Chapter 10

Assessing Information and Governance Infrastructure

Information and governance infrastructure for finance provides the foundation for financial development and effective market discipline, and it helps to reinforce official supervision. It refers (a) to the legal and institutional arrangements and structures that affect the quality, availability, and transparency of information on monetary and financial conditions and policies at various levels and (b) to the incentives and organizational structures to set and implement policies by regulators, the regulated institutions, and their counterparties. The information infrastructure includes (a) the framework for monetary and financial policy transparency (discussed in section 10.1); (b) the accounting and auditing framework that helps to define and validate the information that is disclosed to the public and the regulatory authorities (discussed in section 10.2); and (c) the arrangements to compile, process, and share information on financial conditions and credit exposures of borrowers and other issuers of financial claims (credit-reporting and financial information services, discussed in section 10.3).

The governance arrangements for financial and non-financial firms that are publicly listed and traded are of particular interest because they directly affect the functioning of the financial markets where their securities are traded. The corporate governance arrangements and the Organisation for Economic Co-operation and Development (OECD) principles of corporate governance are discussed in section 10.4. The governance of financial firms and of financial sector regulators is covered in different degrees of detail in the standards for financial sector supervision. Selected aspects of financial sector governance are also highlighted in that section.

A key aspect of financial institutions' governance is the institution's disclosure practices, which are determined in part by the supervisory framework, including the listing requirements by securities regulators, and by the company laws. The appropriate scope of

financial institutions' disclosure, including the disclosure standards under the New Basel Capital Accord, is discussed in section 10.5.

The disclosure and governance arrangements for financial and non-financial sectors should be seen in the broader context of public sector governance. Within this broader context, there are significant linkages among the governance arrangements for the regulatory agencies (including the central bank), the regulated entities, and the non-financial sector. This governance nexus should be taken into account in assessing the overall information and governance infrastructure.[1]

10.1 Monetary and Financial Policy Transparency

Good transparency practices for central banks and financial agencies in their conduct of monetary and financial policies can contribute policy effectiveness, policy consistency and good governance. The scope of good transparency practices and the issues in assessing their adequacy and effectiveness are discussed in this section.

10.1.1 Code of Good Practices

The concept of transparency of monetary and financial policies refers to an environment in which the objectives of the policy; the policy's legal, institutional, and economic framework; the policy decisions and their rationale; the data and information related to monetary and financial policies; and the terms of agencies' accountability are provided to the public on an understandable, accessible, and timely basis. The *Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Code) identifies desirable transparency practices for central banks and financial agencies in their conduct of monetary and financial policies. The MFP Code was developed by the IMF in 1999.[2] This document is a distillation of concepts and practices that are already in use and for which there is a record of experience. Together with the *Supporting Document to the Code of Good Practices on Transparency in Monetary and Financial Policies* (Supporting Document; IMF 2000b), the various guidance notes, and the specific templates, the MFP Code serves as the reference material for assessing transparency practices in monetary and financial policies.

The transparency of monetary and financial policies contributes to policy effectiveness, facilitates policy consistency, and strengthens governance. The public's awareness of the goals and instruments of policy, as well as the authorities' credible commitment to meeting the goals, can contribute to good policy making and can improve the effectiveness of policies. Transparency in the mandate, as well as the rules and procedures in the operations of monetary and financial agencies, helps to ensure consistency in cases where conflicts might arise between or within government units. Good governance calls for central banks and financial agencies to be accountable, particularly where the monetary and financial authorities are granted a high degree of autonomy. In the case of monetary policy, transparency about policy process—achieved by providing the private sector with a clear description of the considerations that guide monetary policy decisions—helps ensure that market expectations can be formed more efficiently and, thereby, makes the monetary policy transmission mechanism generally more effective. Through good

transparency practices, the central bank can establish a mechanism for strengthening its credibility by matching its actions to its public statements. Similarly, transparency of a regulatory agency's mandate, operations, and regulatory processes is essential in establishing the credibility and effectiveness of financial sector oversight. Although credibility is achieved by meeting the stated objectives and responsibilities, transparency may also limit self-interest on the part of the regulators and may foster increased commitment of regulated firms to regulatory compliance, prudent behavior, proper risk management, and internal control.

The MFP Code lists 17 good practices on transparency of monetary policies by the central bank and 20 good practices on transparency of financial policies, all grouped into four categories. Many of the good practices are further divided into more detailed practices. The four groups of transparency practices and a summary description of each practice are presented in Annex 10.A. The four groups are (1) clarity of roles, responsibilities, and objectives of central banks and financial agencies; (2) the processes for the formulating and reporting of monetary policy decisions by the central bank and of financial policies by financial agencies; (3) public availability of information on monetary and financial policies; and (4) accountability and assurances of integrity by the central bank and financial agencies.

10.1.2 Assessment Methodology and Assessment Experience

The objectives of MFP transparency assessments are to review the effectiveness of current practices and to recommend desirable transparency practices. The assessments, therefore, are designed to

- Allow the authorities to evaluate the transparency of their monetary policy and their financial supervisory and regulatory frameworks.
- Identify and, where appropriate, recommend desirable transparency practices for central banks and financial agencies.
- Provide input into the overall assessment of the vulnerabilities of a country's monetary and financial system.
- Help identify the developmental needs of a country pertaining specifically to transparency issues and to assist in making informed policy decisions about the reforms needed.
- Provide input on the extent to which transparency practices contribute to policy effectiveness and to monetary and financial stability.

The MFP Code is broad and takes into account the varied institutional and legal frameworks that are found in many countries across various stages of financial development. Consequently, the ways in which transparency is applied and achieved—in terms of timing and manner of disclosure as well as the content of reports—may differ, reflecting different institutional arrangements and legal traditions. Assessments should not be conducted in a mechanistic way because practical policy considerations may require that some disclosures not be made in certain contexts.

In particular, benefits of transparency practices have to be weighed against the potential costs, and it may be appropriate to limit the extent of transparency. For example,

extensive disclosure requirements about internal policy discussion on money and exchange market operations might disrupt markets, constrain the free flow of discussion by policy makers, or prevent the adoption of contingency plans. Thus, there are circumstances in which it would not be appropriate for central banks to disclose their near-term monetary and exchange rate policy implementation tactics or to provide detailed information on foreign exchange operations. Similarly, there may be good reasons for the central bank (and financial agencies) not to make public specific contingency plans, including possible emergency lending. However, the broad principles and procedures governing the decisions on emergency lending could be established and made transparent while maintaining "constructive ambiguity" about their applicability in specific situations (see chapter 5, section 5.2.1). However, limiting transparency in selected areas needs to be seen in the context of a generally transparent environment. Also, the MFP Code is not designed to offer judgment on the appropriateness or desirability of specific monetary and financial policies or frameworks that countries should adopt.

The assessment of observance of the MFP Code should draw on a wide range of information and should focus on the degree and means of disclosure to the public, as well as on the effect of disclosure practices on a policy's effectiveness. The sources of information needed for the assessment typically include relevant laws, regulations, and instructions, as well as other documentation (reports, studies, public statements, Web sites, unpublished guidelines, directives, and assessments); counterparty agencies and officials with whom assessment-related discussions are held; meetings with other domestic authorities; any relevant government or industry associations (such as bankers' associations, auditors, and accountants); and key market participants and analysts who draw on the information disclosed. The methodology for the assessment consists of examining, for each practice in the MFP code, the various forms of disclosure used, frequency of disclosures, quality or content of disclosure, and modes of disclosure. In addition, a fifth dimension—clarity and comprehensibility of transparency—is also examined. The content, clarity, and accessibility of the information that is disclosed are what transforms "disclosure" into "transparency." An assessment of those five dimensions is based on a broad qualitative judgment drawing on country practices and is not based on any specified list of assessment criteria.

Illustrative country practices are summarized in the Supporting Document,[3] which also provides two- or three-part explanations of each transparency practice:

- "Explanation and rationale" elaborates on what is meant and why it is desirable.
- "Application" indicates where and how the practices are implemented, with some quantification and, where applicable, with some country examples.
- "Implementation considerations" deals with practical considerations—benefits and costs, intended audience, domestic versus international dimensions—where relevant. The supporting document also provides a list of references—academic studies as well as official documents—on transparency and accountability issues. The qualitative judgment of various dimensions of transparency can be informed by the supporting document, and this judgment is used to classify the degree of observance of each practice into five categories: observed, broadly observed, partly observed, non-observed, and not applicable. Detailed guidance on the procedures

and practical considerations in conducting the assessments are available in the guidance note (IMF 2000) for assessing the code.
- A supplementary document providing case studies for 15 countries is under preparation.

So far, the IMF Executive Board has conducted two reviews of experiences with assessments of the MFP Code, drawing on MFP Code assessments for 57 countries.[4] In general, the two reviews indicated a high level of observance of transparency practices among the countries reviewed. Observance was strongest with respect to the public availability of information on monetary and financial policies. Many central banks and financial agencies are making more effective use of various channels of communication to increase the public's access to information. In banking supervision and payment system oversight, transparency was weak in practices relating to clarity of the roles, responsibilities, and objectives of the institutions.

Transparency practices with respect to the accountability and assurance of integrity of the central banks and financial agencies continue to be a challenge for many of the countries (see boxes 10.1 and 10.2). This finding also has been borne out in other Fund initiatives such as the Safeguards Assessments (IMF 2002) and in the assessments of Special Data Dissemination Standards (SDDS) (IMF 2003). Among all financial sectors, banking supervisory agencies had the most-developed transparency practices whereas insurance regulatory agencies had the least-developed transparency practices.

Standard-setting bodies have increasingly included transparency-related criteria in their individual standards and codes. The IAIS standards emphasize the need for transparency by the supervisory agency, and various transparency practices of the MFP Code are embedded in the IAIS Core Principles. The *Core Principles for Systemically Important Payment Systems* (see Chapter 11 for references and discussion) calls for effective oversight of such payment systems by the central bank and, consistent with the MFP code, calls for the central bank to define clearly its payment system objectives and to disclose publicly its role and major policies with respect to systemically important payment systems. The coverage of transparency issues in regulatory standards is, however, rather uneven, and there have been recent efforts to specify transparency practices of regulatory agencies in greater detail as a component of good regulatory governance of those agencies (components of good regulatory governance consist of independence, accountability, transparency, and integrity).

10.2 Accounting and Auditing Assessments

An assessment of accounting and auditing standards is a key part of the evaluation of robustness of a country's financial market infrastructure (the third pillar of the Financial Sector Assessment) and includes financial sector governance. A core component of good corporate governance is an accurate disclosure that is based on high-quality accounting and auditing standards. A comprehensive assessment of those standards presents the strengths and weaknesses of accounting and auditing frameworks. The assessment also analyzes the framework's quality and enforcement, as well as its potential success in changing the effectiveness of supervision and the soundness of the financial system. A sound account-

Box 10.1 Main Weaknesses in the Transparency Practices of Central Banks and Monetary Policy

1. Clarity of Roles, Responsibilities, and Objectives of Central Banks

- A general lack of clarity about the hierarchy among a multiplicity of monetary policy objectives and about how potential conflicts among them would be resolved
- Potential conflicts in the policy objectives, as provided for in different statutes
- Lack of clarity in the responsibility over foreign exchange policy
- Absence of specifics and conditions under which governments may override central bank policy decisions
- Existence of legal provisions to use various instruments often encumbered by the need to seek approval from another authority (e.g., the Ministry of Finance)
- Disclosure of certain information that is often limited by strict interpretations of secrecy rules governing operations of some central banks
- Accountability of some central banks weakened by the absence of an explicit legal requirement to report to a legislative body or designated public authority to inform on the conduct of monetary policy and the fulfillment of policy objectives
- Unclear institutional relationships between central banks and governments, as well as associated agency roles and financial transactions

2. Open Process for Formulating and Reporting Monetary Policy Decisions

- Poor or nonexistent explanations for the rationale and functioning of its policy instruments
- Insufficient frequency of disclosures (with some authorities arguing that the guidelines are not clear in that regard)
- Reservations about announcing meeting schedules for policy-making bodies

3. Public Availability of Information on Monetary Policy

- Remaining weaknesses in the availability of specific data templates even through many countries subscribe or plan to subscribe to the International Monetary Fund's data dissemination standard (Special Data Dissemination Standard, or SDDS, and the General Data Dissemination System, or GDDS)
- Timeliness and frequency of publications a common problem
- Concerns about the quality of some of the information that is disclosed

4. Accountability and Assurances of Integrity by the Central Bank

- Deficiencies in some of the procedures in the areas of auditing and accounting
- Many cases of nondisclosure of internal governance procedures, including the standards for the personal conduct of staff members
- Nondisclosure, lack of explicit legal protection for officials and staff members in the conduct of their official duties, or both.

ing framework is a precondition for effective supervision; thus, an examination of the accounting and auditing framework—not necessarily a comprehensive assessment—is an essential prerequisite for undertaking assessments of observance of supervisory standards. This chapter explains the rationale of accounting and auditing standards and provides an overview of International Financial Reporting Standards (IFRSs) and International Standards for Auditing (ISA), highlighting the components of the standards that are particularly relevant for financial sector assessments. The chapter then outlines the World Bank's Report on Observance of Standards and Codes (ROSC) program on accounting and auditing standards, highlighting the key lessons of experience.

