INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/131
FOR IMMEDIATE RELEASE
November 22, 2004

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Discusses Financial Sector Regulation: Issues and Gaps

On October 27, 2004, the Executive Board of the International Monetary Fund (IMF) considered an IMF staff paper, *Financial Sector Regulation: Issues and Gaps*, [1] which looks at issues relating to the design and implementation of financial sector regulation, and experience with the use of international standards in the areas of banking, insurance and securities sectors under the Financial Sector Assessment Program (FSAP).

## Background

In 2000, the IMF Executive Board endorsed a set of international standards in the area of financial sector regulation to help guide polices and reforms in Fund member countries, and thus contribute to stronger financial systems. The assessment of the observance of these standards by Fund member countries is being carried out mainly in the context of the FSAP, based on which Reports on Observance of Standards and Codes (ROSCs) are produced. A key objective of these assessments is to examine whether the regulatory and supervisory framework is adequate to address identified vulnerabilities and risks, and thereby provide an input in formulating the overall assessment of financial system stability.

The Executive Board also called for enhancing the effectiveness of the standards assessment process and to better reflect country specific circumstances. The Financial Stability Forum and the standard setting bodies also requested the Fund staff to provide periodic feedback on the

[1] See also: Financial Sector Regulation: Issues and Gaps—An Update (http://www.imf.org/external/np/mfd/2004/eng/102504.htm); Financial Sector Regulation: Issues and Gaps—Background Paper (http://www.imf.org/external/np/mfd/2004/eng/081704.htm)

experience with the assessment process, emerging issues for regulators, and the adequacy of international guidance given the risks and vulnerabilities observed in financial systems. Fund staff along with others has been analyzing and reviewing the experience with assessments of regulatory systems on a standard by standard basis, as well as working with standard setters on developing and refining financial sector standard assessment methodologies.

This paper provides a broad review of issues in financial regulation across banking, insurance and securities sectors, and highlights some of the practical issues in the implementation of good regulation across sectors. It examines the implementation of financial sector regulation in 36 Fund member countries where regulatory systems have been assessed in all the three sectors in the FSAPs carried out during 2000–2003. A cross-sectoral approach to the review of regulatory systems was chosen in order to identify common regulatory themes, largely because of the increasingly complex ways through which financial risks are being managed by banking, insurance, and securities firms. The paper also discusses the role of good quality regulatory preconditions, some issues regarding the standards themselves, challenges facing financial sector regulators posed by financial conglomeration and internationalization of finance, and structural factors such as dollarization and state ownership of financial institutions. The paper presents itself as work in progress, as more experience and knowledge is gained with assessments of regulatory systems under the FSAP. It emphasizes the need for a cooperative approach in addressing implementation issues involving the Fund, the World Bank, country authorities, and the standard setters.

**Executive Board Assessment**

Executive Directors welcomed the opportunity to discuss issues relating to regulation of financial systems and the experience with the implementation of financial regulatory standards in the banking, insurance, and securities sectors. They acknowledged that some useful conclusions can be drawn from the experience with the implementation of financial sector regulations on the basis of the findings of the Financial Sector Assessment Program in 36 Fund members in 2000–2003, but urged caution in the interpretation of the results owing to potential statistical limitations. They noted the staff's conclusion that, overall, the average level of implementation of the four regulatory components—regulatory governance, prudential framework, regulatory practices, and financial integrity and safety net arrangements—is broadly satisfactory in terms of the technical criteria under the regulatory standards. Directors had a wide ranging discussion on several aspects of the staff's analysis, in particular the significance of the regulatory weaknesses identified.

Directors considered high-quality financial regulation to be a key element of financial stability and important for Fund surveillance, as is being brought out in the Financial Sector Assessment Program. In increasingly integrated financial systems, cross-sectoral and cross-country regulatory issues—and particularly issues related to the design of cross-sectoral regulatory standards—are becoming more important. Directors broadly supported the approaches toward strengthening financial regulation and its implementation suggested by the staff, although a few of them felt that the report would have benefited from more forward-looking analysis and conclusions.

