rigorous approach for establishing limits for each new policy issued by considering the extent to which catastrophe risk is increased or the extent to which concentration becomes a greater concern. Often, for example, this process involves detailed comparison of the distribution of the risks insured in the portfolio with simulation models that help to quantify the risks from the catastrophe. Where a company provides liability insurance, then it would not be sensible to impose or expect similar details in the modeling of catastrophes because aggregation of risk needs to be considered using different techniques.

In the case of a life insurance company, the detailed risk-management systems required for the investment portfolio would vary considerably, depending on the nature of the liabilities and the conditions in the market place, including the access to derivatives and other risk-management instruments. For a company that undertakes investment-linked business, the risk-management focus should be different from that of a company that writes long-term savings contracts with stronger return guarantees.

domestic context" (IAIS 2003a, 50). This characteristic leads the assessor to consider whether an element may be inadequate in the context of a more complex aspect of the market, even though it may well be reasonable in another market or may have been reasonable when it was established in times when the market was less complex. Box 5.3 illustrates the application of flexibility in the context of ICP 19, which requires insurers to provide adequate monitoring and evaluation of insurance risks and to ensure adequate premiums and reinsurance to manage the risks.

5.4.3.5 Observance in Law and Practice

The methodology for the assessment of the ICPs calls for observance both in law and in actual practice. For most criteria, it is not sufficient simply to consider whether or not the law or other legal obligations cover the necessary material. "Observance" usually requires the practices to be recognized in the law or legislation and to be enforced effectively. Here is a useful set of questions to consider:

- Is the practice or power specified in the law, the regulations, or both?
- How do the authorities know it is followed in practice?

The assessment is not clear-cut when the desirable practices are in the law but have not been used because the circumstance for their use has not arisen. For example, particular winding-up provisions may appear adequate but may not have had the benefit of any testing. A more clear-cut example arises when a well-constructed solvency margin regulation exists but is not observed by the firms in practice. This situation will not be assessed as "observed," given the lack of implementation of the regulation. Similarly, if a regulation or criterion cannot be monitored or implemented because the financial reporting or supervisory staffing does not permit it, then it would be difficult to rate the mere existence of a rule in the rule book as sufficient for a rating of "observance."

The requirement of clarity of the law, as well as practice, in the current ICPs is onerous; however, it is possible to consider observance by other means (as suggested in IAIS 2003a, 52). This suggestion is intended to bring an additional flexibility to the assessment. It may be that the approach taken in a jurisdiction is not consistent with the wording of the criteria but the effective result is the same in terms of actual results. For example, the principle of establishing clear priority to policyholders in the event of winding-up an insurer is discussed in the explanatory notes to ICP16 (IAIS 2003a, 30), where the alternative priorities for other stakeholders are recognized. At the same time, essential criteria "c" seeks a high level of priority to the policyholder. This example indicates that a low priority in the winding-up provisions of the law may be effectively erased in effect for policyholders by a policyholder protection scheme, which provides additional or alternative protection. Another example of observance by other means could be represented by the operation of custom or by the role of SROs. In those cases, the custom or practice needs to be considered by the assessor. It should be undisputed and robust.

When using the term *legislation*, the ICPs are not taking a prescriptive view on whether or not an obligation is in the primary insurance law or whether it is in a subsidiary regulation, instrument, or circular. This approach provides flexibility within the context of the legal system. There are, however, some places where the use of the word *law* is taken to

mean the primary law. In those cases, the ICPs consider that it is of particular importance to include the specified feature in the primary insurance law.

5.4.3.5 *Reinsurers, Policyholders, Beneficiaries, and Customers*

The ICPs depend on the definitions of the terms that the IAIS uses in preparing all of their documents. Most of the terms are defined in the IAIS glossary that is available on the IAIS Web site. Several other important definitions are included in the document, and they influence the scope of the assessment of the criteria and the principle.

The term insurers includes reinsurers. Even though the term generally refers to insurers, the reinsurance sector is also included in all respects unless indicated. The only indication that excludes them is with respect to consumer protection because reinsurance is generally taken to be a market between more informed customers (IAIS 2003a, 41).

A wide definition of the terms *policyholders*, *beneficiaries*, and *customers* is used in the ICP. *Policyholders*, when used, describes not only the owner of the policy but also a beneficiary, for example, a third-party claimant or the widow of a deceased policyholder awaiting claim payment. *Customers* is a term used to also include potential policyholders. The definitions are of most importance when considering the consumer protection in particular. For example, under criterion "e" of ICP 25, the effectiveness or otherwise of an "accessible" complaint handling process will depend on whether or not a claimant can access it regardless of whether or not he or she is the policyholder.

Information and *disclosure* will also need to be interpreted in the context of the definitions but within practical rather than literal bounds. The relevance and timeliness of information provided to the potentially affected parties should be a key consideration. The owner of a policy may need particular information not only before purchase but also during the time the contract is in force. The existence of a complaint scheme may be relevant for general information but will be more pertinent to those who indicate that they have a claim and even more so to those who have had a claim denied by an insurer.

5.4.3.6 *Difficulties That Can Have a Pervasive Effect on Assessments*

An underresourced supervisory body will have difficulty with many of the ratings if it is not able to conduct an effective onsite inspection activity because a number of the criteria will be difficult to verify in the absence of such inspections, formal or otherwise. Where this situation is the case, the commentary can be used to make clear the central reason for the situation.

5.4.3.7 *Reporting*

Ultimately, the ICP assessment is intended to be a diagnostic instrument. As a result, ICP methodology emphasizes that the report (a) summarize the findings to highlight areas for improvement and (b) prioritize them in a sensible order. In addition, the report should explain the priorities.

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5.4.3.8 Key Assessment Experience

The experience of assessments to date indicates that the insurance sector generally shows a weaker level of observance of international standards than does the banking sector.[30] Most usually, the reason is reflected in a less well-resourced and less-independent supervisory body and in an insurance law that fails to provide the full range of powers to the supervisor to carry out the task envisioned in the ICPs. It can also reflect, however, a lack of actual soundness in the insurance sector itself. This section considers country experience with individual ICPs and reports the typical difficulties faced in achieving full observance.[31]

Overall, observance differs across core principles, with several weaknesses and strengths. The area in which insurance supervision is most deficient relates to corporate governance of insurance companies. Less than one-third of countries are observant or broadly observant with this core principle. This low level is mainly a result of unclear jurisdiction of the insurance supervisory bodies over corporate governance issues. In general, rules on corporate governance are to be found in corporate law. Also, in the field of internal controls, the supervisory authorities seem to have limited jurisdiction, and the system depends on general corporate laws and regulations.

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

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

Creating all the relevant conditions for effective insurance supervision can be a challenge in less fully developed markets. Statistics that can assist companies in correctly pricing and establishing provisions for insurance products may not be widely studied or reported. Asset markets may suffer from a lack of liquidity or may provide insufficient instruments of a duration necessary to match insurance liabilities. Often, the actuarial profession is particularly limited. In many cases, supervisors are able to take action to alleviate such problems, at least in part. Greater difficulties arise if the jurisdiction faces more widespread challenges, particularly if corruption levels are high and extend to the legal system.

Generally, all supervisors have the obligation to protect the interests of policyholders, and this objective needs to be made more clear and transparent. Opportunities still remain, however, to bring transparency practices into line with best practice by elaborating on the objectives in more detail and with more clarity rather than simply relying on the publication of the law itself. Usually, this stronger transparency practice represents an opportunity for the supervisory authority to take a greater leadership role in their public statements and in commentary in annual reports. An issue that is of concern, although not universal, is that the supervisor in some cases has conflicting objectives, for example, policyholder protection and industry growth.

It is difficult for a supervisory office that remains part of a ministry and subject to generic public service rules to demonstrate full observance of the ICP on adequate supervisory authority. Lack of independence from the Ministry of Finance has been a major issue—mainly in developing countries, where more than half of the sample countries exhibit poor implementation.

Transparency of supervisory process is often inadequate. Many supervisors have internal processes that are well structured and understood within the agency. Nevertheless, the transparency of those processes is often inadequate.

Some supervisors have legal constraints that make supervisory cooperation and exchange of information and cooperation (ICP 5) difficult. Others may be able to cooperate in a legal sense, but the effective cooperation among supervisors inside and outside of the jurisdiction may be less than is desirable. In many cases, cooperation was warranted but did not, in fact, occur. Sometimes, in the extreme, cases have been identified in which the local supervisor made every effort to exchange and elicit information, but the counterpart did not respond. This type of case is difficult to assess, given the party that should have participated but did not was outside the jurisdiction. In cases such as these, it is suggested that the authorities' efforts be congratulated explicitly in the report. Every effort to translate the intent of the standards into practical results by the international associations is to be encouraged in this area.

Weaknesses are found in rules concerning fitness and propriety (ICP 7 on suitability of persons). Frequently, the scope of the persons covered by the rules is limited or legal support (for the otherwise effective moral suasion) to remove unsuitable persons is lacking. Less frequently, the law may not have provisions for testing fitness and propriety.

Usually, changes in control and portfolio transfers (ICP 8) are well covered in law, and transactions, when they arise, are given close attention by supervisors. The one weakness that may arise is the ability to look through the corporate structure beyond the immediate parent and, in particular, to examine transactions that take place outside the jurisdiction (e.g., when two international firms merge with a local operation that does not change direct ownership). The intent of the ICP is to protect policyholders from a change of control whether or not there is an intermediate holding company or other corporate structure, so this possible weakness can present an issue. Often, supervisors do not have the legal power to require local change of ownership of a licensed insurer to require shareholder divestment. That type of power would usually enable any concerns to be addressed by changes to proposed ownership arrangements, by conditions being placed on the approach to the management of the local insurer, or by other solutions. This issue

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Box 5.4 Key Issues in Ongoing Supervision and Prudential Requirements for Insurance

Ongoing Supervision

Ongoing supervision of insurance (ICPs 11–17) shows different degrees of observance, with developing countries showing more pronounced weaknesses. The stress on macroprudential surveillance of the insurance sector is an important step in strengthening supervision.

