

## International Standards for Strengthening Financial Systems: Can Regional Development Banks Address Developing Countries' Concerns?

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Following the eruption of the Asian crisis in mid-1997, the international community has increasingly focused on developing new mechanisms for preventing financial crises. These efforts respond to the realization that, although globalization can bring significant benefits to countries undertaking transparent and sustainable policies, it can also lead to severe disruptions in countries that liberalize their financial systems without having fully dealt with domestic economic and financial weaknesses and fragilities. It is therefore no coincidence that the frequency of financial crises worldwide has increased in recent years in the context of dramatic growth of international capital markets, which followed the liberalization of financial systems and the development of new financial technology without adequate regulatory and supervisory frameworks.

Weak domestic financial systems have not been the only source of severe financial problems, however. In the absence of complete information about a country's capability to deal with external shocks, concerns about one country's financial stability can lead markets to question the financial soundness of other countries broadly viewed as similar, in what has come to be called contagion.<sup>1</sup> Countries can be regarded as similar because of any of a number of factors, including geographical location

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1. Many recent papers attempt to explain this phenomenon; for example, Calvo (2000), Claessens, Dornbusch, and Park (2000), Pericolli and Sbracia (2002), Perry and Lederman (1999), and Reinhart and Kaminsky (2000).

(the neighborhood effect) and comparable economic and financial ratios (such as the debt-to-GDP ratio or the current account deficit-to-GDP ratio). The lesson learned from these episodes is that the intricate workings of global markets need new and better-coordinated global regulatory and supervisory frameworks. Effective domestic regulatory frameworks are essential but are not sufficient to ensure financial stability, because they do not take into account the new interrelationships across countries created by globalization in a world of imperfect information. Efforts to promote financial stabilization, therefore, must focus simultaneously on strengthening domestic financial markets and on improving the international regulatory framework.

It was precisely this discontent with the capacity of the existing international architecture to prevent financial sector crises that led to the creation of the Financial Stability Forum (FSF) in April 1999. The FSF was established for the specific purpose of promoting international financial stability by engaging the cooperation of governments, markets, and international organizations in improving financial supervision and surveillance. A major component of the activities of the FSF has been the coordination of a comprehensive set of international standards and codes to strengthen financial systems. In a nutshell, common standards attempt to tackle two main objectives. First, because they are common, the standards facilitate international comparisons and, hence, avoid the negative externalities created by confusing and incomplete information about a country's economic policies. Second, if these common standards are set at high levels, they can enhance the role of market discipline: countries that want to improve their access to international capital markets (i.e., to obtain more financing at lower cost) will have an incentive to enforce the standards, which can then act as benchmarks to guide policymakers' reform efforts.

Identifying appropriate codes and standards, however, is not an easy task. To the question of what guarantees the stability of financial systems there is a multitude of answers, ranging from the familiar prescription of macroeconomic consistency and sound domestic regulatory financial frameworks to reforms in a number of economic and institutional sectors to the full dissemination of a wide variety of information.

Setting priorities thus becomes a key issue when establishing and implementing standards and codes. The FSF has identified over 60 standards, but it has highlighted a smaller set of 12 principles, grouped in three areas, that the forum deems essential for sound financial systems. These standards have been set by a number of international institutions and are understood as being minimum requirements for good practice (table 4.1; FSF 2001). Each standard, in turn, contains a number of guidelines. Some are very specific, such as the standards on data dissemination, but others, including those governing certain aspects of the transparency of monetary policy, are quite general and allow for variation from country to country.

**Table 4.1 Key standards for sound financial systems**

| Subject area                                      | Key standard                                                                            | Issuing body                                          |
|---------------------------------------------------|-----------------------------------------------------------------------------------------|-------------------------------------------------------|
| <b>Macroeconomic policy and data transparency</b> |                                                                                         |                                                       |
| Monetary and financial policy transparency        | Code of good practices on transparency in monetary and financial policies               | International Monetary Fund                           |
| Fiscal policy transparency                        | Code of good practices on fiscal transparency                                           | International Monetary Fund                           |
| Data dissemination                                | Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS) | International Monetary Fund                           |
| <b>Institutional market infrastructure</b>        |                                                                                         |                                                       |
| Insolvency                                        | Principles and guidelines on effective insolvency and creditor rights systems           | World Bank                                            |
| Corporate governance                              | Principles of corporate governance                                                      | Organization for Economic Cooperation and Development |
| Accounting                                        | International accounting standards (IAS)                                                | International Accounting Standard Board               |
| Auditing                                          | International standards on auditing (ISA)                                               | International Federation of Accountants               |
| Payment and settlement                            | Core principles for systemically important payment systems                              | Committee on Payment and Settlement Systems           |
| Market integrity                                  | The forty recommendations of the financial action task force on money laundering        | Financial Action Task Force                           |
| <b>Financial regulation and supervision</b>       |                                                                                         |                                                       |
| Banking supervision                               | Core principles for effective banking supervision                                       | Basel Committee on Banking Supervision                |
| Securities regulation                             | Objectives and principles of securities regulation                                      | International Organization of Securities Commissions  |
| Insurance supervision                             | Insurance core principle                                                                | International Association of Insurance Supervisors    |

Source: Financial Stability Forum.

Given the importance that the multilateral organizations attach to the observance of standards and codes, in 1999 the International Monetary Fund (IMF) initiated the preparation of Reports on the Observance of Standards and Codes (ROSCs). Assessments of the status and progress of countries on one or more standards are conducted on a voluntary basis. Sometimes these assessments take place in the context of the IMF surveillance process (Article IV consultations). It is the intention of the IMF to maintain a standardized format for all ROSCs and to publish them on the institution's Web site.<sup>2</sup>

Table 4.2 lists those ROSCs that had been published as of July 27, 2004. (Other ROSCs not listed might have been completed but not yet published.) For each individual international standard, the table indicates which countries either have conducted a self-assessment on that standard or have been assessed by a group of experts from the IMF or the World Bank or both. As the table shows, by far the majority of countries that have participated in this process are developing countries.<sup>3</sup> It also shows that the standards on which the greatest number of countries has sought assessments are those related to transparency and banking supervision; this is not at all surprising, given the recent emphasis on strengthening domestic banking systems. Finally, the table reveals a large disparity in the degree of countries' participation in standards assessment. For example, only three ROSCs have been prepared for Chile, but Argentina has been involved in eight (although four of these were self-assessments).

Policymakers' responses to the establishment, implementation, and assessment of international standards and codes have been mixed. Although the potential benefits of common standards are generally recognized, a number of policymakers and analysts have raised important concerns about the process. Their criticisms cover a wide range of issues: Some claim that the standards do not adequately take into account certain key features of developing countries, whereas other critics argue that an inappropriate sequencing in implementing the standards can create more problems than it solves.

This chapter examines the appropriateness and effectiveness of international standards for the purpose of financial crisis prevention in developing countries. It begins by reviewing a variety of concerns raised by analysts and policymakers. To fully illustrate the nature of these concerns, the chapter also discusses in greater detail recent criticisms of one of the key guidelines for effective banking supervision: the banking capital

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2. A reading of the ROSCs that had been published as of July 16, 2002, however, indicates that important efforts are still needed to achieve the desired standardization.

3. Of course, one would expect this simply because there are more developing countries than industrial countries in the world. However, industrial countries have not participated in the process to the extent that they should. For example, no industrial country is listed as participating in the standard on corporate governance.

**Table 4.2 ROSC modules published on the International Monetary Fund and World Bank Web sites as of July 27, 2004**

| Module                                            | Countries publishing                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|---------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Monetary and financial policy transparency</b> | Algeria, Argentina, Australia, Barbados, Bulgaria, Cameroon, Canada, Costa Rica, Croatia, Czech Republic, Estonia, Euroland, Germany, Finland, France, Gabon, Georgia, Hong Kong SAR, Hungary, Iceland, Ireland, Israel, Japan, Korea, Kyrgyz Republic, Latvia, Lithuania, Luxembourg, Macedonia, Malta, Mauritius, Mexico, Morocco, New Zealand, Pakistan, Poland, Romania, Senegal, Singapore, Slovak Republic, Sweden, Switzerland, Tunisia, Uganda, Ukraine, United Arab Emirates, United Kingdom                                                                                                                |
| <b>Fiscal transparency</b>                        | Albania, Argentina, Armenia, Australia, Azerbaijan, Bangladesh, Benin, Brazil, Bulgaria, Burkina Faso, Cameroon, Canada, Chile, Colombia, Czech Republic, Estonia, Fiji, France, Georgia, Germany, Ghana, Greece, Honduras, Hong Kong SAR, Hungary, India, Iran, Israel, Italy, Japan, Kazakhstan, Korea, Kyrgyz Republic, Latvia, Lithuania, Malawi, Mali, Mauritania, Mexico, Mongolia, Mozambique, Nicaragua, Pakistan, Papua New Guinea, Peru, Philippines, Poland, Portugal, Romania, Rwanda, Slovak Republic, Slovenia, Sri Lanka, Sweden, Tanzania, Tunisia, Turkey, Uganda, Ukraine, United Kingdom, Uruguay |
| <b>Data dissemination</b>                         | Albania, Argentina, Armenia, Australia, Azerbaijan, Botswana, Burkina Faso, Bulgaria, Cameroon, Canada, Chile, Costa Rica, Czech Republic, Ecuador, Estonia, France, Georgia, Greece, Hong Kong SAR, Hungary, India, Italy, Jordan, Kazakhstan, Korea, Kyrgyz Republic, Latvia, Lithuania, Mauritius, Mexico, Mongolia, Mozambique, Namibia, Norway, Peru, Poland, Romania, Russian Federation, Senegal, South Africa, Sri Lanka, Sweden, Tanzania, Tunisia, Turkey, Uganda, United Kingdom, Uruguay                                                                                                                 |
| <b>Insolvency and creditor rights systems</b>     | Argentina, Czech Republic, Lithuania, Mauritius, Slovakia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| <b>Corporate governance</b>                       | Bulgaria, Chile, Colombia, Croatia, Czech Republic, Egypt, Georgia, Hong Kong SAR, Hungary, India, Korea, Latvia, Lithuania, Malaysia, Malta, Mauritius, Mexico, Morocco, Philippines, Poland, Slovak Republic, Slovenia, South Africa, Turkey, Uganda, Zimbabwe                                                                                                                                                                                                                                                                                                                                                     |
| <b>International accounting standards</b>         | Argentina, <sup>a</sup> Bangladesh, Bulgaria, Colombia, Croatia, Czech Republic, Egypt, Hong Kong SAR, <sup>a</sup> Jamaica, Kenya, Philippines, Poland, Romania, Slovak Republic, Sri Lanka, South Africa, Ukraine, United Kingdom <sup>a</sup>                                                                                                                                                                                                                                                                                                                                                                     |

