# SUMMARY OF REPORTS ON THE INTERNATIONAL FINANCIAL ARCHITECTURE

The Working Group on Transparency and Accountability The Working Group on Strengthening Financial Systems The Working Group on International Financial Crises

October 1998

# PREFACE

The international financial crisis that began in Asia and has now spread to other continents lends urgency to efforts to strengthen the architecture of the international financial system. The importance of these efforts was first given prominence in 1995 at the Halifax summit of heads of state and government of G-7 countries, and progress since has benefited from the involvement of finance ministries and central banks from both developed and emerging market economies.

In response to the crisis in Asia, Finance Ministers and Central Bank Governors from a number of systemically significant economies met in Washington, D.C. in April 1998 to examine issues related to the stability of the international financial system and the effective functioning of global capital markets.<sup>1</sup> In their discussions, Ministers and Governors stressed the importance of strengthening the international financial system through action in three key areas: enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises.

Three working groups were formed to contribute to the international dialogue on how to proceed in these key areas. A strength of these working groups was the diversity of their participants and the openness of their consultation process. Each working group comprised representatives from finance ministries and central banks of developed and emerging market economies; international organisations were invited to participate in the discussions; and contributions and views from other international groups, countries not represented in the working groups, and private sector representatives were sought.

The three working groups have prepared reports on the outcome of their discussions and recommended a range of actions to strengthen the international financial system.

#### ENHANCING TRANSPARENCY AND ACCOUNTABILITY

The Working Group on Transparency and Accountability considered the contributions that transparency and accountability can make to improvements in economic performance, as well as the nature of information needed for effective

<sup>&</sup>lt;sup>1</sup> The April meeting was attended by Finance Ministers and Central Bank Governors from Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom and the United States. The heads of the BIS, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee, attended as observers.

transparency and accountability.<sup>2</sup> Members attached particular importance to enhancing the relevance, reliability, comparability and understandability of information disclosed by the private sector. They recommended that priority be given to compliance with and enforcement of high-quality accounting standards.

There was consensus on the need to improve the coverage, frequency and timeliness with which data on foreign exchange reserves, external debt and financial sector soundness are published. Furthermore, members recommended that consideration be given to compiling and publishing data on the international exposures of investment banks, hedge funds and other institutional investors.

Transparency is an important means of enhancing the performance and public accountability of international financial institutions. Members recommended that international financial institutions adopt a presumption in favour of the release of information, except where release might compromise a well-defined need for confidentiality.

Members emphasised the importance of there being transparency about transparency. Members recommended that the IMF prepare a Transparency Report summarising the extent to which an economy meets internationally recognised disclosure standards.

#### STRENGTHENING FINANCIAL SYSTEMS

The Working Group on Strengthening Financial Systems sought consensus on principles and policies that foster the development of a stable, efficient financial system.<sup>3</sup> Members identified several areas – corporate governance, risk management (including liquidity management) and safety net arrangements – where standards for sound practices need to be enhanced or developed. The report outlines elements that such standards might contain and suggests ways forward.

Members emphasised that the implementation of sound practices is best fostered through market-based incentives backed by official sector actions. The report sets out a number of concrete actions to promote implementation.

Members recognised that cooperation and coordination among national supervisors and regulators and international groups and organisations are crucial to the strengthening of domestic financial systems. The report sets out several options for enhancing international cooperation: for example, the establishment of a

<sup>&</sup>lt;sup>2</sup> Representatives of the following economies contributed to the Working Group on Transparency and Accountability: Argentina, Australia, Brazil, Canada, France, Germany, Hong Kong SAR (co-chair), Japan, Malaysia, Thailand, the United Kingdom (co-chair) and the United States.

<sup>&</sup>lt;sup>3</sup> Representatives of the following economies contributed to the Working Group on Strengthening Financial Systems: Argentina (co-chair), Brazil, Canada, China, France, Germany, India, Italy (co-chair), Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Sweden, Thailand, the United Kingdom and the United States.

Financial Sector Policy Forum that would meet periodically to discuss financial sector issues.

#### MANAGING INTERNATIONAL FINANCIAL CRISES

The Working Group on International Financial Crises examined policies that could help to prevent international financial crises and facilitate the orderly and cooperative resolution of crises that may occur in the future.<sup>4</sup> The report should not be considered an agenda for addressing the problems currently being experienced in many emerging markets.

Members stressed the need to encourage better management of risk by the private and public sectors, and recommended that governments limit the scope and clarify the design of guarantees that they offer.

Effective insolvency and debtor-creditor regimes were identified as important means of limiting financial crises and facilitating rapid and orderly workouts from excessive indebtedness. The report outlines the key principles and features of such regimes.

Countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. Unilateral suspensions of debt payments are inherently disruptive. The report sets out a framework to promote the collective interest of debtors and creditors in cooperative and orderly debt workouts, and principles that could guide the resolution of future international financial crises.