- Market analysis (ICP 11) is a relatively new ICP, and experience from assessments remains to be analyzed. This ICP formally recognizes the importance of analyzing market conditions in the sector and macroprudential surveillance of the sector as key inputs into insurance supervision. For a discussion of financial soundness indicators for use in macroprudential surveillance and market analysis, see chapter 3.
- Reporting to supervisors and offsite monitoring (ICP 12) incorporates financial reporting, audit, and offsite analysis. Usual problems include a lack of audit requirements, accounting standards that are adequate for general purposes but short of supervisory needs, or an overly compliance-oriented supervisory approach to the assessment of returns.
- Some supervisors do not have the powers or the resources for onsite inspections (ICP 13).
- Although many supervisors have powers of intervention (ICP 14 on preventive and corrective measures), they may be subject to legislatively imposed trigger points that are too low, thus preventing early intervention with sound legal support earlier in the process.
- A full set of enforcement sanction powers (ICP 15), whether they have been applied in the past in every case or not, is important to the supervisor. Sometimes, they add only to the ability to use moral suasion effectively. The ICP is oriented in this way so the weaknesses tend to reflect certain limitations in the law where the supervisor is provided with powers limited to those that will be expected to be used in practice. Sometimes, the supervisor finds it useful to threaten to use powers even if he or she does not ever use them in fact. In those situations, the full armory is desirable.
- It is usual that the processes of winding-up and exit from the market (ICP 16) are set out in the law but, in some cases, the normal commercial rules apply, which would not provide the necessary policyholder protection. Policyholder protection schemes do not exist in every jurisdiction, and the assessor may wish to take this information into consideration when reviewing the market exit arrangements. In some cases, the definition of the point of intervention is considered to be open to interpretation and, therefore, gives rise to legal dispute. In cases such as those, the supervisor may be rendered ineffective while his or her intervention is subject to lengthy challenge—an undesirable situation in the interests of policyholders.
- With respect to groupwide supervision (ICP 17), historically, insurance laws have been designed for "ring fencing" the supervised entity and limiting impositions on the rest of the group, whether they be subsidiaries or siblings or parents in the corporate structure.

Observance of Prudential Requirements

Observance relating to prudential requirements must be interpreted with care because the lack of risk sensitivity of the principles and standards renders it possible for almost every jurisdiction to score highly. General levels of observance are high on liability valuation and capital adequacy because the criteria cannot differentiate between stronger and weaker loss reserves (both within a jurisdiction and between jurisdictions) or determine the appropriateness of a capital buffer regime. Weaknesses are more pronounced on asset quality regulation.

- Risk assessment and management (ICP 18) and insurance activity (ICP 19) are new principles, and experience from assessments remains to be analyzed.
- Core principles on capital adequacy and solvency critically depend on realistic and consistent valuations for assets and liabilities. If liabilities are inadequate or if assets are overvalued, then the capital regime is undermined. Asset valuation standards vary greatly among jurisdictions, and liability valuation standards vary both within and among jurisdictions. Significant efforts are under way in a number of countries and regions to develop better standards. Nevertheless, quantitative benchmarks have yet to be developed or proposed by the IAIS, and until this change happens, the lack of differentiation between stronger and weaker prudential regimes will remain a feature of ICP assessments—and will necessitate a more detailed technical analysis.
- The core principle on derivatives and similar commitments (ICP 22) is either observed (having had supervisory attention) or not applicable (where the activity has been prohibited). Many developing and emerging markets commonly lack regulation over this activity.

can also be related to the lack of a full set of sanction powers to facilitate and support the supervisor in its activities.

Corporate governance (ICP 9) and internal control (ICP 10) tend to show strengths or weaknesses together. Where the powers exist, the topics of corporate governance and internal control may have been the subject of recent rules but may not have yet found their way into reliable evidence of effective practice in the institutions; instead, new rules are being formulated on these topics and their robustness remains untested. In addition, where onsite inspections are not carried out, it is difficult for the supervisor to verify the full observance of these requirements.

Ongoing supervision, prudential requirements, and AML–CFT procedures for insurance were generally well observed (according to 2000 standards), but weaknesses were evident in implementation despite strong laws being in place. Some of the core principles in this area (e.g., market analysis, risk management, insurance fraud, AML–CFT) are relatively new; implementation experience at the country level is new, and assessment experience remains to be analyzed. Nevertheless, available evidence suggests that nearly one-third of all sample countries (and the majority of developing countries) demonstrated weak regulation of asset quality, and 60 percent of developing countries insufficiently supervised reinsurance practices of insurance companies. Procedures for orderly winding-up of failed insurers (and securities firms) were missing in a significant number of countries sampled. Approximately, only one-third of the countries had adequate insolvency and bankruptcy regimes. Box 5.4 provides additional details on key weaknesses and issues in the ongoing supervision and prudential requirements for insurance.

Development issues related to the insurance sector will need specific attention in the course of ICP assessments. To this end, the assessor will need to consider the factors that affect the contribution of the insurance sector to overall economic development. The usual starting point is the development of the sector itself. The insurance sector, particularly the life insurance sector, can play a key role as a mobilizer and manager of savings and as a long-term institutional investor. The sector cannot do so, however, if the custody of policyholder funds is at risk or if the population does not have the capacity to invest in the sector's products. Over time, it can be expected that this situation will improve as the sector develops, but limitations may exist. In the long run, a sector that is growing, that acts as an effective investor, and that provides long-term capital will be good for the economy and good for the overall well-being of the population—not just for those who are policyholders—as the economy develops.

Systemic risk should also be considered. In the case of insurance, this kind of risk can arise from two main sources and should be—in a reasonably well-run system—limited. First, the sector itself may be weak. Solvency may be in question or the economic environment may be such that it could reasonably be at risk, which can be serious, particularly if resolution measures are inadequate or if supervisory intervention is restricted. The failure of an insurer leads to significant hardship for those immediately affected[32] and may lead to a loss of confidence in the sector as a whole that could take a considerable period to restore. The second source of risk rests in the linkages, if any, with the banking sector or with securities markets. For example, where an insurance company is owned by a bank, any potential weakness in the insurer may cause difficulty, or at least an imposition, on the capital of the bank. Insofar as the insurance sector is a significant protection seller

in credit derivatives markets, weaknesses of insurers could have implications for financial stability. Moreover, when insurance companies are major holders of key instruments traded in the capital market, then market volatility may be significantly influenced by portfolio decisions of insurers.

5.5 Assessment of Securities Market Regulation

Securities markets are a critical component of many economies, and the regulation of securities markets can be fundamental to a country's financial development and integration into the global market. Consequently, securities market regulation is an important element of financial stability. This section looks at the objectives and principles of securities regulation (core principles), which were developed by the International Organization of Securities Commissions (IOSCO)[33] as the key global standard for securities regulation. The section briefly reviews the development of the core principles and examines the ways in which they reflect the broad responsibilities of securities regulators and the nature of IOSCO as a whole. The section then looks at the preconditions for effective securities regulation, which, though fundamental, can be both difficult to achieve and challenging to assess. The section next turns to the IOSCO methodology, which is the principal tool used to assess securities market regulation, and addresses key considerations in conducting an assessment. After reviewing assessment experience to date and discussing some of the key findings, the section concludes by addressing three key topics in securities market regulation and development: (a) demutualization, (b) creation of an integrated regulator or supervisor, and (c) enforcement and the exchange of information.

Securities markets are tremendously varied, both in terms of their legal framework and their level of development. The specific responsibilities of securities regulators are equally varied. Therefore, it is not practical to set forth a single legal or institutional framework suitable for securities market regulation or to identify typical country practice. Indeed, this limitation was a major challenge for the drafters of the IOSCO core principles. Therefore, instead of presenting a single, unified regulatory framework, the core principles identify three key objectives that "form a basis for an effective system of securities regulation" (IOSCO 2003b, 1). Those objectives, which are discussed in greater detail next, are (a) protecting investors; (b) ensuring that markets are fair, efficient, and transparent; and (c) reducing systemic risk. After identifying the three objectives, IOSCO sets forth 30 principles that are intended to give "practical effect" to the objectives. IOSCO then elaborates on the principles through extensive discussion, while noting that, as markets change, the strategies for implementing the principles also will necessarily change. The principles state that "there is often no single correct approach to a regulatory issue. Legislation and regulatory structures vary between jurisdictions and reflect local market conditions and historical development" (IOSCO 2003b, 3). As a result of those factors, assessing securities market regulation can be fraught with numerous challenges. This section seeks to shed light on some of those challenges.

5.5.1 IOSCO Core Principles—Relevance to Stability Considerations and Structural Development

The *Objectives and Principles of Securities Regulation* (the IOSCO core principles) of the International Organization of Securities Commissions is the key global standard for securities market regulation. The IOSCO bylaws state that the organization's members (a) will exchange information about their experiences so they can foster the development of domestic markets, (b) will work together to establish standards and improve market surveillance of international transactions, and (c) will provide mutual assistance to promote market integrity. IOSCO adopted the core principles in September 1998, and they have been identified by the Financial Stability Forum as one of the 12 key international standards. The IOSCO core principles provide evidence of "IOSCO's commitment to the establishment and maintenance of high regulatory standards for the securities industry" (IOSCO 2003b, 2). Over the years, IOSCO has produced many resolutions and numerous technical reports relating to different aspects of securities market regulation. However, before the development of the IOSCO core principles, the organization had never produced a framework statement covering the fundamental aspects of securities regulation.

