Elmeskov, Martin, and Scarpetta (1998) believe that EPLs are most detrimental in the intermediate bargaining case. In a comprehensive evaluation, OECD (2004) finds that EPLs reduce the employment rate among youth and women, but not prime-age men—a classic insider-outsider scenario.

81. **The case study countries stand out in terms of low EPLs, and both Denmark and the Netherlands undertook reforms**. Since the late 1980s (when data became available), EPLs were lowered in both Denmark in the Netherlands, pushing them toward the bottom, while Ireland and the United Kingdom changed little, yet maintaining their relative positions. The Danish liberalization in the 1990s reflects the expanding role of temporary work agencies (OECD, 2004). Dutch reform began in the late 1980s, and focused on streamlining laying off rules and relaxing hiring procedures (see Barrell and Genre, 1999). Working-time rules became more flexible, which had the effect of encouraging part-time work. Overtime legislation was also relaxed. Further reforms of fixed-terms contracts, probation periods, and dismissal procedures took place in the late 1990s. In particular, temporary work agencies gained more prominence as regulations relating to them were relaxed; this contributed to the explosion of part-time work and flexible contracts, especially among women.

III. How Good is Financial Sector Regulation and Supervision in Europe?[45]

A. Introduction

82. **This chapter analyzes regulatory and supervisory frameworks in the European Union (EU), building on assessments carried out under the IMF-World Bank Financial Sector Assessment Program (FSAP)**.[46] The FSAP has so far covered about two thirds of the IMF membership, including virtually the whole EU (Table III.1). It is therefore an important source of comparable information on the quality of supervisory frameworks in the EU and around the globe. This chapter is an attempt to synthesize the information from the FSAP assessments in a comprehensive way, focusing on the EU countries. It is the first time this type of analysis is carried out for the EU.

83. **The findings of the chapter should be treated as partial because some issues—notably those related to cross-border activities—are difficult to cover comprehensively with country-specific FSAPs**. Also, the analysis presented in this chapter, while illustrative, is limited by the fact that it builds on country FSAPs carried out at different points in time during 2000–06. Some of the areas for improvement identified in the assessments have been

[45] Prepared by Martin Čihák and Alexander Tieman (both MFD).

[46] The chapter focuses on prudential and conduct-of-business regulation and supervision; it does not cover other parts of the regulatory framework, such as those dealing with competition issues. To save words, the term "supervision" is used to mean "regulation and supervision."

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addressed by the authorities, while new issues have emerged (e.g., the rapid credit growth in the new member states and its cross-border dimension) as the financial system became more integrated. Even though each of the assessments covered principles on cross-border supervisory cooperation, and many attempted to go even beyond these basic principles, individual country FSAPs may not be an efficient way to analyze multilateral issues. Additional analyses would have to be done to cover in greater depth EU-wide issues, such as cross-border crisis management, systemic liquidity support, cross-border payments and settlements systems, deposit insurance systems, the Lamfalussy process, and *de facto* day-to-day implementation of cross-border supervisory coordination (especially in the face of new challenges and financial market trends). Cross-country exercises of the kind that has recently been initiated for the Nordic and Baltic countries are better suited for this than country FSAPs.

84. **With these caveats in mind, a combination of quantitative and qualitative approaches is used in this chapter to analyze the information from the FSAP**. The quantitative approach is based on the gradings in the assessments of observance of standards. The analysis focuses on cross-country differences in gradings in the EU and a sample of comparable non-EU countries. While this approach has some limitations (in particular, it assumes that international standards measure the correct characteristics of the supervisory system and that the assessments are precise and consistent across countries), there is no data set measuring the quality of supervision that would be more appropriate for these purposes. The quantitative analysis of gradings is complemented by an analysis of qualitative information in the FSAPs, in particular of the overall FSAP assessments, which cover also some issues that are not captured well by the standards assessments (e.g., the cross-border crisis management framework).

85. **The findings from this analysis lead to suggestions relating to the EU's Financial Services Action Plan** (EU-FSAP).[47] The action plan was initiated in 1999, around the time the FSAP was launched in Washington. Roughly six years later, the program (FSAP) has covered virtually the whole EU, and it seems logical to ask, what it has to say about the action plan (EU-FSAP). The action plan contained three strategic objectives: (i) a single EU wholesale market; (ii) open and secure retail networks; and (iii) state-of-the art prudential rules and supervision. The analysis in this chapter leads to suggestions on where the reform effort should focus to achieve the third objective.

86. **To answer the titular question, the findings in this chapter suggest that the supervisory systems in the EU are of a higher quality than in comparable countries, even though they were still found in some respects below the international standards and are not uniform across EU member countries**. Based on the FSAP assessments, the supervisory systems in the EU were of a higher and more even quality than in the non-EU countries. However, this should not be a reason for complacency, since there were still gaps

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[47] A more common abbreviation is FSAP; EU-FSAP is used here to distinguish it from the Fund-Bank FSAP.

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between the EU practices and the international standards. Of all the principles in the international standards being reviewed, not a single one was fully observed by all the EU member countries.

87. **The chapter also highlights an issue raised by most FSAPs in the EU: the need to adjust the supervisory frameworks to meet new challenges, such as, in particular, increasing international financial integration**. For example, the recently completed FSAP for Belgium identified as a key challenge the need to "ensure that the authorities' capacity to identify and address risks in the financial system keeps pace with the rapidly evolving markets and increased complexity of financial groups against the backdrop of European and global integration," and to "maintain vigilance over the financial sector's expansion abroad to prevent such a beneficial move from threatening the stability of the financial system" (see IMF Country Report No. 06/75).

88. **The structure of the chapter is as follows**. Section B discusses the methodology of the analysis. Section C presents results of the analysis of individual gradings and discusses the main areas for improvement in compliance with the various standards. Section D surveys the qualitative findings in the FSAPs to highlight those issues that were not captured in the standards assessments, but were found important in the overall FSAP assessments. Section E concludes.

B. Methodology

89. **To analyze supervision in the EU, Section C uses data on countries' observance of internationally accepted standards in banking, insurance, and securities regulation ("standards")**. The standards covered in this analysis are the Basel Core Principles for Effective Banking Supervision (BCP), the International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP), and the International Association of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation. The IMF and World Bank have endorsed internationally recognized standards and codes in 9 other areas, some of which are also relevant for the financial sector (namely, payments and securities settlements systems, transparency, and anti-money laundering). For simplicity, this chapter focuses on the three basic standards for banking, insurance, and securities regulation. The analysis was also carried out for the financial policy transparency and payments and securities settlements systems standards, but the results are omitted here for brevity.[48]

90. **The degree of observance is measured by gradings, which are an integral part of each standard**. Each standard contains a list of requirements against which observance is measured. For example, the BCP contains 25 "Core Principles" (CPs) that cover a wide

[48] See http://www.imf.org/external/standards/index.htm for a full listing of the standards and other relevant materials. The focus of this chapter is on the internationally accepted standards, not on EU standards. The two sets of standards are closely, but not perfectly, aligned.

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range of issues, from the aims of supervision, autonomy, powers, and resources (CP1), through capital adequacy (CP6), regulation of risks (CPs 11–13), to supervision of foreign banks (CP25). Similarly, the ICP and IOSCO standards also consist of a number of principles (see Tables III.4–III.6 for a basic "dictionary" of the three standards). The observance of each principle is assessed on a 4-point scale, from "fully observed" to "non-observed," even though the exact names of the grades differ slightly across the three sectors. Most of the assessments have been prepared as part of the FSAP.[49] Most countries have chosen to publish the summaries of the financial sector assessments (Reports on Standards and Codes, or ROSCs), which however do not contain the gradings of the individual principles. The detailed assessments with the underlying gradings have been published only for a minority of countries (in the EU, only for 3 countries—see Table III.1). Given that most of the detailed assessments have not been published, this chapter uses the data in a way that protects the confidentiality of the unpublished information.[50]

91. **To arrive at a concise summary of the assessments of compliance with standards, the individual gradings are analyzed quantitatively**. Grading is not an exact science and emphasis should always be placed on the commentaries that accompany each principle grading, rather than on the grading itself. The primary goal of the assessment is not to apply a "grade" but rather to highlight areas needing attention in order to set the stage for improvements and develop an action plan that prioritizes the improvements needed to achieve full compliance with the principles. Nonetheless, to summarize the results in a number of countries, such as the 25 EU countries, it is practical to start with the gradings. The approach is similar to that adopted by IMF (2004) to study issues and gaps in supervisory and regulatory frameworks and by Čihák and Podpiera (2006) to analyze integrated supervisory agencies. This is the first time the available cross-country data on quality of supervision are used in this manner specifically for the EU member countries. The following calculations are used:

- ***Principle-by-principle gradings***. For each standard and each principle, the 4-point scale assessment was transformed into a numeric value from 0 (non-observed) to 100 (fully observed).

- ***Summary grading***. An average of the principle-by-principle gradings was calculated to arrive at a summary grading for each standard. This summary grading is also a number from 0 (non-observed) to 100 (fully observed). In principle, when more data

[49] Standards assessments are carried out by independent experts from the IMF, World Bank, and cooperating institutions. For the BCP, two independent experts are required ("four eyes principle"). The assessments go through several stages of internal review to ensure quality and consistency across countries. For further information on the assessment methodologies, see http://www.imf.org/external/standards/index.htm. In several cases, assessments were carried out separately from the FSAP program. In addition, for off-shore financial centers (OFC), assessments were prepared as part of the Fund's OFC assessment program.

[50] The published ROSCs and detailed assessments are available at the IMF and World Bank websites.

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become available, it may be possible to test empirically for the significance of the individual principles in explaining supervisory performance and use that as a basis for constructing a summary grading. In the absence of such data, an unweighted average was used for simplicity.

- ***Component gradings***. Given that the individual principles cover different subjects, and given that the composition of the principles is different across the three sectors (banking, insurance, securities regulation), it is easier to carry out cross-sectoral comparisons if the principles are aggregated into components that are the same across the sectors. The aggregation by IMF (2004) is followed, which identified the following four components of good supervisory framework: (i) regulatory governance, which includes aims, independence, and accountability of regulators; (ii) prudential framework, i.e., risk management, capital adequacy, internal control, and corporate governance; (iii) regulatory practices, i.e., monitoring and supervision, enforcement, conglomerates, and licensing; and (iv) financial integrity/safety net, including consumer protection, and addressing financial crimes. Table III.7 provides a mapping of the individual principles into the four components.[51] For each of the four components, an observance index was calculated as an unweighted average of the individual principles included in the component. The advantage of the component gradings is that they provide more details than the general level of observance, while allowing for comparisons across the three sectors (which is not the case with the individual principles).