10.2.1 Role of the Accounting and Auditing Framework: Relevance to Development and Stability

Accounting and auditing standards of high quality provide the basis for reliable and transparent disclosure of information to relevant stakeholders. Disclosure is crucial for informed financial decisions, efficient resource allocation, and effective functioning of markets. Chapter 4 discusses the fact that they form the core of the information infrastructure needed for financial development. Accounting, auditing, and disclosure requirements of high quality for financial institutions are regarded as one of the key basic areas of financial reform necessary to prevent a financial crisis.[5] By contributing to good corporate governance, high-quality accounting and auditing influence perceptions of risk, cost, and

Box 10.2 Main Weaknesses in the Transparency Practices in Financial Policies

1. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies

- Lack of legal basis for the objectives and responsibilities for some financial agencies
- Lack of documentation spelling out explicit and detailed definition of the institutional oversight role of some central banks with respect to payment systems and its relations with banking activities
- Lack of explicit and clearly defined authority along with the necessary powers to issue and enforce accompanying regulations; little specific focus on the implicit risks of participation in payment systems
- Insufficient published information on objectives, operations, and outcomes of financial agencies
- Legal requirements for submission of reports on developments not sufficiently comprehensive
- Lack of clarity with respect to terms of appointment and dismissal of key officers
- Little information on formal arrangements for cooperation and exchange of information among various supervisory agencies
- Absence of information on investor protection schemes in securities regulations
- Lack of legal underpinning of the regulations and procedures for securities

2. Open Process for Formulating and Reporting Financial Policies

- Absence of public disclosure of the relationships between financial agencies
- Lack of specific requirements for periodic reporting on financial agencies
- Lack of disclosure of information-sharing arrangements among agencies
- Absence of public announcement of changes in payment systems policies

3. Public Availability of Information on Financial Policies

- Inadequate coverage of payment system operations and banking supervision in many annual reports; insufficient discussion of progress on achieving policy objectives in insurance supervisory agencies periodic reports
- Need for the body of applicable laws, regulations, and other guidelines for the insurance sector to be made more user friendly (especially for non-specialists)
- Sparse information on capital market development and processes for market supervision
- Poor disclosure of information on emergency financial support to institutions

4. Accountability and Assurances of Integrity by Financial Agencies

- Accountability of financial agencies not clearly defined in legislation
- Lack of a code of conduct for the staff members performing supervisory functions
- Information on internal control and audit, internal governance procedures, accounting policies, and so forth, not consistently disclosed
- Insurance sector frequently suffers from weak internal arrangements for the resolution of conflicts and disputes settlement processes

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availability of capital, as well as foster financial stability through strengthened market discipline.

Standards such as these are not well implemented in many emerging market and transition economies, and many countries do not require the reporting of key financial data by individual institutions, including their consolidated financial exposure. This gap can hamper the ability to filter out healthy from unhealthy institutions. Moreover, the lack of appropriate information can prevent the effective monitoring of financial institutions and their risk taking.[6] For example, insufficient or incorrect disclosures of credit risks may constrain the ability of investors to assess risks and the ability of supervisors to act in a timely manner (Mishkin 2001). Sound accounting and auditing standards and practices are also important prerequisites for financial liberalization because they form part of the proper institutional framework that places appropriate constraints on risk taking. Accounting and auditing are 2 of the 12 areas of standards that are recognized internationally as key to effective operation of domestic and international financial systems, as already outlined in chapter 1.

10.2.2 Scope and Content of International Accounting and Auditing Standards

International accounting and auditing standards have been developed respectively by the International Accounting Standards Board (IASB) and its predecessor the International Accounting Standards Committee (IASC),[7] and by the International Federation of Accountants (IFAC).[8] IFRSs encompass both the previously adopted—and, in some cases, amended—International Accounting Standards (IASs), as well as newly developed, IASB-issued IFRSs.

The original IASs were issued from 1973 to 2000 by the IASC, which was replaced by the IASB in 2001. The IASB has since amended or eliminated some IASs, has proposed to amend others, has proposed to replace some IASs with new IFRSs, and has adopted or proposed new IFRSs on topics for which there were no previous standards. Thus, standards are continuously changing and being upgraded to reflect the current conditions and needs of financial markets. Narrowly interpreted, IFRSs refer to the new numbered series of pronouncements that the IASB has issued, distinct from the IAS series issued by its predecessor IASC. More broadly, IFRSs refer to the entire body of IASB pronouncements, including standards and their interpretations, as well as to the IASs and their interpretation approved by the predecessor IASC. The standards issued by the IASC, many of which were revised by the IASB in 2004, will continue to be designated as IASs.

Currently, 36 effective IAS–IFRS standards, with 11 interpretations, are accompanied by documents providing the framework for the preparation and presentation of financial statements, as well as guidance on interpretation of standards. The framework defines the objectives of financial statements, identifies the qualitative characteristics that make information in the statements useful, and defines the basic elements of financial statements and the concepts in recognizing and measuring them (e.g., asset, liability, income). The framework addresses the general-purpose financial statements designed to meet the needs of shareholders, creditors, employees, government agencies, and the public at large for information about a public entity's financial position, performance, and cash flows.

Hence, it does not cover special-purpose reporting to tax and regulatory authorities. A complete set of financial statements includes a balance sheet, income statement, cash flow statement, statement of changes in equity, and notes composing the summary of accounting policies and other explanatory notes.[9]

Some of the IASs and IFRSs are particularly important in financial sector assessments. A number of the standards are more relevant for the financial institutions. For instance, IAS 32 and IAS 39 provide requirements on the recognition, measurement, and disclosure of financial instruments, and IAS 30 applies to the disclosures by banks and other similar institutions of their income statement, balance sheet, and contingencies and commitments, including other off-balance sheet items. IAS 1 is also particularly pertinent because it deals with the content of financial statements generally. Boxes 10.3, 10.4, 10.5, and 10.6, provide further details of the scope of IAS 39, IAS 32, IAS 30, and IAS 1, respectively. IAS 39, which seeks the measurement of specified assets at fair value, may have significant effect on the volatility of earnings, levels of provisioning, and various observed prudential ratios, and it has raised concerns among regulators. IAS 32 on financial instruments calls for a range of financial risk disclosures, thus seeking to improve transparency of financial risks, which may pose a challenge for some classes of financial institutions (particularly insurance companies) with traditionally weak risk disclosures. Those considerations highlight the significant challenges in aligning prudential standards with evolving accounting standards and the complexities involved in achieving convergence of national and international standards. Evolving issues in international convergence in major markets are summarized in box 10.7.

There are 33 ISAs, accompanied by a "Code of Ethics for Professional Accountants" and other related engagement standards.[10] The auditing standards provide requirements on a range of issues, including quality control (ISA 220), documentation (ISA 230), responsibility to consider fraud and error (ISA 240), risk assessments of internal control (ISA 400), analytical procedures (ISA 520), and the auditor's report on financial statements (ISA 700).

The IASB and the IFAC's IAASB constantly revise and update the standards to reflect current trends and issues in financial reporting and auditing, which reflect globalization, capital flows, regionalization, technology changes, and so forth. Recent events in industrialized countries relating to corporate business failures and misstatements of financial information have also raised the attention to the role and oversight of the auditing profession, the governance of standard-setting bodies, and the scope of corporate governance as it relates to reporting and disclosure. The IASB has been issuing new standards (IFRSs), and revising current IASs, while IFAC and its numerous committees and have been actively revising ISAs. For example, it recently released proposed revisions to ISA 230 on audit documentation. The IFAC's Public Sector Committee (PSC) focuses on the accounting, auditing, and financial reporting needs of national, regional, and local governments, as well as on related agencies, and it proposes benchmark guidelines. It has also undertaken a multiyear initiative that is focusing on developing International Public Sector Accounting Standards (IPSAS) for government budget reporting that is based on IASs. It has also published a guidance paper on anti-money-laundering.

One issue of particular relevance, especially to developing and emerging market economies, is the role of small and medium enterprises (SMEs) and the need to have

Box 10.3 IAS 39: Financial Instruments, Recognition, and Measurement

IAS 39 (revised March 2004) covers a broad range of financial instruments, including the following:

- Cash
- Demand and time deposits
- Commercial paper
- Accounts, notes, and loans receivable and payable
- Debt and equity securities
- Asset-backed securities (collateralized mortgages, repurchase agreements, and securitized receivables)
- Derivatives (swaps, forwards, futures, options, rights, and warrants) and embedded derivatives
- Leases
- Rights and obligations with insurance risk under insurance contracts
- Employers rights and obligations under pension contracts

IAS 39 requires that financial assets be classified in one of the following categories to determine how a particular asset is recognized and measured in financial statements:

- Financial assets at fair value through profit or loss
- Available-for-sale financial assets
- Loan and receivables
- Held-to-maturity investments

The general principle is that available-for-sale financial assets are to be valued at fair value, whereas held-to-maturity may be valued at amortized cost.

IAS 39 recognizes two classes of financial liabilities:

- Financial liabilities at fair value through profit and loss
- Other liabilities measured at amortized cost using the effective interest method

IAS 39 has been a source of debate within financial markets, especially among commercial banks. IAS 39 requires entities to value derivatives, shares, and bonds at fair market value, not at historical costs, but does not recognize macro-hedging and internal-risk transfers. However, banks are heavy users of macro-hedging and inter-group transfers of risks. Not recognizing macro-hedging (see below) would mean that marked-to-market changes in the value of derivative position would be booked to earnings and would raise volatility. If recognized, derivative position would be booked to equity and not earnings. Consequently, a number of European banks, especially in France, have opposed IAS 39 because they believe that it could damage their risk management practice (especially in a fixed interest rate environment) and could lead to earnings fluctuations and, thus, lower share prices. The European Central Bank, prudential supervisors, and securities regulators are also opposed to the fair value option on the grounds that it may, in their view, be used inappropriately (see Europe case below).

IAS 39 permits hedge accounting only under certain circumstances, provided that the hedge accounting meets the following criteria (see IAS 39.88):

- The hedge accounting is formally designated and documented, including the entity's risk management objective and strategy for undertaking the hedge, the identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and the process of how the entity will assess the hedging instrument's effectiveness.
- The hedge accounting is expected to be highly effective in achieving offsetting changes in fair value or cash flows that are attributed to the hedged risk as designated and documented, and this effectiveness can be reliably measured.

In October 2004, the European Union's Accounting Regulatory Committee opposed the adoption of the extant IAS 39 as issued by the IASB. Instead, it adopted a "carved out" version of IAS 39, which (a) removed the fair value option as it applies to liabilities and (b) allowed the use of fair value hedge accounting for the interest rate hedges for core deposits on a portfolio basis. European banks will be able to choose between the original or altered set of rules for hedge accounting.

simplified financial reporting requirements for those enterprises. The financial reporting needs of SMEs in both developing and industrial countries are gaining greater attention by regulators. In that regard, the IASB and the IFAC have committed themselves to identifying and addressing the needs of SMEs. The IASB undertook a research project in 2001 in response to the growing call in the field to support a separate set of accounting

Box 10.4 IAS 32: Financial Instruments, Disclosure, and Presentation

IAS 32 is closely related to IAS 39 and attempts to enhance financial statement users' understanding of the significance of financial instruments to an entity's position, performance, and cash flows.

The fundamental principle of IAS 32 holds that a financial instrument should be classified from the perspective of issuer as (a) a set of financial assets, (b) a financial liability, or (c) an equity instrument according to the substance of the contract, not the legal form. The enterprise must make the decision at the time that the instrument is initially recognized.

Some financial instruments—compound instruments—have both a liability and an equity component from the issuer's perspective. In that case, IAS 32 requires that the component parts be accounted for and presented separately according to their substance and on the basis of the definitions of liability and equity. The split is made at issuance and is not revised for subsequent changes in market interest rates, share prices, or other events that change the likelihood that the conversion option will be exercised.

Disclosure rules apply to all financial instruments, including risk management and hedges. For each class of financial asset, liability, and equity instrument, the following must be disclosed:

- Information about the extent and nature of the entity's use of financial instruments, including significant terms and conditions that may affect the amount, timing, and certainty of future cash flows
- The accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied
- The business purposes served by the instruments, the risks associated with them, and the management policies for controlling those risks
- Interest rate and credit risk exposures

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Box 10.5 IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions

The goal of IAS 30 is to provide users with information required to evaluate the financial position and performance of banks and to enable them to better understand the special characteristics of banking operations. The standards require a bank to present a balance sheet that groups assets and liabilities by nature and lists them in an order that reflects their relative liquidity, as well as prescribes specific assets and liabilities to be disclosed.