The purpose of the core principles is to strengthen securities markets by enhancing the regulatory framework. As noted above, the core principles set out three objectives on which securities regulation is based: (a) promoting investor protection; (b) ensuring that markets are fair, efficient, and transparent; and (c) reducing systemic risk. Although each of the principles is presented as equally important, the document underscores the statement in the IOSCO bylaws that IOSCO members should be guided at all times by their concern for investor protection. Investors are to be protected from misleading, manipulative, and fraudulent practices. The most important means for doing so is full disclosure. Regulation should also promote fair and efficient markets with the highest levels of transparency, defined to include both pretrade and posttrade transparency. Finally, the core principles call for regulators to reduce systemic risk. Although regulators cannot prevent firms from failing, the regulations should contain the risks and mitigate the impact of any such failures. The core principles then set out 30 principles of securities regulation that are intended to give "practical effect" to the objectives. Each of the 30 principles is elaborated and explained in significant detail. Because the three objectives are overlapping, it is impossible to link each principle to a specific objective. However, certain principles promote one or two of the objectives in particular.

The IOSCO objectives and core principles (IOP) are stated at a general level—as is the case with other regulatory standards—and permit considerable flexibility in implementation. Each of the 30 principles is supplemented by narrative discussion, illustrating how the objective of the principle might be achieved while simultaneously recognizing that the nature of a particular market will necessarily dictate how the principle is implemented. "The particular manner in which a jurisdiction implements the objectives and principles described in this document must have regard to the entire domestic context, including the relevant legal and commercial framework" (IOSCO 2003b, 3). In addition, the IOSCO core principles were drafted with the recognition that markets change over time and that regulators must have the flexibility to adapt their supervision to changing market conditions. The document notes that there is not a single approach for imple-

menting the principles and that multiple approaches, often depending on the broader legal and regulatory system, may be effective.

The IOSCO core principles also reflect the broad scope of responsibilities possessed by most securities regulators. Securities regulators are responsible for a much broader array of activities than banking supervisors. Like banking supervisors, securities regulators supervise the activities of market intermediaries. However, they also supervise securities markets, collective investment schemes, investment managers or advisers, and issuer disclosure. Some securities regulators also have responsibility for enforcing company law. The core principles thus cover a large range of issues. The 30 core principles, therefore, are grouped into eight subject areas as illustrated in Annex 5.D. Principles 1–5 relate to the regulator and to its powers, resources, independence, and accountability. Principles 6–7 relate to self-regulatory organizations and their supervision. Principles 8–10 relate to enforcement, and Principles 11–13 relate to cooperation, including international cooperation for enforcement and regulatory purposes. Principles 14–16 relate to issuers and the disclosure of information. Principles 17–20 relate to collective investment schemes and their operation. Principles 21–24 relate to the supervision of market intermediaries, and Principles 25–30 relate to how a jurisdiction's overall regulatory structure ensures the integrity of secondary markets, including through robust clearance and settlement function that is addressed in Principle 30.[34]

Because of securities regulators' broad responsibilities for the effective functioning of the markets, the links between (a) observance of the IOSCO core principles and (b) market development and stability are fundamental. As the core principles themselves note, securities markets are vital to the development and strength of national economies. They not only support "corporate initiatives, finance the exploitation of new ideas, and facilitate the management of financial risk" (IOSCO 2003b, 1) but also—with the growth of collective investment schemes—have become increasingly important to individual wealth and retirement planning. Sound domestic markets are important to domestic financial development; with globalization, they have become increasingly important to the strength and stability of the global economy. Indeed, much work has been done to show (a) that financial diversification and development outside of the banking system enhances efficiency, as well as encourages development and promotes stability and (b) that an alternative source of intermediation may help strengthen the banking sector, which, again, will enhance financial development and stability.[35] Improving the quality of regulation and enhancing the supervision and surveillance promotes investor confidence, better risk management, and more efficient and robust institutions and markets. These actions, in turn, will promote economic growth. In addition, the preconditions for a strong securities market, including a well-functioning legal system and observance of contract and property rights, are the institutional factors that promote both financial stability and financial development.

5.5.2 Preconditions for Effective Securities Market Regulation

Effective securities regulation depends on the existence of a number of "preconditions." The IOSCO core principles recognize that "securities law and regulation cannot exist in isolation from the other laws and the accounting requirements of a jurisdiction" (IOSCO

2003b, 8). In particular, the principles note that "there must be an appropriate and effective legal, tax and accounting framework within which the securities markets can operate" (IOSCO 2003b, 8). The preconditions are not formally part of the core principles because they are outside the jurisdictional authority of most securities regulators. IOSCO identifies in an annex to the core principles certain elements of the legal framework that are particularly important for effective securities regulation. These elements include (a) company law; (b) a commercial code or established contract law, including recognition and enforcement of property rights; (c) clear and consistent tax laws, especially with respect to the treatment of investments and investment products; (d) bankruptcy and insolvency laws; (e) competition law; (f) banking law; and (g) a fair and efficient judicial system or other dispute resolution system in which orders can be enforced and illegal behavior sanctioned (IOSCO 2003b, annex III).

Weaknesses in the preconditions can have a significant deleterious impact on the effectiveness of securities regulation and on market development. Investor protection must be grounded in a legal framework for investors to have confidence in the markets. For example, without an effective bankruptcy law, investors will be reluctant to risk investing in a company that may fail because they will be without any legal recourse. Similarly, investors would be reluctant to leave assets in accounts with a securities firm or an asset management company if bankruptcy and property law did not support a clear separation of client assets from the general assets of a firm. Without uniform accounting standards, companies will not be able to present a consistent and meaningful financial picture to investors. The absence of a fair and impartial judicial system that can mediate disputes or enforce sanctions will weaken the credibility and effectiveness of securities regulation.

As part of the IOSCO assessment, it is important to gain an understanding of the relevant preconditions in a particular country, which will require access to information from a wide variety of other sources, including assessments of other financial sector components. Information will be needed from country authorities other than the securities regulator and from market participants. Assessments of the legal system and accounting standards would provide information on shortcomings, if any, that might affect securities regulator's activities. In addition, when considering actions to enhance securities regulation, country authorities will need to determine whether the preconditions themselves should be addressed first to ensure that the proposed action will achieve its objective.

5.5.3 Assessment Methodology and Assessment Experience

The core principles were initially adopted as a stand-alone document, without an accompanying methodology for implementation. When IOSCO adopted the core principles, they were intended as an incentive document, expressing the commitment of IOSCO members "insofar as it is within their authority to use their best endeavors within their jurisdiction to ensure adherence to those principles" (IOSCO 2003b, 3). At the same time, IOSCO also recognized that the core principles could serve as a benchmark or, as IOSCO put it, a "yardstick against which progress towards effective regulation can be measured" (IOSCO 2003b, 2). Therefore, IOSCO began the development of detailed questionnaires to help securities regulators assess the extent to which they were implementing the core

principles. The questionnaires included a "high-level" questionnaire and five additional questionnaires that focused on specific areas of securities regulation.

The *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (IOSCO 2003a; hereinafter, the Methodology) has been developed as a tool to provide guidance on assessing the level of implementation of the IOSCO core principles. The core principles were themselves helpful as a starting point for assessing securities market regulation; however, they were drafted at a broad conceptual level to accommodate differences in the laws, regulatory framework, and market structures among IOSCO members. They, therefore, provided little or no guidance to assessors as to how to assess whether they were implemented in practice. Although the self-assessment questionnaires could be used by third-party assessors, they were a cumbersome tool, particularly for those assessors who were less familiar with the market and the regulatory system that they were assessing. As an alternative, the World Bank and the International Monetary Fund developed a guidance note for use by assessors as they worked with the IOSCO core principles. Although helpful, this note was quite general, and IOSCO members believed that more detailed and comprehensive guidance could be of greater assistance. In response, IOSCO set up a task force that was specifically mandated to develop a methodology that could be used by both self-assessors and third-party assessors such as the Bank and the Fund. The task force consisted of IOSCO member regulators from both developed and emerging markets. Staff members from the Bank and the Fund also participated. The Methodology built on the self-assessment questionnaires and the guidance note that were already in existence.

IOSCO developed the Methodology for its own use and for use by third-party assessors. IOSCO intended all along for the Methodology to be used as a tool for conducting self-assessments. At the same time, IOSCO recognized that the Methodology would be used by third-party assessors, some of whom might not be securities regulators. Thus, IOSCO members tried to achieve multiple objectives in drafting the Methodology. To reflect the complexity of regulating a wide variety of types of markets in different stages of development, IOSCO sought to ensure that the Methodology was sufficiently multifaceted. IOSCO also wanted to be sure, however, that the Methodology—and assessments based on the Methodology—would reflect the high standards of regulation that the core principles embodied and would not be watered down or diluted for different markets. IOSCO also sought to ensure a degree of consistency in assessments across different markets. Consequently, the Methodology is a long and complex document, with numerous "key issues" and "key questions" for assessors to draw on and a rather strict benchmarking system. The benchmarking system is intended to add consistency and objectivity to an inherently subjective assessment process while allowing for some flexibility.

The organization of the Methodology follows the format of the core principles. The Methodology groups each of the principles into the eight subject areas used in the presentation of IOSCO core principles. Each grouping of the principles is introduced with an introductory note. It then introduces each individual principle and sets forth that principle's "key issues" and associated "key questions." These descriptions are followed by an elaborate benchmarking system through which IOSCO essentially indicates the relative importance of different aspects of the principles. The benchmarking system recognizes five levels of observance of each principle: "fully implemented," "broadly imple-

mented," "partly implemented," "not implemented," and "not applicable." An explanatory note may accompany these levels. (Annex 5.E illustrates the structure and use of the Methodology for one of the core principles.)

The work of the IOSCO task force reflected the experience being gained in the context of Bank-Fund assessments and country self-assessments. For example, in the Methodology's benchmarking system, IOSCO initially had not included a "broadly implemented" category. However, IOSCO concluded that the benchmarks should be expanded to reflect those situations in which the regulatory system or regulator had implemented nearly all aspects of a particular principle, though not every detail. To reflect this situation, IOSCO incorporated the new category "broadly implemented" into the benchmarking system. Similarly, as a result of feedback from assessors that the application of benchmarks was too rigid, explicit language was included in the instructions to the Methodology to make clear that the benchmarks were intended to be applied in a flexible manner that would take account of the specific regulatory context.

