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WHEN DO GOVERNMENTS IMPLEMENT VOLUNTARY CODES AND STANDARDS?

THE EXPERIENCE OF FINANCIAL CODES IN EAST ASIA

Andrew Walter

Senior Lecturer in International Relations, London School of Economics

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Andrew Walter

Dr Andrew Walter is Senior Lecturer in International Relations at the London School of Economics, specializing in the political economy of international money and finance. He has published articles on the political economy of international money, finance and investment, on the history of thought, and a book on international monetary relations since 1870 (World Power and World Money: The Role of Hegemony and International Monetary Order [1993]). He is currently completing a book on the implementation of international financial regulatory standards in East Asia since the crisis.

Abstract

Can there be a world-wide 'race to the top' in financial regulatory practices? The international standards and codes issued by major international institutions in recent years assumes this is possible. In this paper, I consider to what extent this effort has been successful in East Asia. East Asia is a good case study of compliance with this new regime for at least three reasons. First, East Asian countries were a particular focus of this international convergence strategy because of the widely accepted view that inadequate financial sector supervision was a fundamental cause of the Asian crisis of the late 1990s. Second, the standards and codes themselves are largely based upon a western, even Anglo-Saxon, model of financial sector governance that poses special difficulties for many East Asian economies. Third, as I demonstrate below, there are considerable differences within East Asia relating to the degree of success in compliance with the standards and codes, and across different standards. Exploring these differences can help to illuminate the causes of failure and success in compliance in general.

Introduction

Can there be a worldwide 'race to the top' in financial regulatory practices? The approach of the major countries, working through various international institutions in recent years to promote a set of global 'best practice' standards and codes, appears to assume that such convergence is indeed possible. In this paper, I consider to what extent this effort has been successful in East Asia.

East Asia is a good case study of compliance with this new regime for at least three reasons. First, East Asian countries were a particular focus of this international convergence strategy because of the widely accepted view that inadequate financial sector supervision was a fundamental cause of the deep crisis in Japan and subsequently in other East Asian economies. Indeed, in the wake of the 1997-8 financial storm that hit East Asia, most governments in the region pledged to adopt international regulatory best practices. Second, the standards and codes themselves are largely based upon a western, even Anglo-Saxon, model of financial sector governance that has posed special difficulties for many East Asian economies. Third, as I demonstrate below, there are considerable differences within East Asia relating to the degree of success in compliance with the standards and codes, and across different standards. Exploring these differences can help to illuminate the causes of failure and success in compliance in general.

The organization of this chapter is as follows. Section One outlines the nature and origins of the new international financial regulatory regime represented by the standards and codes. Section Two presents a theory of compliance and elaborates an hypothesis on the determinants of compliance and compliance failure. Section Three considers whether this helps to explain the actual degree of compliance in East Asian countries in some specific areas of regulatory policy. A fourth and final section discusses the implications for successful financial regulatory reform.

I argue that the main problem with the standards and codes strategy is that it underestimates the likelihood of compliance failure in reforming countries, as does some recent academic work.[i] In some cases, formal and real compliance is substantial, but in others, external pressure has not succeeded in producing either. In yet other cases, formal convergence is high but real compliance failures often remain chronic, with potentially dangerous consequences. If market pressure for compliance is therefore often weak, so too is pressure from the IMF and World Bank. Indeed, there are reasons to doubt that these international institutions have a strong interest in exposing the degree of compliance failure in the region and in developing countries generally.

International financial standards and codes and the Asian crisis

Origins of the standards and codes exercise

The initial steps towards an international regime for financial regulation began in 1974, with the creation of the Basle Committee on Banking Supervision (BCBS) by the G-10 central bank governors under the auspices of the Bank for International

Settlements (BIS). In response to the globalization of banking, the BCBS subsequently agreed the Basle Concordat on the sharing of supervisory responsibilities in 1983 and the Basle Capital Adequacy Accord of 1988 (Kapstein 1994). The key objective was to agree some minimum standards of banking sector supervision and to encourage their adoption in the major developed countries.

Adoption proceeded via the voluntary agreement of bank regulators in the G-10 countries, though in practice most developing countries also formally adopted the 1988 Capital Accord in the 1990s (Ho 2002). Even though the Accord was a product of political compromise rather than reflecting 'best practice', its political success entrenched the position of the BCBS at the heart of global financial regulatory standard setting. It also suggested that there could be powerful incentives for non-signatory governments to converge, at least in formal terms, upon standards set by rich country regulators. Less noticed by commentators at the time was that convergence on the detailed provisions of the Accord was often poor.