#### CONSULTATION

The three Working Groups have sought to develop recommendations in areas where consensus could be achieved and have set out options for consideration in other areas. They recognise the importance of the views of others and welcome their advice and counsel. Interested parties in the private and official sector are invited to convey their comments to the secretariat (fax +41-61 280 9100) by end October, 1998.

<sup>&</sup>lt;sup>4</sup> Representatives of the following economies contributed to the Working Group on International Financial Crises: Argentina, Australia, Belgium, Brazil, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Korea, Mexico (co-chair), the Netherlands, Singapore, South Africa, Thailand, the United Kingdom and the United States (co-chair).

#### Report of the Working Group on Transparency and Accountability

# **EXECUTIVE SUMMARY**

The international financial crisis that began in Asia, like others that preceded it, demonstrates the importance of transparency and accountability. In particular, a lack of transparency and accountability exacerbated financial weaknesses at the firm and national levels and complicated efforts to resolve the ensuing crisis. To be sure, transparency and accountability are not a panacea. They would not necessarily have prevented the crisis. However, they might have helped to prevent the build-up of financial and economic imbalances, induced a prompter adjustment in policies, and limited contagion. In short, transparency and accountability help to improve economic performance.

Transparency refers to a process by which information about existing conditions, decisions and actions is made accessible, visible and understandable. Transparency contributes to the efficient allocation of resources by ensuring that market participants have sufficient information to identify risks and to distinguish one firm's, or one country's, circumstances from another's. Moreover, transparency helps to inform market expectations, thereby helping to stabilise markets during periods of uncertainty and also contributing to the effectiveness of announced policies.

There are also limits to transparency. Some categories of information are costly to compile, and so infrequent disclosure may be justified. Furthermore, confidentiality may be warranted in some circumstances: for example, to encourage frank internal policy deliberations. In determining the appropriate degree of transparency, the benefits must be balanced against the costs.

Accountability refers to the need to justify and accept responsibility for decisions taken. Accountability imposes discipline on decision-makers, thereby helping to improve the quality of decisions taken. Transparency helps to promote accountability by obliging decision-makers to make their decisions and the reasoning behind them known.

In the context of the international financial system, it is useful to distinguish between the transparency and accountability of three groups of participants: the private sector, national authorities and international financial institutions. The decisions made by any one of these groups are affected by the decisions, or anticipated decisions, of the other two. And there is room for significant improvement in the transparency and accountability of each of these groups.

#### TRANSPARENCY AND ACCOUNTABILITY OF THE PRIVATE SECTOR

There is a significant degree of consensus in the international community on the objectives and elements of private sector disclosures. Through financial statements and other disclosures, firms should provide information that is material to investors' decisions. Such information should reflect the following elements:

- *Timeliness* information of material importance should be disclosed on a periodic and timely basis, using a set of high quality, internationally acceptable accounting standards;
- *Completeness* financial statements should cover all relevant transactions, both on and off balance sheet;
- *Consistency* accounting policies and methodologies should be applied consistently over time, and any changes should be identified and related effects disclosed;
- *Risk management* the strategies used to manage risks should be disclosed;
- Audit and control processes firms should have effective systems of internal control, and financial statements should be reviewed annually by an independent auditor.

Poor disclosure practices in the private sector are attributable in part to the absence of principles and standards to guide the compilation and reporting of information. For example, sound practices on loan accounting and credit risk disclosure for financial institutions are only now being developed. But more importantly, poor disclosure practices stem from inadequate compliance with and enforcement of existing standards.

The Working Group recommends that national standards for private sector disclosures reflect five basic elements: timeliness, completeness, consistency, risk management, and audit and control processes.

The Working Group recommends that private firms adhere to national accounting standards and that national authorities remedy any deficiencies in their enforcement.

### The Working Group recommends that IASC give the highest priority to the completion of a core set of accounting standards and that IOSCO undertake a timely review of these standards.

Just as the crisis that began in Asia highlighted the importance of sound accounting practices, so too did it highlight the importance of improving data on the international exposures of banks and institutional investors. High quality, comprehensive creditor data permit reliable assessments of the vulnerability of domestic financial systems to financial crises abroad, are useful for identifying signs of weakness in debtor countries, improve the quality of debt statistics and balance of payments data, and facilitate efforts to restructure outstanding debt when a country is at risk of or in default.

International banking statistics have been disseminated by the Bank for International Settlements for many years, and improvements in the quality, timeliness and coverage of the BIS statistics have been initiated. The growing influence of institutional investors in global financial markets argues for complementary statistics on their international exposures.

> The Working Group recommends that countries with significant international financial activity that do not currently provide data to the BIS upgrade their statistical reporting capacity in order to be able to collect and report international banking statistics.

> The Working Group recommends that a working party comprising private sector representatives, international groups and national authorities be formed as soon as possible to examine the modalities of compiling and publishing data on the international exposures of investment banks, hedge funds and other institutional investors.