The Methodology represents a compendium of all of IOSCO's work and provides a comprehensive framework for analyzing implementation of the principles. It references in one place many of IOSCO's technical reports, resolutions, statements of good practice, and other relevant materials on securities regulation. It thus is a tremendous resource, giving an assessor the tools to access more in-depth material on a given topic. In addition, the Methodology serves an effective diagnostic and action-planning function. The Methodology is especially strong in establishing the market and regulatory context for the various principles. By organizing the core principles into key issues and key questions and by providing detailed criteria for each topic, the Methodology not only provides a vehicle for analyzing a securities regulatory regime across the entire range of securities regulation but also provides a measure of consistency across markets.

5.5.4 Key Considerations in Conducting an Assessment

An assessment generally begins with an overview of the structure and state of development of securities markets and key institutions in a particular country. Although an in-depth assessment of this information is generally beyond the scope of the assessment of IOSCO core principles, the assessor must understand the effect of the information gathered on the effectiveness of securities regulation in the country being assessed.[36] The nature of the market being assessed and its legal framework must be comprehended fully for the assessment to be well-founded. For example, "markets with a single or a few issuers, that are totally domestic in nature, or that are predominantly institutional, will pose different questions and issues as to the sufficiency of application of the Principles, and as to the potential vulnerabilities likely to arise from their non-application" than markets that feature different characteristics (IOSCO 2003a, 6). In addition, any weaknesses or shortcoming in the preconditions and the effect they have on securities regulation must be considered. Assessors obtain much of this information through the use of a securities markets questionnaire, which seeks data on the structure and performance of securities markets and on the legal and regulatory framework for supervision in the country being assessed (for an example of the sort of quantitative information analyzed, see appendix B, table B.9).

An assessment of securities regulation requires the assessor to be familiar with all the relevant laws and regulations, as well as with other key documents and practices. As noted earlier in the discussion of preconditions, effective securities regulation not only is based on the securities law but also is integrally connected to company law. In addition, accounting and audit standards, investment fund law, bankruptcy law, and other parts of the legal framework are critical. In many countries, codes of conduct and other policy documents that may or may not have the force of law may also be important. Consequently, an assessor must be familiar with a wide range of relevant laws and regulations, as well as with other types of government and nongovernment guidance.

A critical foundation of a third-party assessment is a self-assessment completed by the regulator. The availability of a thorough and candid self-assessment is critical to enable a third-party assessor to complete a fair and accurate assessment. A well-prepared self-assessment that includes the summaries of the relevant legal and regulatory texts and a thorough description of the institutional framework and supervisory practices is essential. As noted earlier, before the development of the Methodology, IOSCO members completed a series of self-assessment questionnaires, including a so-called "high-level" assessment and additional assessments covering specific aspects of securities regulation. Those questionnaires are highly informative and, though cumbersome to use, have been helpful to the third-party assessors, especially since IOSCO developed a concordance key to cross-reference specific items in the questionnaires to the Methodology. However, with the adoption of the Methodology, IOSCO members may undertake updated self-assessments directly pursuant to the Methodology. A number of IOSCO members have already started to do so, and some are undergoing "assisted self-assessments" in which they obtain the assistance of other IOSCO members to help them complete the self-assessment. A comprehensive and candid self-assessment prepared pursuant to the new Methodology would serve as a good foundation for developing a complete profile of the market and for assessing how it is regulated, as well as for identifying strengths and weaknesses for further consideration.

Third-party assessors must conduct in-depth discussions with the securities regulator, other relevant authorities, and market participants on the relative strengths and weaknesses of the securities regulator. Assessors should meet with authorities, securities firms, exchanges, SROs, industry groups, depositories, and other agencies and must share the draft assessment with the regulator and discuss comments.

An IOSCO self-assessment and an FSAP assessment follow similar formats. Both types of assessments begin with a discussion of the institutional and market structure of securities regulation in the country being assessed. The information and the methodology used for the assessment are then set forth, followed by a discussion of the sufficiency of the preconditions for effective securities regulation. The heart of the assessment is the principle-by-principle assessment, which contains a detailed discussion of each principle, noting relevant factual information, actual practices that are followed, and effectiveness of oversight. Comments by the assessor are important to document how the assessor arrived at his or her conclusions. Thus, this information should be described in reasonable detail, with reference to the supporting authority as necessary. The assessment concludes with recommended actions and the securities regulator's response.

An assessment must take into account what is actually taking place in practice. The IOSCO methodology explicitly recognizes that there is a significant difference in terms of effective securities regulation between laws and rules that may look good on paper and those that are enforced in practice. The Methodology specifically states that it envisions that assessors will conduct their assessments from two perspectives: first, whether the laws and rules are sufficient and the programs or procedures intended to implement those laws and rules are effective and, second, whether the laws, rules, and programs and procedures are actually implemented in practice. It can be challenging for assessors to gain a realistic understanding of how securities regulation operates in practice, requiring candid discussions with regulators, market practitioners, investor representatives, and others.

5.5.5 Assessment Experience

As of the end of April 2004, 54 IOSCO assessments had been completed in the FSAP process. This number is approximately one-half of the 105 assessments that had been completed or were under way or planned. Not all FSAP assessments include an IOSCO assessment. In April 2002, Bank and Fund staff members issued a report reviewing the experience with the assessment of the IOSCO core principles (see IMF and World Bank 2002a).

Assessors have had some difficulty in applying the Methodology's benchmarks in practice. As the Methodology was being completed, the Bank and the Fund conducted a testing program in which they undertook eight IOSCO assessments pursuant to the Methodology. The eight assessments took place across all geographic regions and in both industrialized and emerging market economies. The assessors comprised World Bank staff members, IMF consultants, and experts nominated by IOSCO. Uniformly, the assessors found that the benchmarking system set forth in the Methodology made it difficult to apply the Methodology with the flexibility they believed IOSCO had intended. Members of IOSCO who had conducted self-assessments pursuant to the Methodology had a similar reaction.

As a result, IOSCO has drafted new instructions on the use of the Methodology to clarify that the Methodology contemplates "the exercise of disciplined flexibility" in the benchmarking process. Assessors are expected to use their discretion in arriving at a rating but must document their conclusions, particularly to the extent they may depart from the benchmarking parameters. Thus, for example, in assessing under Principle 2 whether a securities regulator operates independently from the Ministry of Finance, an assessor must consider whether the regulator must consult with the government ministry on particular matters of regulatory policy. If the circumstances of such consultation include any decision making on day-to-day matters, then under the benchmarking as strictly applied, the regulator would receive a "not implemented" on this principle. However, the assessor may conclude that the matters on which the regulator must consult do not impair the independence of the regulator. In that case, the assessor may give the regulator a higher rating, as long as the reasons for this assessment are well documented. By maintaining the benchmarks but permitting them to be applied with discretion, IOSCO is hoping that the benchmarks will be able simultaneously to bring objectivity to, and a measure of

consistency across, assessments while allowing for the flexibility necessary to ensure that the resulting assessment is appropriate for the regulatory system assessed.

Several key conclusions on securities market regulatory practices have emerged from the assessments so far.[37] Weaknesses in the implementation of many of the principles were evident across the range of jurisdictions assessed, although the most marked concerns related to assessments of developing and emerging markets. The assessment experience also highlighted the difficulties in drawing clear connections between the weaknesses identified in the regulation of securities market and financial sector vulnerabilities.

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

In turn, the principles that have relatively higher levels of full and broad implementation are the following: (a) Principles 18–19 (regulation of collective investment schemes, (b) Principles 21 and 25 (regulation of market intermediaries and the secondary market), and (c) Principles 1 and 4–5 (activities of the regulator). Some common deficiencies noted by the assessors in terms of the issues relating to the regulator include the following: a lack of operational independence; limited enforcement powers; and inadequate resources, which thus hamper the ability to perform regulatory functions efficiently and effectively. The lack of operational independence raises particular questions as to control of resources (both human and financial). The lack of a clear mandate—or the lack of clear regulatory powers—also inhibits regulatory functions such as licensing, access to necessary (sometimes confidential) data, and so forth. Other common deficiencies include the need for appropriate regulations dealing with collective investment schemes, the need to expand the scope of the regulator's responsibilities, the need to improve licensing requirements for trading systems, and the need to increase the scope of trading arrangements.

Although assessors are not able to readily consider preconditions, the comments in specific assessments do, nevertheless, allude to the poor state of legal and accounting systems in many jurisdictions. For example, many assessments note the inadequacy of the accounting framework—both in terms of standards and professional arrangements—as being linked to weaknesses in the implementation of the principles for issuers. Likewise, audit issues are commonplace, and aspects of the oversight of auditors feature prominently in many assessments. The insolvency regime is, not surprisingly, often cited as requiring attention in those jurisdictions that exhibit lower levels of implementation of the principles related to market intermediaries. An efficient court system, a highly skilled legal profession, and a set of well-designed administrative review processes would no doubt

support strengthening the enforcement of laws in the countries that have been assessed as not having fully implemented the principles relating to enforcement and cooperation (Principles 8–10 and 11–13). (See section 5.5.6 and Annex 5.F for a further discussion of enforcement issues.)

5.5.6 Special Topics in Securities Market Development and Regulation

Three key topics in securities market regulation and development are discussed in this section: (a) demutualization of stock exchanges, (b) creation of integrated regulator or supervisor, and (c) enforcement and exchange of information.

5.5.6.1 *Demutualization*

The past decade has witnessed tremendous changes in the structure of securities markets as lawmakers, regulators, and market participants try to contend with the effects of globalization and the development of advanced technology. New forms of markets have been created, and traditional markets have struggled to stay competitive. Regulators have been forced to face difficult questions of what constitutes the essential elements of a market and how they should be regulated going forward. The viability of self-regulation, which, in fact, in many countries predated stand-alone securities regulators, has also come into question.