In the 1990s, attention shifted towards financial regulation in the developing world, or as the politically correct would have it, 'emerging market' economies. The emergence of the 'Washington Consensus' on economic policy in the late 1980s reflected a growing confidence in the appropriateness of western economic policy models for developing countries. Then, in late 1994, the vulnerabilities posed to developing countries by the growth of short term portfolio capital flows was underlined by the Mexican crisis. The crisis of this star pupil of Latin American economic reform led to a heated debate about the virtues of capital account liberalization in particular. The G-7 countries placed particular emphasis upon the lack of timely and reliable publicly available data relating to Mexico's financial and general economic position in the lead-up to the crisis. 'Transparency' became the new mantra.[ii]

The IMF was to take the lead in establishing benchmarks for the public provision of timely and reliable economic data. This subsequently led to the creation of the Specific and then the General Data Dissemination Standards (SDDS, GDDS) in March 1996 and December 1997 respectively. The SDDS was specifically designed 'to guide countries seeking access to international capital markets in the dissemination of economic and financial data to the public.' Within little more than two years, however, it became clear that transparency by itself would not solve the problem. Thailand, notably, had posted data to the SDDS since 19 September 1996 (as had Malaysia, the Philippines and Singapore), well before the Baht crisis broke. Indonesia had posted its data on 21 May 1997.[iii]

The impact of the Asian crisis

When much of East Asia succumbed to financial crisis only a few years after Mexico, the reform debate was reignited and ranged more broadly than at any time since the Bretton Woods conference of 1944. Although there were different interpretations of the Asian crisis, the one that most appealed in official circles in the developed world blamed poor domestic governance, exacerbated by cronyism and corruption, for creating moral hazard in the financial and corporate sectors (Krugman 1998; Corsetti et al 1998).[iv] As an IMF review in 2000 stated, 'financial sector vulnerability was at the root of the Asian crisis.' (Boorman et al. 2000: 5). This

interpretation also played an important role in the design of the structural reforms contained in the IMF-led rescue packages (Blustein 2001). The same critique of the crisis-hit developing countries in the region had already been applied to Japan by officials in the US and Europe.

The conventional wisdom that evolved out of Asia's crises in the 1990s, then, was that domestic financial sector governance should move to the very top of the international reform agenda. The proposed solution was essentially to promote a move in key developing countries from (putting it kindly) a 'relational-patrimonial' system of financial regulation towards a western-style arms-length, 'rules-based' system of prudential regulation and supervision. The elaboration and promotion of the international standards and codes was, on the model of the Basle Capital Accord, to be the means of achieving such convergence.

This standard-setting effort is now largely complete, although work continues on upgrading the various standards and codes. At the apex of this regime are the twelve 'key standards for sound financial systems'. Table 1 outlines these key standards, the international standard-setting body responsible for their issuance and the date of promulgation. As can be seen, the standards range from sectoral (e.g.: banking regulation) and functional (e.g.: accounting) areas, to the actual making of substantive policy (e.g.: fiscal policy) and the transparency of policy (e.g.: SDDS).

Table 1: Description of International Standards and Codes

Year of Adoption	Standard-Setter	Standard or Code and Official Objective
Macroeconomic Policy and Data Transparency Standards		
1996-7	IMF	*Special Data Dissemination Standard* (SDDS), *General Data Dissemination Standard* (GDDS): The SDDS serves to guide countries that have, or that might seek, access to international capital markets in the dissemination of comprehensive, timely, accessible and reliable economic, financial and socio-demographic data to the public. The GDDS serves to guide any member countries in the provision to the public of such data.
1998	IMF	*Code of Good Practices on Fiscal Transparency*: contains transparency requirements to provide assurances to the public and to capital markets that a sufficiently complete picture of the structure and finances of government is available so as to allow the soundness of fiscal policy to be reliably assessed.
1999	IMF	*Code of Good Practices on Transparency in Monetary and Financial Policies:* identifies desirable transparency practices for central banks in their conduct of monetary policy and for central banks and other financial agencies in their conduct of financial policies.
Institutional and Market Infrastructure Standards		
1990/2002	FATF	*The Forty Recommendations of the Financial Action Task Force on Money Laundering*: set out the basic framework for effective anti-money laundering policies. *Special Recommendations on Terrorist Financing*: set out the basic framework to detect, prevent and suppress the financing of terrorism and terrorist acts.
1999	OECD	*Principles of Corporate Governance*: aimed at improving the legal, institutional, and regulatory framework for corporate governance in OECD and non-OECD countries.
2001	CPSS/IOSCO	*Core Principles for Systemically Important Payment Systems (CPSIPS), Recommendations for Securities Settlement Systems (RSSS):* CPSIPS sets out core principles for the design and operation

		of systemically important payment systems. RSSS identifies minimum requirements that securities settlement systems should meet and the best practices that systems should strive for.
2002	IFRSB	*International Accounting Standards*: set out principles to be observed in the preparation of financial statements. A total of 41 IFRS have been issued as of July 2003; updating is ongoing.
2002	IFAC	*International Standards on Auditing*: ISAs contain basic principles of auditing and essential procedures together with related guidance in the form of explanatory and other material.
2001 draft, not yet agreed	World Bank	*Principles and Guidelines for Effective Insolvency and Creditor Rights*: intended to help countries develop effective insolvency and creditor rights systems.
Financial Regulation and Supervision		
1997 (revised 2000)	IAIS	*Insurance Core Principles*: comprise essential principles designed to contribute to effective insurance supervision that promotes financial stability.
1998	IOSCO	*Objectives and Principles of Securities Regulation*: designed to help governments to establish effective systems to regulate securities markets and to promote investor confidence.
1999	BCBS	*Core Principles for Effective Banking Supervision:* intended to serve as a basic reference for bank supervisory and other public authorities in all countries and internationally. The 25 basic principles are considered essential for any bank supervisory system to be effective.