*(table continues next page)*

**Table 4.2 ROSC modules published on the International Monetary Fund and World Bank Web sites as of July 27, 2004** *(continued)*

| Module                                        | Countries publishing                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|-----------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>International auditing standards</b>       | Argentina, <sup>a</sup> Bangladesh, Bulgaria, Colombia, Croatia, Czech Republic, Egypt, Hong Kong SAR, <sup>a</sup> Jamaica, Kenya, Lebanon, Lithuania, Macedonia, Mauritius, Morocco, Philippines, Poland, Romania, Slovak Republic, Sri Lanka, South Africa, Ukraine, United Kingdom <sup>a</sup>                                                                                                                                                                                                                                  |
| <b>Systemically important payment systems</b> | Barbados, Bulgaria, Cameroon, Canada, Costa Rica, Croatia, Czech Republic, Estonia, Euroland, Finland, Georgia, Germany, Hong Kong SAR, Hungary, Iceland, Ireland, Israel, Japan, Korea, Kyrgyz Republic, Latvia, Lithuania, Luxembourg, Macedonia, Malta, Mauritius, Mexico, Morocco, Mozambique, Poland, Singapore, Slovak Republic, Slovenia, Sweden, Switzerland, Tunisia, Uganda, Ukraine, United Arab Emirates, United Kingdom                                                                                                 |
| <b>Banking supervision<sup>b</sup></b>        | Algeria, Argentina, Australia, Barbados, Bulgaria, Cameroon, Canada, Costa Rica, Croatia, Czech Republic, Estonia, Finland, Gabon, Georgia, Germany, Ghana, Hong Kong SAR, Hungary, Iceland, Ireland, Israel, Japan, Korea, Kuwait, Kyrgyz Republic, Latvia, Lithuania, Luxembourg, Macedonia, Malta, Mauritius, Mexico, Morocco, Mozambique, New Zealand, Pakistan, Philippines, Poland, Romania, Senegal, Slovak Republic, Slovenia, Sweden, Switzerland, Tanzania, Tunisia, Uganda, Ukraine, United Arab Emirates, United Kingdom |
| <b>Securities regulation</b>                  | Argentina, <sup>a</sup> Barbados, Bulgaria, Canada, Croatia, Czech Republic, Estonia, Finland, Germany, Ghana, Hong Kong SAR, Hungary, Iceland, Ireland, Israel, Japan, Korea, Kuwait, Latvia, Luxembourg, Malta, Mexico, Morocco, New Zealand, Pakistan, Philippines, Poland, Romania, Senegal, Singapore, Slovak Republic, Slovenia, Sweden, Switzerland, Tunisia, Uganda, <sup>a</sup> United Kingdom                                                                                                                             |
| <b>Insurance core principles</b>              | Argentina, <sup>a</sup> Barbados, Bulgaria, Cameroon, Canada, Croatia, Czech Republic, Estonia, Finland, Gabon, Georgia, Germany, Ghana, Hong Kong SAR, Hungary, Iceland, Ireland, Israel, Japan, Korea, Latvia, Lithuania, Luxembourg, Malta, Mexico, Morocco, Poland, Senegal, Singapore, Slovak Republic, Slovenia, Sweden, Switzerland, Tunisia, Uganda, <sup>a</sup> United Kingdom <sup>a</sup>                                                                                                                                |

a. Self-assessment.

b. Not all countries are considered against all core principles for effective banking supervision.

Sources: IMF and World Bank Web sites, [www.imf.org/external/np/rosc/rosc.asp](http://www.imf.org/external/np/rosc/rosc.asp) and [www.worldbank.org/ifa/rosc.html](http://www.worldbank.org/ifa/rosc.html).

adequacy standard as recommended by the Basel Committee on Banking Supervision. Focusing on this standard should prove useful given the importance attached by the international community to ensuring a sound regulatory and supervisory framework for the banking sector in developing countries. The chapter goes on to address these concerns and advance policy recommendations. Central to this discussion is the identification of a key role for the regional development banks (RDBs).

## **Concerns about Common International Standards as Applied to Developing Countries**

There is general agreement about the long-term benefits of establishing international standards to guide individual countries' policies for the purpose of achieving financial stability. Most analysts agree with the principle that under ideal conditions, policy standards, and especially those for the financial sector, should converge across countries in the long run. However, many analysts argue that the pressing issue for developing countries is how to handle the transition period, when the preconditions needed for the effective implementation of international standards may not yet be in place. Concerns raised regarding the setting and implementation of international standards in general are summarized here. To exemplify these concerns, the capital adequacy requirement recommended by the Basel Committee on Banking Supervision—a standard that has been the center of much attention and criticism—then will be explored in greater detail.

### **General Concerns**

The general concerns about standards that have been raised are all inter-related. However, for expositional purposes they can be classified into four categories: perceptions of and discontent with a one-size-fits-all approach, problems with the sequencing of and countries' capacity to implement the standards, the ownership problem arising from lack of sufficient participation by developing countries in setting the standards, and questions about the effectiveness of the standards methodology.

#### **One-Size-Fits-All Approach**

From the perspective of this chapter, the most important concern is the first one. Because developing countries face different constraints than do industrial countries, at least in the short run, standards designed for the latter may not be appropriate for the former. Perhaps one of the clearest formulations of this concern is that of Jin Lique, deputy finance minister of China, at a conference organized by the IMF:

Developing countries are given to understand that they can preempt a financial crisis and achieve economic stability, provided they follow rigorously the international standards and codes. But there are two questions to answer: first, are the standards and codes suitable to the developing country at their stage of development; and second, do they have a minimum institutional capacity to apply these standards and codes at the same level as developed countries?<sup>4</sup>

Notice that the minister's concern is not with the establishment of common principles in the long run, but with the adequacy of common standards at this time, for countries at any level of development. High-level officials from some of the industrial countries have raised the same concern. For example, Gordon Brown, UK chancellor of the exchequer, has written that, "there exists a danger of pushing inappropriate measures for a given country's state of financial and institutional development, and any order of priority for implementation of the codes and standards must be carefully established on an individual basis to ensure positive net benefits" (Brown 1998, 8). Although the relevance of this concern depends on the standard in question, it will be argued next that it is fully relevant for the banks' capital adequacy standard.

### Sequencing and Issues of Implementation Capacity

Concerns about sequencing and implementation capacity are closely related to those concerns about uniformity of standards. A main issue is that, without appropriate institutions such as adequate legal frameworks and appropriate judicial systems, compliance with the so-called key standards may not produce the desired results. For example, a government may fully comply with standards for disclosure yet actually disclose very little, because ineffective control within the government results in a lack of accurate data.<sup>5</sup> A natural, yet unresolved question is, therefore, should countries not first set up appropriate institutions to guarantee the quality (and quantity) of data to be disseminated before actually testing whether the country meets the standard for disclosure?

Policymakers' concern about inappropriate sequencing when applying to developing countries' policy recommendations largely designed in and for industrial countries is based on past disastrous experiences. For example, the liberalization of domestic financial markets, a prescription whose long-run benefits are widely accepted, became a popular policy in Latin America in the late 1970s and early 1980s. The banking crises that followed, which resulted in the worst economic episode in the region in recent history—the lost decade—are well known. Was financial liberalization the

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4. Quoted in *IMF Survey*, April 2, 2001, 103.

5. This was the outcome in the 1998 Uganda case study on transparency practices as reported by Brown (1998).



culprit? Not really. Rather, it was a sequencing problem. Successful financial liberalization requires the adoption of sound regulatory and supervisory frameworks, and those preconditions were not in place in the region. This was a lesson well learned—but only after the fact.<sup>6</sup>

Further examples of the right sequencing of reforms abound in the literature. One of the best-known arguments is that liberalization of the capital account should only be undertaken when a sound banking system is in place and fiscal stability has been achieved.<sup>7</sup> Notwithstanding the proliferation of examples supporting the need for such sequencing, only very recently has the IMF published statements supporting the maintenance of controls on capital inflows in cases in which the domestic financial system may not be sound enough to intermediate those inflows (see, e.g., Fischer 2001).

Having suffered through many cases of wrong sequencing in policy reform, it is only natural that this issue appears high on the list of developing-country policymakers' concerns. Even if the timing of the implementation of standards is right, however, a number of countries are concerned about their capacity to pursue the task effectively. The requirements, in terms of resources and technical ability, may well surpass those available to some countries, especially in the poorest regions of the world, such as sub-Saharan Africa.

### Ownership Problem

Another concern often voiced by representatives of developing countries is that their countries do not participate fully in the design and prioritization of the standards that they are then asked to adopt. The argument is that underrepresentation of developing countries in standards-setting institutions and forums contributes to the problems of adequacy, sequencing, and implementation already discussed. A complementary argument is that their limited involvement leads to a lack of "ownership" by developing countries of the proposed reforms, and that this is an important deterrent for national legislatures in supporting the implementation of the standards.

Table 4.3 shows that the number of countries participating in the different standards-setting bodies varies considerably. For example, standards set by the IMF and the World Bank, such as those on transparency and dissemination, enjoy the participation of the entire membership of those institutions (184 countries). In contrast, the Basel Committee on Banking Supervision has a membership of only 13 countries, all from the

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6. The seminal work by Carlos Diaz-Alejandro (1985) was one of the first studies establishing the importance of sequencing.

7. For a full discussion of the preconditions needed for an effective and sustained liberalization of the capital account, see Mathieson and Rojas-Suarez (1993).