One increasingly common consequence of those developments is a worldwide trend toward the demutualization of stock exchanges. Many stock exchanges began as mutual—or member—organizations where, in exchange for the privilege of membership, an individual or a securities firm was (a) given certain benefits, including the right to trade on the exchange and to make a market in certain securities, and (b) certain responsibilities, including the obligation to act in accordance with the membership rules for the benefit of the exchange at large. This system worked effectively for many years, and, indeed, many would argue that it still does. However, others believe that this membership structure served to constrain the exchanges from competing effectively with their rivals, including fast and efficient electronic systems that could execute trades rapidly at little cost. To marshal greater resources that would enable them to compete more aggressively, a significant number of exchanges decided to transform themselves into for-profit stock companies in which shares would be offered to the public and even, in some cases, listed on the exchange itself. In a number of cases, government authorities initiated the demutualization of domestic exchanges, believing that this action would improve the competitiveness and efficiency of their markets. According to the World Federation of Exchanges, a total of 42 exchanges had demutualized as of March 2003. This figure includes exchanges in both developed and emerging markets, including, for example, the London Stock Exchange, Australian Stock Exchange, Deutsche Borse, Athens Stock Exchange, Philippines Stock Exchange, and Kuala Lumpur Stock Exchange, among others.

The transformation of stock exchanges into for-profit share companies raises significant issues for securities regulators. Although many of the issues exist in the case of traditional stock exchanges, demutualization served to highlight the potential conflicts of interest.[38] In particular, exchanges that have demutualized may have a heightened con-

flict of interest between their business and regulatory functions, including in the administration of their own operating rules. For example, when operated by a management team whose main goal is to create a profit, an exchange may have less interest in devoting resources to its regulatory functions. Furthermore, as a for-profit enterprise, an exchange may come into conflict in regulating its own competitors. Regulators have handled those potential conflicts in a variety of ways. Some regulators have removed regulation from the exchange function entirely, giving it to an independent self-regulatory organization or even assuming all or part of the functions themselves. In other cases, improving internal controls at the exchange—coupled with enhanced regulatory oversight or strengthened corporate governance—has been considered sufficient.

From an assessor's perspective, the key issue is to be aware of the market structure that exists in the country being assessed, to recognize the regulatory implications of that structure, and to have a comprehensive understanding of the way in which the regulatory authorities have addressed those implications. When assessing a market with a demutualized exchange, the assessor should consider how the regulatory responsibilities of the exchange are being handled, what procedures the exchange or other parts of the regulatory system have in place to address potential conflicts of interest, and whether the regulator has an effective program of oversight.

5.5.6.2 *Creation of an Integrated Regulator or Supervisor—Security Regulator's Perspective*

During the past decade, a number of securities regulators in both developed and emerging markets have been merged into or reorganized as an integrated regulator or supervisor.[39] That is, the securities regulator has become part of an organization with the broader mandate of regulating or supervising not only securities firms and markets but also other segments of the financial sector. Thus, securities regulators may now be merged with authorities responsible for banking supervision, insurance supervision, or both or may, in fact, have even broader authority over pensions or other forms of financial activity. The effect of this development on the effectiveness of securities regulation remains unclear. In particular, it is not yet clear whether an integrated supervisor promotes effective implementation of the IOSCO core principles. Some of the fundamental objectives of securities regulation—particularly market conduct and market integrity—are not identical to, and indeed may be inconsistent with, the objectives of other forms of regulatory supervision. This situation may cause a conflict within the integrated supervisor. This possible conflict raises questions relating to whether sectoral integration of supervisory functions should be based on specific objectives of supervision and whether appropriate internal organization of an integrated supervisor could facilitate efficient resolution of conflicts, if any. See appendix F for further details.

From an assessor's perspective, a number of factors are important to consider. What were the reasons that motivated the country authorities to establish a single regulator? Are they being achieved? Is the supervisor effectively monitoring risk transfers among different financial firms in different sectors? Has the supervisor retained personnel and experienced staff members from the securities regulator? Is the investor protection objective of securities regulation being achieved? For example, how would the integrated supervisor

handle a situation in which a financial intermediary in that country were to develop a significant problem? How would the supervisor protect investors in such a case?

5.5.6.3 *Enforcement and the Exchange of Information*

Enforcement plays a central part in the operation of well-run capital markets. It is essential for a securities regulator to be diligent in administering the laws and rules and to take effective enforcement action against those who contravene them. Only by taking strong and immediate action can the regulator send a message to the market that wrongdoing will not be tolerated. In many countries that have been assessed, enforcement is very weak, in part because of an inadequacy in resources and insufficient authority.

Enforcement is one area where securities regulation differs markedly from banking supervision. As with bank supervisors, securities regulators are responsible for overseeing market intermediaries and their relationship with their clients. However, securities regulators also are responsible for overseeing the markets more broadly, including the regulation of collective investment schemes and their advisers or operators, as well as the supervision of issuers and listings. Thus, to achieve their investor protection objective, securities regulators must cast a broad enforcement net as they seek to detect and deter fraud, including accounting and financial fraud, in both organized and unorganized markets, between intermediaries and their clients, and in public statements by issuers. In addition, the scope of cooperation and exchange of information among securities regulators for law enforcement purposes is often quite wide ranging, going well beyond the safety and soundness information. Those and other considerations pose challenges in the assessment process. Some of the issues in assessing enforcement are highlighted in Annex 5.F.

Annex 5.A Legal and Institutional Environment for Effective Bank Insolvency Procedures

Autonomy of Banking Authority

The basic framework for bank insolvency needs to (a) be set out in the law that states the goals to be pursued by the banking authorities when dealing with insolvent banks and (b) empower the authorities to implement the bank insolvency framework. Moreover, the law should grant operational autonomy to official decision makers who are responsible for enforcing prudential rules; initiating and supervising insolvency proceedings; and acting as official administrators, liquidators, or all of the preceding.

To ensure the autonomy of banking authorities, the law should include provisions that do the following:

- Grant security of tenure to high-level officials of the banking authorities. In particular, the law should stipulate who can dismiss the heads or high-level officials of banking authorities and under what conditions. Dismissal should occur only for cause, and the grounds should be limited to, for instance, (a) inability, (b) illness or other forms of incapacitation preventing one from performing one's duties over

a significant period of time, (c) willful misconduct, (d) gross negligence, or (e) noncompliance with explicit fitness criteria.
- Grant banking authorities the appropriate degree of budgetary autonomy and flexibility in using its financial resources within the framework of the law, subject always to appropriate accounting and auditing.
- Allow banking authorities to act without interference in their day-to-day operations and decisionmaking, and insulate them from potential pressure from the political establishment and market participants.

Legal Mandate

The legal mandates and functions of each of the official agencies and authorities involved in the resolution of insolvent banks such as (a) the central bank, (b) the supervisory agency, (c) the deposit insurance agency, and (d) the Ministry of Finance should be clearly delineated in a manner that avoids gaps or overlaps. While the legal framework should provide for the exchange of information and coordination, it also should require each agency to exercise its powers independently. A mechanism for the resolution of potential disputes in an open and transparent manner should be provided for in the law.

Appropriate Legal Protection of Banking Authorities and Their Staff Members

Laws should grant legal protection for bank authorities and their staff members to fulfill their responsibilities. Legal protection should be coupled in a balanced manner with the legal accountability necessary to prevent any abuse of power so as not to discourage authorities and officials from taking prompt and decisive action.

Of particular importance is personal protection from civil and criminal liability of senior staff members and other officers or agents of the banking authorities who are involved in the declaration of a bank's insolvency and in the administration of its restructuring, liquidation (including individuals who are appointed as official administrators or liquidators), or both—other than for intentional wrongdoing (e.g., abuse of power, theft, conversion of assets, conspiracy, etc.). This type of protection can be extended (a) by granting express statutory immunity from liability for actions and omissions that the persons concerned have taken in discharge of their legal responsibilities, (b) by making their agency vicariously liable for their faults, (c) by including appropriate indemnification provisions in their contracts of employment, or, perhaps, (d) by a combination of the three mechanisms, depending on the specific legal position of the officials concerned.

Transparency

For a banking authority, the combination of a precise mandate with a high degree of transparency in its implementation is crucial because it reduces simultaneously the opportunities for (a) the pursuit of personal interests on the part of supervisors, (b) the exercise of undue influence over the decision-making process by market participants (so-called "regulatory capture"), and (c) political interference. The legal framework should require agencies dealing with insolvent banks to operate with the maximum degree of transparency compatible with the need to preserve confidentiality.[40]

The transparency of the supervisory function is often difficult to achieve in practice because decisions are typically highly invisible for cogent reasons of confidentiality. This lack of transparency makes supervisory decisions an easy target for interference by politicians and market participants requesting forbearance. The scope for interference can be limited if the decision making relating to supervisory enforcement (including revocation of a license), and the commencement of insolvency proceedings is based on precise rules and on well-specified criteria. In principle, considerations of confidentiality are less likely to justify nontransparency of the official decision makers' evaluations and actions after the commencement of insolvency proceedings.[41] Even where reasons of confidentiality preclude open decision making or the disclosure by an agency of detailed information to the public at large, the provision of more comprehensive information to the politically responsible executive branch of government will still be appropriate.

Accountability and Judicial Review

Banking authorities are subject to various forms of accountability. First, they will need to explain the way in which they conduct their affairs and perform their mandate to the government, the legislature, and the public (and those authorities are thus subject to some measure of hierarchical, political, and public accountability). Second, in certain cases, they are legally accountable in civil and criminal law proceedings, with appropriate legal protection as noted earlier. In addition, they will occasionally need to substantiate before the courts of law the legality of their decisions.

The possibility of judicial scrutiny helps to ensure that administrative decisions are made consistently and on proper grounds. To guarantee the legality of official actions and the protection of the legitimate interests of private parties, affected parties should be able to challenge the decisions made by the banking authorities in administrative law by bringing judicial review proceedings before the administrative courts or by appealing to a special tribunal.[42] Where the external review of decisions takes the form of a special appeals mechanism, it should be entrusted to an independent and impartial tribunal established by law and comprising persons with requisite experience and skills.