On the income statement, the following specific items should be reported:

- Interest income and expenses
- Dividend income
- Fee and commission income
- Net gains and losses from securities dealings
- Net gains and losses from investment securities
- Net gains and losses from foreign currency dealings
- Other operating income and expenses (including general administrative expenses)
- Loan losses

The following disclosures are included:

- Specific contingencies and commitments (including items not on the balance sheet)
- Specific disclosures for the maturity of assets and liabilities on the basis of the remaining period from the balance-sheet date to the contractual maturity date
- Concentration of assets, liabilities, and items not on the balance sheet (by geographical area, customer or industry groups, or other aspects of risk)
- Losses on loans and advances
- Fair value of each class of financial assets and financial liabilities
- Amounts set aside for general banking risks
- Secured liabilities as well as nature and amount of assets pledged as securities

Box 10.6 IAS 1: Presentation of Financial Statements

IAS 1 reflects the broad guidelines set forth in the Framework for the Preparation and Presentation of Financial Statements and is designed to prescribe the basis for presentation of general purpose financial statements and to ensure compatibility both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out the overall framework and responsibilities for the presentation of financial statements, guidelines for their structure, and minimum requirements for the content of the financial statements. Its main objective is to provide information about an entity's assets; liabilities; equity; income and expenses, including gains and losses; other changes in equity; and cash flows. It should also provide data about key components under each of those items.

The standard requires that statements "present fairly" the financial position, performance, and cash flows of an equity. It requires the faithful presentation of effects of transactions and other events, as well as conditions of assets, liabilities, income, and expenses.

An entity must normally present a classified balance sheet, separating current and noncurrent assets and liabilities. A list of minimum items on the balance sheet is provided.

Other issues that the standard covers include going concern, accrual, consistency, materiality, offsetting, reporting period, income statement, statement of changes in equity, notes, and disclosures about dividends.

standards for SMEs. One issue that it encountered in the process, however, was how to accurately "define" SMEs. In June 2004, it published a discussion paper on the proposal to develop separate standards and to set up an advisory panel to monitor the discussion. Going forward, IASB is expected to publish a draft of the SME versions of all existing standards.

Another important issue that arises in many countries with significant presence of Institutions Offering Islamic Financial Services (IIFS) is that the accounting standards designed for conventional types of business are not applicable to these institutions. A number of IASs and IFRSs are not suitable for Islamic financial institutions, and moreover financial statements of IIFS contain items for which there are no applicable IAS/IFRS.To address this problem, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1990, as a self regulatory body of IIFS (including also some government and regulatory bodies in the governance structure) to set accounting standards that complement IAS/IFRS and at the same time recognize the specific contractual features of Islamic finance. AAOIFI has issued a number of important accounting and auditing standards for Islamic finance instruments and institutions, as well as some governance and ethics standards relating to Sharia compliance; several countries and IIFS have begun to adopt or draw these standards. For a compilation of these standards see AAOIFI (2004). With growing financial innovations in the Islamic finance industry, and the increased focus on appropriate risk measurement and disclosure in Islamic finance, the financial reporting and governance standards are continuing to evolve, and gaining increasing acceptance among countries and IIFS.

10.2.3 ROSCs and Role of the Bank and the Fund

As part of the FSAP–ROSC initiative,[11] the World Bank has developed a program to assist member countries in strengthening their financial reporting regimes through the

implementation of IFRS and ISA. The program's objectives are twofold: (a) an assessment and (b) the development of a country plan. Its assessment activities cover the following:

- Determine the comparability of national accounting and auditing standards with IFRS and ISA, respectively.
- Determine the extent of compliance with established accounting and auditing standards, rules, and regulations, as well as the effectiveness of enforcement mechanisms.
- Identify strengths and weaknesses of the institutional framework in supporting high-quality financial reporting.

The basic premises on which a ROSC accounting and auditing (A&A) diagnostic exercise is carried out are as follows:

- IFRS and ISA are endorsed by the Bank, the Fund, and other international institutions as the primary benchmarks for corporate financial reporting standards. IFRS and ISA should be mandated for all "public interest entities," which are defined by the nature of their business, their size, their number of employees, or their corporate status with a wide range of stakeholders. Examples of public interest entities may include banks and financial institutions, insurance companies, investment funds, pension funds, listed companies, and other economically significant business entities.
- SMEs should be subject to a simplified financial reporting regime given their lesser degree of responsibility with respect to the public. This simplified regime for SMEs typically includes less-stringent accounting and reporting requirements.
- If one considers the distinctive responsibility of independent auditors with respect to a wide array of stakeholders, independent auditors should be subject to adequate public oversight.

Box 10.7 International Convergence Process

In September 2002, the U.S. Financial Accounting Standards Board (FASB) and the IASB agreed to reduce existing differences between U.S. Generally Accepted Accounting Principles (GAAP) and IFRS. This "convergence" process is a two-stage approach involving a short-term project and a more difficult long-term one. The short-term project, which is designed to eliminate minor differences by January 2005, has largely been completed; the combination of work programs is under way to eliminate more substantive differences as soon as feasible but it is likely to take several years.

In January 2005, EU-listed companies began to apply IFRS, a move that will bring impetus both to the international convergence process and toward achieving a common financial market in Europe. As with any major change, the move poses many challenges. Switching to international standards will also require companies to invest in new systems and will require governments to adopt their tax policies. On the positive side, it can expand the pool of investors, lower the cost of capital, improve the efficiency of capital allocation, and reduce the expenditure needed to consolidate the accounts of subsidiaries. Switching to global standards will also allow any given company or investor to understand the financial statements of companies outside its jurisdiction. Multinational companies will no longer have to reconcile multiple financial statements.

- Access to the auditing profession should be limited to individuals who have demonstrated academic and professional abilities through a certification process that complies with IFAC International Educational Standards for Professional Accountants.

The assessment of A&A standards is designed (a) to focus on complying with national standards and on fostering a country-led program to make national standards comparable with international standards within a feasible time frame and (b) to develop a sufficient infrastructure to effectively adopt IFRS and ISA. The focus on assisting member countries for improving their institutional capacity to support implementation of high-quality A&A standards is consistent with the Bank's operational activities.

The assessment process places emphasis on country involvement and on efforts to design a country-led program. The program attempts to improve A&A performance, to involve all key stakeholders, and to be linked to progress in related critical areas such as corporate governance and financial sector reform. Detailed A&A ROSCs are done on a stand-alone basis or, occasionally, as part of the FSAP. When detailed A&A assessments are not available, the focus of financial sector assessments is directed to a comparison of national standards with IAS 30, 32, 39; the legal and institutional framework for A&A; the quality of A&A of financial institutions; and a review of disclosure practices applying to financial institutions (see section 10.5).

10.2.4 Focus of A&A Assessments

Assessments of A&A standards address financial reporting by public interest entities, which are defined as such because of their business, size, and number of employees or because their corporate status is such that they have a wide range of stakeholders. Public interest entities include credit institutions, insurance companies, investment firms, pension funds, and listed companies. The assessments cover the following four areas:

- *Institutional Framework*—The ROSC A&A focuses on the current state of the institutional framework and, accordingly, provides policy recommendations for strengthening it. The goal is to enable the framework to promote high-quality A&A practices. The framework assessment includes (a) the laws and regulations[12] (quality of the design of the framework), (b) the history and current state of the A&A profession, (c) the strengths and weaknesses of accounting education and training, (d) the A&A standard-setting process, and (e) the arrangements for ensuring compliance with A&A requirements (enforcement mechanisms).
- *Comparability of National and International Standards*—One key benefit of conformity of any country's A&A standards to IFRS and ISA is the promotion of sound financial reporting that facilitates cross-border usage. Generally, the standards and regulations of different countries have reached various levels of conformity. The methodology for this examination, which helps to identify gaps, is based on IFRS and ISA.
- *Compliance with National Standards*—Enforcement of the standards is a key underpinning of a sound financial reporting environment. Efficient and effective

enforcement is also important because corporate stakeholders depend on access to high-quality financial information.

- *Action Plan*—To strengthen the corporate financial reporting regime, the ROSC's A&A module identifies areas for improvement. Those findings serve as the basis for working with policy makers and other stakeholders to develop an action plan to improve A&A practices.

10.2.5 ROSC A&A Methodology

The World Bank has developed a diagnostic tool to gather and analyze pertinent information for preparing A&A ROSCs. This tool consists of a set of questionnaires under each of the following four components: (a) A&A environment, (b) national accounting standards in relation to IASs, (c) actual accounting practices in relation to national standards, and (d) auditing standards and practices. The process adopts a highly participatory approach, with strong involvement of policy makers and other country stakeholders, and culminates in the creation of a country action plan. The information gathered from the diagnostic tool is supplemented with a due diligence exercise to capture primary experiences of practitioners and other facts on professional accounting and auditing practices in the country. The details of the assessment process, the diagnostic tools and questionnaires, and the ROSC preparation procedure are further discussed in Annex 10.B.

10.2.6 Assessment Experience

By the end of December 2004, 38 A&A ROSCs had been completed, 28 of which have been published, and this process has contributed to progress in implementation. A regional breakdown shows that 15 were completed in the Central and Eastern Europe region, 7 in the Middle East, 7 in Latin America and the Caribbean, 5 in Africa, 2 in East Asia, and 2 in South Asia. The majority (29) of the assessments were conducted in middle-income countries whereas only 7 were done in low-income countries and 2 in high-income countries. It is anticipated that the A&A assessments will be conducted in an increasing number of low-income countries. The program has provided a body of experience that has informed the work of standard-setting bodies and that has facilitated reforms in several countries.

The experience gained in implementing the A&A ROSC program thus far suggests a few key issues and lessons to consider in moving forward:

- Adoption of IFRS and ISA as applicable standards is crucial in all countries, particularly when business entities contribute materially to the economy, the public interest, or both. However, if efficient and effective monitoring and enforcement mechanisms are lacking—which creates an environment of noncompliance—then adoption of the standards is not sufficient. This situation is most often the case in developing countries and emerging markets. Similarly, wholesale adoption of the standards without simultaneously developing the necessary legal and institutional infrastructure and without improving professional skills in auditing and accounting may be an inappropriate solution.

- In many developing and emerging market countries, observance of A&A standards is constrained by (a) the lack of access to the standards and related publications by students and professionals; (b) the non-availability of standardized implementation guidelines and practice manuals in a country context; (c) the lack of proper training on the practical application of both standards and the code of ethics for professional accountants and auditors; and (d) a rudimentary academic environment that is illustrated by deficient curriculum, lack of appropriate academic literature, and a shortage of well-trained instructors.
- A greater participation of developing countries in the process of developing and revising the standards is critical to facilitate the design and implementation of standards that reflect the realities in developing countries.
- Reaching an international consensus on a common framework of principles for the regulation and supervision of the A&A profession is important.

10.3 Credit-Reporting Systems and Financial Information Services

The concept of credit-reporting systems in finance is a new subject and has received increasing attention in recent years in light of its key role in improving information available to financial intermediaries for their decisions and, thereby, facilitating improved access to finance. Credit reports are becoming more and more important throughout the world, fueled by demand for that type of data not only from banks and other financial intermediaries but also from private firms, retailers, employers, and others. Bank supervisors and regulators are also increasing their demand for high-quality credit data to more effectively monitor credit risks in supervised financial institutions. Credit-reporting systems are also seen as playing a key role in improving credit risk measurements as envisaged under the New Basel Capital Accord. Given the previous context, government officials, as well as bank supervisors and regulators, are interested in knowing answers to the following questions. What is a credit-reporting system? What does a credit report looks like? What would be good practices of a robust credit-reporting system in terms of the key elements involved?

The discussion of those issues is organized as follows. Section 10.3.1 provides a brief introduction of credit-reporting systems and their role in financial development and stability. Section 10.3.2 describes the fundamental elements of a credit-reporting system and identifies good practices for credit reporting. Section 10.3.3 presents the potential uses of credit registries for strengthening credit risk measurements and the supervisory review process. Section 10.3.4 briefly summarizes the role of credit rating agencies.

10.3.1 Introduction to Credit-Reporting Systems

Credit or consumer reporting firms and other types of public credit information registries provide rapid access to accurate and reliable standardized information on credit history and financial condition of potential borrowers, be they individuals or firms, and help to support a well-functioning credit market. Credit reporting addresses a fundamental problem of credit markets: asymmetric information between borrowers and lenders, which

leads to adverse selection and moral hazard. Credit information sharing allows lenders to more accurately evaluate risk and to avoid adverse selection. Similarly, credit-reporting mechanisms strengthen incentives for borrowers to repay and thus reduce moral hazard because late or nonpayment with one institution can result in sanctions from many others. Credit reporting expands access to finance, especially for lower income consumers, micro-enterprises, or small businesses. Credit reporting can also play a key role in improving the efficiency of financial institutions by reducing loan processing costs, as well as the time required to process loan applications.