**Table 4.3 Countries participating in standards-setting bodies**

| Type of standards                      | Organization                                          | Number of countries participating |
|----------------------------------------|-------------------------------------------------------|-----------------------------------|
| Monetary and financial policies        | International Monetary Fund                           | 184                               |
| Fiscal transparency                    | International Monetary Fund                           | 184                               |
| Data dissemination                     | International Monetary Fund                           | 184                               |
| Insolvency and creditor rights         | World Bank                                            | 184                               |
| Corporate governance                   | Organization for Economic Cooperation and Development | 30 <sup>a</sup>                   |
| International accounting standards     | International Accounting Standards Board              | 106                               |
| International auditing standards       | International Federation of Accountants               | 118                               |
| Systemically important payment systems | Committee on Payment and Settlement Systems           | 10 <sup>b</sup>                   |
| Banking supervision                    | Basel Committee on Banking Supervision                | 13 <sup>c</sup>                   |
| Securities regulation                  | International Organization of Securities Commissions  | 105                               |
| Insurance core principles              | International Association of Insurance Supervisors    | 94                                |

a. Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.

b. Group of Ten countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and United States.

c. Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom, and United States.

Source: Web sites of the organizations listed: [www.fsforum.org/compendium/who\\_are\\_the\\_standard\\_setting\\_bodies.html](http://www.fsforum.org/compendium/who_are_the_standard_setting_bodies.html).

industrial world. It is true that the Basel Committee consults intensively with a large number of developing countries, especially through the Core Principles Liaison Group, but the strong perception in developing countries is that the last word remains within the membership.

Perhaps the most frequently voiced concern about developing-country involvement is the limited membership of the FSF, the main institution

in charge of coordinating financial standards and codes. The FSF's membership consists of the Group of Seven major industrial countries plus four countries that represent important financial centers: Australia, Hong Kong, Singapore, and the Netherlands. The response of the FSF to this concern has been not to broaden its membership but, rather, to establish a number of working groups with significant participation by developing countries.

Table 4.4 lists the members of the FSF working groups. The degree of developing-country participation varies significantly, depending on the subject matter. For example, whereas the working group on highly leveraged institutions remains limited to industrial countries, half the members participating in the working group on deposit insurance are developing countries. However, in spite of these efforts by the FSF to diversify countries' participation, the perception of lack of ownership of the standards remains strong among developing countries.<sup>8</sup>

### Are the Standards Producing the Expected Results?

The institutions engaged in setting and assessing international standards fully recognize that adoption of these standards is simply an additional instrument in the policymakers' toolbox for crisis prevention, not a magic wand that can ensure financial stability. Indeed, some analysts and members of the press have recently questioned the effectiveness of the policy recommendations, including international standards, made by multilateral institutions. The Argentinean crisis of early 2002, which combined severe banking disruptions with defaults on domestic and international obligations, has heightened this concern, summarized in the following two questions: first, why did Argentina, one of the developing countries most involved in the ROSC process (as already noted, it has four official ROSCs and four self-assessments published on the IMF Web site), suffer what appears to be one of the deepest and lengthiest financial crises in recent history? Second, why did a positive assessment by the IMF and the World Bank of Argentina's progress in the implementation of four standards not help shield the country against this crisis? An explanation of the Argentinean crisis is certainly beyond the scope of this chapter, but it is not difficult to predict that this episode will be cited over and over again by those who are skeptical about the usefulness of standards.

### Concerns with a Key Standard: Banks' Capital Requirements

The capital adequacy standard recommended in the Basel Capital Accord is a key item in the Core Principles for Effective Banking Supervision,

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8. Some representatives from industrial countries agree with this view; see, for example, Brown (1998).

**Table 4.4 Membership in Financial Stability Forum working groups**

| Working group                                                                          | Terms of reference                                                                                                                                                                       | Final report                                                                            | Countries participating                                                                                                                                         |
|----------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Task Force on Implementation of Standards</b><br>(September 1999 to March 2000)     | Explore issues related to and consider a strategy for fostering the implementation of international standards for strengthening financial systems                                        | Issues of the Task Force on Implementation of Standards                                 | Australia, Canada, China, France, Germany, Hong Kong SAR (chair), India, Italy, Japan, Mexico, Netherlands, South Africa, Sweden, United Kingdom, United States |
| <b>Incentives to Foster Implementation of Standards</b> (April 2000 to September 2001) | Monitor progress in implementing core standards and further raise market awareness of standards                                                                                          | Final Report of the Follow-up Group on Incentives to Foster implementation of Standards | Argentina, Australia, Canada, France, Germany (chair), Hong Kong SAR, India, Italy, Japan, Sweden, United Kingdom, United States                                |
| <b>Working Group on Capital Flows</b><br>(April 1999 to April 2000)                    | Evaluate measures in borrower and creditor countries that could reduce the volatility of capital flows and the risks to financial systems of excessive short-term external indebtedness. | Report of the Working Group on Capital Flows                                            | Brazil, Canada, Chile, France, Germany, Italy (chair), Japan, Malaysia, South Africa, United Kingdom, United States                                             |
| <b>Working Group on Offshore Centres</b><br>(April 1999 to April 2000)                 | Consider the significance of offshore financial centers for global financial stability                                                                                                   | Report of the Working Group on Offshore Centres                                         | Canada (chair), France, Germany, Italy, Japan, Singapore, Switzerland, Thailand, United Kingdom, United States                                                  |
| <b>Working Group on Enhanced Disclosure</b> (June 1999 to April 2001)                  | Assess the feasibility and utility of enhanced public disclosure by financial intermediaries                                                                                             | Multidisciplinary Working Group on Enhanced Disclosure Final Report                     | Australia, Canada, France, Germany, Japan, Mexico, Sweden, United Kingdom, United States                                                                        |
| <b>Working Group on Highly Leveraged Institutions</b> (April 1999 to April 2000)       | Recommend actions to reduce the destabilizing potential of institutions employing a high degree of leverage in the financial markets of developed and developing countries               | Report of the Working Group on Highly Leveraged Institutions                            | Australia, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Netherlands, United Kingdom (chair), United States                                             |
| <b>Working Group on Deposit Insurance</b><br>(April 2000 to September 2001)            | Review recent experience with deposit insurance schemes and consider the desirability and feasibility of setting out international guidance for such arrangements                        | Guidance for Developing Effective Deposit Insurance Systems                             | Argentina, Canada (chair), Chile, France, Germany, Hungary, Italy, Jamaica, Japan, Mexico, Philippines, United States                                           |

Source: FSF (2001a).

which in turn form the basis for the FSF standards on banking supervision.<sup>9</sup> Although strictly speaking, minimum capital requirements as recommended by the Basel accord were established only for internationally active banks, in practice they have formed the basis for assessing capital adequacy in all banks, including those that operate only domestically. In fact, this practice is fully recognized in the core principles themselves, with no other comment than that the recommended capital requirement is intended as a minimum and that national supervisors may set more stringent requirements.

The international capital standard can be used to exemplify widespread concerns about financial standards in general, as discussed above. The fundamental reason for the concern is that there is evidence showing that capital standards have not been very useful as a supervisory tool in a number of crisis episodes in developing countries. In these episodes, capital requirements were unable to prevent the eruption of a severe banking crisis. The rest of this subsection explores how each of the concerns with the standards applies to the capital adequacy ratio.<sup>10</sup>

### Basel Capital Standard Has Not Always Produced the Expected Results in Developing Countries

Encouraged by the perceived success of capital requirements as a supervisory tool in industrial countries, developing countries have been advised to adopt similar rules governing capital adequacy.<sup>11</sup> Indeed, during the 1990s many developing countries directed their financial reform efforts toward implementing the recommendations of the Basel accord. However, the recent experience of banking problems in developing countries (despite their diverse outcomes), especially in emerging markets, indicates that capital requirements often have not performed their expected role as an effective supervisory tool: The accumulation of capital on banks' balance sheets failed to act as a buffer against unexpected adverse shocks.

Recent evidence supports this view. Figure 4.1 shows, for a group of eight countries, the rate of growth of the banking system's net equity

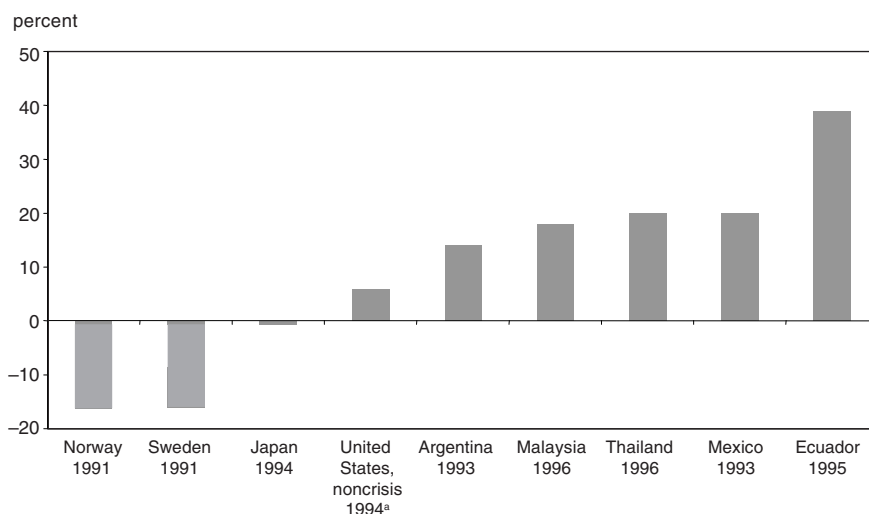
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9. As established in the FSF's *Compendium of Standards* (2001b), the standard on Banking Financial Regulation and Supervision were set by the Basel Committee on Banking Supervision in its 1997 document (Basel Committee on Banking Supervision 1997). This document contains 25 principles. Principle 6 states that capital requirements should be those established in the Basel Capital Accord (Basel Committee on Banking Supervision 1988).

10. For a full discussion of the issues raised here, see Rojas-Suarez (2001a).

11. Undoubtedly the preferred summary statistic for bank risk, one that includes a composite assessment of credit and market risk, is the capital-to-risk-weighted-assets ratio. This ratio can serve this function because, at least in theory, enforcement of each of the other supervisory ratios implies an adjustment in the value of assets and liabilities that ultimately affects the size of the bank's capital account.