At the same time, the mechanisms of legal accountability should not undermine the effectiveness and credibility of the banking authorities' actions. In particular, the banking authorities' margin of discretion should be respected, and a court or appeals tribunal (or both) should not be able to substitute its own policy decisions for those of the relevant authority. Accordingly, the review mechanism should seek only to ensure that the banking authorities act legally and within the limits of their powers and should not allow a reassessment of their actions on substantive grounds. Any reconsideration of decisions on the merits should be confined within the agency and incorporated into its internal operating procedures.

Coordination among Banking Authorities

If one is to deal with an insolvent bank effectively, the following are essential: timely cooperation and coordination between the various banking authorities and other public bodies concerned (e.g., the central bank; the operators of payment and settlement systems; the deposit insurance agency; and, where required, the supervisors of other sectors and jurisdictions, including the securities and insurance sectors).[43] Whenever the

restructuring stage is reached (see chapter 5, section 5.3.5), coordination with the officials responsible for the restructuring will be crucial.

At the domestic level, there should be a sound legal basis for the exchange of information and coordination among all the public bodies involved. The law should not impede the sharing of information; in particular, the duties of secrecy owed by official decision makers should not prevent interagency disclosures. Furthermore, means should be clarified for coordination among agencies, particularly with respect to banks that belong to financial conglomerates. In this context, there should be clear principles for determining which supervisory authority bears primary responsibility, and the obligation of each authority to keep other bodies informed should be recognized.

Where an insolvent bank operates in several jurisdictions, the banking authorities should be able to exchange information and to coordinate actions with their foreign counterparts. The operational terms of cooperation should be laid down in bilateral arrangements between the respective national authorities, for example, in the form of memoranda of understanding or through an exchange of letters. A duty of confidentiality should apply to all information shared between the authorities, in accordance with the national legislation of the countries concerned. The flow of information between host and home supervisors should be in both directions.

Annex 5.B Consolidated Supervision

Given the complexities in conducting effective consolidated supervision, it is critical that the supervisory authorities have the necessary tools to carry out their responsibilities. Some of the preconditions and prerequisites for effective banking supervision, which were discussed earlier (particularly, an appropriate legal framework and operational independence of the supervisory agency or agencies), are especially important in the conduct of effective consolidated supervision.

- The legal framework must grant the supervisor the necessary powers to conduct consolidated supervision over the entire span of institutions under its jurisdiction. Supervisors should have (a) sufficient flexibility in licensing and authorization, (b) the power to request information sufficient to effectively assess the banking group's risk profile and the adequacy of its risk management, and (c) sufficient enforcement powers to address technical compliance not only with laws and regulations but also with safety and soundness concerns that may arise within the banking group. In addition, they must have the ability to sanction intragroup transactions that, while strictly legal from a groupwide perspective, have undesirable consequences for the regulated group entities.
- Additional important considerations are the agency's (or agencies') operational independence and adequacy of resources. Issues to be reconciled include reporting requirements and accountability for the agency, as well as its funding and staffing. A supervisory agency that must report to another ministry may suffer political interference, especially when controversial decisions need to be made. Likewise, an agency that is underfunded or that cannot retain qualified staff members will not be able to maintain an effective supervisory program.

- Consolidated supervision allows financial sector supervisors to better understand the relationship among the different legal entities so they can assess the potential for adverse developments in one part of the group that may affect the operation of others. This assessment is done by monitoring and evaluating the additional risks posed to regulated financial institutions by affiliated institutions. It is important to stress, however, that consolidated supervision is a complement to, not a substitute for, single entity supervision. The supervisor responsible for consolidated supervision will, inter alia, have to be cognizant of the effect of the policies of the various supervisors of entities within the group.

Consolidation of accounts is a necessary prerequisite for obtaining meaningful financial information on groups of corporations and for supervising banks on a consolidated basis. Taking into account the groupwide financial exposures and intragroup financial relationships allows a better assessment of the implication of group membership for the financial condition of individual group members.

The consolidation of financial accounts, however, is not sufficient to capture many of the risks facing the bank through group membership. For example, consolidated financial accounts do not provide qualitative information about the group, such as the quality of management or internal controls. Similarly, some group entities, for technical reasons, may not be subject to consolidation in the financial accounts. A robust consolidated supervision program must thus incorporate both qualitative and quantitative analyses of the group's risk profile.

In many other jurisdictions, the concepts of consolidation and supervision on a consolidated basis are still not firmly established. The legal framework is still insufficiently developed; the concept of "group" and the question of how to deal with not only limited liability but also communalities of interest between corporations belonging to a group still need to be clarified. Also, the distinction between consolidation of accounts and supervision on a consolidated basis need to be kept clearly in mind. Those two concepts are clearly connected, but each poses different legal questions.

Effective consolidated supervision requires close cooperation among domestic sectoral supervisors. Similarly, the administrative and management arrangements within the various responsible authorities need to ensure the good coordination and the smooth exchange of information among home or host regulators abroad. Those exchanges will often be conducted within the auspices of a memorandum of understanding (MOU). However, the existence of an MOU will not in itself ensure that relevant information is provided. Much will depend on a relationship of trust being developed between the different regulators so information is exchanged proactively and in a timely manner.

The importance of assessing wider risks from other group members to the regulated entity is stressed in the core principles for banks, securities firms, and insurance companies, although there are differences in emphasis in the respective approaches. Gaps could expose a major bank or other financial institution within the group entity—and, hence, expose the system at large—to unacceptable risks from unregulated group entities. Similarly, overlaps could mean a diversion of scarce regulatory resources, either imposing unnecessary burdens on both regulated firms and taxpayers or, even more seriously, leading to an underfunding of regulatory effort in other areas of potentially high systemic risk.

Annex 5.C IAIS Insurance Core Principles

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The IAIS Insurance Core Principles comprise 28 principles that need to be in place for a regulatory and supervisory system to be effective (IAIS 2003a). The principles relate to the following:

- Conditions for effective insurance supervision help set out the elements of the environment where supervision can be most effective.
  - ICP 1 Conditions for effective insurance supervision include broad requirements in financial policy and financial market infrastructure to support effective supervision.
- The supervisory system deals with the mandates and responsibilities of the supervisor.
  - ICP 2 Supervisory objectives seek clarity in law.
  - ICP 3 Supervisory authority seeks adequate powers, resources, and legal protection.
  - ICP 4 Supervisory process seeks transparency and accountability.
  - ICP 5 Supervisory cooperation and information sharing cover cooperation within the insurance sector and across the financial services sector, as well as nationally and internationally.
- The supervised entity deals with the form and governance of insurers.
  - ICP 6 Licensing calls for requirements for licensing to be clear, objective, and public.
  - ICP 7 Suitability of persons requires ongoing assessment of fitness and propriety of significant owners and key functionaries.
  - ICP 8 Changes in control and portfolio transfers require supervisory approval of changes in significant ownership and control, in mergers, and in portfolio transfer.
  - ICP 9 Corporate governance requires prudent management of an insurer's business on the basis of standards that stress the role of board and senior management.
  - ICP 10 Internal control states the requirements for internal control systems, including internal audit and reporting, as well as compliance functions.
- Ongoing supervision outlines the actual practice of the supervisor.
  - ICP 11 Market analysis requires macro–prudential surveillance of the sector.
  - ICP 12 Reporting to supervisors and conducting off-site monitoring require comprehensive reporting that is done on a solo and a group basis, plus maintenance of an ongoing monitoring framework.
  - ICP 13 Onsite inspection requires comprehensive inspection powers for both the insurer and outsourced companies, plus clarified scope of inspections.
  - ICP 14 Preventive and corrective measures require an adequate, timely, and graduated spectrum of remedial measures.

- ICP 15 Enforcement or sanctions will require measures that are based on clear objective criteria.
- ICP 16 Winding-up and exit from the market will require criteria and procedures for insolvency and calls for priority with respect to policyholders.
- ICP 17 Groupwide supervision calls for consolidated—groupwide—supervision of the insurance group or conglomerate.

- Prudential requirements address the key financial and risk-management processes that should be imposed on and in place within insurance companies.
  - ICP 18 Risk assessment and management state the requirements for risk-management systems and their review by supervision.
  - ICP 19 Insurance activity requires strategic underwriting and pricing policies, as well as limits on risk retained through reinsurance.
  - ICP 20 Liabilities specify supervisory requirements to assess adequacy of technical provisions held against the policy liabilities.
  - ICP 21 Investments require compliance with standards on investment policy, asset mix, valuation, risk management, and asset–liability management.
  - ICP 22 Derivatives and similar commitments cover restrictions on their use and on requirements for disclosures.
  - ICP 23 (capital adequacy and solvency) covers sufficiency of technical provisions to cover expected claims and expenses as well as sufficiency of capital to cover significant unexpected losses.
- Markets and consumers deal with distribution, customer protections, disclosure, and fraud.
  - ICP 24 Intermediaries cover licensing and business requirements for insurance intermediaries.
  - ICP 25 Consumer protection covers requirements on the providing of information to consumers before and during a contract.
  - ICP 26 Information, disclosure, and transparency toward the market call for adequate disclosure by insurance firms.
  - ICP 27 Fraud calls for measures to prevent, detect, and remedy insurance fraud.
- Anti-money-laundering should aid in combating the financing of terrorism.
  - ICP 28 Anti-money laundering and combating the financing of terrorism [AML–CFT]) requires effective measures to deter, detect, and report AML–CFT offenses in line with FATF standards.