Some empirical work has been done to provide evidence of the importance of credit registries in credit markets. For example, Jappelli and Pagano (2001) analyze the effect of credit registries—both private and public—and find a positive effect on the volume of bank lending (as a percentage of GDP) and a decrease in credit risk. Barron and Staten (2003) show that greater availability of information reduces default rates and improves access to credit. Kallberg and Udell (2003) demonstrate that data from Dun and Bradstreet Corporation, a private credit information firm, have greater predictive power in calculating probability of default than a firm's financial statements. Galindo and Miller (2001) argue that firms in countries with better credit information are less credit constrained because they rely less on internal funds. Overall, theoretical and empirical analyses show that banks' sharing of information on borrowers helps to curtail the effects of adverse selection and moral hazard, reduces credit risk, improves access to credit markets, and strengthens the stability of the banking system.

10.3.2 Elements of a Robust Credit-Reporting System

Good practices of a robust credit-reporting system are presented in this section to provide broad guidance on issues to consider in establishing a new credit-reporting system and in identifying areas for the improvement in, or the assessing of, an existing credit-reporting system. This section describes several fundamental elements with respect to the structure of a sound credit-reporting system. It is not a comprehensive and complete illustration but a general guideline. The appropriate design of the system in any particular economy may largely vary by its size, the level of penetration of financial services, the degree of competition, and the legal framework. The implementation of Basel II may also affect the design and operation of the systems (see section 10.3.3).

10.3.2.1 Providers and Users of Credit Data

Typically, in a credit-reporting system, the major credit information providers and users include both financial firms and several categories of non-financial firms:

- Commercial banks and other regulated financial institutions
- Non-bank financial intermediaries
- Credit card issuers, insurance firms, automobile finance companies, and mortgage lenders and guarantors
- Retailers (appliance retailers and others)
- Firms providing business-to-business credit and trade credit
- Microfinance institutions

- Other businesses that provide goods or services on credit (utilities, cell phone providers, agribusiness, etc.)

10.3.2.2 Credit-Reporting Institutional Arrangements

Institutional forms for credit-reporting arrangements around the world include both public credit registries administered by central banks and private credit-reporting firms of varied ownership structure. A survey conducted by the World Bank between 1999 and 2001 covers both private firms that specialize in credit data from banks and other financial intermediaries as well as firms that specialize in trade credit, which is typically the most important source of external finance for small businesses. The survey reveals that public and private credit registers are present in a large number of developed and emerging market economies throughout the world (see Miller 2003). Forty-one countries have public credit registers, 44 countries have private credit bureaus, and many have both types. Table 10.1 summarizes the pros and cons of different types of private credit registries and public registries.

10.3.2.3 Quality of the Data Collected and Distributed

The quality and scope of the credit data collected and used is critical to establishing a sound credit-reporting system. The heart of a credit report is the record of the payment history of a consumer or a firm, which summarizes types of loans, current and past, from different creditors and their amounts, including past due amounts and past due history. The following summarizes the key recommendations with respect to the credit-reporting system, drawing on country practices:

Table 10.1. Institutional Arrangements for Private Credit Registries

Institutional Type	*Pros*	*Cons*
Private firm with no bank ownership	• All types of data • Independence	• No automatic access to data
Private firm with bank ownership	• All types of data • Special access to specific bank data	• Independence may be questioned
Bank association	• Access to bank data • Integrity	• Only bank data and bank access
Chamber of Commerce	• Retail and nonbank data • Broad cover • Historical record	• No bank data • Limited funds for modernization
Commercial and credit insurance firms	• In-depth data on commercial sector	• Limited coverage • High cost per entry
Industry-specific databases	• In-depth data on single sector	• Limited scope—cannot cross-check data
Public ownership such as a central bank	• Automatic access to credit data	• Only bank data

Source: Miller (2003).

- The credit information database should be an open system rather than a closed network. Majority ownership by a limited group of lenders will discourage a broader database.
- It is advisable to collect both positive and negative information instead of negative information only. In this way, responsible borrowers can document good credit histories and can build their "reputation collateral." A borrower's good name or reputation collateral provides an incentive to meet commitments much the same way as does a pledge of physical collateral, also reducing moral hazard.
- Credit data should be properly maintained for a reasonable time frame, at a minimum, 5 years. And negative data should not be deleted, even when a debt is repaid. Negative data encourage borrowers to honor obligations.
- Data should be inaccessible after a certain amount of time. Time limits may vary by size of loan and type of inquiry. International best practice is to establish time limits on the length of the credit history record available to a lender. Economic research shows that the recent credit payment record is most relevant for predicting future default. Moreover, the fact that, after a certain period of time, information, especially with respect to defaults, will not be distributed to lenders creates additional incentives for the borrower to improve credit repayment behavior and to "clean up" the record. For example, records are available only for 5 years in Australia, Brazil, Germany, Ireland, Peru, and Spain and for 7 years in the United States and Mexico. It is essential that all information in the file is kept for this set period. For example, if a debt is paid, then information on it should stay in the registry for the period prescribed. Deleting either full records or parts of records significantly lowers predictive power of the data in the registry and weakens any stimulating effect that the bureau has with respect to repayment incentive.
- Credit reports should not include highly sensitive information such as political or religious affiliation. Other identifying information such as gender should be carefully evaluated.

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10.3.2.4 Legal and Regulatory Framework for Credit Reporting

The legal and regulatory framework for credit reporting is usually governed by several laws and regulations and varies greatly around the world. Those laws include the following:

- Regulations concerning bank secrecy
- Data protection law
- Consumer protection
- Fair credit granting and consumer credit regulations
- Provisions with respect to privacy and personal or corporate secrets in existing laws

Several countries chose to pass a specific law regulating credit-reporting entities: Israel, Kazakhstan (draft version), Korea, Mexico, Peru, Russia (currently in a draft version), Sweden, Thailand, Ukraine (draft version) and United States. In almost all European countries, as well as in Australia, New Zealand, Hong Kong, Taiwan, and Argentina, the focus is on regulating the data management process rather than on credit-reporting agen-

cies as institutions. In those countries, major legislation governing operation of a credit registry involves a data protection law.

Economic research shows that the registries are most effective when they are able to collect information from a wide number of sources, including bank and non-bank financial institutions, as well as from firms selling goods on credit. The legal framework should be able to support this type of a system and should not restrict the ability of some creditors to participate in a credit bureau. The Fair Credit Reporting Act (FCRA) in the United States (Federal Trade Commission 2005) and data protection laws in Europe allow information exchange among all types of creditors. There are usually no restrictions on the collection of information from public sources such as court records, bankruptcy filings, and so forth. Credit bureaus create added value by merging information from public sources with the information collected by the credit bureau and by allowing automated access to such records.

An effective legal and regulatory framework for a credit registry should encourage information sharing and should promote competition while achieving a balance between information sharing and privacy and consumer protection. It should include the following characteristics:

- The legal framework should encourage information sharing among lenders; for instance, certain laws may be established or amended to provide legal clarity with respect to acceptable information sharing practices.
- The legal framework should encourage appropriate competition in credit markets.
- The tradeoff between privacy protection and information sharing should be taken into account. Although improper sharing of credit information causes privacy issues, broad privacy or data protection laws may unduly limit credit reporting. Thus, the legal framework should be constructed to achieve a proper balance.
- Consumer protection should also be considered in the legal framework. Customer protection should be enhanced in the law through appropriate access to data and expeditious resolution of credit-reporting issues. Borrowers should have access to their own data and should be notified of adverse actions that result from a credit report. Reports should include information with respect to all the persons who have access to data. Consumer-friendly procedures should be developed to challenge erroneous information in a reasonable time frame. For example, a specific contact would be established to provide "one-stop service" for consumers to resolve credit issues.

One of the key provisions in the credit-reporting and data protection laws is the ability of the subject of the information to view his or her own record. One of the most effective mechanisms for maintaining quality and accuracy of information in the database is ensured by notifying the borrower when credit is refused. The notice informs the borrower that the decision to refuse credit was in whole or in part based on the information obtained from a credit registry, specifying the registry's name. The notice should also state that, according to the law, the borrower can obtain a record from the credit bureau, and the notice should provide contact information for this bureau. In most countries, the consumer is entitled to obtain a free report if he or she has received this type of notice. Alternatively, the price for a report may be set at some low level. Notice of refusal of

credit also serves as a good educational tool to inform the consumer of the importance of building a good credit history and of improving one's standing.

The subject of the credit report, whether an individual or a firm, is in the best position to know who has a valid reason for accessing that report. Subjects of such credit reports know where they have requested credit or employment and whether other firms or individuals have a valid reason to request the information. Therefore, one of the best ways to limit unauthorized use of credit information is to develop systems that record all queries for an individual's report. Consumers can review this information if they think their data have been used in an inappropriate manner. This simple reporting tool can greatly help to detect misuse of the data by lenders and others who may request this information, as well as by the staff of a credit-reporting firm.

Procedures, particularly non-judicial dispute resolution mechanisms, should be in place to facilitate challenges to erroneous data. Again, the consumer or firm that is the object of the credit report is in the best position to know whether data in the report are correct or flawed. At the same time, the consumer or firm has an incentive to challenge negative information in the report, even if the individual person or company knows it to be accurate. Those two facts should be balanced in regulations on dispute resolution in credit reporting. Providing access to credit-reporting firms by means of the Internet and by phone can encourage consumers to review their reports and to identify reporting errors. As stated above, it is particularly important that consumers have access to reports when an adverse action has been taken. Clear procedures should be established in regulations that specify the steps in the dispute resolution process and the time frame that credit-reporting firms have to verify and respond to complaints. The regulations may include requirements that credit-reporting firms operate toll-free phone numbers to take complaints or to otherwise facilitate consumer access. If the credit-reporting firm and consumer differ over the validity of the information, the consumer should be able to add a comment to this effect on the credit report. However, consumers should not be able to effectively hamper the functioning of the system by their interaction with the credit-reporting firm. For example, requirements that all consumers get a free copy of their credit report every year, even if they have not requested it, can add great cost to the system. Similarly, allowing consumers to obtain unlimited numbers of free credit reports on themselves can lead to abuse.

Country experience shows that the regulatory framework is usually weaker than the legal framework in developing countries. The following questions should be carefully considered in establishing or improving a regulatory framework:

- Is enforcement strong enough in the regulatory framework? Can—and do—regulators effectively enforce laws and regulations by means of audits, lawsuits, and fines or by reviewing industry codes of conduct?
- Do consumers have the ability to bring complaints outside the judicial system?

10.3.2.5 Consumer Outreach and Education

The role of credit reports is often misunderstood by consumers; thus, appropriate transparency and outreach should be used to foster consumer education. People seldom think about or review their credit report until they have a problem, so the association they have

with credit reports is often a negative one. Consumers are unlikely to fully appreciate what role credit reports have in facilitating access to credit or how the consumers may contribute to a more competitive credit market. When there is a problem, consumers may not know either the laws and regulations pertaining to this activity or their rights and responsibilities under those statutes. An important role for the regulator is that of providing outreach and education to consumers, both to ensure that consumers are able to exercise their basic rights and to encourage the development of the industry. The regulator can accomplish this function in many ways, including by making available the laws and regulations pertaining to credit reporting in easy-to-understand formats and through multiple media (e.g., Web sites, printed communication, information distributed at banks, etc.) and by sponsoring or encouraging public service ads and announcements related to credit reporting. The regulator can require that notices of an adverse action that was based on a credit report include information about the consumer's rights under the law. The public outreach function may be particularly important when a credit-reporting system is first established to gain the public's confidence and to maximize participation in the system. Some recommended elements of this outreach effort include the following.

- Enough information should be made available on managing credit and on the rights and responsibilities of borrowers with respect to credit reporting. For example, materials at the appropriate level and language could be provided through the Internet, banks, retailers, and government offices. Also, media communication such as radio and television public service advertisements could play an important role in dissemination efforts.
- Industry should take an active part in providing consumer assistance.
- It is advisable to strengthen not only outreach to lenders with respect to the importance of credit information but also outreach to other interested parties such as judges and microfinance institutions.

10.3.3 Credit Registries, Efforts to Strengthen Credit Risk Measurement, and New Basel Capital Accord (Basel II)

Credit registries possess enormous potential as a key tool in the hands of supervisory authorities that would enable those authorities to face the challenges of implementation of Basel II.[13] Moreover, effective use of the information contained in credit registries, whether public or private, will enable credit institutions to improve the identification and control of their banking risks, thereby helping to pave the way for more advanced risk and capital measurement approaches envisaged in Basel II.

As already explained, credit registries facilitate the sharing of information among lenders and with supervisors—subject to adequate safeguards—on credit history loan characteristics and specified characteristics of borrowers (households and firms separately), which enables each bank to assess the quality of its credit assets and enables the supervisors to monitor credit risk in the entire system. The access to credit information by banks helps to impose discipline on borrowers and fosters greater transparency, as well as more competition.