92. **The gradings were obtained and analyzed for all EU countries and a sample of comparable non-EU countries**. The EU sample consists of all 25 EU member countries. BCP assessments are available for all 25 countries; ICP and IOSCO assessments are available for a majority of countries.[52] The non-EU sample consists of 11 advanced economies and 9 emerging markets that had a completed FSAP assessment (Table III.2). To make the EU and non-EU samples comparable, developing countries were excluded from the sample of non-EU countries. The classification of advanced countries, emerging markets,

[51] The mapping is relatively straightforward for most principles, except for a few in the areas of prudential framework and regulatory practices. In particular, some of the principles under regulatory practices (e.g., group-wide supervision and licensing) could also be placed under prudential framework. In all cases, the approach of IMF (2004) is followed, but the interpretation of the results for the components needs to take into account that the mapping of the principles into components is a useful exercise, but not an exact science.

[52] Not all assessments are carried out in all FSAPs. The ICP and IOSCO assessments are therefore available for only 13 and 17 EU member countries, respectively. In order to have as many observations as possible, some assessments available in a draft form (in particular, Australia, Denmark, and Portugal) were included.

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and developing countries used for this purposes followed the IMF's World Economic Outlook (see, e.g., IMF, 2006, for an explanation of the classification methodology).[53]

93. **When interpreting the results, one needs to bear in mind that the gradings are a series of country-by-country snapshots, some of which may have become outdated**. The individual assessments were undertaken at different points in time during 2000–06 (Table III.1). Some of the earlier gradings may have become outdated due to steps by country authorities subsequent to the FSAP, or due to other new developments. For those countries where the gradings were updated through a formal FSAP update (Table III.1), the updated gradings were taken into account; for others, the FSAP gradings are still the most recent available cross-country information. The existence of lags between regulatory developments and reassessments of gradings means that older assessments are likely to underestimate the true quality of supervision in the country. Interestingly, however, statistical tests do not suggest a strong link between the "vintage" of the FSAP assessment and the overall grading.[54]

94. **The quantitative analysis of the gradings was complemented by an overview of the qualitative findings in the FSAPs**. The gradings provide only very compressed information about the quality of the regulatory framework. Supervisory frameworks include elements that are not easy to quantify, and information may be lost if one focuses only on quantitative analysis. Each assessment therefore contains a rich set of underlying, qualitative information, which was also analyzed. Moreover, not all principles are equally relevant in all countries, and there are issues that may not be captured by the standard assessments. The FSAP reports put the standards assessments and other analytical tools together into an integrated assessment of the financial sector. The key messages from these overall assessments are surveyed in Section D.

C. Analysis of Compliance with Principles

95. **The EU member countries showed, on average, a higher level of observance of standards than non-EU member countries**. The degree of observance of the three standards and their subcomponents was on average about 8 percentage points higher in the EU countries than in the non-EU countries (Figure III.1). This difference was not statistically significant in banking and insurance regulation, but it was statistically significant for

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[53] Given that the World Economic Outlook puts emerging markets and developing countries in one group, the two sub-groups were separated using GDP per capita as the deciding criterion.

[54] The average gradings were regressed on the "vintage" of the assessment (the year in which it was carried out), controlling for differences in the level of development (approximated by GDP per capita). The sign of GDP per capita was positive and highly significant, but the sign for the vintage—even though positive, as expected—was insignificant (e.g., for the BCP, the p-value was 0.14). The insignificance can be caused by two effects: on one hand, countries with better regulatory frameworks were perhaps more likely to request an FSAP earlier; on the other hand, those with a later FSAP had extra time to put their framework in order.

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securities market regulation and for the regulatory governance component of insurance regulation, and it was robustly positive across the various components of the regulatory framework. Similar results were obtained when EU-15 countries were compared with non-EU advanced economies, and when new member states (NMS) were compared with a sample of non-EU emerging markets (Table III.3 and Figure III.4).[55]

96. **Despite the relatively favorable performance vis-à-vis non-EU countries, compliance in the EU was still below the standards**. The overall level of compliance, ranging from 79 percent in insurance to 85 percent in securities regulation, was still significantly below full compliance (i.e., 100 percent).[56] The distance from full compliance (15–21 percentage points) was bigger than the difference with respect to the non-EU countries (5–13 percentage points).

97. **No principle was observed fully by all EU member countries**. For example, in banking, two EU countries observed all core principles, but no principle was observed fully across the EU. On average, there were about 9 less-than-fully compliant EU countries for each principle. For some principles, more than a half of the EU countries were less-than-fully compliant (Figure III.3). This is an interesting observation, particularly given that the standards in question were designed as an "aspirational minimum" for sound supervisory practices, i.e., as benchmarks that all countries should aspire to fulfill. Supervisory frameworks in advanced economies should be expected to exceed the minimum standards by a margin. It is possible that the level of observance has improved subsequently to the FSAPs (some of the follow-up work in Article IV missions suggests so); however, new reassessments of compliance would be needed to confirm the improvement.

98. **Observance tended to be the weakest in insurance supervision**. The average level of observance in insurance supervision was lower than in banking and securities regulation. This was true both for EU and for non-EU countries (Figure III.1). For example, the difference between average levels of observance in banking and insurance was about 6 percentage points in the EU countries and about 8 percentage points in non-EU countries (Table III.3).

99. **EU member countries also showed a slightly more even level of observance than non-EU member countries** (Figures III.2, III.5, and III.6). Various measures of cross-country variability (e.g., standard deviation, minimum minus maximum, variation coefficient) suggest that EU member countries have a lower variability in quality of supervision. Standard statistical tests allow to reject the hypothesis of equal cross-country

[55] The standards were designed as universally applicable. In principle, therefore, one would not have to take the level of economic development into account. However, in practice, the level of compliance is positively correlated with economic development, as illustrated in Table 3 and in IMF (2004). It is therefore useful to analyze the gradings not only for all countries, but also by peer groups of countries, as done in Table III.3.

[56] For illustration, the value of 67 percent corresponds to the "largely compliant" grading, so it could be said that on average, the EU regulatory systems were more than "largely compliant." However, they were significantly less than "fully compliant," and some were even less than "largely compliant" (Table III.2).

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variance inside and outside of EU only for some components of the regulatory framework, but as with the average levels, the sign of the difference is relatively robust across the various regulatory components (Table III.3).

100. **Within the EU, there was a notable difference in observance for the EU-15 countries and the 10 NMS** (Table III.3 and Figure III.4). The level of observance in the EU-15 countries is higher (by 13–18 percentage points on average), and less uneven than in the NMS (the standard deviation being 4–10 percentage points lower on average).

101. **Cross-country variability in the EU tended to be higher in regulatory governance than in other aspects of the supervisory framework**. Both in banking and in insurance, regulatory governance shows higher cross-country variability than the prudential framework, regulatory practices, or financial integrity and safety nets. In securities regulation, the prudential framework is the component with the highest cross-country variability (Table III.3).

102. **The principle-by-principle analysis of standard assessments suggested several specific areas for attention**. Of the 72 principles contained in the three standards, 19 principles were fully observed by less than a half of the assessed EU countries (Table III.8). These comprise 6 principles in banking, 9 in insurance, and 4 in securities. In the following three paragraphs, these 19 principles are listed, sector by sector, in an order of priority (approximated by the number of less-than-fully compliant countries). The fact that a principle is not listed here does not mean that there is no scope for improvement; as mentioned earlier, for each principle, at least one country was less than fully compliant.

103. **In banking, areas most in need of improvement include supervision of other risks, connected lending, issues relating to money laundering; supervisory objectives, autonomy, powers, and resources; remedial measures; and consolidated supervision**. More specifically:

- *Supervision of other risks.* The relevant principle (CP13) requires that banking supervisors be satisfied that banks have in place a comprehensive risk management process to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks. Sixteen EU countries did not fully satisfy this criterion. The reasons for less-then-full compliance varied from country to country, in some cases the reason was lack of specific guidelines on interest rate risk and operational risk, in other cases weak guidelines on liquidity risk.

- *Connected lending*. The relevant principle (CP10) requires that—to prevent abuses arising from connected lending—banking supervisors have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks. Fifteen EU countries did not fully satisfy this criterion. The most frequent issues include absence of legal prohibition to lend to connected parties on more favorable terms than to non-related counterparts, absence

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of a limit above which exposures to connected parties are subject to board approval, absence of supervisory power to deem that a connection exists in cases others than those specified in the law, and absence of a power to deduct connected lending from capital or to require it to be collateralized.

- *Money laundering*. The relevant principle (CP15) requires that banking supervisors determine that banks have adequate policies, practices, and procedures in place, including strict know-your-customer rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements. Fifteen EU countries did not fully satisfy this criterion. One of the common issues was low frequency of the relevant on-site inspections.

- *Supervisory objectives, autonomy, powers, and resources*. The relevant principle (CP1) requires clear responsibilities and objectives for each agency involved in the supervision of banks. Fifteen EU countries did not fully satisfy this criterion. The most frequent weaknesses related to the potential for political interference in day-to-day supervision, the lack of budgetary independence, and the need to strengthen the legal protection of supervisors.

- *Remedial measures.* The relevant principle (CP22) requires that banking supervisors have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements, when there are regulatory violations, or where depositors are threatened in any other way. Fifteen EU countries did not fully satisfy this criterion. The most frequent problems included limited powers to remove individuals, lack of statutory "prompt corrective action" procedures, and lack of powers to restrict dividend payments.

- *Consolidated supervision.* The relevant principle (CP20) notes that an essential element of banking supervision is the ability of the supervisors to supervise a banking group on a consolidated basis. Thirteen EU countries did not fully satisfy this criterion. The assessments often noted that supervisors need to rise to the challenge posed by conglomerization of systems, which can provide systems with more stability, but can also pose additional challenges resulting from possible drain of capital from one type of institutions to another. It can also create opportunities for arbitrage when prudential requirements are not well-aligned across the different business lines. The most common issues related to insufficient resources in insurance supervision or the absence of a fully articulated structure for sharing of information and assessments.

104. **In insurance regulation, the number of areas with low observance was much higher**. They ranged from market conduct issues to internal controls, derivatives and off-balance sheet items, organization of the supervisor, corporate governance, assets, on-site inspection, licensing, and cross-border business operations. More specifically:

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- *Market conduct issues.* The relevant principle (CP11)[57] requires insurance supervisors to ensure that insurers and intermediaries exercise the necessary knowledge, skills and integrity in dealings with their customers. Nine of the thirteen assessed EU countries did not fully satisfy this criterion. The most frequent recommendations relate to ensuring that market conduct issues are better handled at the point of sale when the agent is actually selling the product. Some assessments noted that this is especially relevant for unit linked products, which may not be suitable for all customers (from a risk tolerance perspective) and may be sold on the basis of unrealistic expectations.