**Figure 4.1 Real net equity growth in selected banking systems on the eve of a crisis**



a. The United States did not experience a crisis in 1994 but instead is used here as a benchmark.

Source: Rojas-Suarez and Weisbrod (1997), Rojas-Suarez (2001b), various central bank statistics, and IMF *International Financial Statistics* (various issues).

during the year before the eruption of a major banking crisis. If equity capital were at all a good indicator of banking soundness (i.e., if insufficient or decreasing capital accurately signaled banking weaknesses), banks in countries about to fall into a major crisis should be facing difficulties in raising capital. This has indeed been the case in banking crises in industrial countries. As the figure shows, during the year before banking crises erupted in Sweden, Norway, and Japan, net real equity growth became negative. (The figure also illustrates a noncrisis episode in the United States to show that, in normal times, net real equity grows at moderate rates.) In contrast, however, on the eve of disastrous crisis episodes in several developing countries, real net equity growth was not only positive but indeed reached very high levels. Cases in point are Thailand, Mexico, and Ecuador, where this indicator did not serve as a warning signal of major banking turbulence. Large and growing stocks of net equity did not prevent the eruption of severe banking crises. Notice also that the behavior of net equity growth was related to the country's level of development, not to its size. For example, banks' real net equity growth was negative on the eve of the banking crises in the two small industrialized countries in the sample: Norway and Sweden. Thus, net equity behaved as expected for industrial countries in these two countries, despite their small size.

Rojas-Suarez (2001b) presents further evidence that capital ratios have been meaningless in signaling banking problems in many developing countries. The main result is that, among traditional indicators used by supervisors as early warning indicators of banking problems, the capital-to-assets ratio has performed the worst. For example, in Mexico, a country that claimed to have adopted the Basel capital standards recommendations just before the 1994 banking crisis, the behavior of the capital-to-risk-weighted-assets ratio was useful in predicting problems in only 7 percent of the banks that experienced severe crises. Indeed, according to the data provided by the Mexican bank supervisory authority, most banks in Mexico were in full compliance with the capital requirements, with ratios well above 8 percent.

The conclusion to be drawn from this evidence is not that capital requirements can never be of use for supervisors in developing countries. As the discussion below will demonstrate, the appropriate conclusion is instead that, for capital standards to work, some preconditions must be met that many developing countries may not be meeting today. Effective banking supervision may therefore need to take into account certain important differences between developing countries and industrial countries.

### What Will It Take for Capital Standards to Work?

There are a number of reasons for the disappointing performance of capital requirements as an effective supervisory tool in developing countries. The main argument of this chapter is that, for this standard to work, two sets of conditions need to be met. The first relates to the quality of data and the overall supervisory framework, and the second to the depth and efficiency of markets. The first set of conditions is well known and is fully recognized by members of the standards-setting bodies: compliance with adequate accounting and regulatory frameworks is necessary to make the capital adequacy standard work. Inappropriate accounting standards and reporting systems, improper classification of nonperforming loans, and underprovision of reserves against credit losses stand out as the best examples of inadequacies that reduce the effectiveness of capital requirements. In addition, a deficient judicial framework, one that is unable to enforce supervisory actions when a bank's performance is deemed faulty, seriously undermines the effectiveness of bank ratios.

If these were the only preconditions, however, concerns about the appropriateness of the capital standard for developing countries would be exaggerated. All that would be needed is an adequate prioritization and ordering of the Basel Committee's core principles. This, indeed, is often done in practice. A more fundamental problem with the capital standards, however, goes beyond the establishment of rules and regulations to highlight a feature that is unique to developing countries; namely, the lack of deep and liquid capital markets. Even when accounting, reporting, and

legal frameworks are adequate, capitalization ratios will be less effective if liquid markets for bank shares, subordinated debt, and other bank liabilities and assets are not available to validate the real value of bank capital as distinct from its accounting value. Therefore, changes in the market value of bank capital that provide supervisors in industrial countries with information regarding the quality of reported capital will not be effective in developing countries. A second set of conditions for the appropriate performance of capital standards is needed to address this problem.

In contrast to the situation in industrial countries, asset ownership, both financial and real, in many developing countries remains highly concentrated, making the potential market for equity capital small and uncompetitive. In such an environment, the intent of the capital standard—to increase the ratio of uninsured funding (equity and subordinated debt) to insured funding (deposits) in order to reduce bank stockholders' incentive to take risks at the expense of existing public safety nets—can easily be subverted.<sup>12</sup> Shareholders' wealth may not really be at risk when they supply equity capital to a bank, because shareholders can finance their stake with a loan from a related party, which may even be a nonfinancial corporation and hence outside the regulators' purview. Thus, concentration of wealth provides incentives for bank owners in developing countries to supply low-quality bank capital and, therefore, to take on greater risks than do their counterparts in industrial countries.

This indicates that it can be relatively easy for bank owners in some developing countries to raise large amounts of low-quality equity capital relative to the bank's capital base in a short time. Indeed, this may explain the results shown in figure 4.1: The rapid growth of net accounting equity on the eve of banking crises in several developing countries may reflect the low quality of capital in these economies. In countries that lack a market that can accurately assess the quality of bank capital, capitalization ratios cannot reveal the true riskiness of bank activities and therefore cannot serve as an effective supervisory tool.

Clearly, the severity of this problem varies widely across developing countries. In many of these countries, the constraints limiting the usefulness of capital requirements are extremely binding. This raises the question of whether there is an alternative to the use of capital standards for assessing the strengths of banks now, or in the immediate future, until the preconditions for the effectiveness of the capital standard are in place. I address this issue later in this chapter.

In some countries, however, a continuous increase in the participation of banks based in industrial countries is effectively reducing the prevalence of connected lending both among financial institutions and between financial institutions and the real sector. Furthermore, in this (still small)

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12. This point has been advanced by Rojas-Suarez and Weisbrod (1997) and by Rojas-Suarez (2001b).



group of countries, the accounting, regulatory, and supervisory frameworks have improved dramatically. Although very few developing economies have sufficiently deep and liquid capital markets (Chile, Hong Kong, and Singapore may be the leaders on this score), the participation of foreign banks can provide an outside source of capital for the pursuit of new wealth. The competition induced by the entry of new providers of wealth can indeed contribute to improving the usefulness of capitalization ratios. For this group of countries, the relevant question is whether adopting the internationally accepted capital standards recommended by the Basel Committee (both the current and the newly proposed accords) is appropriate.

### Sequencing and the Level of Development Matter

The foregoing discussion clearly demonstrates the importance of the level of financial development for the effectiveness of capital standards. For industrial countries, in which deep and liquid capital markets validate the value of accounting capital, the standard has proved useful. In contrast, in the least developed countries in the world, wealth concentration and the resulting absence of competitive capital markets severely hinders the usefulness of any bank capital standard. Between these two extremes there is a group of developing countries in which the participation of foreign banks has improved the functioning of markets. In this group of countries, mostly classified as emerging markets, capital adequacy requirements can act as an effective supervisory tool. The question here is whether the capital standards recommended under the Basel accord are the right ones for strengthening the banking systems of developing countries with an intermediate degree of financial deepening.

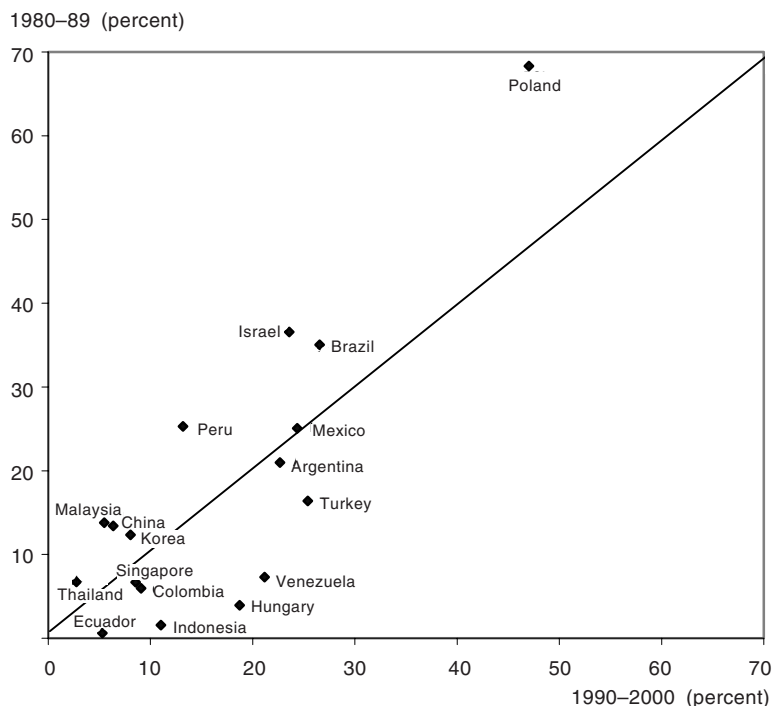
My assessment is that, paradoxically, the usefulness of the Basel capital standard is limited when that standard is applied in a manner similar to that in industrial countries. Indeed, I would argue that a straightforward application of that standard can actually weaken banking systems in emerging markets.

An example that serves to clarify this point is the treatment of bank credit to the government.<sup>13</sup> Under the current Basel accord, loans to the domestic public sector carry a zero risk weight if the country belongs to the Organization for Economic Cooperation and Development (OECD), and a 100 percent weight if it does not. The idea, of course, is that government claims from OECD countries can be considered safe assets. However, when applying the Basel recommendations to their domestic economies, most non-OECD countries attach a zero risk weight to their own government paper. That is, banks in emerging markets treat paper issued by their governments as a safe asset—a dubious assumption if one takes

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13. See Rojas-Suarez (2001a) for additional examples of how strict application of the Basel capital standards can have unintended consequences in emerging markets.

**Figure 4.2 Claims on government as percent of total assets of banks in selected emerging markets, 1980s and 1990s**



Note: Data are for claims on central and noncentral government by deposit money banks and are averages for the periods.