Each principle is elaborated through criteria. It is in the criteria that the full meaning of each principle is found in considerable detail. Although those criteria are not reproduced here, they need to be carefully reviewed if one is to gain a full understanding of the meaning and intention of each core principle. The IAIS emphasizes that the criteria are intended to be implemented both in form and in practice. The criteria consist of two distinct groupings:

- Essential criteria—those components that are intrinsic to the implementation of the core principle (all of which should be met for a supervisory authority to demonstrate "observed" status for each principle)
- Advanced criteria—those components that are considered to improve on the essential criteria and thus enhance the supervisory regime (which are not used for assessing observance with a principle but are used when commenting on a jurisdiction's supervisory framework and making recommendations)

Annex 5.D List of IOSCO Objectives and Principles of Securities Regulation

The three core objectives of securities regulation are (a) protecting investors; (b) ensuring that markets are fair, efficient, and transparent; and (c) reducing systemic risk.

Principles Relating to the Regulator

1. The responsibilities of the regulator should be clear and objectively stated.
2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.
3. The regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers.
4. The regulator should adopt clear and consistent regulatory processes.
5. The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.

Principles for Self-Regulation

6. The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

Principles for the Enforcement of Securities Regulation

8. The regulator should have comprehensive inspection, investigation, and surveillance powers.
9. The regulator should have comprehensive enforcement powers.

10. The regulatory system should ensure effective and credible use of inspection, investigation, surveillance, and enforcement powers, as well as implementation of an effective compliance program.

Principles for Cooperation in Regulation

11. The regulator should have authority to share public and nonpublic information with domestic and foreign counterparts.
12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and nonpublic information with their domestic and foreign counterparts.
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in connection with the discharge of their functions and the exercise of their powers.

Principles for Issuers

14. There should be full, timely, and accurate disclosure of financial results and other information that is material to investors' decisions.
15. Holders of securities in a company should be treated in a fair and equitable manner.
16. Accounting and auditing standards should be of a high and internationally acceptable quality.

Principles for Collective Investment Schemes

17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
18. The regulatory system should provide rules for governing the legal form and structure of collective investment schemes, as well as the segregation and protection of client assets.
19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
20. Regulation should ensure that there is a proper and disclosed basis for asset valuation, as well as for the pricing and the redemption of units in a collective investment scheme.

Principles for Market Intermediaries

21. Regulation should provide for minimum entry standards for market intermediaries.

22. There should be requirements concerning initial and ongoing capital and other prudential requirements for market intermediaries; the requirements should reflect the risks that the intermediaries undertake.
23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that are designed to protect the interests of clients and to ensure proper management of risk; under such standards, management of the intermediary should accept primary responsibility for those matters.
24. Procedures for dealing with the failure of a market intermediary should minimize damage and loss to investors and should contain ways to handle systemic risk.

Principles for the Secondary Market

25. The establishment of trading systems, including securities exchanges, should be subject to regulatory authorization and oversight.
26. Ongoing regulatory supervision of exchanges and trading systems should strive to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance amid the demands of different market participants.
27. Regulation should promote transparency of trading.
28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.
29. Regulation should strive to ensure the proper management of large exposures, default risk, and market disruption.
30. Systems for clearance and settlement of securities transactions should be subject to regulatory oversight and should be designed to ensure not only that they are fair, effective, and efficient but also that they reduce systemic risk.

Annex 5.E IOSCO Methodology—Scope and Use of Principle 8

The IOSCO methodology document (IOSCO 2003a) introduces the group of principles relating to enforcement (Principles 8 through 10) with a preamble that defines the term enforcement and explains each of the core principles in this group. The methodology calls for a broad interpretation of enforcement, covering wide-ranging powers of surveillance, inspection, and investigation. It then explains each of the principles under this group. In particular, it states that Principle 8 deals with preventive measures and with the methods for obtaining information by the regulator. It then clarifies that the scope of those principles encompasses all agencies involved in enforcement and is not limited only to the primary regulator.

Key issues relating to Principle 8 are then listed, which spell out in greater detail specific powers of the regulator that would be needed—including (a) power to require regular reporting or to seek information through inspections of a market participant's business operations and (b) types of documents and records to which access should be required. This list is followed by key questions, which are listed below.

Principle 8

Principle 8: The regulator should have comprehensive inspection, investigation, and surveillance powers.

Key Questions

1. Can the regulator inspect a regulated entity's business operations, including its books and records, without giving prior notice?
2. Can the regulator obtain books and records and request data or information from regulated entities without judicial action, even in the absence of suspected misconduct,
   a. In response to a particular inquiry?
   b. On a routine basis?
3. Does the regulator have the power to supervise its authorized exchanges and regulated trading systems through surveillance?
4. Does the regulator have record-keeping and record-retention requirements for regulated entities?
5. Are regulated entities required
   a. To maintain records concerning client identity?
   b. To maintain records that permit tracing of funds and securities in and out of brokerage and bank accounts related to securities transactions?
   c. To put in place measures to minimize potential money laundering?
6. Does the regulator have the authority to determine or have access to the identity of all customers of regulated entities?
7. Where a regulator outsources inspection or other regulatory enforcement authority to an SRO or a third party?
   a. Does the regulator supervise the outsourced functions of third parties?
   b. Does the regulator have full access to information maintained or obtained by the third parties?
   c. Can the regulator cause changes or improvements to be made in the third parties' processes?
   d. Are the third parties subject to disclosure and confidentiality requirements that are no less stringent than those applicable to the regulator?

Benchmarking Rubric for Principle 8

- *Fully Implemented*—Requires affirmative responses to all applicable questions
- *Broadly Implemented*—Requires affirmative responses to all applicable questions, except to Question 7(c)
- *Partly Implemented*—Requires affirmative responses to all applicable questions, except to Questions 7(c) and 7(d) or, where the regulator must cooperate with other authorities to obtain records of regulated entities, such cooperation is not sufficiently timely

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- *Not Implemented*—Inability to respond affirmatively to one or more of Questions 1, 2(a), 2(b), 3, 4, 5(a), 5(b), 5(c), 6, 7(a), or 7(b)

The questions stated earlier serve as a set of criteria by which implementation is graded. For example in the case of New Zealand, the securities commission had affirmative responses to all the questions except 7c; the securities commission cannot require a registered securities exchange—which performs significant inquiry and enforcement functions—to improve its processes or conduct rules. Therefore, a grading of "broadly implemented" was assigned. In another country (an emerging market), although the regulator had comprehensive surveillance and investigative powers and had determined affirmative answers to all questions, the scope of existing regulations relating to Question 4 was assessed as requiring some further improvements. The assessors recommended the preparation of an explicit and comprehensive record-keeping standard for the regulated firms (including information on investment objectives, audit trails, etc.) to facilitate the inspection of the firm's operations. A "broadly implemented" grading was assigned.

Annex 5.F Enforcement and the Exchange of Information

Securities regulators have a range of enforcement powers. According to the IOSCO core principles and the methodology, securities regulators must, in addition to their inspection and surveillance powers, be able to conduct investigations of possible violations of the securities laws. To conduct those investigations, a securities regulator needs to be able to "monitor the entities subject to its supervision, to collect information on a routine and ad hoc basis, and to take enforcement action to ensure that persons and entities comply with relevant securities laws" (IOSCO 2003a, 37). The methodology makes very clear that the principles envision a broad definition of enforcement in which regulators will be able to demonstrate effective and credible use of their enforcement powers, including taking effective actions to investigate and address misconduct or abuses. "An effective program, for example, could combine various means to identify, detect, deter, and sanction such misconduct. A wide range of possible sanctions could meet the standards according to the nature of the legal system assessed. The regulator, however, should be able to provide documentation that demonstrates that sanctions available (whatever their nature) are effective, proportionate, and dissuasive" (IOSCO 2003a, 37). In many countries, the criminal prosecutor is responsible for prosecuting securities violations, and the regulator will turn over its investigative file to the prosecutor for follow-up. In those situations, effective securities enforcement can be a challenge, particularly if the prosecutor has other priorities.

To implement those principles, a regulator needs to be able to obtain information from the organizations that it regulates, both on a routine and for-a-cause basis, when it believes that a breach may have occurred. The regulator needs also to be able to obtain both bank and brokerage records, even when banks may be subject to the supervision of a different government agency. Those records must include information relating to client identity so the regulator can conduct its investigation. In addition, the regulator must be able to require the production of information from third parties. If the regulator does not have such powers itself, it needs to be able to cooperate effectively with other

government regulators and to be able to obtain this information through the competent authority. The powers must be used effectively and credibly for an effective enforcement program to exist.

However, as the principles make clear, because securities transactions are often global in nature and can cross many geographic borders both easily and quickly and because proceeds of securities transactions similarly can be transferred elsewhere, securities enforcement is no longer a purely domestic matter. Rather, securities regulators have to cooperate with their foreign counterparts to conduct an effective domestic enforcement program. As the methodology states, "[E]ffective regulation can be compromised when necessary information is located in another jurisdiction and is not available or accessible" (IOSCO 2003a, 50).

Exchange of information for securities enforcement purposes is also unlike that which occurs for the purposes of banking supervision. Bank supervisors, of course, also operate in a global environment where the banks they supervise may have branches or subsidiaries in another country or, indeed, may be the branches or subsidiaries of banks that are themselves headquartered elsewhere. To ensure effective consolidated supervision, bank supervisors must cooperate with their foreign counterparts and must obtain information about the activities of banks in other countries that have a bearing on the operation of banks under their supervision. Information on safety and soundness is critical. Securities regulators cooperate in a similar fashion for regulatory oversight purposes and maintain similar cooperative regulatory relationships with their foreign counterparts. However, for purposes of enforcement, the type of cooperation and information exchange that takes place is of a different order.

First, for enforcement purposes, securities regulators often need detailed, client-specific information. A securities regulator may need to know what the name of an account holder is, how much money was in the account during a specified time period, where the funds came from, and where they were transferred to if they are no longer in the account. If the client withdrew the funds or securities from the account, the regulator will want to know when and how they were withdrawn and who signed on behalf of the client. Moreover, because of the speed with which evidence can disappear, the regulator may need to know this information overnight. Unlike most bank supervisors, the securities regulator may need this information to conduct a civil or criminal investigation or to support its request for an emergency court order to freeze funds or securities. In addition, unlike bank supervision, the regulator who is receiving the information request may or may not supervise any of the entities in question (neither the account holder nor the entity where the account is located). The target regulator may, in fact, have no interest in the matter whatsoever. Thus, although traditional safety and soundness concerns are important to both bank supervisors and securities regulators, information exchange for securities regulation extends well beyond those concerns.