- *Internal controls.* The relevant principle (CP5) requires the insurance supervisor to be able to: review the internal controls that the board of directors and management approve and apply; request strengthening of the controls where necessary; and require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management. Nine of the thirteen assessed EU countries did not fully satisfy this criterion, in most cases because of a lack of legislative support for internal control in the operations of insurance companies.

- *Derivatives and off-balance sheet items.* The relevant principle (CP9) requires the insurance supervisor to be able to set requirements with respect to the use of derivatives and off-balance sheet items. Nine of the thirteen assessed EU countries did not fully satisfy this criterion, most frequently suggesting that insurers be required to have in place risk management policies and systems as regards to any derivatives positions, and that the onsite inspection program be amended to state more precisely the work that has to be done by supervisors with regard to derivatives.

- *Organization of the supervisor.* The relevant principle (CP1) requires that the insurance supervisor be organized so as to be able to accomplish its primary task, i.e., to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. Eight of the thirteen assessed EU countries did not fully satisfy this criterion, the most common reason being potential political interference in supervision and lack of adequate resources.

- *Corporate governance.* The relevant principle (CP4) requires establishing standards to deal with corporate governance. Seven of the thirteen assessed EU countries did not fully satisfy this criterion, the most frequent problems relating to the supervisory agency's powers being insufficient with respect to corporate governance.

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[57] For simplicity, the references to individual ICP principles are based on the 2000 IAIS standard, which has so far been used for a majority of EU countries that had the ICP assessment. ICP assessments based on the 2003 IAIS standards were also included in the analysis and are reflected in this summary.

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- *Assets.* The relevant principle (CP6) requires that standards be established with respect to the assets of companies licensed to operate in the jurisdiction. Seven of the thirteen assessed EU countries did not fully satisfy this criterion, mostly recommending that supervisors ensure that insurance companies and groups have proper internal controls to ensure that assets are managed in accordance with the overall investment policy, and suggesting to spell out inspection procedures for the review of investment practices and policies, and asset valuation.

- *On-site inspection.* The relevant principle (CP13) requires that the insurance supervisor be able to carry out on-site inspections to review the business and affairs of the company, including the inspection of books, records, accounts, and other documents. Seven of the thirteen assessed EU countries did not fully satisfy this criterion, the main concerns relating to extended periods between inspections for most companies and less than fully-developed implementation of a risk-based approach.

- *Licensing.* The relevant principle (CP2) requires that companies wishing to underwrite insurance in the domestic insurance market be licensed. Seven of the thirteen assessed EU countries did not fully satisfy this criterion.

- *Cross-border business operations.* The relevant principle (CP15) notes that the insurance supervisor should ensure that: no foreign insurance establishment escapes supervision; all insurance establishments of international insurance groups and international insurers are subject to effective supervision; the creation of a cross-border insurance establishment is subject to consultation between host and home supervisors; and foreign insurers providing insurance cover on a cross-border services basis are subject to effective supervision. Seven of the thirteen assessed EU countries did not fully satisfy this criterion. The reasons varied from country to country, one of the concerns being insufficient resources for the supervisor to actively supervise branches of financial institutions abroad.

105. **In securities regulation, the number of low-compliance areas was relatively smaller**. The main areas for improvement relate to enforcement powers, compliance program, capital and other prudential requirements, powers, resources, capacity, and operational independence and accountability. More specifically:

- *Enforcement powers and compliance program.* The relevant principle (Q10) requires an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. Nine of the seventeen assessed EU countries did not fully satisfy this criterion, most frequently because of limits on the ability of the supervisor to carry out full inspections, investigations, surveillance and enforcement.

- *Capital and other prudential requirements.* The relevant principle (Q22) requires that there be initial and ongoing capital and other prudential requirements for market

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intermediaries that reflect the risks that the intermediaries undertake. Nine of the seventeen assessed EU countries did not fully satisfy this criterion, most frequently noting an absence of legal immunity for actions in good faith by the regulatory authority.

- *Powers, resources, capacity.* The relevant principle (Q03) requires that the regulator have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. Nine of the seventeen assessed EU countries did not fully satisfy this criterion, mostly calling for more supervisory resources, and recommending some clarifications in the supervisory powers and institutional arrangements.

- *Operational independence and accountability*. The relevant principle (Q02) requires that the regulator be operationally independent and accountable in the exercise of its functions and powers. Nine of the seventeen assessed EU countries did not fully satisfy this criterion, the most frequent reasons being lack of budgetary independence and potential for political interference.

106. **Many of the above gaps were recognized by the authorities and are being addressed as part of the EU-FSAP**. Since the beginning of the initiative, new directives were adopted on winding-up and liquidation of banks and insurance undertakings, directives governing the capital adequacy framework for banks and investment firms were amended, a Commission recommendation was issued on disclosure of financial instruments, and substantial improvements in the Anti-Money Laundering framework were achieved by an amendment to the EU's money laundering directive, among other things. The Lamfalussy process is getting up to speed, and some of the remaining gaps identified by FSAPs will be addressed by the Capital Requirements Directive (CRD), to be implemented in the coming years; the Financial Conglomerates Directive, addressing the role of international financial conglomerates; and Solvency II, which is still being prepared. Also, prudential authorities have undertaken substantial improvements in their cross-border cooperation through formal Memoranda of Understanding and other efforts. Progress in regulatory frameworks was confirmed by the recent FSAP updates and other IMF surveillance work.[58]

107. **At the same time, the financial environment changed substantially since the FSAP process started**. In particular, the role of international financial conglomerates has increased. Also, the rapid credit growth in Central and Eastern Europe—and the cross-border issues related to the role of foreign banks—was a much less prominent issue several years ago.

[58] However, of the 25 EU countries, formal FSAP updates have so far been completed only for Hungary and Slovenia. FSAP updates for Ireland and Poland are ongoing.

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D. Survey of the Main FSAP Recommendations

108. **In addition to the quantitative findings derived from gradings, several recurrent themes emerge from a qualitative survey of the main messages in overall FSAP assessments on EU countries**. This section reviews the available Financial System Stability Assessment (FSSA) reports for the EU member countries,[59] and it also presents results of a survey of IMF mission chiefs of FSAPs in EU countries. The main reason for going beyond the quantitative analysis of the previous section is that not all the principles have the same macro-relevance, and some issues are not at all covered by the standards. It is therefore important to combine the quantitative analysis of the gradings with a survey of the qualitative assessments in the FSAPs, which take a broader picture than standards alone and take into account the relevance of the various principles in the macroeconomic context of a country.

109. **Overall, supervisory systems in most EU countries were described as being of high quality in the FSSAs**. Sixteen FSSAs (73 percent) explicitly declared that the financial system is well supervised, even though issues and gaps were identified in most cases, and substantial gaps were found in some NMS. This is consistent with the gradings summarized in Section C and Table III.3.

110. **Most FSSAs in the EU countries highlighted the need to adjust the supervisory frameworks to meet new challenges, in particular those relating to cross-sector and cross-border financial integration**. A majority of FSSAs for EU member countries stressed that the consolidation of the financial markets has increased the importance of effective cooperation within and across national jurisdictions. In several countries, this issue was raised in the context of strengthening consolidated supervision.[60] Additionally, a number of EU FSSAs urged continued work, both domestically and internationally, in the areas of crisis management, deposit insurance, cross-border payment and settlements systems, and day-to-day cross-border supervisory cooperation. As a recent example, the 2006 FSAP on Belgium recommended that the supervisory agency positions itself to meet new challenges stemming from the following cross-sector and cross-border issues: (i) the dominant role of conglomerates in the domestic market and their increasingly international character; (ii) the demands of Basel II and Solvency II; (iii) the implementation of the Financial Services Action Plan and the ongoing integration within the European market; and (iv) the changes in, and special requirements of, new cross-border financial market infrastructures, such as Euronext and Euroclear. As another example, the 2004 FSAP for the Netherlands included key recommendations on cross-border securities settlements and cross-border crisis management, both of which required close cooperation with foreign counterparts, and a

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[59] This survey was based on FSSAs available for 22 EU countries (for Hungary and Slovenia, FSSAs from FSAP updates are available and were used instead of FSSAs from initial assessments). FSSAs from initial assessments for Denmark, Portugal, and Spain are not yet available.

[60] This is consistent with the finding of Section C that the principles on consolidated supervision have been among those with the lowest level of observance.

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recommendation on the deposit guarantee system, suggesting to take account of the broader European context of depositor/investor protection arrangements.

111. **Although cross-border issues were often noted as important in countries with extensive operation of international financial conglomerates, FSAPs usually devoted limited resources to analyzing these issues**. In particular, the perspective of the foreign parties (both official and private sector) involved was often not analyzed in depth. A survey of the IMF FSAP mission chiefs for the EU countries (Box III.1) suggests that this has primarily to do with resource constraints, and to some extent with constraint on access to data and the right people at foreign supervisors, which are less committed to FSAP in a foreign country. There are some examples of limited interactions with foreign parties (e.g., a discussion with the German BaFin during the U.K. FSAP, and discussions with Euroclear in London, Paris, and Amsterdam, and some Euroclear private sector customers during the Belgium FSAP), but most missions did not meet foreign supervisors, for resource reasons.

112. **Addressing the cross-border issues will require much more than just satisfying the international standards**. Indeed, the average level of observance in the area of cross-border supervisory cooperation in terms of the gradings was relatively good in banking and securities regulation (which is why this issue did not appear among the least observed principles in Table III.8 and Section C).[61] The prominence of cross-border issues in the FSSAs reflected FSAP teams' assessment of risks and vulnerabilities related to cross-border exposures, rather than necessarily a sub-par observance of the (minimum) standards in the area of cross-border cooperation. Reflecting the importance of cross-border issues, teams in several recent FSAPs have met the relevant foreign supervisors. This approach is feasible in countries where the cross-border exposures are concentrated (e.g., some of the Central and Eastern European countries). However, where supervisors from a number of countries would have to be involved, this approach may not be feasible, for resource efficiency reasons, in a single-country FSAP.

[61] The relatively good performance of course does not mean that all countries were fully compliant with these principles. For example, in banking, each of the two relevant BCP principles (CP24 and 25) was observed less than fully in 8 EU countries. Some of these cases were in the NMS countries and related to the need to engage more actively in cross-border information exchange; others were in the EU-15 countries and stemmed from relatively minor issues relating to licensing of foreign institutions and foreign branches of domestic institutions.