#### TRANSPARENCY AND ACCOUNTABILITY OF NATIONAL AUTHORITIES

One of the primary responsibilities of national authorities is the maintenance of macroeconomic stability. Thus, the transparency and accountability of national authorities require the provision of timely, comprehensive and accurate information about macroeconomic developments as well as macroeconomic policies. The private sector is increasingly providing economic and financial statistics, yet owing to the public good nature of information and to the externalities associated with the provision of economic data, the public sector is best positioned to compile and disseminate information about economic developments.

The IMF has established standards for the dissemination of macroeconomic statistics – the Special Data Dissemination Standard for countries seeking to access international capital markets and the General Data Dissemination System for all member countries. The crisis that began in Asia has revealed a need to strengthen these standards in the areas of reserves, external debt and indicators of financial sector soundness. Specifically, the recent crisis demonstrated that gross reserves can be a misleading indicator of the authorities' foreign currency liquidity position, i.e., of the foreign currency resources available to the authorities to meet a sudden increase in the demand for foreign currency liabilities and forward positions.

The Working Group recommends that national authorities publish timely, accurate and comprehensive information about their foreign exchange liquidity position, including their forward books.

In view of members' support for greater transparency about foreign exchange reserves, the Working Group recommends that the benefits and costs of greater transparency be given further consideration so as to determine the appropriate degree of transparency, e.g., frequency and timeliness.

The external liabilities of the broader public sector and the private sector often exceed those of the national authorities, and thus to facilitate assessment of a country's external position and exposure to foreign exchange liquidity risk, it is essential to supplement information about the national authorities' foreign currency liquidity position with data on the external position of other sectors. To this end, it would be desirable to have all subscribers to the SDDS compile and disseminate their international investment position – a detailed balance sheet of a country's external assets and liabilities. Moreover, it would be desirable to supplement the IIP with information about the foreign currency liquidity position of the public sector, the financial sector and the corporate sector.

### The Working Group recommends that national authorities compile and disseminate on a regular and timely basis information about the foreign exchange liquidity position of the public, financial and corporate sectors.

Whereas macroeconomic statistics are needed to assess the effectiveness of current policies, information about macroeconomic policies is needed to assess the policy framework and the policy stance. The general public and market participants need both sets of information to hold national authorities accountable for their policy decisions.

A framework for fiscal transparency has been developed by the IMF, based on the following four objectives: clarity of roles and responsibilities; public availability of information; open budget preparation, execution and reporting; and independent assurances of integrity. No such framework yet exists for monetary policy transparency, although there is consensus on the areas that such a framework should cover: policy objectives, operating targets, the policy reaction function and the decision-making process.

> The Working Group recommends that fiscal authorities observe the Code of Good Practices on Fiscal Transparency and that the IMF establish a mechanism for monitoring compliance with the Code.

The Working Group recommends that a diverse group of central banks be assembled to draft a code of best practices on monetary policy transparency, in co-operation with the IMF. Such a code would be part of the broader effort underway at the IMF to develop a code on monetary and financial policies.

# TRANSPARENCY AND ACCOUNTABILITY OF INTERNATIONAL FINANCIAL INSTITUTIONS

International financial institutions have played an important role in highlighting the importance of transparency and in the development and dissemination of internationally recognised disclosure standards. And to strengthen their credibility as proponents of transparency, as well as to enhance their accountability to the general public, IFIs have made significant efforts to improve the transparency of their own views and operations. Nevertheless, there remains room for improvement.

> The Working Group recommends that, as a general principle, IFIs adopt a presumption in favour of the release of information, except where release might compromise confidentiality.

> The Working Group recommends that IFIs establish, publicly announce and periodically revisit an explicit, well-articulated definition of the areas in which confidentiality should apply and the criteria for applying it.

Balancing the accountability and efficiency gains of greater transparency against the need for confidentiality poses challenges for all IFIs, but the challenges are arguably greatest for the IMF. For example, in terms of the transparency of its views about the sustainability of a member's current policies, a potential conflict arises when the IMF advises a country to adjust its policies or risk a crisis, which may spill over into other countries, but the authorities fail to heed the IMF's advice.

In weighing the benefits and costs, there was consensus in the Working Group against establishing a mechanical or formalistic system of progressively stronger public warnings identifying countries that failed to heed the IMF's advice. Members of the Working Group held divergent views on the merits of releasing Article IV reports and the staff mission's concluding statement following Article IV discussions between IMF staff and national authorities. There was consensus, however, in support of the release of other IMF documents.

> The Working Group recommends that national authorities support the publication of Letters of Intent, background papers to Article IV reports, and Public Information Notices following the Executive Board's discussion of Article IV reports.

### The Working Group recommends that the IMF publish policy papers, programme documentation such as Policy Framework Papers, and Public Information Notices following the Executive Board's discussion of policy papers and programme reviews.

The case for greater transparency regarding the policy advice and project assessments of multilateral development banks is less controversial than that for the IMF. Transparency at MDBs facilitates increased public participation in the design and implementation of development projects and thereby contributes to the local acceptance and ultimate success of projects.

> The Working Group recommends that MDBs publish all country assistance strategies, progress reports, environmental impact assessments, internal and external evaluations, and policy papers.