Information from credit registries can be used to support both onsite and offsite supervision, as well as to facilitate macroprudential surveillance. Because supervisors have access to the entire population of loans granted by each credit institution, they can use this information to construct a range of financial soundness indicators for individual banks, peer groups, and the system as a whole. The information can be used to select samples for more detailed examination in onsite inspection. Also, comparison of the information reported by different credit institutions can help those conducting offsite surveillance to detect the potential of any one bank's systematic overvaluation of credit worthiness of its borrowers or a deterioration in the credit quality of a bank's loan portfolio relative to the rest of the system. The information from credit registries can help when analyzing the dynamics of aggregate credit risk—and bank-specific risks—and its macroeconomic and institutional determinants. Finally, information in credit registries—together with other information outside the registries—can help when estimating (or validating bank estimates for) probability of default of different borrowers, when providing input into estimating loss given default (LGD), and when verifying the bank's estimate of exposure at default.

Credit registries can be a useful tool to validate the bank's own internal ratings and internal assumptions about credit risk modeling. The statistical techniques to verify borrower rating systems are well developed, and it is relatively easy to discriminate among the relative positions of obligors. However, the validation of probabilities of default associated with each rating is more difficult because data are scarce, particularly on defaulted obligors and on the correlation among defaults, which is hard to quantify. In this context, a rating system for borrowers—developed by supervisors and based on data on the entire population of all credit institutions—could provide a yardstick with which to compare and validate ratings and probabilities used by individual institutions. This approach would require credit registries to be managed by supervisors and to contain a certain minimum quantity of information so an overall rating system could be developed.

The estimation of LGD is typically based on market prices of defaulted loans and bonds or on a credit institution's own data on discounted cash flows—revenues and expenses—following default so best estimates of loan losses can be obtained (using both internal and external data). Little progress has been made on the techniques to validate LGD. Information from credit registries can be used to estimate the key determinants of LGD (by means of a regression model), and the possibility of using credit registries to document loan losses offers a realistic option to develop estimation and validation procedures for LGD. Similar observations apply to exposure at Default (EAD). In addition, the transition matrix for the entire credit system, as well as the sectoral and geographic differences in credit quality, can all be monitored using the credit registries. Finally, the broad recognition of credit risk mitigation techniques in Basel II calls for the credit registries to carry precise information on loan characteristics so they can be used to estimate the value of guarantees, collateral, and other risk mitigants accurately.

If they are to harness the potential of credit registries, their information structure should have adequate information to estimate the value of Probability of Default (PD), EAD, LGD, maturity, risk mitigation factors, and loan loss provisions so various parameters of credit risk models can be estimated by banks and validated by supervisors. For this purpose, required minimum information that should be included in the data structure of

credit registries should be evaluated so credit registries can contribute to effective implementation of Basel II.

10.3.4 Role of Credit Rating Agencies in Financial Stability and Development

Credit Rating Agencies—or External Credit Assessment Institutions, as referred to in the New Basel Capital Accord—provide independent, forward-looking "opinions" to investors on the credit worthiness—or ability and willingness to service debt in full and in time—of an obligor (debt issuer) with respect to a specific financial obligation, or a class of financial obligations, or a specific financial program such as a commercial paper issuance. Those opinions are expressed in the form of (a) a credit rating for various financial instruments and transactions such as corporate bonds (both financial and non-financial institutions); (b) obligations issued by sovereign (central governments) and sub-sovereign (state and local governments) borrowers, other public institutions, and supra-nationals (multilateral and regional institutions); and (c) structured finance transactions (e.g., asset-backed securities, project finance transactions, collateralized debt obligations).

The ratings are based on current information obtained from the obligors and other sources that the rating agencies consider reliable. Judging credit quality involves analyzing a broad scope of relevant risk factors, often subjective, which are unique to particular industries, issuers, and countries. For a discussion of what methodologies are used in assessing country credit ratings, what the sources of possible biases are in those assessments, and how the rating methodology has evolved in recent years, see Bhatia (2002). Credit ratings may be of long-term or short-term duration, depending on the maturity of the instrument. Rating agencies differentiate the ability to service foreign and local currency debt in their analysis and issue separate ratings by currency. They may be subject to downgrade or upgrade should a rating agency consider that material changes in the financial condition of an issuing entity warrant a rating review.[14]

10.3.4.1 Effect on Development

By providing independent information to investors, rating agencies facilitate access to financing in domestic and international markets and, thereby, enhance growth opportunities. Credit ratings provide a relative ranking of an issuer's creditworthiness under similar stress conditions and, thereby, facilitate determination of the risk premium required to invest in the riskier securities. Historical studies by Moody's confirm that there is a clear pattern of higher probabilities of default (a key input into estimating risk premium) for obligations with a lower credit rating. For instance, from 1970 to 1996, the average 1-year default rate was 0.01 percent for A-rated issuers, 0.12 percent for Baa-rated issuers, 1.36 percent for Ba-rated issuers, and 7.27 percent for B-rated issuers. Default is defined as any missed or delayed disbursement of interest, principal, or both (see http://www.moodys.com).

Thus, development of credit rating agencies, together with sound accounting auditing and other information infrastructure, is a key institutional reform to help develop corporate and sub-sovereign bond markets, as well as asset-backed securities markets and project

finance. This reform would complement the development of government securities markets at the central government level, which would help determine a risk-free rate as a benchmark against which the riskier securities could be priced. Also, local governments in emerging and developing economies are increasingly seeking ways to raise debt on private credit markets to finance local investments. For this purpose, development of sub-sovereign credit evaluation—and the associated information system and credit rating arrangements—has become an important topic for investors and policy markers (El Daher, 1999).

Sovereign credit ratings are seen as a fundamental factor in the global financial architecture to facilitate access to foreign capital by developing and emerging markets. Rating agencies rely on a constellation of both qualitative and quantitative factors (economic structure and growth prospects, macroeconomic policies, contingent liabilities, financial sector health, political factors, etc.) in arriving at a "sovereign credit rating" as a forward-looking estimate of default probability (Beers, Cavanaugh, and Ogawa 2002). Ratings assigned to entities in each country are most frequently the same as the sovereign's or lower, but they may be higher (because of specific structural features). Several developing countries have received official assistance to obtain credit ratings as a step toward strengthening their access to international capital markets (IMF 2003a).

10.3.4.2 Effect on Financial Stability

Rating agencies contribute to enhancing financial stability through two channels. First, by summarizing a large and diverse amount of information for the benefit of investors and by acting as a monitor of default prospects and default events, rating agencies provide market incentives for improved governance by issuers. Second, bank regulators increasingly use rating information in assessing capital adequacy. The standardized approach of the New Basel Capital Accord spells out six criteria that supervisors can use to evaluate external credit assessment institutions before allowing their ratings to be used as the basis for assigning risk weights on banks' exposures.

The recognition criteria consist of (a) objectivity (use of rigorous rating methodology that is subject to validation and back testing); (b) independence (free-form political or industry pressures); (c) international access and transparency of assessments (ratings should be disclosed and should be available to both domestic and international investors); (d) disclosure (of assessment methodology, including definition of default, time horizon, and the meaning of each rating); (e) resources (sufficient to carry out high-quality assessments); and (f) credibility (wide acceptance and integrity of the process). See Basel Committee on Banking Supervision (2004).

Rating agencies may weaken financial stability through the effect of rating changes on market perceptions. Recent experience has also highlighted that "procyclical" behavior of ratings agencies may have contributed to financial instability because of asset price changes arising from upgrading in good times and downgrading in bad times; rating changes also have significant spillover effects on other asset markets, including in neighboring developed and developing countries (Kaminsky and Schmuckler 2002).

10.4 Corporate Governance Assessments

The state of corporate governance can have an important effect on the availability and cost of capital for all firms, and good corporate governance of financial firms plays a key role in fostering financial stability. Corporate governance constitutes a set of relationships among a company's management, its board, its shareholders, and other stakeholders. Those relationships define, among other things, the property rights of shareholders, the mechanisms of exercising and protecting those rights, and the way of ensuring a fair return. Corporate governance also provides the structure through which it sets the objectives of the company, as well as determines the means of attaining those objectives and monitoring performance. Good corporate governance (a) should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and (b) should facilitate effective monitoring. This section first discusses the rationale and the role of corporate governance issues in financial sector assessments and then outlines the principles of corporate governance developed by the OECD, which is the international standard for practices in this area. Finally, this section also summarizes the corporate governance assessments by the World Bank under the ROSC initiative and the main lessons of assessment experience so far.

Detailed assessments of corporate governance standards are typically undertaken on a stand-alone basis as part of World Bank's ROSC Program. They are not normally undertaken as a component of FSAP, except occasionally when the related issues have been given priority in financial sector policies.[15] Nevertheless, all financial sector assessments look at certain core corporate governance issues as part of the review of preconditions for effective supervision and as part of assessing the observance of IOSCO objectives and principles of securities regulation. For example, IOSCO principles for issuers are, in effect, a requirement that issuers pursue good corporate governance policies in terms of transparency, disclosure, and fair and equitable treatment of holders of securities. This requirement is typically enforced both through corporate governance clauses in listing requirements and through provisions of company laws. Moreover, all financial sector supervisory standards include principles and criteria of varying depth that seek to ensure adequate governance of supervised entities. In addition, the institutions of financial markets and individual financial institutions themselves together play a critical role in fostering good governance of non-financial firms through the monitoring by financial institutions of their counterparties as part of risk management and through investment guidelines that reward good governance of issuers.[16]

10.4.1 Rationale for Good Corporate Governance?

A good corporate governance regime is central to the efficient use of capital. First, it promotes market confidence; helps to attract additional long-term capital, both domestic and foreign; and fosters market discipline through good disclosure and transparency. Second, good corporate governance helps to ensure that corporations take into account the interests not only of a wide range of constituencies but also of the communities within which they operate and that their boards are accountable to the company and the shareholders.

Those actions, in turn, help to ensure that corporations operate for the benefit of society as a whole.

The experiences of economic transition and the financial crises in many developing and emerging market economies have confirmed that good corporate governance practices can strongly contribute to financial market development and financial stability. Good corporate governance helps to bridge the gap between the interest of those who run a company and the shareholders who own it, thereby increasing investor confidence and making it easier for companies to raise equity capital and to finance investment. Good corporate governance also helps ensure that a company honors its legal commitments and forms value-creating relations with stakeholders, including employees and creditors (OECD 2003).

Empirical evidence[17] suggests that good corporate governance will do the following:

- Increase the efficiency of capital allocation within and across firms.
- Reduce the cost of capital for issuers.
- Help broaden access to capital.
- Reduce vulnerability to crises.
- Foster savings.
- Render corruption more difficult.

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10.4.2 OECD Principles of Corporate Governance

In response to a call by the OECD council meeting at the ministerial level on April 27–28, 1998, to develop a set of corporate governance standards and guidelines, the OECD issued in 1999 the *OECD Principles of Corporate Governance* after extensive consultations. Since then, the principles have formed the basis for corporate governance initiatives in both OECD and non-OECD countries alike. Hence, they represent the minimum standard that countries with different traditions could agree on, without being unduly prescriptive. In particular, they are equally applicable to countries with a civil and common-law tradition, different levels of ownership concentration, and models of board representation. Moreover, they have been adopted as one of the 12 key standards for sound financial systems by the Financial Stability Forum. They have been endorsed by the Bank and the Fund executive boards, and they form the basis of the corporate governance component of the World Bank–IMF ROSCs.

The OECD principles were reviewed and revised by the OECD Steering Group on Corporate Governance under a mandate from OECD ministers in 2002. This review and the subsequent revisions were supported by a comprehensive survey of corporate governance practices and by information on practices outside the OECD area derived from regional corporate governance round tables. The revised OECD principles were issued in April 2004.

The OECD principles have been devised with four fundamental concepts in mind: responsibility, accountability, fairness, and transparency. The OECD principles allow for diversity of rules and regulations and are primarily concerned with listed companies. A set of 32 principles is organized into six sections that ensure the following: (a) the basis for an effective corporate governance framework, (b) the rights of shareholders, (c) the

Box 10.8 OECD Principles of Corporate Governance: Overview of the Main Areas of the OECD Principles

1. The Basis of an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities.

There are four core principles under this category, including the requirement that "supervisory, regulatory, and enforcement authorities should have the authority, integrity, and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent, and fully explained" (OECD (2004).

2. Rights of Shareholders and Key Ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights. Seven core principles in this category spell out the various rights of shareholders and call for effective shareholder participation in key corporate governance decisions. This category requires, among other things, that the equity component of compensation schemes for board members and employees be subject to shareholder approval; that market for corporate control be allowed to function in an efficient transparent and fair manner to protect the rights of all shareholders; and that the exercise of ownership rights by all shareholders, including institutional investor, be facilitated, for example, through disclosure by institutional investors of overall corporate governance and voting policies with respect to their investments.

3. Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. This category comprises three core principles, including the requirements that insider trading and abusive self-dealing should be prohibited and that members of the board and key executives should be required to disclose material interest in any transaction or matter affecting the corporation.

4. Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and should encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and sustainability of financially sound enterprises. Six core principles make up this category, including the requirements that effective redress be made for violation of stakeholder interest protected by law and that the corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditors' rights.

5. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters with respect to the corporation, including the financial situation, performance, ownership, and governance of the company. Six core principles in this category spell out the types of material information that should be disclosed and call for not only high-quality accounting and disclosure standards in preparing the reports, annual audits, and accountability of external auditors but also effective channels of communications. The principles call for effective promotion of analysis and advice by analysts, brokers, rating agencies, and others who are free from material conflicts of interests that might compromise the integrity of their analysis or advice.

6. Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. The six core principles in this category call for board members to act on a fully informed basis, treat all shareholders fairly, and apply high ethical standards; spell out eight key functions of the board (e.g., ensuring the integrity of the corporation's accounting and financial reporting systems); and require the board to exercise objective and independent judgment on corporate affairs. The exercise of board functions might require a sufficient number of non-executive directors and sufficient access to accurate, relevant, and timely information.

Note: Information in this box is based on OECD (2004).

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equitable treatment of shareholders, (d) the role of stakeholders in corporate governance, (e) the disclosure and transparency, and (f) the responsibilities of the board. The scope of the OECD principles is summarized in box 10.8.

The recent revisions to the principles covered four main areas: (a) a new set of principles on the development of regulatory framework to underpin corporate governance framework and mechanisms for implementation and enforcements; (b) additional principles to strengthen the exercise of informed ownership by shareholders, particularly those calling on institutional investors to disclose their corporate governance policies and those strengthening the rights of shareholders to choose Board members; (c) strengthened principles to reinforce Board oversight and enhance Board members' independent judgment; and (d) new and strengthened principles to contain conflicts of interest through enhanced disclosure and transparency (e.g., on related party transactions), thus making auditors more accountable to shareholders and promoting auditors' independence.

The principles have been framed to keep in mind primarily non-financial firms, but the core principles apply equally well to financial firms. However, additional safeguards and controls apply to financial institutions' governance as reflected in various financial supervisory standards. The key issues in financial sector governance are highlighted in Annex 10.C.

10.4.3 World Bank ROSC Corporate Governance Assessments

As part of the ROSC initiative, the World Bank has established a program to assist its member countries in strengthening their corporate governance frameworks. The objectives of this program are to accomplish the following:

- Benchmark the country's corporate governance framework and company practices against the OECD Principles for Corporate Governance.
- Assist the country in developing and implementing a country action plan for improving institutional capacity with a view to strengthening the country's corporate governance framework.
- Raise awareness of good corporate governance practices among the country's public and private sector stakeholders.

Participation in corporate governance ROSC assessments is voluntary, and the World Bank conducts the assessments at the invitation of country authorities, sometimes in the context of an FSAP assessment. The World Bank has developed a template to gather pertinent information for preparing the Corporate Governance ROSC as a diagnostic instrument. The template gathers both quantitative and qualitative information on ownership and control structure of listed companies, capital market structure, legal and institutional factors affecting corporate governance, rights and obligations of listed companies, intermediaries and investors in a given country, relevant disclosure practices, and functions and responsibilities of governing bodies of the corporation. Although the assessments are relevant to all countries, they are particularly pertinent in middle-income countries seeking to build strong capital markets. They are also a useful instrument for transition economies, where mass privatization has created a large pool of listed companies with

thousands of shareholders, and for low-income countries seeking to attract international portfolio investors.

The assessments are also a tool for communication between policy makers and domestic and international investors to reach a common understanding in an environment where countries are grappling with the establishment of a market for corporate control and are competing to attract capital. Assessments do not advocate a single model of corporate governance but do promote choice for issuers and investors.

Box 10.9 Methodology and Format of Corporate Governance Assessments

The World Bank has developed a questionnaire in the form of a template that is available on its Web site.* An updated template, following the 2004 revision of the OECD principles, has been prepared and will be available on the same Web site to assist in assessments. It is structured along the six chapters of the OECD Principles and seeks to gather both quantitative and qualitative information on capital markets, listed companies, and enforcement of securities and corporate laws. The objective of the updated template is to facilitate the gathering of information necessary to formulate a diagnosis of the institutional framework underlying corporate governance, as well as the prevailing practices and enforcement. For each OECD Principle, a set of questions has been prepared to assess the compliance of the country under assessment.

The updated template includes a section on the ownership structure of the assessed country because this structure is an important determinant of corporate governance practices. It endeavors to identify pyramid structures, cross-shareholdings, and business groups, and it gathers information on the divergence between cash flow rights and voting rights. Although the OECD Principles are mainly concerned with the rights of shareholders and stakeholders, disclosure, and responsibilities of insiders, the updated template also addresses the issue of institutional capacity.

A first template was produced at the beginning of 2000 as a pilot template, and it was revised into a second version in the same year and was vetted by the OECD, IMF, and SEC. Consultation took place for the preparation of the third generation expanded template in 2003. The fourth and current version, reflecting the revisions to the OECD Principles in 2004, is being finalized. In addition, special template modules have been developed that focus on financial institutions' governance, including governance of banks and non-bank financial institutions (insurance companies, pension funds, and mutual funds), drawing on lessons learned from previous assessments. The modules have been pilot tested in the Czech Republic (mutual funds, bank, and insurance modules), and the Slovak Republic (pension funds). A new module is under development to assess the governance of state-owned enterprises (SOEs); the module is based on the OECD Guidelines on the corporate governance of SOEs.

The format of the assessment reports is elaborated in the operational guidelines for ROSC reports issued by the World Bank and the IMF. The content has evolved over time. It started with a 15-page narrative describing corporate governance practices of the assessed country, plus a matrix benchmarking the adherence to each OECD Principle. In a second phase, policy recommendations were added. The latest format attempts to differentiate between compliance of the legal and regulatory framework and actual practices of market participants and includes a chapter on institutional strengthening. For FY2005, the format was enhanced with the multiple goals of (a) enhancing readability and clarity, (b) adding further standardization, and (c) developing themes that cut across the various OECD Principles. The new format has (a) a short (5-page) discussion that focuses on key issues and policy recommendations and is in a form similar to commercial brokerage research and (b) a 15-page principle-by-principle assessment that presents the issues in more detail.

The corporate governance country assessment is conducted as an "external" assessment. The World Bank is responsible for researching and drafting the assessment. A local consultant is typically commissioned to complete a "template" (questionnaire) that was designed to capture a country's corporate governance legal and regulatory framework, as well as information on corporate governance practices. World Bank experts then visit a country to meet with government officials, market participants, investors, and issuers, and to draft an assessment report.

* A copy of the template can be downloaded from http://www.worldbank.org/ifa/CGTemplate_0603.doc.

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The assessment team works closely with stakeholders and makes recommendations that can lead to a country action plan. The World Bank publishes the ROSC report on its Web site with permission of the country authorities.[18] The published reports are accessible at http://www.worldbank.org/ifa/rosc_cg.html. The procedures and format of the corporate governance assessments are further explained in box 10.9.

The format of the assessments allows for systematic benchmarking across countries and regions. It is divided into five parts: (a) an executive summary, (b) a report on key corporate governance issues and major recommendations, preceeded by a capital markets profile, (c) a table of assessment ratings by principle, (d) a principle-by-principle review, and (e) a set of specific technical recommendations.

Each OECD principle is evaluated on the basis of quantitative and qualitative standards. "Observed" means that all essential criteria are met. "Largely observed" means that only minor shortcomings are observed—deficiencies that do not raise any questions about the authorities' ability and intent to achieve full observance within a reasonable period of time. "Partially observed" means that, although the legal and regulatory framework may be fully compliant with the OECD principle, practices and enforcement diverge. "Materially not observed" means that, despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. "Not observed" means that no substantive progress toward observance has been achieved.

The assessments are complementary to private sector rating activities in this field. The World Bank assessments focus on country analysis, whereas some rating agencies have started to focus on corporate governance of companies. Standard & Poor's and Moody's have begun rating companies in emerging markets. Other similar exercises are carried out by specialized firms such as Pensions Investment Research Consultants in the United Kingdom or Deminor in Belgium and France. New rating companies for corporate governance have emerged in Russia and South Korea.

10.4.4 Key Findings from Country Assessments

The work of Fremont and Capaul (2002) reviews the lessons of corporate governance assessments and its findings are discussed in this section. None of the assessed countries comply with the OECD principles in all respects. Yet all countries surveyed have undertaken or are currently undertaking reforms to bring their legal and regulatory frameworks in compliance with the OECD principles. In most countries surveyed, there is a growing interest toward improving corporate governance practices. A large number of countries, including Brazil, Croatia, the Philippines, and Romania have developed their own corporate governance codes of best practice. The World Bank corporate governance assessments also have been a catalyst to trigger interest and reform.

Some of the key policy issues that have arisen in corporate governance assessments include the following:

- A Code of Corporate Governance should be developed at the country level to provide more detailed guidelines to complement existing laws and regulations, and foster good practices.
- Director-training facilities should be promoted.

- Further legal reforms are needed to ensure additional rights to shareholders, particularly protection of minority shareholders, and to promote more comprehensive governance policy, including effective exercise of voting rights by institutional investors acting in fiduciary capacity.
- Institutional framework for corporate governance requires further strengthening to avoid duplication and overlap (and to promote better coordination) among multiple regulators with oversight responsibilities for listed companies (e.g., overlap and coordination issues could arise among agencies overseeing company law enforcement, securities regulatory agencies, and other law enforcement and regulatory agencies).
- Enforcement of corporate Governance Laws needs to be strengthened in several areas, including listing rules, content of disclosure, shareholders' rights and equitable treatment of shareholders.

In most countries surveyed, business transactions have traditionally taken place on the basis of personal relationships and trust, and little attention has been paid to publicly available information. Corporate governance reform is a way to extend this trust to all market participants by enforcing shareholders' rights, as well as other rules and practices underlying good corporate governance. The OECD principles assume that countries have an efficient legal and regulatory framework in place and that securities regulators have the means and capabilities to enforce the rules and regulations of their capital markets. However, experience from the countries surveyed demonstrates that this assumption is often not the case. Typically, courts are underfinanced, unmotivated, unclear as to how the law applies, unfamiliar with economic issues, or even corrupt. Moreover, securities regulators have little direct power to enforce penalties. Enforcement of prevailing rules and regulations is mostly the responsibility of the courts, which consequently leads to poor enforcement of the rules and regulations underlying corporate governance. In countries with weak judicial enforcement, concentrated enforcement through the market regulators may be preferable to enforcement through the courts.

The legal framework and corporate governance arrangements should recognize various forms of organizing companies when incorporating and policy makers should offer issuers different corporate governance options (in terms of disclosure and governance standards). This "menu of options" approach to corporate governance standards would facilitate reforms and enhance the relevance of the OECD principles for developing countries and transition economies.This approach provides a means for issuers and investors to choose the markets and the companies that are most appropriate to their specific risk profile. At the same time, standardization of options is desirable to lower transaction costs for issuers and investors alike.

10.5 Disclosure Regime for Financial Institutions

The evolving regulatory practices for banks and other financial institutions, in particular the New Basel Capital accord, places a strong emphasis on harnessing market forces,

through adequate disclosure and enhanced transparency of financial institutions. The strengthening of transparency and market discipline is designed to complement the capital requirements and supervisory review and other tools of official supervision in promoting soundness. This section highlights key issues in assessing the adequacy of disclosure regime for financial institutions.

10.5.1 Current Practices and Evolving Standards

Public disclosure practices of banks are typically governed by banking laws in some countries and by the listing requirements for publicly traded companies under the countries' securities regulations and the applicable company laws. This type of disclosure of financial information on banks and other financial institutions helps to enforce prudential standards and to protect investors and creditors by promoting market discipline. Market discipline is an effective tool to limit excessive risk taking by banks, particularly in countries with a generous government safety net.[19] Market discipline becomes even more fundamental because supervisory approaches are increasingly shifting from hard prudential limits toward a more risk-based supervisory review. In this framework, banks establish their own policies with respect to risk tolerance and risk management while supervisors validate those policies and procedures, supported by harnessing market forces to foster sound risk management policies. In support of enhanced market discipline, additional disclosure requirements are being introduced as one of the pillars (Pillar III) in the New Capital Accord (Basel II).[20]

The New Basel Capital Accord (Basel II) provides a new international standard on disclosure practices for banks, although elements of it are already covered in the IFRS, in the national listing requirements, and to some extent in Basel Core Principles (e.g., Core Principle 21). The Basel Core Principles, however, do not explicitly require disclosure of banks' financial information.[21] Nevertheless, disclosure practices consistent with the spirit of the principle should be taken into account in BCP assessment. For example, the New Zealand financial supervisory framework relies to a large extent on market discipline, with only a limited recourse to prudential limits and onsite inspections. Therefore, the effectiveness of mandatory disclosure requirements was considered and taken into account in the assessment of several core principles.[22]

The Basel Committee has issued several papers with guidelines for supervisors to enhance disclosure and has described best practices in disclosure of specific banks' activities such as lending and derivatives.[23] In addition, the BIS survey of disclosure practices by banks contains a detailed list of disclosures and provides a benchmark for comparing the practices of domestic banks in the different categories (e.g., disclosure of capital elements, asset quality, derivative activities). The benchmark provided is the level of disclosure in those areas by international banks.[24] Given that the survey looks only at the type of items that are disclosed, conclusions with respect to the comprehensiveness of domestic banks' practices—as compared with those of international banks—should be qualified to take into account the adequacy of the underlying accounting practices.[25]

Countries adopting risk-based supervision frameworks should considerably enhance the disclosure of banks' risk exposures and risk management techniques in line with the new accord requirements. A detailed example of a rather comprehensive disclosure

requirement on banks' risk exposures is the requirements imposed on bank holding companies by the U.S. Securities and Exchange Commission (SEC).[26] The recommended disclosure templates of Pillar III (see section 10.5.2) are more detailed in several areas and more focused on specific types of risks, and they complement the SEC requirements. In addition, supervision could become more effective if national authorities disclose aggregate information on the level and trends in risk exposures of the system.[27]

10.5.2 Pillar III and Market Discipline

Pillar III (market discipline) of the New Basel Capital Accord is intended to complement the minimum capital requirements laid out in Pillar I and the supervisory review (of capital) process laid out in Pillar II of the New Basel Capital Accord.[28] This development is an important one because it recognizes the role of market discipline in supplementing the efforts of supervisors in monitoring the safety and soundness of banks. It also places the responsibility for promoting transparency, hitherto largely in the ambit of accounting and corporate governance standards, into the formal framework of banking supervision.