Source: International Monetary Fund, *International Financial Statistics*.

into account the default history of governments in emerging markets, highlighted by the recent defaults in Argentina, Russia, and Ecuador.<sup>14</sup> The problem with this practice is that, by economizing on capital requirements, banks have a strong incentive to concentrate a significant portion of their asset holdings in government paper. This incentive not only gives a false impression of bank safety but, even more important, also contributes to weakening banks' franchise value, which is rooted in their capacity to assess credit risk.

Figure 4.2 illustrates this point. It shows that, in many emerging markets (those to the right of the 45 degree line in the figure), the share of government paper on banks' balance sheets increased during the 1990s relative to the 1980s. This result is a sad irony: A significant component

14. Argentina does not attach a zero risk weight to government paper, but the weights it uses still favor this kind of instrument.

of the efforts of financial sector reform undertaken in the early 1990s aimed at decreasing the share of banks' claims on government. Of course, the results in figure 4.2 should not be entirely attributed to inappropriate implementation of regulatory reform. In a number of countries, banking crises were resolved by replacing bad loans with government paper (Mexico and the post-1997 East Asian crisis countries are notorious for this). Given the lack of access of emerging markets to international capital markets during crises, it is very difficult to conceive of alternative procedures for resolving banking crises. To take this into account, I eliminated periods of banking crisis from the sample, from the start of the crisis to five years afterward. The basic result did not change: Many banking systems in emerging markets held as much or more government paper in the 1990s than in the 1980s.<sup>15</sup>

As figure 4.2 shows, claims on government as a percentage of bank deposits not only increased for many countries, but by the end of 2000 were also very high in absolute terms. Several large countries such as Argentina, Brazil, India, Mexico, and Poland displayed ratios close to 30 percent. Indeed, in this sample of countries, Chile was the only country that succeeded in reducing this ratio to low levels (1.7 percent by 2000).

A thorough understanding of banks' decisions to hold public rather than private assets would require the specification of a complete model. However, it is fair to argue that the regulatory treatment of government paper has played an important role in banks' decisions. This regulatory incentive has important consequences during recessions as banks tended to magnify the downward trend in economic activity by shifting their portfolio further away from credit to the private sector and toward government paper.

The evidence presented here indicates that the regulatory treatment of banks' claims on government tends to reduce the soundness of banking systems in emerging markets.<sup>16</sup> This concern may seem obvious, yet it is not taken into account when assessing country progress in strengthening financial systems. Indeed, emerging markets that attach zero risk

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15. The case of Argentina is particularly telling. During the early 1990s, following the implementation of the currency board, Argentinean banks decreased in relative terms their holdings of government paper. After the banking crisis of 1995, there was an increase in holdings of government paper, which one can associate with the restructuring efforts of the financial sector, including improving the liquidity of the banks. However, long after the crisis was completely resolved, banks continued to increase their claims on government. By the end of 2000, banks' claims on all levels of government as a share of their total assets reached 25 percent, close to the 27 percent observed in 1991 when the currency board was introduced.

16. A possible counterargument is that domestic government debt is safer than public external debt. However, given the long history of government-induced domestic defaults, in the form of either outright confiscation of deposits or sharp devaluations and inflations that drastically reduced the real value of government paper held by residents, I find this argument simply unconvincing.

weight to domestic government liabilities would not receive a warning signal from the multilateral organizations even if the government were highly indebted, because such practice is not perceived as conflicting with the international standards.

What does this all say about sequencing? The answer again lies in the level of a country's development. For industrial countries, no sequencing is necessary: They can comply with the Basel accord and even improve on it (as has actually happened in the current proposal for a modified accord, called Basel II). For the least-developed countries, where the workings of markets are highly limited, sequencing is a central issue. It is essential to first establish the appropriate legal, judicial, and accounting framework before placing high hopes on the effectiveness of capital standards. This, however, does not mean that these countries cannot design appropriate supervisory tools that work. The section below on the role of regional development banks presents some suggestions on this subject.

For the more advanced developing countries, sequencing is also important but is of a different nature. Having fulfilled the requirements for the adequate functioning of capital standards, their challenge is to adapt the Basel requirements to their own circumstances. As the example above demonstrates, it is inappropriate to attach zero risk weight to government paper if market indicators signal concerns about the default probability of such instruments. A straightforward sequencing follows: It is essential to achieve a sustainable path for public debt before treating government paper as a risk-free asset on banks' balance sheets.

### Can Better Developing-Country Representation in Standards Setting Help?

Given the difficulties discussed above, it should be no surprise that developing countries feel an urgent need to participate in the design of standards for the supervision of their banking systems. The need for increased participation becomes even more pressing when one considers the issues that will arise for the stability of financial markets in developing countries if the newly proposed Basel II is implemented.

Under Basel II, banks that are large or internationally active can choose to use either ratings provided by external agencies or their own internal rating systems as a basis for classifying the credit risk of loans and for calculating regulatory capital requirements. Concerns about the adverse effects on developing countries of implementing this proposal have been widely analyzed (see, e.g., Griffith-Jones and Spratt 2001; Reisen 2001; and Latin American Shadow Financial Regulatory Committee 2001). Here I will summarize only two such worries.<sup>17</sup>

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17. These concerns have been raised by the Latin American Shadow Financial Regulatory Committee, chaired by the author.

The first concern is that the adoption of either of these two approaches in industrial countries may exacerbate the volatility of capital flows to developing countries, for two reasons. First, banks in industrial countries that base their credit assessments on their own internal risk procedures will be given greater discretion in assessing the risks involved in lending to developing countries, in contrast to current practices in which all loans to non-OECD corporations and governments carry a 100 percent risk weight. If an underestimated risk from a credit to a developing country materializes, international banks will quickly reverse the inflows, to economize on capital requirements, and this will exacerbate the sharp turns in capital flows to developing countries. Second, if international banks adopt the ratings provided by external agencies, the volatility of capital flows to developing countries will increase even more. This is so because rating agencies have a track record of lowering ratings to developing countries after problems have emerged. Indeed, credit rating agencies are better at risk confirmation than risk diagnosis. This will make international bank credit to developing countries even more procyclical than it is now.

The second concern relates to the more favorable treatment of capital requirements for short-term interbank lending. Whereas the current Basel accord already requires lower capital charges for short-term interbank lending, the proposed new accord lowers even further the maturity on interbank loans subject to preferential treatment. This implies that international banks will have an incentive to reduce the maturity of loans extended to developing countries. This, in turn, will increase the vulnerability of developing countries' financial markets to adverse shocks. This strongly conflicts with the efforts of many developing countries to improve the resilience of their financial systems by extending the maturity of loans. Most important, this recommended policy strongly conflicts with the intent of the FSF to avoid the eruption of systemic crises.

This is a clear example of how particular features of developing countries warrant strong representation of these countries in international forums and standards-setting bodies. Such representation is needed to allow these countries to voice concerns about international policy recommendations that could weaken rather than strengthen their financial systems.

## **Role for Regional Development Banks in International Standards Setting**

The conclusion to be drawn from this discussion is that policymakers in developing countries and standards-setting bodies face a difficult dilemma: how to ensure convergence toward sound international standards in the long run while recognizing that lack of preconditions for the effective

functioning of some standards could render the implementation of those standards counterproductive in the short run. This chapter argues that the answer lies in the design of country- and region-specific policies aimed at dealing with the transition. This means identifying the necessary preconditions for the standards to work, designing transitional policies to deal with short-term constraints, recognizing the proper sequencing and timing for implementing the standards, and building the necessary institutional framework to make the standards sustainable.

This section advances some recommendations for dealing with these multiple tasks. The first part builds on the example of bank capital standards and suggests ways in which the issue of the lack of preconditions can be handled. The recommendations advanced here show that complementary policies, specific to each country's level of development, can go a long way toward ensuring the success of the capital standards in the long run, even if the standard should prove ineffective or even have adverse consequences in the immediate term. The second part of this section generalizes the lessons learned from the capital adequacy example and suggests that the regional development banks can play a fundamental role in supporting countries' efforts toward achieving financial stability during the transition.

### **Supplementing International Standards with Country- and Region-Specific Recommendations**

As already discussed, a country's level of financial development is central in determining whether the Basel capital requirements are appropriate and will be effective in that country. As a consequence, policy recommendations to deal with problems associated with capital requirements also need to differ across countries and across regions.

This chapter has distinguished two groups of developing countries according to their degree of financial deepening. For the less financially developed countries, in which capital standards have no meaningful use, it is obvious that sustainable policy consists of removing the constraints on the effectiveness of the standards. This means implementing appropriate accounting, regulatory, and judicial frameworks and developing markets capable of validating banks' chosen accounting capital ratios. Such reforms, however, often take a long time to implement. During the transition, it is essential to identify and develop indicators of banking problems (other than capital ratios) that reveal the true riskiness of banks. For example, in most developing countries, deposit markets have been identified as markets that work, in the sense that they have provided effective early-warning signals about the relative strength of banks. Recommendations for policymakers in this set of countries, therefore, should focus on strengthening the role of market discipline as a substitute for

the inadequacies of the regulatory capital requirements. Specific recommendations include the following:

- encourage the public offering of uninsured certificates of deposits;
- publish interbank bid and offer rates, to improve the flow of information about bank quality;
- concentrate regulatory efforts on the improvement of deposit insurance schemes, to further enhance the role of market discipline;
- avoid giving banks too much access to central bank liquidity, to contain the moral hazard problems associated with a lender of last resort;
- improve the credibility of safety nets by establishing prompt corrective actions to deal with banking problems; and
- most important, encourage the internationalization of the country's financial markets through the promotion of foreign banking, because market depth can only be achieved if a diverse group of investors and users of capital enter the market, reducing market concentration.

The policy recommendations are quite different for the second group of developing countries. In these countries, a higher level of financial development allows for meaningful capital standards, but the particular features of these countries, such as their limited access to international capital markets and, in some cases, the low quality of their government paper, imply that strict application of the Basel accord may weaken their domestic financial system. The main recommendation for this group of countries is to design a transitional capital standard that appropriately reflects the risk of banks' assets, because neither the current nor the proposed Basel accord fits the bill in the short run.