#### TRANSPARENCY REPORT: TRANSPARENCY ABOUT TRANSPARENCY

The existence of disclosure standards such as national accounting standards and the SDDS helps to highlight the importance of transparency. However, improvements in transparency depend on the implementation of and compliance with recognised standards. The benefits inherent in transparency provide the strongest incentive for compliance. But this incentive can be strengthened through monitoring, or independent assessments of a firm's or country's observance of recognised disclosure standards. Moreover, a monitoring mechanism is a crucial means of enhancing the credibility of a firm's or country's claim to be transparent or to have moved from a low transparency regime to a higher one.

# The Working Group recommends that groups that set disclosure standards also propose and help to establish mechanisms for monitoring compliance with those standards.

To improve accessibility and use, compliance assessments could be summarised and collected into a single, country-specific report – a Transparency Report. Considering the near-universality of its membership and the regularity of its consultations with national authorities, the IMF is well positioned to oversee the preparation of such reports. Transparency Reports could be published together with PINs following the Executive Board's Article IV discussions.

> The Working Group recommends that the IMF, in the context of its Article IV consultations, prepare a report – a Transparency Report – that summarises the degree to which an economy meets internationally recognised disclosure standards.

#### **Report of the Working Group on Strengthening Financial Systems**

# **EXECUTIVE SUMMARY**

Like many crises before it, the international financial crisis that began in Asia clearly demonstrates the importance of robust and efficient domestic financial systems. Weak banking systems and poorly developed capital markets contributed to the misallocation of resources that led to the crisis. Key to the strengthening of domestic financial systems is the implementation of sound practices for supervision, settlement, accounting and disclosure. This requires close international cooperation and collaboration among those in the official sector who are involved in the supervision of financial systems.

Implementation of sound practices requires that, first, there be a consensus on what constitutes sound practices. In many areas of banking supervision and securities regulation, international consensus has been reached and principles or standards have been established. In other areas, there still is a need to define best practices and develop standards. Standards should be developed in a collaborative manner to ensure that both the developed and emerging world have a voice in the standard-setting processes. The inclusion of a wider range of countries helps to ensure that the standards developed are more widely adopted in a timely fashion.

# The Working Group endorses this broad international consultative process for the development and refinement of sets of standards and sound practices.

The implementation of sound practices depends on incentives to do so. These can be in the form of market-based incentives, either alone or in combination with official or regulatory incentives. The global nature of financial markets highlights the importance of international cooperation among those in the official sector involved in the supervision of financial systems. The Working Group looked at ways to best foster cooperation and coordination to ensure consistent application and to make best use of the limited resources available to help strengthen financial systems.

#### **STANDARDS**

The Basle Committee on Banking Supervision (BCBS) has produced the *Core Principles for Effective Banking Supervision* and the International Organisation of Securities Commissions (IOSCO) has produced the *Statement of Objectives and Principles of Securities Regulation* and *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*. These, along with the

IMF's *Special Data Dissemination Standard*, represent a significant contribution to efforts to strengthen financial systems and should be implemented rapidly.

### The Working Group endorses these existing sets of principles and underscores the importance of their rapid implementation.

The Working Party considers it essential to develop sets of sound practice in the area of corporate governance. Economies become vulnerable to systemic stress when a large number of individual firms fails to formulate and pursue prudent business strategies, to establish and apply effective systems of internal control, and to monitor and manage the full range of financial and commercial risks to which they are exposed. The Working Group attaches particular importance to elements of corporate governance and structure relating to risk management and control – most notably the management of liquidity and foreign exchange risk. The mismatch between the maturity of foreign currency assets and liabilities in national banking systems must not get too far out of line with the capacity of the domestic authorities to supply foreign currency liquidity from the official reserves and any contingent financing that may be available.

> The Working Group considers it essential that sets of sound practices in the area of corporate governance continue to be developed, and supports the related efforts of the OECD and the BCBS. The Working Group encourages the prompt implementation of the BCBS recommendations regarding internal controls. The Basle-based committees, working together with the IFIs, should also consider the management of both domestic and foreign currency liquidity in different sectors. The IMF should give priority to work on the macroeconomic dimensions of liquidity and related risks.

The lack of well-developed money and capital markets is another important root cause of banking crises. The Working Party emphasised the importance of fostering the emergence and growth of these markets where they are not found currently and will seek concrete ways to give momentum to their development.

# SAFETY NETS

In the crisis in Asia the authorities faced difficult choices in considering whether, and on what terms, they would offer support so that financially troubled banks and non-bank entities could meet their obligations. Explicit safety net arrangements help to reduce the risk of indiscriminate extension of public guarantees. Yet care must be taken in designing them, as poorly designed or overly generous arrangements dull incentives to monitor risks, thereby increasing the likelihood of the crises they aspire to deal with. A well-designed set of explicit, ex ante procedures with pre-ordained hierarchies of claims and/or loss sharing arrangements reduces the need for ad hoc, ex post actions. The Group stresses the importance of identifying criteria to determine the appropriate limits on the extension of public guarantees.