It can be challenging for assessors to attain a comprehensive and realistic understanding of the effectiveness of a regulator's securities enforcement program because there are few concrete standards of measurement and there is a great diversity in approaches. Bringing a large number of enforcement actions does not necessarily mean that enforcement is effective. Assessors should consider the full range of enforcement powers that the regulator possesses and how it uses those powers to pursue enforcement actions. The

assessor should evaluate how the regulator obtains information, from whom it gets information, and what kind of information it can obtain. The assessor must then consider how the regulator then uses this information to build an enforcement case. Can and does the regulator bring enforcement actions that are based on the investigation it has conducted? If not, does the regulator turn this information over to another domestic authority who can bring an enforcement case? Does that authority bring the case? The assessor also must consider whether there are barriers to domestic information exchange and whether there are gateways for information exchange with foreign counterparts. In particular, the assessor must consider whether there are blocking, bank-secrecy, or other types of privacy laws that could interfere with information exchange. The assessor must determine (a) whether the securities regulator can and does obtain information, including client identifying information, on behalf of a foreign counterpart even if it has no underlying interest in the matter; (b) on what conditions, if any, this information is obtained; and (c) how long it will take.

Notes

1. Typical LOLR instruments are a discount window, or a standing facility, often linked to a payment system.
2. The IMF–Monetary and Financial System Department (MFD), Operational Paper OP/00/01, *Emergency Liquidity Support Facilities*, provides a detailed discussion of the various elements of LOLR activities.
3. The details of this type of "incentive-compatible" system are discussed in Garcia (1999, 2000, 2001) and in Beck (2003). The adverse impact of deposit insurance on bank soundness is analyzed in Barth, Caprio, and Ross (2004) and in Demirguc-Kunt and Detragiache (2003). Also note that poorly designed deposit insurance could have a negative impact on financial development, as noted in Cull, Senbet, and Sorge (2001).
4. Nearly two-thirds of the schemes established since 2000 cover deposits in foreign currency.
5. Pros and cons of, as well as country experiences with, blanket guarantees are discussed in IMF Occasional Paper 223, "Managing Systemic Banking Crises" (Hoelscher and Quintyn 2003).
6. For further details on protection funds for insurance companies, see Takahiro (2001).
7. See Sundararajan, Marston, and Basu (2001) for a discussion of empirical evidence on the links between stability and observance of the BCP. For a comprehensive analysis of links between bank regulation and banking performance, see Barth, Caprio, and Levine (2005).
8. See IMF and World Bank (2002b). For a more recent update, see IMF (2004a) on issues and gaps in financial sector regulation.
9. See chapter 9 for a discussion. Sequencing and prioritization of reform programs may require technical assistance in some country circumstances.
10. This section is based on Basel Committee on Banking Supervision (1999).

11. For more detailed guidance on how to perform a self-assessment, see the Basel Committee document (http://www.bis.org/publ/bcbs81.htm) *Conducting a Supervisory Self-Assessment—Practical Application* (Basel 2001).
12. For each core principle, the assessment methodology requires a categorization of practices according to the degree of compliance. Four categories are envisaged: "compliant," "largely compliant," "materially noncompliant," and "noncompliant." Whether or not efforts to achieve full compliance are under way is also noted.
13. In countries with significant cross-border financial services, it is important to meet with supervisory authorities of home countries of major financial institutions to discuss supervisory cooperation, information sharing, and related issues in consolidated supervision.
14. This section is based on IMF and World Bank (2002a) and the IMF (2004a) paper "Financial Sector Regulation—Issues and Gaps."
15. See also World Bank (2001).
16. This section is based on Miles (2002).
17. Another term for an LCFI is *financial conglomerate* (a formal definition of which is being adopted in EU legislation) or, in the United States, *Large Complex Banking Organizations* (LCBOs).
18. For example, for EU member states, a host regulator of a branch of a bank incorporated in another member state has very limited supervisory powers. However, the branch may be a very large player, in both the domestic banking system and capital markets, as well as in international financial market activity conducted from the host country.
19. Technical risk is the risk of a shortfall of an insurance company's technical provisions held against its policy liabilities. The assessment of provisions will take into account the size and timing of expected payments on the policy, future premium receipts, and future investment income.
20. This section is based on Sundararajan and Errico (2002).
21. The earlier version that was adopted in October 2000 consisted of only 17 principles.
22. In the insurance context, portfolio transfers can be particularly relevant because they enable the transfer of obligations through means other than the change of control of the insurer, in effect, changing the control over the policyholder interests without sale of shares in the company. Thus, it is important that the supervisory assessment of change of control also be extended to the processes for portfolio transfer.
23. A quantitative analysis of the market could include, for example, the development in financial markets generally; the number of insurers and reinsurers subdivided by ownership structure, whether a branch, domestic, or foreign; the number of insurers and reinsurers entering and exiting the market; the market indicators such as premiums, balance–sheet totals, and profitability; the investment structure; the new product developments and market share; the distribution channels; and the use of reinsurance (IAIS 2003a, 23).
24. See Essential Criteria C—the last of 7 bullets (IAIS 2003a).
25. For example, see IAIS 2002 on capital adequacy. Also, in the EU, the solvency II project is working toward the development of a harmonized, risk-based, three-pillar approach (similar to Basel II) for use throughout the EU. This effort is part of a broader

initiative of supervisory and multijurisdictional organizations to strengthen capital adequacy and solvency frameworks. For example, the IAIS and the International Actuarial Association are working on a global framework for insurers' insolvency assessment.

26. The IAIS approved the following supervisory guidelines or issues papers in October 2003: "Quantifying and Assessing Insurance Liabilities" (IAIS 2003d), "Stress Testing by Insurers" (IAIS 2003c), "Nonlife Insurance Securitization" (IAIS 2003e), and "Solvency Control Levels" (IAIS 2003b). A guidance paper on investment risk management was issued in October 2004 (IAIS 2004a). The IAIS also prepared "Principles on the Supervision of Insurance Activities on the Internet" (IAIS 2004b), and "Standard on Disclosures Concerning Technical Performance and Risks of Nonlife Insurers and Reinsurers"(IAIS 2004c) was issued in October 2004.
27. The essential and advanced criteria for assessment purposes are integrated with the ICPs into one single document (Takahiro 2003), with the procedural and benchmarking aspects of the assessment process presented in annex 2 of the same document.
28. For a discussion of issues in analyzing soundness and structure of insurance sector, including suggestions on indicators to analyze, see Das, Davies, and Podpiera (2003).
29. See paragraph 1.7. of the explanatory note to ICP 1 (Takahiro 2003).
30. This section is based mainly on a survey conducted in 2002 of assessment experiences of 42 jurisdictions, which were assessed using the ICPs adopted in October 2000. See International Monetary Fund and World Bank (2001), "Experience with Insurance Core Principles—Assessment under the Financial Sector Assessment Program." For an update of information on insurance assessment, see IMF (2004a), "Financial Sector Regulation—Issues and Gaps—Background Paper."
31. For a detailed principle-by-principle listing of typical issues that arise to reach full compliance, see the IMF background paper (IMF 2004a) "Financial Sector Regulation—Issues and Gaps—Background Paper."
32. Insurance company counterparts do not, because of the nature of the product, have the opportunity to diversify credit risk and may often be in situations of hardship in the absence of the insurance claim proceeds in any event.
33. IOSCO was established in 1983 to bring together securities regulators from around the world in an effort to ensure better regulation of securities markets. It was created from its predecessor organization, the Inter-American Regional Association of Securities Regulations that was established in 1974. IOSCO has grown considerably since its inception and currently has more than 180 members. The core principles are presented in IOSCO public document 125 "Objectives and Principles of Securities Regulation," originally issued in September 1998 and last updated in May 2003 (IOSCO 2003b).
34. The assessment of Principle 30 is intended to be supplemented by reference to the IOSCO–CPSS Recommendations for Securities Settlement Systems and the associated assessment methodology.
35. See, for example, Schinasi (2003) and Dalla (2003).
36. See chapter 4 for a discussion of the scope of analysis of securities markets and their structure and functioning as part of the development assessment. See also chapter 2 for a discussion of indicators of structure and performance of securities markets.

37. For a detailed principle-by-principle listing of typical issues that arise to reach full compliance, see IMF (2004a).
38. See, IOSCO (2001) and Carson (2003) for a discussion.
39. This subject of integrated supervision is discussed in greater detail in appendix F of this Handbook. See also De Luna Martinez and Rose (2003).
40. The IMF Code of Good Practices on Transparency of Monetary and Financial Policies (IMF 2000) should serve in this context as an important vehicle in promoting good regulatory governance.
41. Even then, however, it would be impermissible for the authority responsible for the official administration or liquidation of the bank to divulge legally protected information relating to the affairs of particular clients. And in the context of bank restructuring, the need to protect the bank's commercial interests could preclude the publication of detailed transactional or operational information.
42. In jurisdictions where bank insolvency proceedings are court-based, the insolvency courts should have exclusive jurisdiction to determine all relevant disputes. Accordingly, the actions of the supervisory authority relating to its participation in the insolvency proceedings—including its decision to commence such proceedings—should not be subject to judicial review by the administrative courts. Allowing parties to challenge the authority's actions by way of judicial review would be unnecessary because the authority cannot make fully determined decisions on the issues but, instead, needs the approval of the insolvency court. Moreover, the possibility of parallel proceedings in insolvency and administrative law could produce conflicts and serious disruption of the insolvency process.
43. Coordination with the Ministry of Finance is also key, especially in those cases that may involve the actual or potential use of public funds.

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