I recommend that the standard for such countries have two basic components. The first is the development of risk-based regulations for loan-loss provisions. Although this was recognized by the Basel Committee to be an essential complement to any capital standard, the proposal in this chapter is one based on prioritization: given the high frequency of adverse shocks in developing countries, the expected probability of such a shock is much higher than in industrial countries. In this environment, provisioning becomes, at times, more important than capitalization. The second component is the establishment of a reduced number of risk categories for classifying assets, with the central qualification that the categories reflect the particular features of banks' assets in developing countries. Issues that need to be considered in the design of appropriate risk categories include adequate risk assessment of government paper and the introduction of different capital charges for borrowers in the tradable



and nontradable sectors.<sup>18</sup> This distinction responds to the well-known vulnerability of the nontradable sector to adverse shocks, such as a sudden cessation of international capital inflows.

Additional recommendations are designed to allow these countries to deepen their financial systems and so to improve the effectiveness of accepted international capital standards. They include further enhancing the mechanisms of market discipline and deepening the process of financial internationalization through the increased participation of foreign institutional investors. Needless to say, all these recommendations presuppose that those proposed for the less financially developed countries in the first group are also met.

### **Improving the Effectiveness of International Standards: Role of Regional Development Banks**

This chapter's discussion of a key international standard, the capital adequacy ratio, has served to illustrate the validity of concerns raised by policymakers in developing countries and by a number of analysts about the effectiveness of international standards in general. The main conclusion here is that the divergence in financial deepening both between developing and industrial countries and among developing countries warrants the design of additional policies to deal with a transition period during which the standards may either lack effectiveness (in the least developed countries) or have unwanted side effects (in the more advanced developing countries).

Recognizing that there is no incompatibility between common international standards in the long run and country- and region-specific policies in the short run can go a long way toward securing financial stability for developing countries. Responsibility for setting international standards has been clearly identified, and tasks have been assigned to a number of international organizations and forums, but transitional issues and the corresponding design of policies have received considerably less attention.

Who should deal with the transition? Clearly, responsibility for policy decisions rests ultimately with the countries themselves, but a strong case can be made for a key role for RDBs. Because each RDB has extensive experience and expertise in dealing with the particular economic and financial features of its region, the RDBs are well equipped to help countries in identifying constraints on the effective implementation of standards. Furthermore, common institutional arrangements and market practices shared by countries within a region or subregion allow RDBs to exploit important synergies in designing common solutions applicable to several countries within the region.

Indeed, RDBs are ideal institutions to coordinate the tasks that I have

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18. For a more comprehensive analysis of this proposal, see Rojas-Suarez (2001a).



identified here as essential for the successful implementation of international standards in developing countries in the long run. First, because countries in a region or subregion often share common goals (including in some cases regional integration), RDBs are in an optimal position to help them prioritize the implementation of standards. Second, because countries within a region often share similar experiences during the eruption and resolution of financial crises (e.g., the Latin American crises of the 1980s or the East Asian crises of the 1990s), RDBs are well aware of the constraints, both in institutional frameworks and in the development of markets, that may impede the immediate effectiveness of international standards. Third, because of their deep knowledge of the economic and political circumstances of countries in their region, RDBs can provide strong support in designing transitional policies to strengthen financial systems in the immediate future, when some international standards may not be appropriate. Fourth, because of the collaboration between RDBs and several standards-setting bodies, especially the IMF and the World Bank, RDBs can help voice the concerns of developing countries in adopting and adapting the standards. Fifth, because of their experience in advising countries on a large variety of development issues, RDBs can provide the necessary technical assistance to help countries meet the preconditions for the effective implementation of standards.

What instruments should RDBs use or develop to conduct these tasks? It is my view that the instruments needed at the regional level are similar to those employed at the global level. First, to design transition policies aimed at making international standards effective in the long run, RDBs could set up special task forces and possibly even subregional working groups. Such groups could also be of great help in dealing with the issue of appropriate representation. Consideration could also be given to the participation of global standards-setting bodies in these initiatives. Second, to disseminate information about efforts toward financial stability in a country or group of countries, RDBs could organize forums, conferences, and seminars that stress the participation of the private sector. Third, RDBs can use their financial sector reform programs to ensure progress in implementing country- or region-specific policies to strengthen financial systems. Once agreement has been reached on appropriate transition policies, there is no reason for not including them as part of the conditionality of these programs. Fourth, as countries graduate from transition policies and are ready to move to the full implementation of international standards, RDBs can coordinate their efforts with those of other multilateral organizations in the provision of necessary technical assistance.<sup>19</sup>

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19. The need for technical assistance at the regional level to complement efforts at the global level is fully recognized in the following statement by Andrew Crockett, chairman of the FSF: "Widespread international support is needed to provide expertise and funding for the provision of technical assistance and training to assist countries in implementing international standards" (Crockett 2001, 2).

In summary, to the question posed in the title of this paper (Can RDBs help address developing-country concerns with international standards?), the answer is a definite yes, not only can RDBs help, but they should help.<sup>20</sup> Regional efforts are not only desirable but are, indeed, indispensable for achieving the sustainable convergence of developing countries toward international standards.

## Conclusion

This chapter has argued that although international policy standards, especially those for the financial sector, should converge across countries in the long run, the pressing issue for developing countries is how to handle the transition period, when the preconditions needed for effective implementation of international standards may not yet be in place. Indeed, if the preconditions for the effective functioning of some standards are not fulfilled, it could render their implementation ineffective and even counterproductive in the short run. The ineffectiveness of international bank capital standards to control excessive risk taking by banks in a number of developing countries was presented as an example.

A second conclusion is that a country's level of development, especially with respect to financial deepening, matters significantly both in deciding whether a country is ready to implement an international standard and in designing transition policies—different from the international standards but effective in the short run—to strengthen financial systems. In addition, the degree of financial deepening is important in determining the appropriate sequencing and timing for implementing the standards. Developing countries' disastrous experiences with implementing policies in the wrong sequence (most notoriously, engaging in financial liberalization without adequate supervision of financial institutions) justify their concerns.

RDBs can play a key role in helping countries to design transition policies leading to a sustainable implementation of the standards in the long run. Indeed, here the RDBs can fill an important vacuum: Although the responsibility for setting international standards has been clearly identified and tasks have been assigned to a number of international organizations and forums, transition issues and the corresponding design of policies have not been given the attention they deserve. The existence of common institutional arrangements and market practices among countries within a region or subregion makes RDBs well equipped to help countries in several ways: in prioritizing the implementation of standards;

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20. As reported by Crockett (2001), the FSF has recently initiated regional meetings to discuss financial sector vulnerabilities at the regional level. The need for identification and resolution of regional financial weaknesses is therefore recognized at the global level.

in identifying the constraints, both in institutional frameworks and development of markets, that may impede the immediate effectiveness of international standards; in providing strong support in designing transition policies to strengthen financial systems in the immediate term, when some international standards may not be appropriate; in helping voice the concerns of developing countries in adopting and adapting the standards; and in providing the necessary technical assistance to help countries meet the preconditions for the effective implementation of standards. Regional efforts are not only desirable but are, indeed, indispensable for achieving the sustainable convergence of developing countries toward international standards.

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## Comment

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I focus here on prudential standards for banks, because failure in this area has been so important for the disasters that have recently befallen developing countries. The primary purpose of prudential standards is to protect the financial sector from excessive risk, and there is clear and growing evidence that the failure to do so is at the root of the historically unprecedented instability of banking systems throughout the world over the last two decades. The problem is not one of stupidity but, rather, one of perverse economic incentives and a lack of political will within developing countries and within multilateral agencies to promote real reform.

Financial institutions that are protected, explicitly or implicitly, by taxpayer-financed deposit insurance or other similar measures tend to misallocate capital in a way that makes financial systems extraordinarily unstable. This occurs during normal times, when government protection from default risk insulates less competent management from the discipline of competition, or invites those with the greatest political influence (i.e., those with comparative advantages in arranging taxpayer-financed bailouts) into the banking industry.

The problem worsens substantially in the wake of adverse shocks to the economy: Protected banks buffeted by such shocks redouble their lobbying efforts, begging for forbearance from the enforcement of prudential regulations. (Forbearance is a polite word for a conscious political decision not to enforce prudential guidelines, such as accounting rules for

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booking of losses and for measuring profits and capital.) The result has been over 100 major banking sector collapses worldwide over the last two decades, many of which have entailed costs the likes of which have never been seen before.

Politicians have been encouraged to provide such forbearance by false claims that regulatory enforcement will magnify the effects of a recession through a regulation-induced credit crunch. The evidence, however, indicates the opposite. Many researchers (e.g., Boyd et al. 2000; Cull, Senbet, and Sorge 2000; Honohan and Klingebiel 2000) have shown that failure to limit bank risk taking in the wake of a recession actually deepens the cyclical decline by allowing bankers to bet the nation's banking system on bad risks. Often these are risks that also serve their selfish economic interests at the expense of the health of the financial system or the economy. Forbearance is the opposite of a truly countercyclical policy.

In short, the record clearly shows, and the background paper by Liliana Rojas-Suarez documents this well, that prudential standards have not worked, in large part because the measures on which they are based are not credible. It warrants emphasis that this is largely a political problem—a lack of political will not just to create standards but to enforce them. It follows that the key requirement of any meaningful set of standards is a reliable enforcement mechanism. This “Prince Hamlet” is often absent from the play of global pontificating about standards, perhaps because it is an inconvenient fact for the Group of Seven to recognize, given that their own failings in this area are as obvious, if not always as spectacular, as those of developing economies. Japan is, of course, the case in which the failings of the past decade have been both obvious and spectacular.

In other words, the Basel standards are a failure—for all countries—in large part because the largest countries (the Group of Seven, or G-7) have not taken them seriously. It is worth asking, however, whether enforcing these standards could conceivably produce a stable global banking system, and whether (assuming that the standards could be made effective) doing so would be advisable for developing countries. My own view is negative on both counts. The Basel standards are not only unenforced at present, but they are unlikely to do much good if they were enforced, especially in developing countries. A new approach is needed, and luckily, one is readily available.