Having in place a well-designed framework for the resolution process in the case of a future systemic crisis will alter expectations by the public and by institutional investors and may thus help to enhance financial stability. The Group's report introduces some basic guidelines and urges that they be developed further in a collaborative effort, drawing on the experience of various international fora.

The Working Group recommends adopting, implementing and enforcing a method of structured early intervention in the banking sector which includes a well-considered set of mechanisms to ensure a consistent, timely and graduated response by supervisors.

Depositor protection schemes are also part of the financial safety net. Among their most important goals are: increasing the stability of the financial system by reducing the risk of bank runs and contagion, and assisting small depositors who typically do not have the capacity to monitor the soundness of banks.

# The Group encourages the BCBS, with substantive input from the IMF and the World Bank, to develop guidelines for deposit insurance with emphasis on measures to reduce moral hazard and adverse selection.

Insolvency regimes are also an important part of an economy-wide safety net because they serve to make the risks and consequences of a failure of a corporate entity easier to quantify for all parties involved and lower the prospect of ad hoc, ex post assistance or guarantees which distort incentives. The Working Group on International Financial Crises developed key principles and features of effective insolvency regimes for commercial entities.

# The Working Group supports the key principles and features of insolvency regimes in view of their importance for enhancing financial stability.

When ex post actions are necessary, however, it is important to distinguish between restructuring banks and other financial institutions in "normal times" (defined by the absence of systemic risk within the financial system and through the economy at large) and in crisis situations. The Working Group will continue in its efforts to develop guidelines for restructuring of financial institutions in normal and crisis situations.

#### IMPLEMENTATION OF STANDARDS AND SOUND PRACTICES

Market discipline should be employed to promote the implementation of sound practices. However, such discipline does not work without adequate transparency and appropriate incentives to price risk. The lack of international consensus on sound practices for loan valuation, loan-loss provisioning and credit risk disclosure seriously impairs the ability of market analysts as well as regulators to understand and assess the risks inherent in a financial institution's activities.

### The Working Group supports the ongoing work of the BCBS in the improvement of asset valuation and loan loss provisioning and underscores the importance of IASC completing its set of core accounting standards.

It may make sense for financial market participants to establish a mechanism for developing collective, publicly available assessments of key aspects of national financial infrastructure – such as the supervisory systems for financial institutions; accounting and disclosure practices; corporate governance; legal regimes relevant to investment, including arrangements for dealing with insolvency; and payment and settlement systems.

The Working Group recommends that the official sector initiate a dialogue with relevant private organisations, professional groups and institutions on how the private sector can more effectively utilise the information that is now, or will become, available on the key institutional aspects of national financial systems.

Among regulatory tools, the Basle Capital Accord is an excellent example of a relatively straightforward regulatory device that has proved useful in focusing attention on the importance of bank capital. The Accord is under review, motivated in part by a desire to foster improved risk evaluation and management in conditions where the nature of banks' activities and financial techniques are undergoing rapid change.

# The Working Group advocates timely progress on this review of the Basle Capital Accord.

Access to major financial markets for emerging market institutions is an important element in the effort to strengthen financial systems. An international consensus on concrete criteria to be used by national authorities when determining conditions for market access could help to ensure equitable conditions for market entry and to prevent competition in laxity.

> The Working Group is of one view on the benefits of open access, but recognises that it should not occur in such a way as to undermine the quality of supervision. Principles guiding

#### national practices with respect to market access for banks should be developed jointly by industrial and emerging market countries. The IFIs could provide a forum for such efforts.

Conditionality for IFI programmes is a powerful means of fostering implementation of standards and sound practices and the Working Group supports the application of conditionality to measures pertaining to financial stability, recognising that the proper sequencing must be carefully considered as well as the impact on social stability, particularly in crisis situations.

Official oversight is another way in which implementation can be encouraged. The particular type and combination of oversight mechanisms (conditionality, surveillance, peer review, comprehensive technical assistance programmes) that are most suitable for enhancing financial stability will vary from country to country.

### The Working Group is of the view that all countries should go through some process of independent assessment, subject to the condition that the process meets certain minimum standards and contains a core set of elements.

With respect to surveillance, the IMF has the advantage of having a well established surveillance mechanism that covers all member countries. However, it lacks the resources and expertise to conduct financial sector surveillance alone. The World Bank, on the other hand, has greater resources and expertise in this field, but its country coverage is limited. The Working Group recommends that financial sector surveillance be anchored in the IMF's surveillance process but benefit from expertise at the World Bank and elsewhere. Serious consideration of using peer reviews as a component of, or complement to, financial sector surveillance is warranted.

# INTERNATIONAL COOPERATION

At present, supervision of the global financial system is fragmented both functionally and geographically, while global financial markets are becoming increasingly integrated. Geographical fragmentation is addressed through cooperation among different international groupings of functional supervisors, and the functional separation by cooperation among international groupings of banking, securities and insurance supervisors in the Joint Forum. The Working Party exchanged views on the adequacy of these arrangements and how they can be improved or reformed.