Disclosure under Pillar III, however, is limited in scope to those items that have a direct bearing on the computation of capital adequacy of the institution. Thus, under Pillar III, a bank would have to disclose information material using the approach that it has adopted under Pillar I. However, this limitation in scope does not limit the amount of information that is required to be disclosed, and the suggested disclosures are still substantial and comprehensive, as discussed below.

To facilitate disclosure, Pillar III provides 13 templates. They cover the following: (a) scope of application, (b) capital structure, (c) capital adequacy, (d) credit risk (general), (e) credit risk (standardized approach), (f) credit risk (IRB approach), (g) equity (banking book) positions, (h) credit risk mitigation, (i) securitization, (j) market risk (standardized approach), (k) market risk (internal models approach), (l) operational risk, and (m) interest rate risk in the banking book. Each template, in turn, breaks up the disclosure requirements into (a) quantitative and (b) qualitative disclosure. For example, under credit risk (standardized approach), banks are required to disclose not only the percentage of a bank's outstandings in each risk bucket that is covered by each agency's ratings but also the names of the rating agency and the agency's role.

Pillar III disclosure is to apply only to the top consolidated level of the banking group to which Pillar I applies. Hence, individual banks within the banking group need not separately meet those requirements. However, the Total and Tier I capital ratios of individual banks within the group are to be disclosed separately by the Pillar III entity in the template on capital adequacy.

The disclosure has to be detailed at the portfolio level, where applicable. Thus, for example, if the bank implements a foundation internal ratings–based approach, then in the template for credit risk, it should disclose for each of the five portfolios a broad overview of the model approach with a description of the definitions of the variables and with methods for estimating and validating the variables as part of the quantitative disclosure. For the quantitative disclosure, it should disclose for each of the portfolios exposures across different probability of default (PD) grades and should supplement this information with (a) historical data on actual loss experience in the preceding period for each

portfolio, (b) analysis of how these data differ from past experience, and (c) a discussion of the factors that affected the loss experience.

The purpose of such detailed disclosure is to enable concerned market participants to make their own assessments of the risk exposures and risk assessment processes and, hence, to develop a truer picture of the capital adequacy of the institution. The structured presentation will allow for a consistent framework across institutions, which will enhance comparability. This development is particularly important because, under some approaches in Basel II, banks would be using internal methodologies and data sources for computing capital instead of supervisor-defined risk weights, as in the past.

The frequency of the Pillar III disclosures is intended to be generally semiannual, though an underlying expectation is that all material information should be published as soon as practicable. Further, there is also an expectation that all large internationally active banks and the significant banks would disclose information on their Tier I and total capital adequacy ratios and their components on a quarterly basis. Similarly, all information on risk exposure that is prone to rapid change should also be disclosed quarterly. However, qualitative disclosures of a general nature, which are not subject to this frequency of change (e.g., those that deal with risk management objectives and policies), need to be reported only on an annual basis.

The incentive, location, and manner of disclosure are left to the jurisdictions. An important consideration in the design of the disclosure has been that the framework does not conflict with the requirements under the accounting standards, which are much broader in scope. Hence, the medium and location of the disclosure could vary and would also depend on the method used by supervisors to effect the disclosure. Thus, the disclosure could be affected by making it mandatory under the accounting regime or the listing requirements. In other cases, it could be built into a supervisory regulation or reporting requirements. In some cases, it may be influenced by pure moral suasion or may be voluntarily adopted to maintain competitive equality. Further, in some cases (e.g., credit risk mitigation techniques and credit derivatives, asset securitization, and internal ratings), the incentive for disclosure is provided by virtue of its being a qualifying criterion for the recognition or use of those techniques under the New Basel Capital Accord.

There is a presumption of validation built into the disclosure, especially where the disclosure forms part of the accounting requirements, which are generally audited because they should be consistent with the audited statements. In case the disclosures are part of the supervisory reporting requirements that are subsequently made public, there is a presumption that the information is reliable. When it is published by the bank on a stand-alone basis or on the bank's Web site, then banks should ensure that this information has undergone some verification before being posted.

However, Pillar III stops short of requiring that the disclosure be audited by an external or independent party, unless, of course, this step automatically forms part of the regime under which the disclosure is made. The additional reporting burden is a clear disincentive for banks to voluntarily adopt Pillar III. Supervisors will have to find effective means

of ensuring reliability of disclosure, especially in circumstances where this disclosure takes place outside their purview. Nevertheless, it can be expected that the markets would be quick to penalize any incorrect disclosure ex post. While one is interpreting the disclosure, care will have to be exercised to take into account the different items of national discretion that have been applied in the particular jurisdiction because this information could affect comparability across countries.

Annex 10.A Code of Good Practices on Transparency in Monetary and Financial Policies

The Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code) consists of a set of good transparency practices for central banks and monetary authorities (I–IV) and for financial agencies (V–VIII), which are outlined in this Annex.

1. Clarity of Roles, Responsibilities, and Objectives of Central Banks for Monetary Policy

1.1 calls for the ultimate objectives and institutional framework to be clearly defined in law or regulation, including responsibilities, modalities of accountability, and procedures for appointments and overriding decisions.

1.2 deals with the institutional relationship between monetary policy and fiscal operations, including disclosure of advances to the government, bond market participation, and profit allocation.

1.3 deals with the agency roles performed by the central bank on behalf of the government, including debt and reserves management.

2. Open Process for Formulating and Reporting Monetary Policy Decisions

2.1 covers the framework, instruments, and targets used by the central bank and calls for explanation and disclosure of rules and procedures.

2.2 deals with the composition, structure, and functions of the policy-making body and calls for disclosure of meeting schedules.

2.3 calls for the timely explanation of changes in monetary policy settings with a pre-announced maximum delay.

2.4 calls for periodic reporting on the macroeconomic situations and progress toward achieving objectives.

2.5 calls for public consultations over proposed changes in regulations.

2.6 calls for disclosure of regulations on data reporting by financial institutions.

3. Public Availability of Information on Monetary Policy

3.1 calls for adherence to IMF data dissemination standards.

3.2 calls for public disclosure of balance sheet information and aggregate market transactions on a frequent and pre-announced schedule. It also includes disclosure of detailed balance sheet information and aggregate information on emergency financial support.

3.3 calls for the maintenance of public information services, including an annual report.

3.4 calls for disclosure of texts of regulations.

4. Accountability and Assurances of Integrity by the Central Bank

4.1 calls for public appearances of officials to report on monetary policy conduct.

4.2 calls for disclosure of audited financial statements on a pre-announced schedule and disclosure of internal governance arrangements.

4.3 calls for annual disclosure of information on expenses and revenues.

4.4 calls for disclosure of standards of conduct for staff members (including conflict of interest rules) and legal protections.

5. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies

5.1 calls for the objectives and institutional framework to be clearly defined in law or regulation and publicly disclosed and explained, including responsibilities, procedures for appointment, and modalities of accountability.

5.2 calls for disclosure of the institutional relationship between financial agencies.

5.3 calls for disclosure on the role of oversight agencies with respect to payment systems.

5.4 calls for disclosure of the relationship between financial agencies and self-regulatory agencies.

5.5 calls for similar transparency practices to govern the oversight of self-regulatory agencies.

6. Open Process for Formulating and Financial Policies

6.1 calls for disclosure of information on the regulatory framework, regulations, fees, and information-sharing arrangements for financial agencies.

6.2 calls for timely disclosure of significant changes in policies.

6.3 calls for periodic reporting on progress toward achieving objectives.

6.4 calls for a presumption of public consultations over proposed changes in regulations.

7. Public Availability of Information on Financial Policies

7.1 calls for periodic public reporting of major developments in the sector.

7.2 calls for public disclosure of aggregate data on a timely and regular basis.

7.3 calls for the disclosure of balance-sheet information of financial agencies, including emergency liquidity support.

7.4 calls for the maintenance of public information agencies, as well as periodic and annual reports.

7.5 calls for disclosure of the text of regulations.

7.6 calls for disclosure of information on guarantees, including their nature, funding, and performance.

7.7 calls for disclosure of oversight of consumer protection arrangements.

8. Accountability and Assurances of Integrity by Financial Agencies

8.1 calls for public appearances of officials to report on the conduct of financial policies and their objectives.

8.2 calls for disclosure of audited financial statements on a pre-announced schedule and for disclosure of internal governance arrangements.

8.3 calls for annual disclosure of information on expenses and revenues.

8.4 calls for disclosure of standards of conduct for staff members (including conflict of interest rules) and legal protections.

Annex 10.B Methodology for Assessing Accounting and Auditing

At the inception of the assessment, policy makers identify the relevant stakeholders who have an interest in accounting and auditing matters. The stakeholders may include securities market regulators, banking regulators, NBFI regulators, accounting and auditing firms, professional associations, institutional investors, and officials from the Finance Ministry. A National Steering Committee (NSC) composed of those selected stakeholders is then formed and chaired by a high-ranking government official. Throughout the ROSC process, the NSC provides input on all of the issues being reviewed. It also acts as the World Bank's counterpart in preparing the ROSC report and country action plan, as well as the intermediary with the government in securing approval for the publication of the final report. Finally, it oversees implementation of the action plan. However, the actual degree and manner of the NSC's involvement in the assessment phase varies across countries and is stipulated at the outset within the terms of reference. NSC members can, for example, assist Bank staff members through regular meetings as the Bank staff complete the questionnaires or can fill in the questionnaires themselves. The assessment is conducted by using the four-part diagnostic tool (described in the following four sections) and is carried out by means of prepared and standardized questionnaires.

Part I: Assessment of the Accounting and Auditing Environment

This assessment involves gathering data on the following areas (this detailed list is not all-inclusive) and essentially provides an overview of the country's institutional framework.

- *Statutory Environment:* Companies Act, Commercial Code, securities market, and banking and NBFI regulations, as well as accounting and auditing laws

- *Public Accounting Profession:* regulations, professional bodies, certifications and licensing arrangements, public perceptions, and liability and indemnity insurance
- *Academic and Professional Education and Training*: academic and professional programs, examinations, and experience requirements
- *Accounting and Auditing Standards:* standards, code of ethics, and independence
- *Monitoring and Enforcement:* respective regulatory authorities for banking, securities markets, NBFIs, insurance and the auditing profession, and the stock exchange
- *Quality and Availability of Financial Reporting:* availability of reporting
- *Various Issues:* country data, securities markets, financial institutions, forms of business enterprises, and the accounting profession

Part II: Assessment of National Accounting Standards with Reference to IAS

This assessment involves gathering data to determine the framework for the preparation and presentation of financial statements and the major gaps between national and international accounting standards. The preparers also interview national experts, including those with jurisdiction over setting national standards. To assess the gaps, the assessment asks the following three questions (plus follow-up questions) for each of the 41 IAS and IFRS:

- Has the respective standard been adopted as a national standard?
- Are the following accounting treatments and disclosures (as they pertain to that IAS) specifically mandated by the national standards?
- What is the effect of any difference between national standards and IFRS on the relevance and reliability of the financial statements for external users?

Part III: Assessment of Actual Accounting Practices (Review of Compliance with Selected Local Accounting Requirements)

This process reviews sample sets of financial statements of public interest entities, including the listed companies, to determine the level of compliance with existing national standards. The review, which requires the involvement of independent reviewers with appropriate technical knowledge, also focuses on institutional arrangements underpinning the quality of auditing and accounting practices. The response to the questionnaire is supplemented by a due diligence review that is conducted by members of the assessment team. The questionnaire addresses 18 topics, including components of financial statements; presentation of balance sheets, income statements, cash flows, and changes in equity; consolidated statements; interest; foreign currency translation; and income taxes. For each given topic, it presents the applicable IFRS requirement and asks the following three questions:

- What is the equivalent national accounting requirement?
- Do financial statements comply with the national accounting requirements?
- If no, then how has the item been treated?