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Box III.1. Cross-Border Issues in FSAPs for EU Countries: A Survey

A survey of FSAP mission chiefs for EU countries suggests that cross-border issues have received attention in FSAPs, but FSAPs generally had limited resources that prevented covering these issues in depth. In most cases, the attention was driven by the presence of systemically important foreign banks, substantial foreign exposure of domestic banks, and in some new member states by foreign ownership of the banking system. In most FSAPs, coverage of cross-border issues was limited by resource constraints and access to data.

The United Kingdom FSAP (2003) focused on the role of London as an international financial center. Cross-border supervisory coordination was an important issue for the mission. The mission met with U.S. and German supervisors to get their perspectives on coordination with the U.K. supervisors. There was no substantial emphasis on cross-border crisis management.

The Lithuania FSAP mission (2002) saw cross-border issues as central to the financial system of this small, open economy, with considerable foreign ownership of financial sector assets. The prominence of these issues was emphasized by the (then) run-up to EU accession. However, the mission did not meet foreign supervisors or private sector representatives.

In the Netherlands (2004) and Belgium (2006) FSAPs, cross-border supervisory issues were important topics for the standards assessments. In addition, in the Netherlands, the general discussions and the vulnerability analysis focused on the substantial foreign operations of Dutch banks. Some FSAP recommendations related to the area of international coordination. In Belgium, both the issue of foreign operations of large Belgian banks and foreign ownership of some large Belgian banks were discussed. As the foreign operations of Belgian banks are mainly in Central and Eastern Europe, the systemic importance for the Belgian system was judged to be limited and no in-depth analysis was performed. The mission looked into the issue of cooperation with the Dutch supervisor, but did not meet foreign supervisors or private sector representatives.

The FSAPs for Norway (2005), Sweden (2002), and Finland (2001) highlighted cross-border issues as key aspects in the standards assessments. More generally, the scope for spillovers among the Nordic countries was seen as an important issue. Given the prominence of Swedish banks throughout the region, the stress tests and scenario analyses for the Swedish FSAP were based on the Nordic area. However, the mission was somewhat constrained by its limited capacity to analyze the exposures in the Nordic region in detail. In Finland and Norway, the issue was the foreign ownership of a systemically important bank. In Norway, an additional issue was the relatively generous Norwegian deposit insurance system, and its implications for cross-border banking. No meetings with foreign supervisors took place, but at the time of the Norway FSAP the regional Nordic-Baltic surveillance exercise was already being planned.

The Greece FSAP (2006) mentioned the lack of a cross-border crisis management framework, weak cooperation between Greek supervisors and the supervisors of other southeastern European countries and the associated lack of clarity on lender of last resort issues for Greek branches operating in southeastern European countries. In addition, differences in regulatory frameworks across the region raised concerns about regulatory arbitrage. After considering the costs and benefits, the mission decided not to meet with foreign supervisors or private sector representatives.

The ongoing Poland FSAP update (2006) mentions cross-border issues as important given that about three quarters of the banking system is foreign-owned. Cross-border issues were addressed as part of the stress tests, as part of a follow-up on standards assessments, and as part of more general discussions on the role of foreign-owned banks. However, in-depth analyses of the cross-border issues were to some extent overshadowed by domestic issues, and limited by time and resource constraints. For example, the mission did not meet with foreign supervisors and representatives of the foreign owners of the local banks.

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113. **The cross-border financial sector issues in Europe are not just those relating to home-host supervision; these other issues can be covered only superficially in the FSAP, given its country focus and resource constraints**. There are important cross-border issues relating to crisis management, safety nets, lender of last resort functions, and risk management in conglomerates. The cross-border dimension of these issues has been covered in FSAPs only to a limited extent (Box III.2). Outside the FSAP, two assessment with a heavy cross-border component were performed for the euro area, focusing on transparency in monetary and financial policies and payments systems regulations (IMF 2001). As the very nature of these issues was cross-border, the mission visited several major European countries.

114. **Turning to other than cross-border issues, virtually all FSSAs highlighted the need to improve monitoring of new system-wide risks**. This was typically worded in terms of improvements in macroprudential surveillance processes and outputs, related to monitoring and analyzing new risks, implementing stress tests, and collecting and disseminating additional or more timely indicators.

115. **Strengthening of regulations was proposed in specific segments**. Substantial improvements in insurance regulation were recommended most frequently (in about a half of the surveyed FSSAs), which is consistent with the relatively lower level of compliance in this area. In some FSSAs, regulators were urged to focus on certain types of activities (e.g., in several countries, risks related to large and growing portfolios of residential mortgage loans).

116. **The need to strengthen regulatory governance was raised in a majority of FSSAs**. This is consistent with the quantitative findings of the previous section. The exact recommendations ranged from the need to reduce the potential for political interference in day-to-day supervision, to issues such as the need to strengthen the legal protection of supervisors, or the lack of budgetary independence.

117. **Corporate governance and disclosures in the financial sector were also a recurrent theme**. About a third of the FSSAs highlighted the need for improvements in corporate governance of financial institutions and their public disclosures.

118. **Other issues not explicitly covered by the standards have been prominent in some EU country FSAPs**. This includes the role of public ownership in the financial sector (e.g., in Germany) and the relationship between concentration, competition, and stability (e.g., in France and Italy). Prudential regulation can play a role, but only a secondary one, in addressing these issues.

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Box III.2. FSAP Coverage of Cross-Border Issues Other Than Home-Host Supervisory Cooperation

Crisis Management. Crisis management of cross-border and cross-sector conglomerates necessarily involves authorities from different countries and sectors. Recognizing this point, national authorities increasingly focus on international cooperation and information exchange. At the European level, there is the 2003 Memorandum of Understanding (MoU) between supervisors and central banks and the 2005 MoU between ministries of finance, supervisors, and central banks. These MoUs center on information exchange in normal times as well as in times of crisis. The functioning of the MoUs in times of crisis remains untested (even though the authorities have recently started performing crisis exercises to improve coordination and test communications), and the issue of who will be responsible for the costs of a cross-border crisis has not been tackled. Although every crisis is different and hence it would be difficult to spell out who would be responsible for the costs in all different eventualities, this issue requires further thought. Possible issues for discussion could include whether it would be sensible to set up a primary responsible institution analogous to the model of the lead supervisor and whether it might be worthwhile to consider setting up a contact group dealing with these issues, which could take decisions quickly and efficiently in times of crises. Another issue is the lack of a mandate to take externalities in other countries into account when making decisions on crisis management. As no supervisor with a supranational mandate exists in Europe, responsibilities and objectives of the current supervisors are not aligned to take full account of possible impacts abroad when taking steps in crisis management at home. *The scope of the FSAP, as a program for individual countries, has generally limited analysis of these issues.*

Safety nets. The EU Directive on deposit-guarantee schemes has provided a basis for some harmonization in deposit insurance arrangements. All EU countries have adopted an explicit deposit insurance scheme with compulsory participation, but the minimum coverage limit currently falls short of the minimum in some jurisdictions which are under transitional arrangements after their recent accession. However, practical arrangements with respect to coverage limits, funding, and co-insurance differ substantially across EU members. These substantial differences have led the European Commission (EC) to undertake a wide-ranging review of deposit insurance arrangements. The EC's review provided three main reasons for further harmonization of deposit guarantee schemes: (i) to avoid possible competitive distortions; (ii) to avoid possible (dis)incentives for banks to elect to change the location of their corporate seat; and (iii) to ease crisis management procedures. In addition to issues raised by the Commission, some other challenges with respect to the existing deposit insurance regime exist, in particular the issue of whether the minimum coverage limits prescribed by the directive are appropriate for the new member states, given their level of development. The main challenge remains how to adapt or harmonize the current arrangements in order to diminish distortions. *The FSAPs have reviewed safety nets in individual countries, but have not analyzed the related EU-wide issues.*

Lender of Last Resort Issues. There exists potential for tension between the roles of the National Central Banks and the ECB as providers of emergency liquidity. National Central Banks remain responsible for the decision to provide emergency liquidity assistance in case of idiosyncratic shocks and bear the associated costs. Meanwhile, the ESCB is responsible for systemic liquidity issues. In practice, however, in a situation of considerable stress and under time pressure, the distinction between the two may not be clear-cut. *The scope of the FSAP, as a program for individual countries, has prohibited analysis of this issue.*

Risk Management in Conglomerates. International financial conglomerates have organized their sophisticated risk management capabilities in different ways. Most conglomerates feature some form of centralized (group) risk management, but most conglomerates have not centralized all their risk management functions. *In cases where an important part of risk management takes place abroad, the FSAP analysis is limited in its potential to assess the regulatory and supervisory regimes involved. In addition, bottom-up stress tests of such conglomerates might not reflect the full nature of risks presented by a particular scenario when the foreign risk management team has not been involved in the exercise.*

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E. Conclusions

119. **The main finding of this chapter is that supervisory systems in the EU are generally of a high quality, but notable gaps and issues remain**. Based on the assessments of compliance with international standards, supervisory systems in the EU were judged to be of a higher and more even quality than those in comparable non-EU countries. However, there were still gaps to be addressed to achieve full compliance with the international standards: the overall level of compliance in the EU was 79–85 percent (compared with 100 percent for full compliance) and not a single principle was observed fully by all EU countries. Moreover, many FSAP have noted that the authorities need to prepare for new challenges, including those from the increased role of conglomerates in their domestic markets and their increasingly international character.

120. **The analysis in this chapter allows to identify what is needed to achieve one of the key strategic objectives of the EU's Financial Services Action Plan (EU-FSAP), namely "state-of-the-art prudential rules and supervision**."[62] Given that the EU countries have a higher overall degree of compliance and lower cross-country variability than comparable non-EU countries, it might be argued that the regulatory frameworks in the EU are already "state-of-the-art." However, an analysis of the FSAP recommendations suggests that there is still a need to (i) close gaps in the existing framework; and (ii) adjust the framework to emerging challenges.

121. **To close the gaps in the existing framework, it is important to bring the quality of supervision in the EU to full compliance with the international standards**. Table III.9 and Section C provide a concise summary of areas where improvements were recommended most often; for each principle, at least one and in some cases as many as 16 EU countries were found in need of improved observance. Some of these gaps are relatively small and may have been closed already, as the country authorities have addressed some of the FSAP recommendations since the respective missions; however, new issues have emerged as the financial systems have become more integrated. Moreover, it is important to bear in mind that the gradings analyzed here are based only on the minimum requirements for each principle. Regulatory frameworks in advanced financial systems, such as those in the EU, should be expected to exceed these standards by wide margins. The BCP, for example, incorporates for this purpose also several additional criteria, going above the minimum

[62] Given that the FSAP assessments were carried out country-by-country over a period of 7 years, and that for most countries there was only one assessment, it would be a stretch to use this approach to analyze progress with respect to the stated criteria in the EU-FSAP. Nonetheless, the presented approach allows to confirm—looking backward—that there was a need for the EU-FSAP, and indicate—looking forward—areas on which the reform program should focus.