The Group also endorses the G-7 *Principles for Information Exchange*, and urges their implementation in industrial and emerging market countries.

The Group also considered global oversight of - and accreditation mechanisms for - supervisors to promote coordination across functions and to help support the independence of supervisors. To this end some members suggested seeking the involvement of the private sector. Other possible approaches include an international group of eminent experts to consult with supervisory authorities, and consideration of standards for internal managerial audits of supervisors.

Cooperation among IFIs and international groupings – to ensure effective surveillance and develop sets of sound practices – is important for strengthening financial systems. The Group discussed the need for enhanced cooperation among the IFIs (including regional MDBs) and international regulatory groupings, but has not yet developed thorough and concrete proposals.

The Group agreed that it would not be feasible to overhaul the IFIs, or set up a new large international financial institution. The division of responsibilities should reflect operational efficiency, avoid extending into each others' core activities, and enhanced accountability. In areas where responsibilities are shared, the IFIs need to ensure collaboration. The Group sees considerable promise in the following innovations:

- a Financial Sector Policy Forum in which finance ministry, central bank, regulatory and IFI representatives could meet to discuss international financial sector issues, across functional levels, and with full inclusion of systemically important emerging markets;
- a system for the exchange of information on financial sector regulatory and supervisory methods and findings; and
- a process of coordination or a clearing house to match demands from individual countries for technical assistance in financial regulation matters with the supply of experts.

The Group welcomes the setting up of the Basle Core Principles Liaison Group and plans for cooperation between the World Bank and IMF, including the creation of the Financial Sector Liaison Committee to adapt the division of work to country-specific situations, foster dissemination of standards and sound practices and help optimise the use of resources and facilitate joint work. The subject of enhanced cooperation will be explored further by the Working Group.

#### **Report of the Working Group on International Financial Crises**

# **EXECUTIVE SUMMARY**

The The larger scale and greater diversity apparent in recent capital flows to emerging markets have been of immense benefit both to emerging market countries and the world as a whole. However, they also allow crises to erupt and spread more quickly and with greater force than in the past. These new risks make it more essential than ever that countries pursue sound domestic policies to minimise their vulnerability to contagion.

Over the past year, many investors have suffered significant losses on certain emerging market debt instruments. As a result, there has been a general withdrawal of funds from emerging markets without respect for the diversity of prospects facing those countries. This report does not aim to address the critical current issues arising from this contagion. Rather, it focuses on the architecture required for the future. The international community has an interest in encouraging credit and investment decisions based on careful analysis that is focused on the long-term strengths and fundamentals of the economies involved. *Moreover, it is critical that the international financial system strengthen its ability to limit and better manage international financial crises, including appropriate roles for the official community and private sector.* 

This report identifies a range of policies and institutional innovations that could help prevent international financial crises and facilitate the orderly resolution of the crises that may occur in the future. It highlights questions that would have to be addressed in the context of a particular crisis, given the circumstances at the time and the types of instruments that are contributing to the crisis. It seeks to identify for further consideration principles that could help guide debtors, their private creditors and the official community in answering these often difficult questions. In particular, this report identifies for consideration policies that could help reduce the frequency and limit the scope of future crises, improve creditor coordination, and promote the orderly, cooperative and equitable resolution of the international financial crises that occur in the future. Some of the recommendations will require further examination and will take time to implement. The report should not be considered an agenda for addressing the problems currently being experienced in many emerging markets.

# POLICIES THAT COULD HELP REDUCE THE FREQUENCY AND LIMIT THE SEVERITY OF INTERNATIONAL FINANCIAL CRISES

The number and depth of recent payments crises have highlighted the critical importance of adopting policies to reduce their frequency and limit their severity. A range of policies can contribute to crisis prevention and help limit the scope of the crises which do occur. A number of these are examined in the reports of the other two Working Groups. This report highlights four issues in particular: limiting the scope of government guarantees; expanding the use of innovative financing arrangements that provide emerging markets with greater insurance against periods of market volatility; maintaining appropriate exchange rate regimes; and implementing effective insolvency and debtor-creditor regimes.

Implicit or explicit access to government resources on subsidised terms distorts market incentives and may encourage private debtors and creditors to take excessive risks.

Limiting, to the extent possible, the range of economic and financial activity that is covered, implicitly or explicitly, by government guarantees and ensuring that those guarantees which are offered are as explicit as possible and are "priced" appropriately, so as to reflect the risks being insured by the government, would contribute critically to crisis prevention.

The Working Group recognises the role of the government in protecting smaller depositors in the banking system and the overall integrity of the payments and financial system. However, preserving the stability of the financial and payments system does not require protecting individual banks, their managers or their equity owners from the risk of failure. (See the report of the Working Group on Strengthening Financial Systems for more detailed recommendations on the management of the financial safety net.)

Recent events have highlighted the continued vulnerability of many emerging markets to external shocks and the consequent need for the prudent management of their external liabilities.