Directors agreed that the existence of certain preconditions—including sound macroeconomic policies, adequate legal and accounting frameworks and standards, and the availability of human and financial resources—is crucial for effective financial regulation. All concerned should, therefore, pay close attention to the adequacy of these regulatory preconditions when designing and implementing regulatory systems, or when assessing regulatory standards. The presence or absence of preconditions should be taken into account in staff assessments of observance of regulatory standards. This would help country authorities align their regulatory regime with the evolving structure of the financial system and the associated risks. In addition, ongoing efforts by standard-setters and country authorities to strengthen regulatory regimes could be usefully combined with reviews by all concerned parties of the regulatory objectives, the governance framework, the availability of resources, and the financial infrastructure on a system-wide basis. At the same time, Directors cautioned that standards should not be weakened to take account of the absence of these preconditions, and most agreed that standard setters should not take on responsibility for ensuring fulfillment of these preconditions by incorporating them in regulatory standards. It was also pointed out that lessons could be drawn from the experience of countries that had achieved strong regulatory implementation despite weak preconditions.

Directors emphasized the importance of continued efforts by standard setters and financial regulators to improve the treatment of cross-sectoral and cross-border issues in regulation. Most Directors agreed that the staff, in close collaboration and dialogue with standard setters, should conduct a stock-taking of barriers, gateways, and practices in these areas to identify common elements and differences. A few Directors suggested that—given the efforts already underway by other international groupings and private sector industry groups—additional work by the staff in this area should meet the test of whether Fund involvement is essential to filling clear gaps in knowledge. Directors called for further improvements in domestic and international coordination, and for exchange of information among regulatory and supervisory agencies. Directors encouraged the staff to work with standard setters to develop guidance on the regulation of financial operations with cross-sectoral and cross-border features. A few Directors called for the development of regulatory standards relating to cross-border remittances.

Directors noted the considerable diversity of financial systems, particularly in terms of their degree of development, dollarization, and the role of state-owned institutions. This would call for additional guidance by standard setters on the application of standards under such diverse conditions, given that standards generally have been developed in the context of advanced financial systems. However, Directors generally stressed that standards should be uniform across countries and guided by high-level general principles, although their implementation should be tailored to individual country circumstances and should not seek to force homogeneity in financial structure across countries. In this regard, many Directors were not in favor of revising existing standards to make them more reflective of structural shifts and diversity across financial systems. In particular, it was felt that separate standards are not needed for state-owned commercial banks. Some Directors suggested that implementation and assessment guidance notes for the staff could be useful vehicles for addressing the structural diversity factors. Attention should be focused on increasing the effectiveness of the current standards, and the staff should work with countries through technical assistance and advice to help them prioritize and sequence their efforts to comply with the various standards. Some Directors, however, felt that refining the current standards is needed to enhance their applicability.

Directors stressed that financial sector work is a key element of the Fund's mandate, and urged greater integration of this work into the Fund's country and multilateral surveillance and its lending operations. Directors considered the staff's role as envisaged in the paper to be broadly consistent with the conclusions of the recent surveillance review, which called for strengthening the coverage of financial sector issues in surveillance. Increased coverage of regulatory preconditions and practices in the context of ongoing surveillance will be useful, but the Fund should take care to limit this work to its areas of clear expertise, and work with others in the field, including the World Bank, to avoid duplication of effort. A number of Directors cautioned against a significant increase in the scope of work relating to preconditions without a further Board discussion on the matter, particularly given the possible resource implications. Fund technical assistance will continue to have a crucial role in supporting countries' efforts to meet financial sector standards. Directors agreed that the staff paper identifies some important issues that could guide further work by the respective standard-setting bodies. These include issues relating to the design and implementation of financial sector regulatory standards. For the respective standards, the IMF staff should work closely with international and standard-setting bodies without getting directly involved in standard setting itself. Directors asked the staff to provide periodic reviews on issues in financial regulation and their effect on financial stability. More broadly, the question of how to make the Fund's work on the financial sector even more relevant and effective will need to be kept under review as we go forward.