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("essential") criteria.[63] In addition, the standards themselves are becoming more challenging. For example, a set of consultative documents has been circulated for public comments by June 2006 to strengthen the BCP. The draft revisions suggest that the standard will be adapted to changes that have occurred since the BCP's creation in 1997 (in particular, the development of cross-border banking and the increased importance of improved supervisory cooperation). Several new "best practices" have been included among "additional criteria," which countries with advanced banking systems should aim for. Also, even though implementation of Basel II is not a prerequisite for compliance with the minimum criteria in the BCP, the proposed BCP revision incorporates a number of sound supervisory practices (e.g., in the areas of risk management and disclosure), which are also a part of Basel II.

122. **Perhaps even more importantly, the supervisory and regulatory authorities should position themselves to address emerging challenges**. The survey of main FSAP findings suggests that these are, in particular, challenges stemming from: (i) the dominant role of conglomerates in their domestic markets and their increasingly international character; (ii) the ongoing integration within the European market; and (iii) the changes in, and special requirements of, new cross-border financial market infrastructures, such as Euronext and Euroclear. A number of EU FSSAs urged continued work, both domestically and internationally, in the areas of crisis management, deposit insurance, and day-to-day cross-border supervisory cooperation. Many of the EU FSSAs also highlighted the need to improve system-wide monitoring of risks. Addressing all these recommendations would be quite difficult on a single-country basis and may require more intensive EU-wide cooperation.

123. **A fuller assessment of EU-wide regulatory and supervisory framework issues is difficult on the basis of country-level FSAPs**. The analysis presented in this chapter is based on assessments conducted at different points in time. This means that its findings are only a broad approximation of the current state of affairs. Moreover, the individual country FSAPs were focused on country-specific issues rather than EU-wide issues. Even though the assessments covered cross-border supervisory arrangements, they could not satisfactorily tackle the main EU-wide issues, such as cross-border crisis management, systemic liquidity support, cross-border payments and settlements systems, deposit insurance systems, the Lamfalussy process, and the de facto day-to-day implementation of cross-border supervisory coordination.

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[63] The notion that financial sector regulation must exceed the minimum standards is consistent in the EU-FSAP. The action plan noted that urgent headway must be made to (i) eliminate any lacunae in the EU prudential framework, arising from new forms of financial business or globalization; (ii) set rigorous and appropriate standards so that the EU banking sector can successfully manage intensification of competitive pressures; (iii) contribute to the development of EU supervisory structures so that they can sustain stability and confidence in an era of changing market structures and globalization; (iv) develop a regulatory and supervisory approach

(continued…)

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that will serve as the basis for successful enlargement; and (v) enable the EU to assume a key role in setting high global standards for regulation and supervision, including financial conglomerates.

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Table III.1. EU Countries: Overview of FSAP Participation
(As of June 26, 2006)

	Country	FSAP Year 1/	Public Availability	
			FSSA	Detailed Assessment 2/
1	Austria	2004	Yes	No
2	Belgium	2006	Yes	No
3	Cyprus	2001 (OFC)	Yes	No
4	Czech Republic	2001	Yes	No
5	Denmark 3/	2006	No	No
6	Estonia 4/	2000	No	No
7	Finland	2001	Yes	No
8	France	2004	Yes	Yes
9	Germany	2003	Yes	No 1/
10	Greece	2006	Yes	No
11	Hungary 4/	2000 (initial)	No	No
		2005 (update)	Yes	No 1/
12	Ireland 4/	2000	Yes	No
13	Italy	2006	Yes	Yes
14	Latvia	2002	Yes	No
15	Lithuania	2002	Yes	No
16	Luxembourg	2002	Yes	No
17	Malta	2003	Yes	No
18	Netherlands	2004	Yes	Yes
19	Poland	2001	Yes	No
20	Portugal 3/	2006	No	No
21	Slovak Republic	2002	Yes	No
22	Slovenia	2001 (initial)	Yes	No
		2004 (update)	Yes	No
23	Spain 3/	2006	Yes	Yes
24	Sweden	2002	Yes	No
25	United Kingdom	2003	Yes	Yes

Source: IMF's FSAP tracking database.

Notes:
1/ Calendar year of the Board discussion of the Financial System Stability Assessment (FSSA).
2/ Detailed Assessment is the assessment of compliance with financial sector standards. Summaries of the assessments (without the underlying gradings) are contained in the FSSA.
3/ Ongoing; analysis based on draft assessments.
4/ Part of the pilot program, when publication was not an option.

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Table III.2. Overview of Economies Included in the Survey 1/

EU		Non-EU	
Advanced Economies (EU-15)		Advanced Economies	
1	Austria	1	Australia
2	Belgium	2	Canada
3	Denmark	3	Hong Kong SAR
4	Finland	4	Iceland
5	France	5	Israel
6	Germany	6	Korea
7	Greece	7	Japan
8	Ireland	8	New Zealand
9	Italy	9	Norway
10	Luxembourg	10	Singapore
11	Netherlands	11	Switzerland
12	Portugal		
13	Spain		
14	Sweden		
15	United Kingdom		
Emerging Markets (New Member States)		Emerging Markets	
1	Czech Republic	1	Brazil
2	Cyprus	2	Bulgaria
3	Estonia	3	Chile
4	Hungary	4	Croatia
5	Latvia	5	Mexico
6	Lithuania	6	Philippines
7	Malta	7	Romania
8	Poland	8	Russia
9	Slovak Republic	9	South Africa
10	Slovenia		

Note:

1/ The classification of advanced economies used in this paper follows the country classification in the IMF's World Economic Outlook (IMF, 2006). The only exception is Cyprus, classified as an advanced economy in the WEO, but compared here with emerging markets because it is one of the New Member States. The results do not change qualitatively if Cyprus is instead classified as advanced economy.

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Table III.3. Banking, Insurance, and Securities Regulation: Overall Observance 1/

	Average 2/			Standard deviation 2/			Maximum 2/		Minimum 2/	
	EU	Non-EU	Diff. 3/	EU	Non-EU	Diff. 3/	EU	Non-EU	EU	Non-EU
All Economies										
Banking (summary)	84.2	79.7	4.5	14.1	25.2	-11.1	100.0	100.0	50.9	25.8
Reg. governance	85.0	83.1	1.9	18.4	20.1	-1.7	100.0	100.0	36.1	33.3
Prud. framework	85.7	81.3	4.4	14.5	24.2	-9.8	100.0	100.0	50.0	27.8
Reg. practices	82.5	76.4	6.1	15.3	27.0	-11.7	100.0	100.0	46.7	20.0
Fin. integrity, safety nets	83.3	76.7	6.7	15.2	27.1	-11.9 *	100.0	100.0	50.0	16.7
Insurance (summary)	78.5	71.4	7.2	25.1	27.6	-2.5	100.0	100.0	33.3	25.5
Reg. governance	78.8	59.0	19.8 *	22.5	20.0	2.5	100.0	100.0	33.3	33.3
Prud. framework	78.3	70.9	7.5	15.2	16.8	-1.7	100.0	100.0	51.9	51.9
Reg. practices	78.3	70.9	7.5	15.2	16.8	-1.7	100.0	100.0	51.9	51.9
Fin. integrity, safety nets	74.4	61.9	12.5	18.8	28.8	-10.0	100.0	100.0	50.0	16.7
Securities (summary)	84.6	71.9	12.6 *	14.5	19.2	-4.7	100.0	94.4	52.2	34.4
Reg. governance	86.0	75.3	10.7 *	16.2	18.4	-2.1	100.0	100.0	9.5	33.3
Prud. framework	84.6	65.1	19.5 *	19.0	21.9	-2.9	100.0	95.2	19.0	28.6
Reg. practices	87.7	72.8	15.0 *	14.1	25.0	-10.9 *	100.0	100.0	22.2	29.2
Fin. integrity, safety nets	80.4	74.1	6.3	18.8	20.1	-1.3	100.0	100.0	11.1	42.9
Advanced Economies										
Banking (summary)	91.6	86.0	5.6	6.7	22.8	-16.0 *	100.0	100.0	75.6	37.6
Reg. governance	91.9	89.4	2.5	12.5	17.2	-4.7	100.0	100.0	66.7	50.0
Prud. framework	93.3	89.3	4.0	6.9	18.8	-11.9	100.0	100.0	77.8	47.2
Reg. practices	90.2	82.7	7.5	9.4	27.9	-18.6 *	100.0	100.0	66.7	20.0
Fin. integrity, safety nets	90.0	78.8	11.2 *	8.5	27.3	-18.9 *	100.0	100.0	83.3	33.3
Insurance (summary)	86.0	77.5	8.5	18.9	24.0	-5.1	100.0	98.0	58.8	43.1
Reg. governance	85.7	61.1	24.6 *	17.8	13.6	4.2	100.0	66.7	66.7	33.3
Prud. framework	87.3	74.7	12.6 *	18.6	26.0	-7.4	100.0	100.0	59.3	40.7
Reg. practices	87.3	74.7	12.6 *	18.6	26.0	-7.4	100.0	100.0	59.3	40.7
Fin. integrity, safety nets	85.7	75.0	10.7	18.9	27.6	-8.7	100.0	100.0	50.0	33.3
Securities (summary)	89.9	81.6	8.3	11.6	14.4	-2.7	100.0	94.4	62.2	58.6
Reg. governance	91.3	84.9	6.4	8.8	10.6	-1.8	100.0	100.0	71.4	71.4
Prud. framework	89.5	75.4	14.1 *	12.9	17.4	-4.6	100.0	95.2	71.4	52.4
Reg. practices	91.7	79.2	12.5	14.0	23.4	-9.4	100.0	100.0	58.3	33.3
Fin. integrity, safety nets	87.5	86.5	1.0	16.4	19.3	-3.0	100.0	100.0	50.0	52.4
Emerging Markets										
Banking (summary)	73.1	72.0	1.1	15.2	25.0	-9.8	93.3	98.9	50.9	33.7
Reg. governance	74.7	75.5	-0.8	21.4	21.0	0.4	100.0	100.0	36.1	38.9
Prud. framework	74.3	71.6	2.7	15.6	25.0	-9.4 *	94.4	97.2	50.0	30.6
Reg. practices	71.0	68.6	2.4	15.6	23.4	-7.8 *	93.3	96.7	46.7	36.7
Fin. integrity, safety nets	73.3	74.1	-0.7	17.9	27.3	-9.3	100.0	100.0	50.0	33.3
Insurance (summary)	68.3	64.8	3.5	29.0	29.9	-0.9	100.0	98.0	25.5	33.3
Reg. governance	66.7	57.1	9.5	27.2	25.2	2.0	100.0	100.0	33.3	33.3
Prud. framework	67.9	66.7	1.2	29.7	29.3	0.4	100.0	96.3	25.9	29.6
Reg. practices	67.9	66.7	1.2	29.7	29.3	0.4	100.0	96.3	25.9	29.6
Fin. integrity, safety nets	56.9	50.0	6.9	40.5	36.4	4.1 *	100.0	100.0	16.7	0.0
Securities (summary)	77.0	65.5	11.5	15.7	20.0	-4.3	90.0	88.9	52.2	34.4
Reg. governance	78.4	68.9	9.5	21.7	20.1	1.6	100.0	90.5	33.3	33.3
Prud. framework	77.6	58.2	19.3	24.9	22.7	2.2	100.0	90.5	28.6	28.6
Reg. practices	82.1	68.5	13.6	13.1	26.4	-13.3 *	100.0	100.0	58.3	29.2
Fin. integrity, safety nets	70.2	65.9	4.4	18.4	16.8	1.6	91.7	91.7	37.5	42.9

Source: Financial sector standards and codes assessments under the FSAP.