> The Working Group encourages the development and greater use of innovative financing techniques that could provide, depending on the nature of the arrangements, either greater payments flexibility or the assurance of new financing in the event of adverse market developments.

Arrangements that could provide more flexibility in payments and greater risksharing among debtors and creditors include: pre-negotiated options that would allow the debtor to extend automatically the maturity of certain obligations, debt instruments under which repayments would be reduced in certain precise, contractually defined circumstances, or other insurance-type products. Contractual arrangements that would provide assured new financing or guaranteed liquidity in the event of market volatility include the contingent credit and liquidity facilities that several countries have recently negotiated. Such contingent credit and liquidity lines may provide additional liquidity at a lower cost than holding a comparable quantity of reserves and may also exert useful ex ante policy discipline. Governments should use such lines prudently, just as they should use their reserves prudently, and, in particular, should not use them as a means of postponing adjustment.

The choice of an exchange rate regime is one of the most critical policy choices any country can make. This report does not seek to resolve the complex issues associated with the choice of an exchange rate regime; it seeks only to identify certain issues so as to help policy-makers avoid policy mistakes which can contribute to an international financial crisis. It should be emphasised that the policy mistakes which can contribute to an international financial crisis can occur in the context of any exchange rate regime.

Recent events in Asia have highlighted the critical importance of strong insolvency and debtor-creditor regimes to crisis prevention, crisis mitigation and crisis resolution. Effective national insolvency regimes contribute to crisis prevention by providing the predictable legal framework needed to address the financial difficulties of troubled firms before the accumulated financial difficulties of the corporate sector spill over into an economy-wide payments crisis. Such a predictable framework is also essential to the orderly resolution of corporate financial difficulties, and thus is an essential element of any regime for orderly and cooperative crisis management. Among the most important basic objectives of an insolvency regime are: to maximise the ex post value of the firm, whether it is liquidated or reorganised; to provide a fair and predictable regime for the distribution of assets recovered from debtors; and to facilitate the provision of credit for commercial transactions by providing an orderly regime for the distribution of the proceeds of debtors' assets.

> The Working Group endorses the key principles and features of effective insolvency and debtor-creditor regimes outlined in Annexes A and B of this report and encourages further efforts in countries and in the relevant fora to strengthen existing insolvency and debtor-creditor regimes.

#### POLICIES TO ENCOURAGE CREDITOR COORDINATION

Difficulties associated with creditor coordination can preclude the orderly and cooperative resolution of international financial crises, as actions taken by an individual creditor in pursuit of its own self-interest, narrowly defined, can reduce the potential resources available for all creditors, in part, by failing to create a framework that provides the debtor with the time and incentives needed to adopt and implement the policy adjustments required for orderly crisis resolution. Certain contractual clauses – the collective representation clause, the majority action clause and the sharing clause – could be incorporated into the legal documentation of sovereign bonds issued in foreign offerings in order to encourage more effective creditor coordination should difficulties occur.

To encourage the adoption of such "collective action clauses", the Working Group recommends that their governments give consideration to: (i) engaging in educational efforts with identified constituencies in major financial centres to promote the use of collective action clauses in sovereign and quasisovereign bonds issued in foreign offerings; (ii) identifying sovereign and quasi-sovereign issuers likely to come to their markets soon and encouraging such issuers to use the collective action clauses; and (iii) examining the use of such clauses in their own sovereign and quasi-sovereign bonds issued in foreign offerings.

The Working Group discussed the possible merits and potential difficulties associated with the creation of new channels to enhance communication between the IMF, other international financial institutions and private market participants and emphasised the need for any arrangement to be fair and transparent.

# **PROMOTING THE ORDERLY, COOPERATIVE AND EQUITABLE RESOLUTION OF INTERNATIONAL FINANCIAL CRISES**

Recent events have highlighted how the larger scale and greater diversity of recent capital flows to emerging markets generate the risk that payments crises can erupt more quickly and can be larger in scope than in the past. The assistance and support of the IMF and other international financial institutions for their members in the event of a crisis, in the context of a strong programme of policy adjustments, remain critically important.

The IMF must have sufficient resources to remain capable of catalysing policy reform and the restoration of market confidence. Therefore, it is essential to implement rapidly the agreed IMF quota increase and to put into place the New Arrangements to Borrow (NAB).

Countries that anticipate possible difficulties should seek early assistance from the IMF, in order to reduce the risk that they will be placed in a position where they lack sufficient resources to meet their debt obligations in full. The combination of adjustment and financing typically associated with IMF assistance should be sufficient to resolve most payments

### difficulties and should continue to constitute the normal framework for managing and resolving international financial crises.

The size, sophistication and heterogeneity characteristic of recent international capital flows have reduced the relevance of the procedures used in the past to ensure an appropriate private sector role in resolving severe international financial crises. In particular, many such procedures were developed and proved effective during the 1980s, in an era when a small number of large international banks provided most capital flows to emerging markets.