Part IV: Assessment of Auditing Standards and Practices

The objectives of this component are (a) to determine the conformity of local auditing standards and requirements with ISA and the related IFAC Code of Ethics for Professional Accountants and (b) to assess the degree of compliance with local auditing standards and requirements. The questionnaire is supplemented by a due diligence review that is conducted by the assessment team, including a facilitated discussion among local professional accountants in public practice. Observance of the 33 ISAs is reviewed by means of the following format. A brief outline of the ISA is provided, followed by the following questions:

- Has this standard been adopted as a national standard, or are there local standards addressing all requirements of this standard?
- Has the local body issued guidance to facilitate the implementation of the standards? If yes, what are the key effects of such guidance?
- Are the following concepts (of the ISA) addressed in local standards?
- Have local standards on matters of relevance in the country (that are not covered by ISAs) been developed on the basis of the conceptual framework embedded in the standard?
- To what extent, if any, does practice tend to differ from the strict wording of the written local standard or standards addressing the requirement of this standard?
- What are the difficulties faced by professional accountants in public practice to fully comply with this standard?

Due Diligence and Final Report

After the assessment is completed, the assessment team conducts an extensive due diligence review on the basis of all the data collected. This process involves the following steps:

- A detailed review of the findings arising from the diagnostic tool
- An inception and closing meeting with the NSC
- Meetings with representatives of the Ministry of Finance, respective regulator of the securities industry, banking sector, insurance and other NBFIs, professional accounting bodies, listed companies, financial institutions, other public interest entities, and institutional investors
- A roundtable with the major auditing firms to discuss the issues faced in the conduct of audit engagements
- Interviews of knowledgeable in-country stakeholders, especially financial statement users

Final Report

The assessment team then presents a final report outlining its factual findings and puts forth policy recommendations to help the country enhance its accounting and auditing standards and practices. The report is reviewed by the NSC. The team may also organize

workshops whereby various national stakeholders discuss the report's findings and policy recommendations. Those deliberations should lead to improved policy recommendations.

Development and Implementation of a Country Action Plan

The action plan is prepared by the NSC on approval of the final report by the authorities. The World Bank, on request by the authorities, may assist in developing the plan. The action plan addresses the most significant areas for improvement and focuses on specific, realistic, and achievable goals. Its implementation may be overseen by the NSC. Combined with the country report, the action plan can contribute to the design of loans, assist in the preparation of key policy documents, and provide benchmarks for the design and monitoring of technical assistance and capacity building programs. The World Bank may, if requested by the government, assist in gathering resources for implementation of the plan. However, long-term developmental programs are necessary for achieving results from accountancy reform initiatives.

Annex 10.C Financial Sector Governance—Selected Issues

Financial sector governance refers to (a) corporate governance of financial institutions and other market participants (e.g., issuers, service providers), as well as governance arrangements for financial sector regulatory agencies, and (b) the nexus of relationships among institutions whereby quality of governance of one institutional segment affects the other. Although quality of financial sector governance will ultimately be conditioned by the overall public sector governance, several key issues arise in assessing and strengthening financial sector governance. First, how well have the components of existing supervisory standards that deal with regulatory governance been implemented in practice? And what is the effect of regulatory governance on the overall effectiveness of supervision and soundness of the financial system? Second, has the governance of financial institutions (particularly banks) required additional controls and safeguards over and above the normal corporate governance practices and standards that apply to non-financial firms? Third, how should regulatory governance and regulatory policies in individual sectors be adjusted to help strengthen and reinforce corporate governance of financial institutions? This last issue has been given prominence in a recent research (see Barth, Caprio, and Levine 2004). Finally, how should policy makers encourage regulated financial institutions to exercise greater focus on the quality of governance of their counterparties (financial and non-financial firms, household, and government)?

Regulatory agency governance can be defined, similar to the definition of public sector governance in Kaufman (2002), as (a) the capacity of the agency to manage resources efficiently and to formulate, implement, and enforce sound policies and regulations and (b) its ability to carry on its mandate consistent with the broader goals and policies of the government and legislature. Regulatory agency governance can be assessed in terms of four key attributes that determine its "capacity" and "ability" to carry out its objectives effectively. Those attributes are independence, accountability, transparency, and integrity.

In the presence of several regulatory agencies and oversight bodies, the overall regulatory governance (not simply the internal governance of a single agency) will also depend on interagency governance arrangements, including division of responsibilities among oversight agencies, as well as information exchange and communication arrangements. The existing supervisory standards cover those elements in varying degrees of depth. The clarity of its mandate, the ability to carry out its mandate through appropriately designed instruments without undue interference, and the legal identity of the agency are among the factors that govern independence. Accountability of the agency to the body that had delegated the responsibility—the government or the legislature—and to the courts and the public (stakeholders) helps to add credibility and reinforce independence.

Transparency means that the agency's objectives, frameworks, regulatory processes and accountability arrangements, and internal processes to ensure integrity are all disclosed to the public in a comprehensive, accessible, and timely manner. Integrity of the agency is ensured by mechanisms such as procedures for appointment and removal of management, internal audit arrangements, standards for the conduct of staff members' personal affairs to prevent conflicts of interest, and the legal protection for staff members in discharging their official duties in good faith. Finally, the combination of information exchange and coordination arrangements among various sectoral supervisors and oversight bodies raises issues relating to the optimal design of institutional arrangements for supervision, as discussed in appendix F, Institutional Structure of Financial Regulation and Supervision.

Recent experience with assessments of observance of the core principles relating to regulatory governance across sectors shows that, in most countries, the principles are well implemented, except in the case of the insurance sector, where compliance was relatively low compared with other sectors (banking and securities). Main weaknesses observed were related to regulators' independence; lack of clarity of regulators' objectives and accountability arrangements; regulatory forbearance, sometimes reflecting lack of legal protection for the regulator; and lack of clarity with respect to the responsibilities of the regulatory body and self-regulatory organizations (see IMF 2004). Also, quality of regulatory governance affects financial system soundness, as illustrated in Das, Quintyn, and Chenard (2004).

In light of the systemic stability concerns associated with the commercial banking functions, supervisory authorities typically place emphasis on additional safeguards to enhance corporate governance of banks. For example, the Basel Committee on Banking Supervision has issued a range of guidance documents, including "Enhancing Corporate Governance for Banking Organizations" (Basel Committee on Banking Supervision 1999b), that bear directly on various aspects of internal governance of banks. The relative emphasis on official regulation and supervision, on the one hand, and corporate governance and market discipline aspects of supervised institutions, on the other hand, varies among countries, in part, reflecting the structure and state of the financial system and, sometimes, the level of systemic stress in the system. Thus, the supervisory approach toward enhanced corporate governance of banks varies over time and across countries. Similarly, the appropriate approach to strengthening governance of non-bank financial institutions is a recurring theme in the design of regulatory policies for non-bank financial sectors, including securities markets and their institutions (see Litan, Pomerleano, and Sundararajan, 2002). In addition, emphasis on disclosure standards for banks under Pillar

III of the New Basel Capital Accord is designed to strengthen governance of, and market discipline on, banks.

Several regulatory authorities, notably the Reserve Bank of New Zealand, place great emphasis on adjusting their supervisory approaches to ensure that corporate governance of banks and market discipline are strong. Those adjustments have been achieved through the following means:

- Holding directors responsible and requiring them to attest to accuracy of disclosures and to quality of regulatory compliance
- Ensuring adequate representation of non-executive independent directors, with a separation of board chairman and chief executive
- Requiring directors to avoid individual and collective conflicts of interests
- Ensuring rigorous internal and external audit arrangements, with external auditors having a measure of independence
- Enforcing regular, timely, comprehensive, meaningful, and reliable financial and governance disclosure
- Promoting incentives for market scrutiny of banks through contestable banking; equal competition between banks and non-banks; limited (or absence of) deposit insurance; and equitable loss sharing among all creditors, depositors, and shareholders

The extent to which financial institutions exercise influence on corporate governance of counterparty institutions, particularly non-financial corporations, also will vary a great deal across countries, but certain policies can make a difference. First, sound principles of risk management and asset selection promoted by the regulator could include adequate attention to corporate governance of counterparties. Second, corporate governance policy that is used by major institutional investors in guiding their asset allocation could be highly effective. Finally, the insolvency and creditor rights regime and other supporting institutional arrangements for bad debt resolution and asset management could provide powerful incentives for banks to exercise due diligence on counterparty credit risk and for debtor institutions to exercise good governance. The governance arrangements and governance nexus would, of course, change in times of crises, with relative roles of regulatory and oversight agencies, as well as the intrusiveness of official supervision and regulation changing rapidly to ensure stability.

Notes

1. See Litan, Pomerleano, and Sundararajan (2002) for a discussion of financial sector governance and the broader governance nexus.
2. See IMF (1999) for further details.
3. See IMF (2000b), the supporting document of the MFP Code.
4. See IMF (2003b).
5. See Mishkin (2001).
6. This possibility highlights the importance of risk disclosures, an issue addressed in the New Basel Capital Accord. See also section 10.5.

7. The IASB is an independent, privately funded organization that is based in London and that sets accounting standards. The board members come from nine countries and have a variety of functional backgrounds. The IASB is committed to developing—in the public interest—a single set of high-quality, understandable, and enforceable global accounting standards that require transparent and comparable information in general-purpose financial statements. For additional information, see http://www.iasb.org.
8. The IFAC is an international organization for the accountancy profession. It works with 157 member organizations that represent 2.5 million accountants in public practice, industry and commerce, government, and academia. Its stated overall mission is to serve the public interest, to strengthen the worldwide accounting profession, and to contribute to sound economies by establishing and promoting adherence to high-quality professional standards, thereby furthering the international convergence of such standards, and by speaking out on public interest issues where its expertise is relevant. International Standards for Auditing (ISAs) are issued by the International Auditing and Assurance Board (IAASB), which functions as an independent setter of standards under the auspices of IFAC (see http://www.ifac.org).
9. See IASB (2004) for a list of IASs with summary descriptions of each standard.
10. See IFAC (2004) for a full listing of code of ethics ISAs and other engagement standards.
11. The ROSC Web site posts details of the accounting and auditing assessment tools and published country modules and these are available at http://www.worldbank.org/ifa/rosc.html.
12. Currently, no international regulatory standards exist for A&A, although efforts to address this gap are under way. In the absence of regulatory standards, Bank staff members draw on their own experiences and international best practices.
13. This section is based on Artigas (2004), a paper from Financial Stability Institute.
14. For example, Standard & Poors may put a country on "credit watch," whereas Moody's puts a country "on review for possible upgrade/downgrade," and Fitch issues "alerts."
15. For a recent example of corporate governance assessment undertaken as part of FSAP, see IMF (2003c).
16. This governance nexus—whereby the broader governance arrangements, financial supervisory policies (affecting governance of supervised financial entities), and policies of supervised financial entities themselves (affecting nonfinancial firm governance) interact with one another—is explored in Litan, Pomerleano, and Sundararajan (2002).
17. Fremont and Capaul (2002); for empirical evidence that investors would be prepared to pay a premium for companies exhibiting high governance standards, see Newell and Wilson (2002) and Bhojraj and Sengupta (2003).
18. When ROSCs are prepared in the context of an FSAP, they may also be published—at the initiative of the authorities—as part of the FSSA report of the IMF.
19. See, for example, Nier and Baumann (2003).
20. See section 10.5.2 for a discussion of disclosure standards in the new capital accord.
21. Compliance with Basel Core Principle 21 requires that the supervisor has the authority to hold management responsible for ensuring that the financial statements issued annually to the public receive proper external verification. However, it does not

indicate that the supervisor has the authority to require that the financial statements be disclosed. An additional criterion indicates that the supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline. Therefore, at most, if financial statements are not disclosed, assessors would note it in the comments to the principle. See Basel Committee on Banking Supervision (1999a).

22. See "New Zealand: Financial System Stability Assessment" (IMF 2004b).
23. See, for example, Basel Committee on Banking Supervision (1998), Basel Committee on Banking Supervision (1999c), and Basel Committee on Banking Supervision (1999d).
24. See Basel Committee on Banking Supervision (2003b).
25. For example, compliance with Core Principle 21 may be affected, even when the supervisors exercise comprehensive powers to enforce wide-ranging disclosures, if the underlying accounting standards were to deviate from international norms.
26. See United States Securities and Exchange Commission (2001) and United States Securities and Exchange Commission (1997).
27. See Section 10.1 on MFP transparency code of good practices for a discussion of transparency of aggregate information. The Financial Stability Reports published by various central banks (see, e.g., http://www.bankofengland.co.uk/financialstability/index.htm) include aggregate information on regulated financial firms.
28. See Basel Committee on Banking Supervision (2003a).

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