Notes:

1/ For each country, the summary grading of a standard (BCP, ICP, and IOSCO) is calculated as the average grading of the principles in the standard. For each principle, 100 is the maximum grading (observance), and 0 is the minimum grading (no observance). For the definitions of the four components of each summary grading, see Table 6.

2/ Calculated across the countries in the sample.

3/ The value for the EU countries minus the value for the non-EU countries.

* Indicates that the difference is significant at a 10 percent level in tests of equality of means and variance, respectively.

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Table III.4. Basel Core Principles for Effective Banking Supervision (BCP): "Dictionary" 1/

Principle No.	Topic	Component 2/
1	Objectives, Autonomy, Powers, And Resources	REG
2	Permissible Activities	PRF
3	Licensing Criteria	PRF
4	Ownership	PRF
5	Investment Criteria	REP
6	Capital Adequacy	REP
7	Credit Policies	REP
8	Loan Evaluation and Loan-Loss Provisioning	REP
9	Large Exposure Limits	REP
10	Connected Lending	REP
11	Country Risk	REP
12	Market Risks	REP
13	Other Risks	REP
14	Internal Control and Audit	REP
15	Money Laundering	FIN
16	On-Site and Off-Site Supervision	PRF
17	Bank Management Contact	PRF
18	Off-Site Supervision	PRF
19	Validation of Supervisory Information	REG
20	Consolidated Supervision	PRF
21	Accounting Standards	FIN
22	Remedial Measures	PRF
23	Globally Consolidated Supervision	PRF
24	Host Country Supervision	PRF
25	Supervision Over Foreign Banks' Establishment	PRF

Notes:

1/ See http://www.imf.org/external/standards/index.htm for further details on the assessment methodology.

2/ See IMF (2004) for more details. REG is regulatory governance, PRF is prudential framework, REP are regulatory practices, and FIN is financial integrity and safety nets.

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Table III.5. International Association of Insurance Supervisors Insurance Core Principles (ICP): "Dictionary" 1/

Principle	Topic	Component
	2000 IAIS standard	
1	Organisation of the supervisor	REG
2	Licensing	PRF
3	Changes in control	PRF
4	Corporate governance	PRF
5	Internal controls	PRF
6	Assets	REP
7	Liabilities	REP
8	Capital adequacy and solvency	PRF
9	Derivatives and off-balance sheet items	REP
10	Reinsurance	REP
11	Market conduct	FIN
12	Financial reporting	PRF
13	On-site inspection	PRF
14	Sanctions	REP
15	Cross-border business operations	PRF
16	Coordination and cooperation	REP
17	Confidentiality	PRF
	2003 IAIS standard	
1	Conditions for effective insurance supervision	REG
2	Supervisory objectives	REG
3	Supervisory authority	REG
4	Supervisory process	REG
5	Supervisory cooperation and information sharing	REP
6	Licensing	REP
7	Suitability of persons	REP
8	Changes in control and portfolio transfers	REP
9	Corporate governance	PRF
10	Internal control	PRF
11	Market analysis	REP
12	Reporting to supervisors and off-site monitoring	REP
13	On-site inspection	REP
14	Preventive and Corrective Measures	REP
15	Enforcement or sanctions	REP
16	Winding-up and exit from the market	REP
17	Group-wide supervision	REP
18	Risk assessment and management	PRF
19	Insurance activity	PRF
20	Liabilities	REP
21	Investments	REP
22	Derivatives and similar commitments	REP
23	Capital adequacy and solvency	PRF
24	Intermediaries	FIN
25	Consumer protection	FIN
26	Information, disclosure & transparency towards the market	FIN
27	Fraud	FIN
28	Anti-money laundering, combating the financing of terrorism (AML/CFT)	FIN

1/ See http://www.imf.org/external/standards/index.htm for further details on the assessment methodology.

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Table III.6. Securities Regulation (IOSCO) Principles: "Dictionary"

Principle	Topic	Component
1	Responsibilities of the regulator	REG
2	Operational independence and accountability	REG
3	Powers, resources, and capacity to perform the functions and exercise the powers.	REG
4	Clear and consistent regulatory processes.	REG
5	Professional standards including standards of confidentiality	REG
6	Appropriate use of Self-Regulatory Organizations (SROs)	REG
7	Standards for SROs	REG
8	Comprehensive inspection, investigation and surveillance powers	PRF
9	Comprehensive enforcement powers	PRF
10	Effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an efective compliance program.	PRF
11	Authority to share both public and non-public information with domestic and foreign counterparts	PRF
12	Setting up information sharing mechanisms	PRF
13	Assistance foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	PRF
14	Full, accurate and timely disclosure of financial results and other information that is material to investors'	FIN
15	Fair and equitable treatment of holders of securities in a company	FIN
16	High and internationally acceptable quality of accounting and auditing standards	FIN
17	Standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme	REP
18	Rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets	REP
19	Disclosure necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme	FIN
20	Proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme	REP
21	Minimum entry standards for market intermediaries	REP
22	There should be initial and ongoing capital and other prudential requirements for market intermediaries that	REP
23	Standards for internal organization and operational conduct	REP
24	Procedure for dealing with the failure of a market intermediary	FIN
25	Regulatory authorization and oversight of the establishment of trading systems	REP
26	Ongoing regulatory supervision of exchanges and trading systems	FIN
27	Transparency of trading.	REP
28	Detecting and detering manipulation and other unfair trading practices.	FIN
29	Proper management of large exposures, default risk and market disruption.	PRF
30	Systems for clearing and settlement of securities transactions	FIN

Notes:

1/ See http://www.imf.org/external/standards/index.htm for further details on the assessment methodology.

2/ See IMF (2004) for more details. REG is regulatory governance, PRF is prudential framework, REP are regulatory practices, and FIN is financial integrity and safety nets.

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Table III.7. Financial Standards and Their Four Main Components

Four Main Components (Abbreviation)	Sub-components	Sector (Principles)		
		Banking (BCP)	Insurance (ICP) 1/	Securities (IOSCO)
Regulatory Governance (REG)	Objectives of regulation Independence and adequate resources Enforcement powers and capabilities Clarity and transparency of regulatory process External participation	1, 19	2000 IAIS: 1 2003 IAIS: 1,2,3,4	1,2,3,4,5,6, 7
Prudential Framework (PRF)	Risk management Risk concentration Capital requirements Corporate governance Internal controls	2,3,4,6,16, 17,18,20,22, 23,24, 25	2000 IAIS: 2,3,4,5,12, 13,15,16, 17 2003 IAIS: 9,10,18,19, 23	8,9,10,11,12, 13, 29.
Regulatory Practices (REP)	Group-wide supervision Monitoring and on-site inspection Reporting to supervisors Enforcement Cooperation and information sharing Confidentiality Licensing, ownership transfer, corporate control Qualifications	5,6,7,8,9,10, 11,12,13, 14	2000 IAIS: 6,7,9, 10, 14, 16 2003 IAIS: 5,6,7,8,11, 12,13,14, 15,16,17,18, 20,21,22	17,18,20,21, 22, 23,25, 27
Financial Integrity and Safety Nets (FIN)	Markets (integrity, financial crime) Customer protection Information, disclosure, transparency	15, 21	2000 IAIS: 11 2003 IAIS: 24,25,26,27, 28	14,15,16,19, 24, 26, 28, 30

Source: Adapted from IMF (2004).
Note:
1/ For each component, the upper row corresponds to the original (2000) IAIS standard, and the lower row corresponds to the revised (2003) IAIS standard.

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Table III.8. Supervisory Principles That Are Observed the Least in the EU 1/

	Lagging Countries 2/		Summary
	Percent of all assessed	Number	Compliance 3/
Banking			
CP13 Other Risks	64	16 of 25	75
CP10 Connected Lending	60	15 of 25	72
CP15 Money Laundering	60	15 of 25	79
CP1 Objectives, Autonomy, Powers, And Resources	60	15 of 25	85
CP22 Remedial Measures	52	13 of 25	75
CP20 Consolidated Supervision	52	13 of 25	75
Insurance			
CP11 Market Conduct	69	9 of 13	64
CP5 Internal Controls	69	9 of 13	64
CP9 Derivatives and off-balance sheet items	69	9 of 13	67
CP1 Organization of Supervisor	62	8 of 13	79
CP4 Corporate Governance	54	7 of 13	67
CP6 Assets	54	7 of 13	74
CP13 On-site Inspection	54	7 of 13	77
CP2 Licensing	54	7 of 13	82
CP15 Cross-border Business Operations	54	7 of 13	85
Securities			
Q10 Enforcement powers, compliance program	53	9 of 17	67
Q22 Capital and other prudential requirements	53	9 of 17	69
Q03 Powers, resources, capacity	53	9 of 17	69
Q02 Operational independence and accountability	53	9 of 17	71

1/ The table lists principles that were not fully observed by more than a half of the assessed EU countries. For each sector, the principles are ordered starting from the worst, defined by the percentage of less-than-fully observant countries (descending), and then by the grading (ascending).
2/ Percent of EU countries with less than full compliance with the principle.
3/ Average over the EU countries (100=full compliance, 0=no compliance).