The same capacity for innovation that enabled the private sector to help create markets for a range of new emerging market debt instruments should be applied to modernise existing procedures and institutions or to develop new practices that will contribute to the orderly and cooperative resolution of future crises.

Such innovation is required because the scale of private capital flows significantly exceeds the resources that can reasonably be provided by the official community, even with the needed quota increase to bolster IMF resources and other measures to supplement the ability of international financial institutions to provide emergency liquidity during severe financial crises. Moreover, the perception that sufficient official financial assistance may be made available to allow a country to meet all contractual obligations without some form of appropriate private sector involvement may distort the incentives of both creditors and debtors, encouraging some creditors to take unwarranted financial risk and some debtor countries to follow inappropriate policies.

A country that anticipates possible difficulties meeting the terms of debt contracts, public or private, should immediately undertake appropriate policy adjustments to enhance its capacity to meet those obligations. The international community has a clear interest in assuring that no country suspends debt payments as an alternative to policy reform and adjustment, given the costs associated with even a temporary suspension of payments.

### Countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time.

Nonetheless, it is unlikely that temporary interruptions in payments on some debt obligations would never occur, particularly if there were to be unanticipated adverse market developments. In cases where an interruption in debt payments is unavoidable, a voluntary, cooperative and orderly debt restructuring, combined with the adoption of a strong programme of policy reform to enhance the debtor's payments capacity, constitutes the most efficient means of crisis resolution. When the government of a crisis country faces the possibility that either it or a significant portion of the country's private sector may be unable to meet their obligations on time and in full, the government should initiate discussions with private creditors aimed at achieving a voluntary agreement on a strategy for addressing the country's debt problems.

In some circumstances, a purely voluntary approach may be impractical. In particular, it might consume so much time that it would lead to an erosion of confidence that would be contrary to the collective interest of creditors and debtors in a cooperative and equitable workout.

Recent experience has underscored the fact that unilateral actions, especially if they substitute for reform and adjustment, are highly disruptive.

In those extreme cases where a temporary suspension of payments cannot be avoided, experience indicates that a disorderly workout is against the interests of debtors, creditors and the international community.

A disorderly workout fails to promote the common interests of all parties in prompt and equitable crisis resolution in two ways: first, it fails to maintain incentives for the debtor to pursue a programme of strong and sustained policy adjustments that will allow the rapid restoration of market access and help maintain the value of outstanding creditor claims, and second, the absence of a rapid and cooperative restructuring of payments can itself contribute to poor economic performance, leading to a reduction in the total resources available for debt service. In extreme cases, it is particularly important for the government of the crisis country to maintain an open and transparent approach to the country's private creditors and work with them to achieve a cooperative, orderly restructuring of contractual obligations.

> In such extreme cases, the interests of all parties in orderly and cooperative restructuring of contractual obligations can be furthered by devising an enhanced framework for future crisis management that would allow the international community to signal its willingness to provide conditional financial support, where appropriate, in the context of a temporary payments suspension, in certain limited circumstances.

Such an informal signal should be provided only if, in the judgment of the international community, a government's decision to suspend debt payments reflects the absence of reasonable alternatives, if the government is undertaking strong policy adjustments and if the government is engaged in good faith efforts with creditors to find a cooperative solution to the country's financial difficulties. Such a signal has been provided in certain exceptional cases during previous crises, so as to support a comprehensive and credible programme of policy reform and to encourage the

negotiation of a cooperative agreement with creditors that places the country on a sustainable payments path, thus promoting the collective interests of both debtors and creditors.

The Working Group supports an IMF policy decision to indicate its willingness to consider providing financial support for policy adjustment, despite the presence of actual and/or impending arrears on the country's obligations to private creditors, including arrears on marketable debt instruments. Such a signal should be provided only if: the government of the crisis country is not interrupting debt payments as an alternative to reform and adjustment; it is implementing a strong programme of policy reform; it is making a good faith effort to work with creditors in finding a cooperative solution to the country's financial difficulties; and international support is critical to the success of a strong adjustment programme.

In some cases governments facing the need for a comprehensive restructuring of debt payments arising from an extreme international financial crisis have imposed temporary capital and exchange controls in order to buttress a temporary suspension of payments. The use of such controls should be considered only in exceptional circumstances and in conjunction with IMF-supported programmes of policy adjustments to create the conditions required for the restoration of financial and macroeconomic stability and the ultimate restoration of currency convertibility. Even in such circumstances, it may be determined that the large costs associated with the suspension of convertibility, given the extensive ties created by modern financial markets, exceeds the possible contribution such measures could make to limiting balance of payments pressures.

Several factors are likely to determine the speed with which a country regains market access, including: the policy measures adopted by the government; the stance of the IMF and the official community more broadly towards the government's policy decisions; and the approach the government adopts towards its private creditors. Recent events have demonstrated that a financial crisis in one country can augment greatly market pressure on other countries. In such circumstances, the official sector may want to provide additional financing to countries which are pursuing appropriate policies but who nevertheless face increased pressure.