Before outlining that approach, let me address the second question, which I take to be the main topic of chapter 4: Do developing countries need to develop their own prudential standards distinct from those of the G-7? It depends on how one defines standards. If by standards one means a specific set of guidelines, the answer is that developing countries must adopt different banking standards that reflect the different risks and different political and institutional environments in which they operate. However, if by standards one means a standard for measuring

success, and a way of establishing credible enforcement of regulatory rules, I would emphatically argue that there is no need for a double standard. It is both patronizing and counterproductive for policymakers to argue, as they typically do, that emerging market countries cannot achieve and should not target financial stability comparable to what is achievable in the G-7 countries. Ironically, the current (often unspoken) G-7 consensus is doubly wrong. It sees uniformity in specific standards as desirable (which it is not) and wrongly views uniformity in effectiveness as unachievable.

What makes emerging market countries different? First, their economic risks are different. Emerging markets have relatively underdeveloped information networks, ineffective enforcement of creditors' rights, and poor corporate governance networks, all of which increase the fundamental risks of lending. Furthermore, their economies are less diversified, often heavily dependent on a few commodities or sectors. The fact that sovereign and private sector debts are denominated in hard external currencies adds another dimension of risk in these countries, and the fiscal risk of sovereign default (particularly given the fact that banks hold enormous amounts of government debt) makes the riskiness of government debt holdings quite different in emerging markets than in industrial countries. (Argentina is the most obvious recent case of a banking sector destroyed by forced acquisition of government debt, which was encouraged by the lack of capital required as backing for those debt holdings.) In addition, exchange rate pegs increase the fragility of borrowers, particularly in the nontraded goods sector, as Rojas-Suarez has pointed out. Thus, the risk weights appropriate for sovereign debt and for different sectors of the economy differ within and across emerging markets in ways that they do not among the G-7 countries.

Second, political risk is greater in emerging markets. Greater political volatility is part of the difference. The other part is greater corruption, which translates into less reliable enforcement of laws and regulations (including prudential regulations), all of which adds to financial sector risk. Contributing to this problem is the greater concentration of wealth in many emerging market countries, which tends to encourage cronyism in the banking sector, particularly through close ties among banks, the government, and the large firms that rely on banks for financing. (These firms are often linked to bank management and to political parties in equal measure.)

Because of these greater risks, emerging market countries should require higher ratios of bank capital to assets, all else being equal, than their counterparts in the G-7. Furthermore, the need for making enforcement of these capital standards credible is even greater.

Beyond these differences, there are also special needs for augmenting capital standards with other measures that encourage stability. Such measures include liquidity standards that protect against systemic risks,

not just capital standards for banks; policies that encourage free entry by foreign banks, because these provide both economic and political discipline; and limits on universal banking, motivated by political economic needs to keep banks from becoming captured by politically influential industrial conglomerates.

The Argentinean approach was a good start: limit deposit insurance to encourage market discipline; require banks to issue subordinated debt (i.e., debt that is junior to deposits), which further encourages market discipline by forcing banks to raise unprotected funds from sophisticated investors; use interest rates charged on loans as the basis for setting risk weights on loans, which are used to compute minimum capital requirements (another way that market information is brought to bear in evaluating and controlling bank risk); use stand-bys as substitutes for liquidity reserves as a means to allow the market to reward banks who can qualify for stand-bys from foreign banks at a low cost; set limits on ownership links between banks and industry to discourage cronyism; and make bank regulators independent (as much as possible) from the political process. However, one must go further (as the Argentinean experience also showed) to tie market views of bank soundness (e.g., as expressed in interest rates on uninsured bank debts) to bank actions and regulatory intervention. In other words, real regulation of risk requires discipline—a credible, predictable connection between observed increases in risk and tangible, effective actions by supervisors enforcing regulations. One must establish supervisory rules that mandate the use of useful market information and that close loopholes that are used by banks and supervisors to avoid disciplining banks when that is needed most.

Market interest rates are potentially very useful measures in emerging markets as well as in the G-7. The evidence on this is conclusive (Calomiris 1999; Demirgüç-Kunt and Detragiache 2000; Rojas-Suarez 2001; World Bank 2001; Calomiris and Powell 2001; Barth, Caprio, and Levine 2002). Contrary to what is often claimed, the difficulty is not in the absence of market infrastructure sufficient to create useful signals but, rather, in the lack of political will to use information already produced by the market.

On the role of the international financial institutions, I continue to advocate the view of the Meltzer Commission: International Monetary Fund (IMF) standards should take into account the extent of credible prudential regulation when determining the level of access a country has to IMF assistance. Countries need to know that when they fail to establish effective regulatory and supervisory systems the IMF will not step in to bail them out of the predictable financial crisis that will result. Existing IMF policy, which does not limit bailouts, encourages weakness in bank supervision and regulation.

Let the regional development banks take the lead in encouraging reform: Experimenting is good. One size indeed does not fit all. Local governments may best be able to learn from each other, and regional development



banks are the organizations best positioned to encourage this kind of learning.

How does one reconcile universalism of standards with individualism of approach to implementing standards? From the standpoint of the universal standard, what matters is the level of risk and the credibility of enforcement. The establishment of market discipline is the only meaningful universal standard. The details of regulation should be left to the countries and will vary according to each country's particular history and institutional environment.

It is time to end duplicitous lip service and patronizing attitudes toward emerging market countries. Market discipline is achievable, and we should expect no less. It was a reality over 100 years ago in many of these countries, and it could be so today. The problem, of course, is that powerful special interests do not want market discipline, and myopic politicians (who want to avoid the political costs of the moment, not ensure the economic benefits of the long run) do not much like it either. Thus, it is likely that financial crises will continue to plague emerging markets for some time. Let us at least recognize this for what it is, however: a lack of political will in the emerging market countries and among the G-7 to require discipline, not an economic failure of markets or an institutional impossibility.

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## Comment

EDUARDO ANINAT

I have witnessed a major evolution among countries as to how they view the Reports on the Observance of Standards and Codes (ROSC) process, or the Financial Sector Assessment Program process, or even the Financial System Stability Assessment—in short, the whole range of ways in which we have been using standards and codes to provide either self-assessments or more formal assessments in a process of consultation with countries since the end of 1999. My evidence comes from direct conversation with country authorities regarding, say, Article IV consultations or programs, and from listening very carefully to the intense discussion we have had on the International Monetary Fund (IMF) board about this.

Although due concern must be given to implementation difficulties, to capacity constraints, to the phasing in of the different standards, and to prioritization, I see now an overwhelming demand on the part of countries to accede in due time and to join in a cooperative and voluntary way this work of standards and codes. I observed much more skepticism about this before I came to the IMF than I do today. Why have things changed? Because countries do not want to be left out of the standards process, or left with a secondary type of standards, or left with truncated standards. They want full access with respect not only to trade markets but to financial markets as well. There is a renewed recognition of the need to clearly define the demand for access in financial markets.

Of course, this cannot be done overnight. There are ownership and transition concerns, which Rojas-Suarez has explored in her chapter. It

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would, however, perhaps be inadvisable, irrational, and to some extent unrepresentative to deny this revealed excess demand for standards and codes, and to implement the process with a long transition phase, when instead countries can do it fully in place with their own peers. The recognition of this fact has been for me part of an interesting learning process at the IMF itself.

No one can claim that these new standards and codes, and in particular the reports on the assessments (either the ROSCs on say, the fiscal side, or the Financial Sector Assessment Programs on the financial-sector side), are going to resolve all the problems facing developing countries, or all the main problems, or even many problems. We have to remember a second, very important fact; namely, that these standards and codes are only tools in a kit that has to be used by professionals, by politicians, by legislators, and by policymakers. They are sophisticated tools that we did not have in the 1960s, the 1970s, and the early 1980s, but they are not yet as fully developed or as sophisticated as we would like them to be, and none of them on their own will solve the market's overriding concerns about structural reform or fiscal or macroeconomic adjustment.

We cannot demand from these tools, from these standards and codes, more than they can give. We must all recognize that this is a dynamic process, an input, with much that is of a transitional nature. Therefore, I find the chapter's comparisons of Argentina and Chile, and how Argentina had published more ROSCs than Chile, in a way not very appropriate. The nature of the problem is completely different in the two countries.

The IMF and the World Bank also have to pay much more attention to the ways in which countries themselves, especially the least-developed countries, with their greater institutional constraints, data problems, lack of expertise, and so forth, want to prioritize during this transition phase: which standards and codes they want to focus on first, which ones second and third, and so on. We all have to learn and listen much more carefully.

As an example, we at the IMF have lately been working with Cambodia. The Cambodian authorities have been very clear in saying they want to work first on those models that concern national economic accounts, statistics regarding the national income process, and classification of output generated by sectors, and not yet the more sophisticated models as applied to a developed, say, insurance or financial sector business. However, we have heard countries like Tunisia say they are more interested in working with the international organizations—the IMF and the World Bank and the regional development banks. There is clearly a role here for doing much more on financial sector deepening.

However, let us consider the fiscal side. When we speak of the fiscal transparency codes and the manuals and guidelines that apply to them, we are not speaking of the theoretical optimal standard. We are speaking here of reasonable best practices that can increase transparency, that can

shed light on the difficult relations between the central government and the subnational governments (namely, provincial and local governments). We can think of Latin America, but many cases apply. We also have the sometimes difficult relationship between the central bank and the central government. There is nothing wrong or detrimental to the countries, the authorities, to the development process in having more transparent rules that help to improve those difficult relationships. The quicker we get there, recognizing constraints, the better for the countries, for the citizens, and for the markets in the world at large.

Finally, we need to consider the issue of improvements in the use of standards and codes. This is a very decisive issue for the success of these tools. On this issue, the IMF has looked back at many of the Latin countries of the 1980s and at several, if perhaps not all, of the countries involved in the Asian crisis of the late 1990s (the big Asian crisis, in which many of these standards were not in place, were underdeveloped, and were not adhered to). During the 1980s and 1990s, there was rudimentary application of international standards. That has changed now, since the availability and information regarding these tools has increased significantly.

In the case of the IMF, I would say there is a dynamic learning curve about the application and usefulness of the standards and codes: I think they will become increasingly useful instruments for the countries. We want to engage on the policy priorities of the countries themselves, rather than to come with a more general aggregate type of approach, as in the past.