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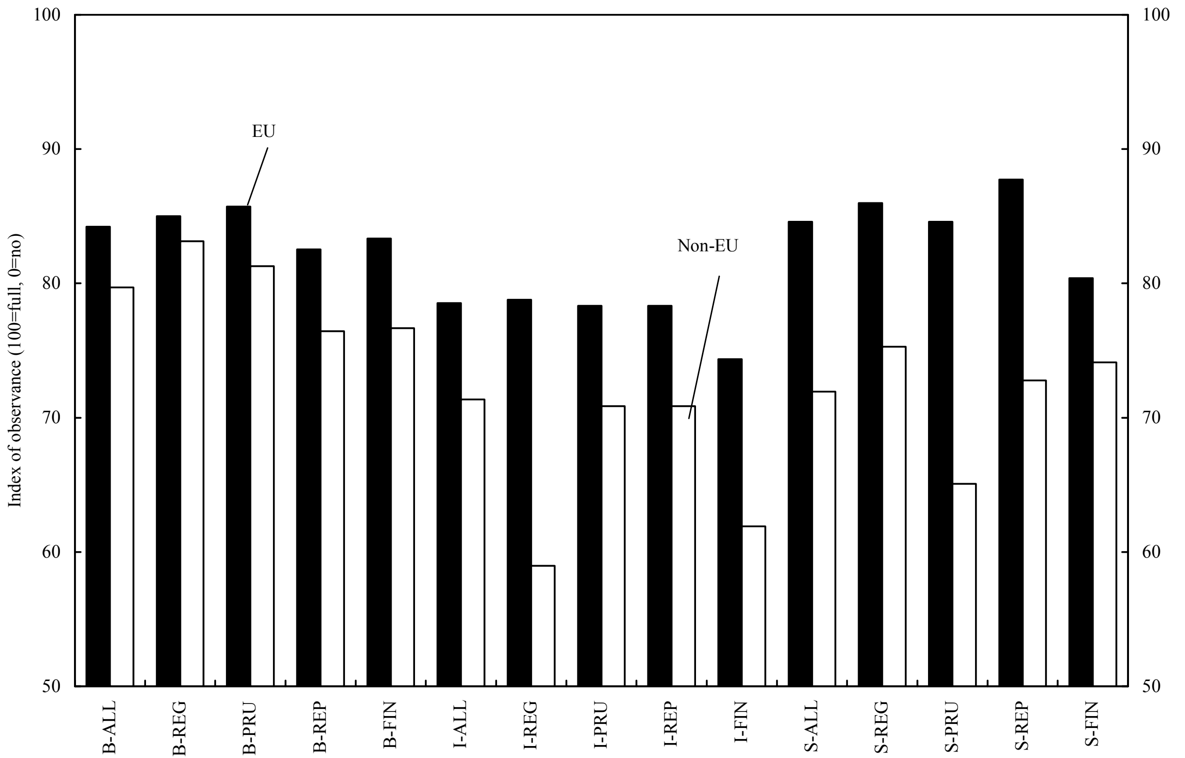
Figure III.1. Banking, Insurance, and Securities Regulation: Overall Observance



Note: Summary and component gradings shown on the horizontal axis. B, I, and S stand for banking, insurance, and securities, respectively; the remaining part of the abbreviations is explained in Table III.7.

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Figure III.2. EU vs. Non-EU Countries: Basel Core Principles

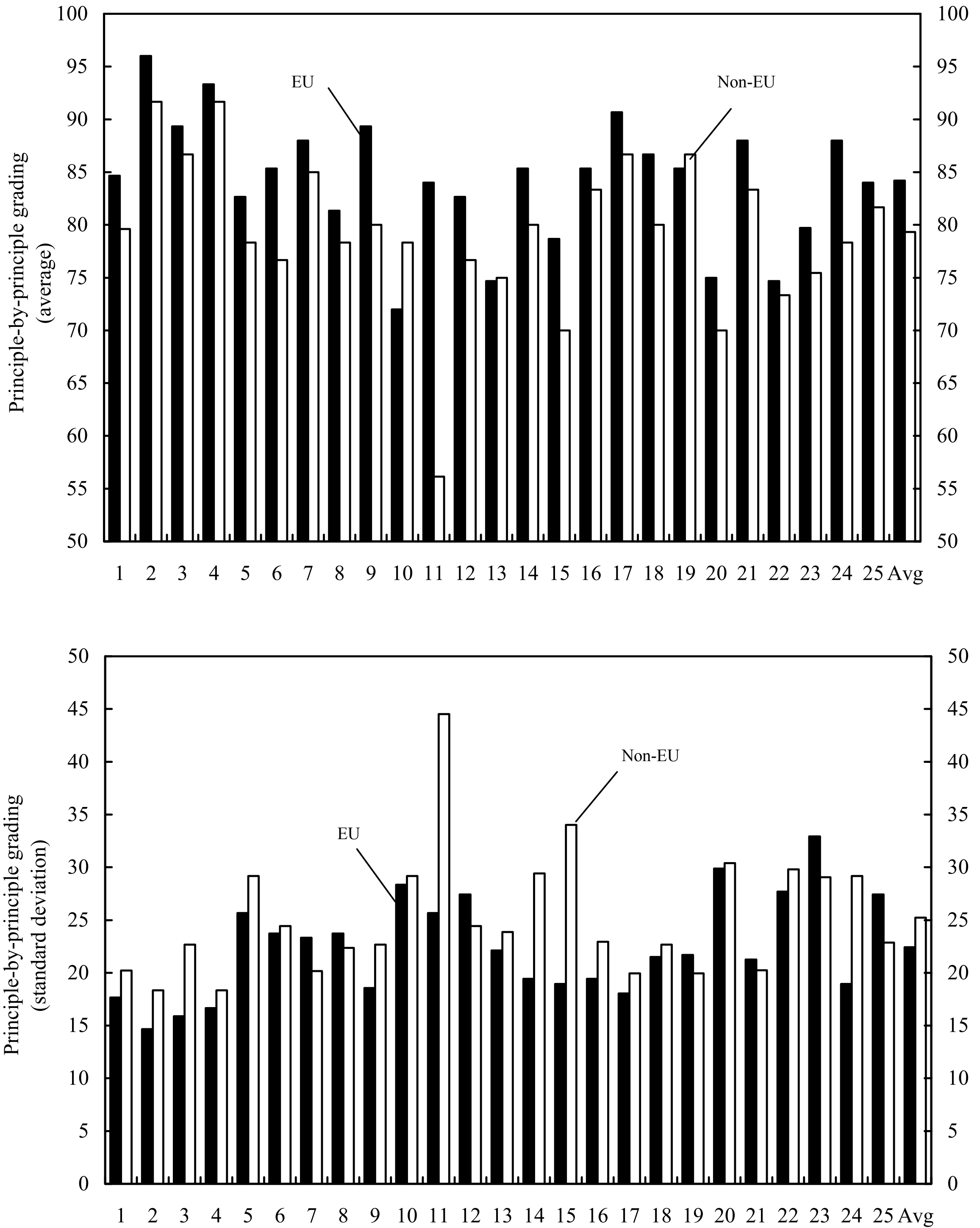

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Figure III.3. EU: Basel Core Principles—Closer Look

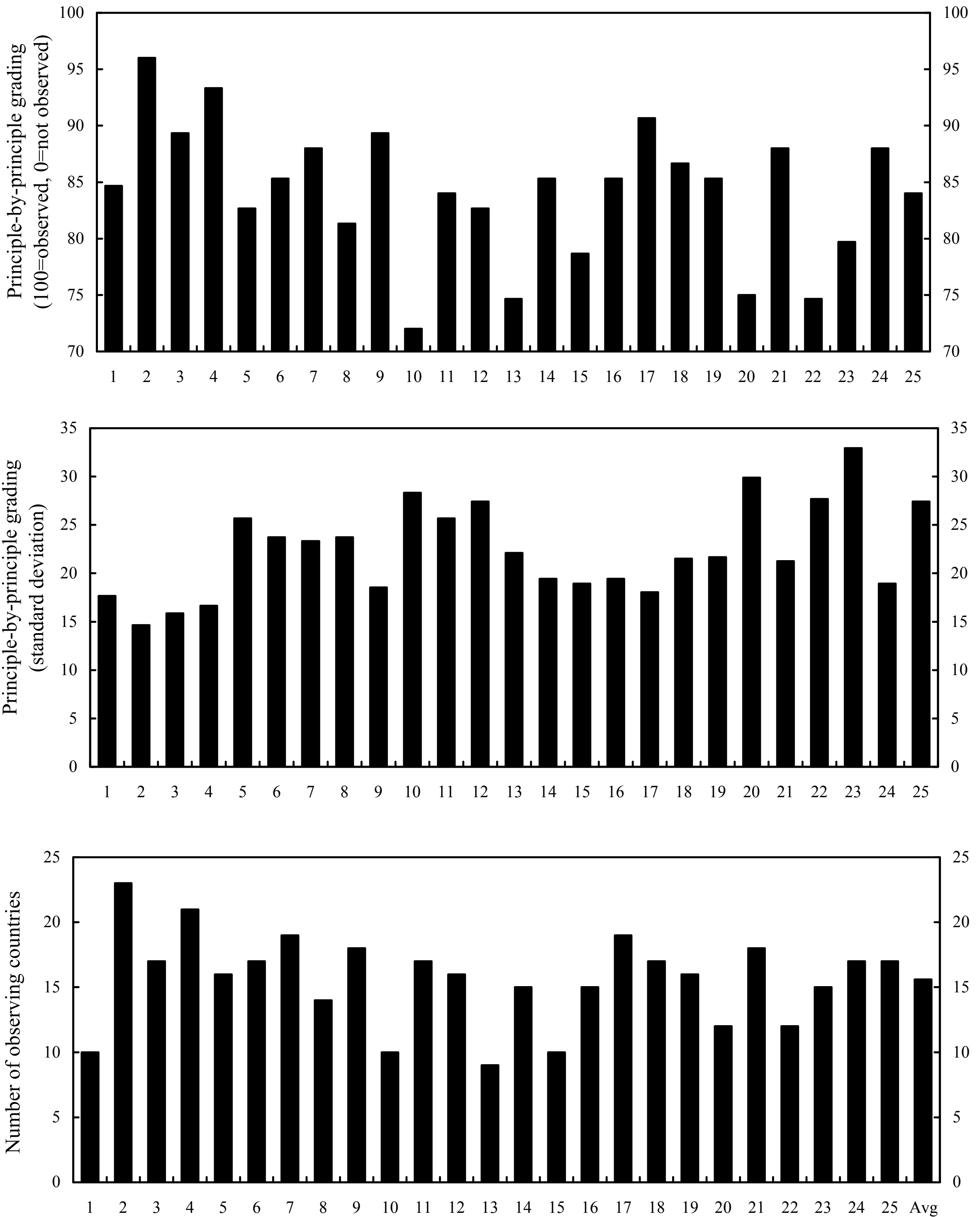

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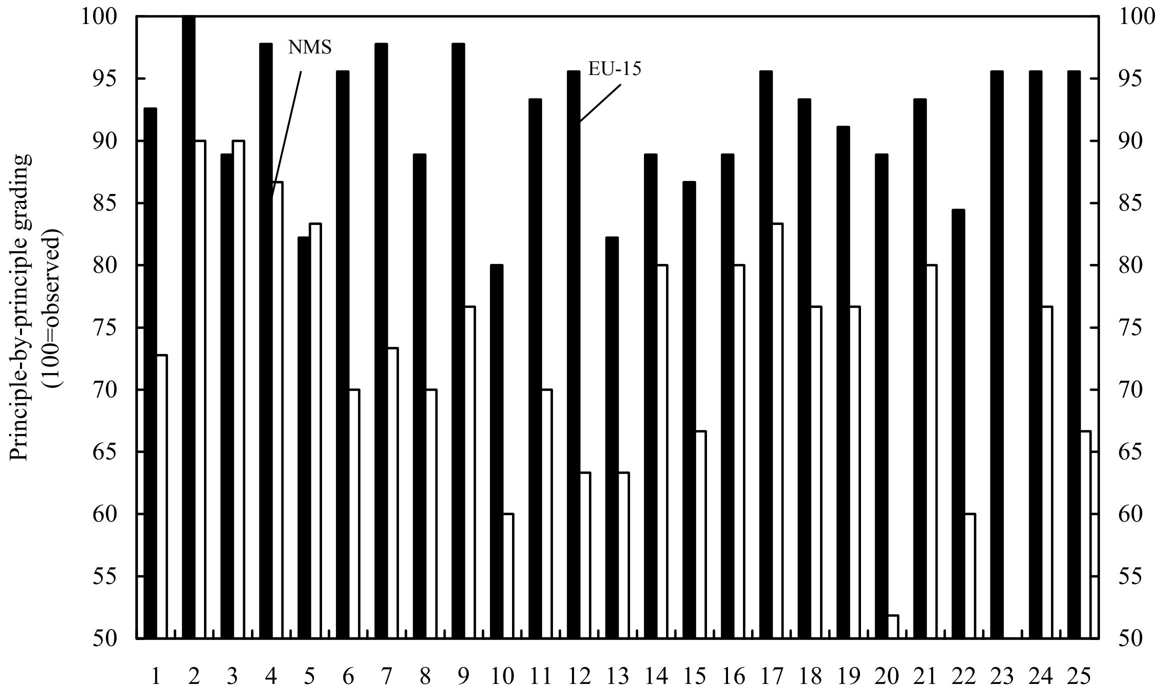
Figure III.4. EU: Basel Core Principles (EU-15 and NMS)



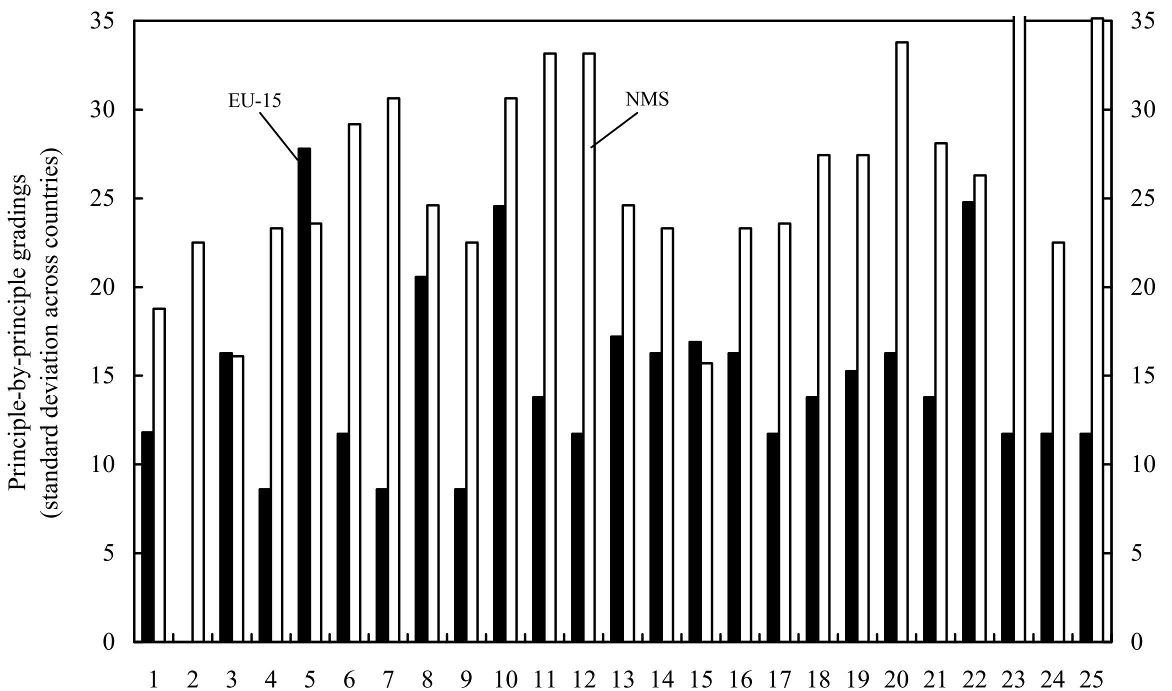


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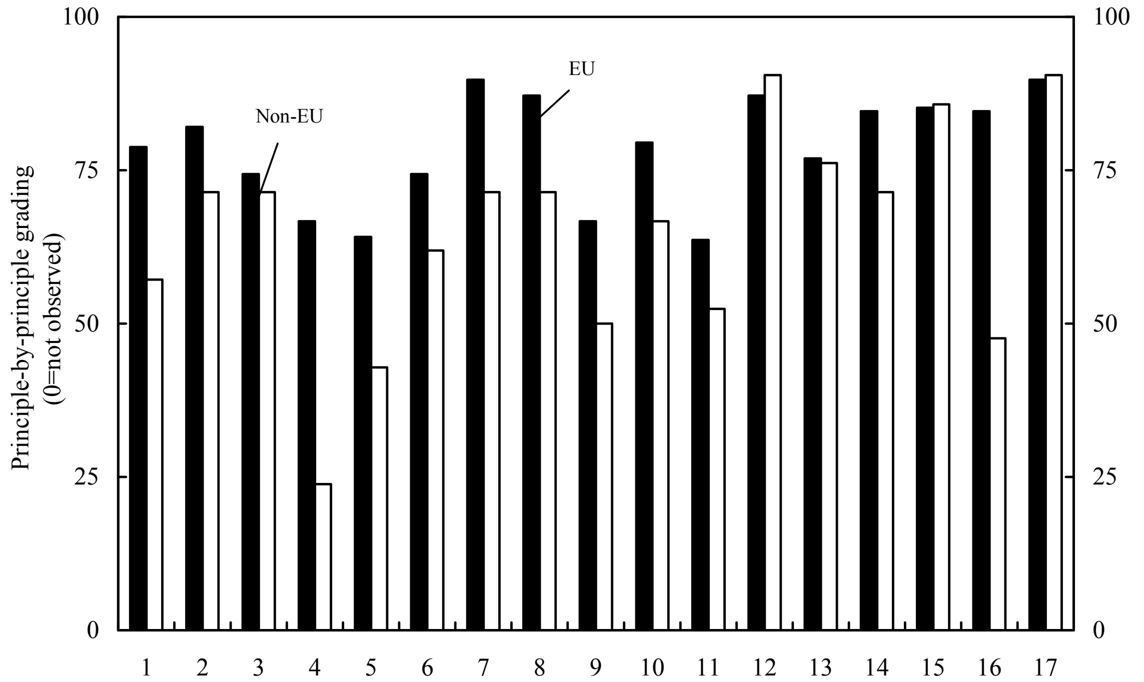
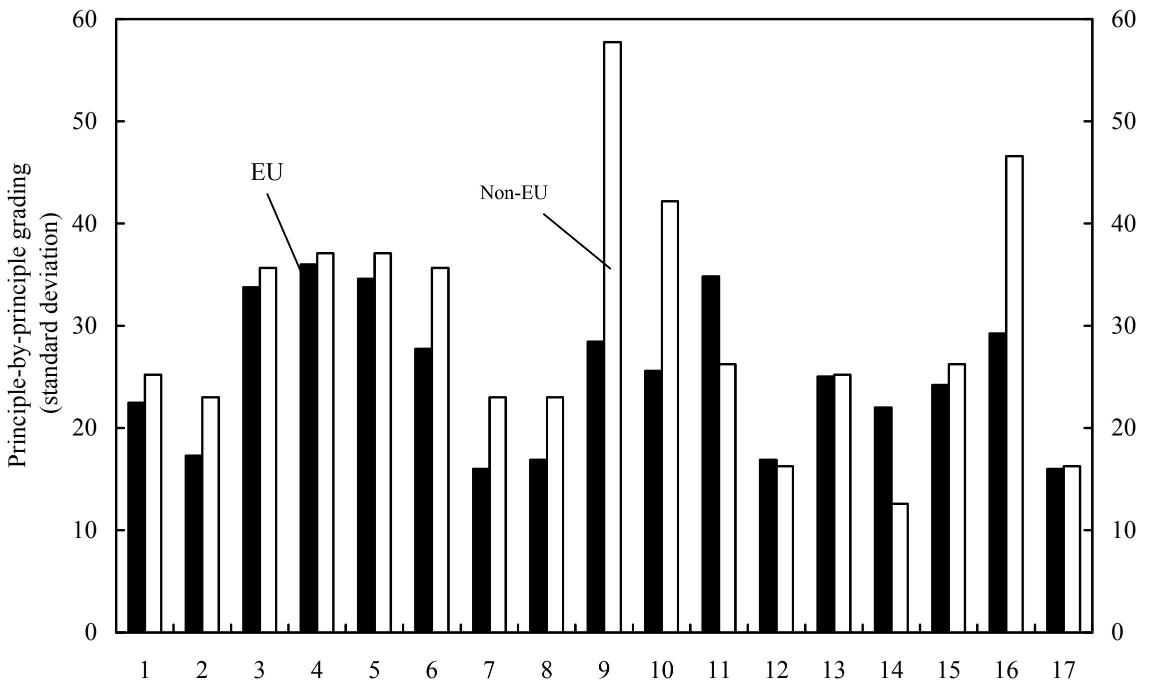
Figure III.5. EU vs. Non-EU Countries: Insurance Core Principles





Note: For ease of presentation, the results are presented in terms of the 2000 IAIS standard, which was used for a majority of EU countries that had the ICP assessment. For those countries that had an ICP assessment according to the 2003 IAIS, gradings have been mapped into the 2000 IAIS standard (Tables III.5 and III.7).

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