Finally, for the private sector, I do see a gap, and I would have liked for the Rojas-Suarez chapter to address this issue more thoroughly. Multilateral organizations can help significantly: We have financial institutions—the World Bank, the IMF, and regional development banks—that can make a difference producing awareness, information, discussions, and seminars on the problems of lack of transparency, malpractice, and overlending and overborrowing. However, if the private sector, the financial markets (including commercial banks), and all the related business do not use the tools to reform their own decision-making process, then I see limits and constraints on where this approach will take us in the coming years. Here there is a tremendous task to be done cooperatively by regional development banks, by the IMF and the World Bank, and by private banking and financial institutions.

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## Comment

HELMUT REISEN

Since the emerging market crises of 1997–98, the international community has attached increasing importance on the design, agreement, implementation, and assessment of financial standards and codes as core elements of crisis prevention. The Financial Stability Forum, established in April 1999 as part of the effort to strengthen financial systems and improve coordination among the agencies responsible for them, posts on its Web site a *Compendium of Standards*<sup>1</sup> citing no fewer than 69 standards. Of these, 12 have been highlighted as being key for sound financial systems (see table 4.1).

In her excellent chapter, Liliana Rojas-Suarez avoids playing the “standards constipation blues” and instead focuses on what is arguably the most widely adopted of all recent financial standards; namely, the bank capital adequacy standard enshrined in the Basel Capital Accord. More than 100 countries claim to adhere to this standard, although it was originally designed for internationally active banks in the Group of Ten industrial countries. I will follow Rojas-Suarez’s lead by first discussing general concerns about applying standards to developing countries and then turning the focus to the Basel accord (both its current 1988 version and its proposed new version) and finally by offering two policy suggestions.

The current international effort to codify best practices and disseminate them widely should help advance the seamless integration of local economies into global markets. When a country becomes globalized, its

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1. The latest (June 2001) update is available at [www.fsforum.org/compendium/key\\_standards\\_for\\_sound\\_financial\\_system.html](http://www.fsforum.org/compendium/key_standards_for_sound_financial_system.html).

institutional, legal, and other structures need to move toward international best practices if that country wants to provide the appropriate market signals and information in the beauty contest known as attracting global capital. If designed appropriately, standards confer efficiency-enhancing value by themselves; hence, countries should have a great self-interest in incorporating these standards as they develop their institutions and markets. Bank capital standards aim at reducing bank insolvencies so as to safeguard a country's banking system, immunizing taxpayers when insolvencies occur and aligning the incentives of bank owners and managers with those of uninsured claimants (Rojas-Suarez 2001).

Whether international standards are appropriate for crisis prevention in developing countries depends much on how they are designed and owned by those countries, and when they are implemented and updated. In her chapter in this book, Rojas-Suarez lists and discusses four concerns. The first is that, for standards as for exchange rate regimes, no single model is right for all countries or at all times. The second is the proper sequencing of standards implementation, taking into account countries' institutional and market development. The third is lack of sufficient participation of developing countries in setting the standards—the ownership issue. Finally, the fourth concern is lack of effectiveness. Let me add here that other concerns have also been voiced (Griffith-Jones 2001; Park 2000; Persaud 2000; Reddy 2001; United Nations 2001; United Nations Conference on Trade and Development 2001):

- standards and codes designed to discipline debtor countries distract attention from the capital supply side (which contributed to the 1997–98 crises and contagion, notably in the form of bank credit reversals) and, thus, slow true progress toward a crisis-resistant global financial architecture;
- ignorance of investors' herding behavior in standards design, notably in standards for market-sensitive risk management and transparency, risks raising rather than reducing the crisis proneness of the world financial system; and
- too-heavy assignment of the tasks of standards design and assessment to international financial organizations introduces a conflict of interest between their assessment and their lending programs and places in doubt the emphasis on voluntary adoption, as incentives and sanctions linked to standard-setting risk become features of surveillance and conditionality.

Rojas-Suarez stresses the fact that, like the opening of countries' capital accounts, the implementation of standards faces issues of sequencing

and capacity constraints. The capacity constraints on poor countries, the proliferation of financial standards in the Financial Stability Forum compendium, and the need for prioritization of standards are intimately linked. This makes it important to think about the parameters for prioritization. Rojas-Suarez shows very convincingly that the depth of local financial markets and the quality of legal and institutional frameworks are parameters of outstanding importance if unwanted side effects are to be avoided and if standards are to be effective. One can think of further parameters: Purely technical standards may be more easily implemented than those with policy implications, which would require that standards implementation form an integral part of the economic reform process, and standards that have an important sociocultural dimension may pose the most enduring challenge to credible implementation. However, the trade-off between the tendency of international organizations to proliferate standards and the capacity constraints of the poor countries will remain. It is urgent to start thinking about opportunity costs in the area of standards and codes.

It is possible that the concern about country ownership has not been overemphasized. Andrew Crockett (2000), for example, worried early on about the trade-off between the legitimacy of the Financial Stability Forum (which rises with the number of countries and the number of shades of opinion sitting in the three working groups) and its effectiveness. Emerging markets with relevant policy experience have been part of the process from early on, and regional groupings have been established. What worries me more is the potential lack of effectiveness of the entire standards and codes process. Argentina shows, in my view, Gresham's Law in action—repaying debt with Reports on the Observance of Standards and Codes (ROSCs) rather than dollars, as it were. As Rojas-Suarez points out, Argentina has been one of the most prolific developing countries in publishing ROSCs on the International Monetary Fund (IMF) Web site, yet it is in deep crisis. In a 1999 report, the International Monetary Fund praised Argentina (for exceeding the requirements of the IMF Code of Good Practices on Fiscal Transparency), just when the rating agencies were starting to downgrade the country's sovereign debt because of fiscal concerns and markets were starting to send the country's dollar bond spreads higher. The other observation that feeds my concerns about the effectiveness of the process is that private capital flows to developing countries have been declining steadily since the process began. Either investors do not, or do not yet, pay attention to ROSCs, or no progress has been made.

Banks remain the most important financial intermediaries in developing countries. Counterproductive effects of bank capital regulation will thus be particularly harmful. Significant changes to the 1988 Basel Capital Accord are currently under discussion, and a final version (Basel II) is to be published in 2002, for implementation in 2005.



Rojas-Suarez has shown in this text, again very convincingly, that unlike the situation in industrial countries, the level of bank capital in developing countries fails to send warning signals ahead of a crisis, not least because of regulatory distortions that encourage bank lending to the public sector: local-currency public liabilities were assigned a zero risk weight in the 1988 Basel accord. This problem is set to change, however: The Basel Committee on Banking Supervision is now proposing two alternative main approaches to the calculation of risk weights: a standardized approach and an internal ratings-based (IRB) approach. Under the standardized approach, debt issued by a sovereign with a triple-A credit rating would receive a zero risk weight; lower ratings would translate into a jump in risk weights to 20, 50, 100, or 150 percent, with the highest weighting being reserved for sovereigns whose credit ratings are below B-minus. The IRB approach is based on mapping risk measures derived from probability of default, or of loss given default and maturity, into risk-weight buckets. Representative values for benchmark risk weights as a function of the default probability for corporate exposures are provided in the committee's proposal. Importantly, these values indicate not a linear but, rather, a strongly exponential rise in risk weightings as one moves along the spectrum toward a higher probability of default. This again should lead to much higher risk weights being imposed on bank holdings of claims against local public authorities.

Rojas-Suarez's chapter divides the world into three country groups in terms of their response to bank capital regulation. This division, which yields many helpful insights, will be overlapped by the strong distinction between investment-grade and speculative-grade borrowers in the Basel II proposals. Simulation exercises show that speculative-grade borrowers, which include the bulk of emerging-market and other developing countries, will suffer from a dramatic rise in debt costs if the IRB approach prevails (Reisen 2001). In contrast, the standardized approach, which links risk weights to ratings by eligible external credit assessment institutions, would leave banks' regulatory capital charges, risk-adjusted returns, and, hence, required yield spreads largely unchanged for most developing-country borrowers.

The concern that Basel II will raise the volatility of private capital flows to speculative-grade developing countries, and hence their vulnerability to currency crises, is based on four aspects of the proposed new accord. The first of these is the rigidity of the 8 percent minimum capital ratio. Linking bank lending to bank equity acts as an automatic amplifier for macroeconomic fluctuations: Banks already lend more when times are good, and less when times are bad, and rigid capital requirements reinforce that habit. Second, agency credit ratings define regulatory capital needs under the standardized approach, yet the cyclical determination of these ratings and the delay in their publication mean that ratings improve, and capital charges decline, during booms, whereas ratings are



lowered during busts, implying higher capital requirements. A third concern is the cyclical nature of the probability of default and of yield spreads, which determine regulatory capital needs and debt costs under the IRB approach. During the 1970–99 period, one-year default rates for speculative-grade borrowers oscillated between 1 percent in tranquil times and 10 percent in crisis years, largely as a result of global, not idiosyncratic, shocks. Such fluctuations in default probability would translate into corresponding procyclical shifts in risk weights, ranging from 100 to 500 percent for speculative-grade borrowers. Finally, the incentives for short-term rather than long-term interbank lending embedded in the Basel accord remain a concern; for speculative-grade developing countries, these regulatory incentives continue to tilt the structure of capital imports toward short-term debt and make them vulnerable to capital-flow reversals. The chapter by Rojas-Suarez demonstrates how this tilt introduces a short-term bias for domestic loans in developing countries.

Regional development banks should not only devote resources to capacity building to help their developing-country clients cope better with adherence to financial standards and codes, but they should also engage in research that investigates, under region-specific circumstances, whether standards are effective and productive or whether they risk producing unintended side effects.

Dani Rodrik (2001) reports World Bank research estimating that it costs a typical developing country \$150 million to implement the requirements of just three existing World Trade Organization agreements (those on customs valuation, sanitary measures, and intellectual property rights). He points out that this corresponds to a year's development budget for many of the least-developed countries. Such quantification of (opportunity) costs would also seem necessary in view of the proliferation of financial standards as well. The estimates should be published as part of any ROSC.

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