Source: IMF and Financial Stability Forum websites; US GAO 2003: 53-5.

There are a number of things to note about this list. First, it reflects how core aspects of domestic economic regulation and governance have become a matter of international concern and negotiation. Second, all of the standards are of relatively recent origin, most post-date the onset of the Asian crisis in July 1997, and some are still in the process of formulation. Third, a wide range of international institutions is responsible for standardsetting, including the major international financial institutions (IFIs) and other more specialized standard-setting bodies (including the International Accounting Standards Board and the International Federation of Accountants, both of which are private sector organizations). Fourth, each of the 12 key standards contains detailed specific codes and principles. By January 2001, in effect, the standards Compendium[v] comprised in total 71 specific standards said to be important for financial stability; the list has since grown. Nevertheless, there is recognition of the need for national flexibility in their implementation, so that even these more detailed rules often remain somewhat abstract. Lastly, many of these standards are interdependent (e.g.: accounting, auditing, and corporate governance standards).[vi]

The Basle Committee's 25 Core Principles for Effective Banking Supervision (hereafter 'Core Principles'), issued in September 1997, is one of the most important key standards (table 2). Along with the Corporate Governance principles and International Financial Reporting [i.e. Accounting] Standards (IFRS), these constitute a central pillar of financial sector regulation and prudential supervision. The Core Principles do not shy away from the basic political issues involved. The first principle, the 'precondition' for effective supervision, advocates what is by now G-10 conventional wisdom: political independence for financial regulators, a clear set of responsibilities and objectives, the power to enforce compliance, legal protection for supervisors, sufficient financial resources, and so on. The discussion on principles 2 and 3 suggests that 'clear and objective criteria… reduce the potential for political interference in the licensing approach.' (BCBS 1997: 15-16). Generally, '[t]he Principles are minimum requirements…intended to serve as a basic reference for

supervisory authorities in all countries and internationally.' (BCBS 1997: 2). The sub-text is fairly clear: excessive state intervention of a discretionary kind, as in many East Asian countries prior to the crisis, is likely to create problems of moral hazard and chronic regulatory failure.

Table 2: Summary of BCBS Core Principles for Effective Banking Supervision (September 1997)

1. **Supervisory framework**
2. **Permissible activities of banks**
3. **Bank licensing criteria**
4. **Ownership review powers**
5. **Investment review powers**
6. **Minimum capital requirements for banks**
7. **Bank credit policies**
8. **Loan evaluation, provisions**
9. **Large exposure rules**
10. **Connected lending rules**
11. **Country risk rules**
12. **Market risk rules**
13. **Other material risk rules**
14. **Internal control systems**
15. **Preventing fraud**
16. **Onsite/offsite supervision**
17. **Contact with management**
18. **Offsite supervision rules**
19. **Mechanisms for independent validation of information**
20. **Consolidated supervision**
21. **Accounting / disclosure**
22. **Remedial measures / exit**
23. **Global consolidation**
24. **Host country supervision**
25. **Supervising foreign banks**

Source: BCBS, available at www.bis.org

Compliance mechanisms

All of the international institutions involved in the standards and codes exercise recognize that promulgation is one thing and compliance is another. The elaboration of a new set of global regulatory benchmarks and transparency in disclosure are seen as crucial in this regard, on the assumption that market pressure will promote compliance even where it is resisted. In addition to market pressure, the IFIs also have an important role to play in encouraging their members to adopt the key standards and codes. Country compliance with standards and codes has been part of the IMF's ongoing Article IV surveillance role since May 1999. The IMF Executive Board has included observance of standards among factors taken into consideration in committing financing to a country under the Contingent Credit Line (CCL) facility.[vii] As we have seen, the upgrading of financial regulatory, accounting and corporate governance standards were also prominent aspects of the IFIs' conditionality packages in Asia and elsewhere in the late 1990s.

In addition, the joint Fund-Bank Financial Sector Assessment Programmes (FSAPs) are intended to allow for dialogue between the IFIs, their executive boards, and national governments on financial sector stability and governance. FSAPs, which are voluntary, 'include a systematic assessment of compliance with the Basle Core Principles for Effective Banking Supervision, transparency practices in monetary and financial policies, and -- if relevant -- standards for securities markets, insurance, and payment systems. Other legal and institutional issues that bear on the financial sector may also be reviewed.'[viii] These reports form the basis of Financial System Stability Assessments (FSSAs), of which 39 had been published as of end January 2003.

Related to FSAPs and FSSAs are the Reports on the Observance of Standards and Codes (ROSCs). These reports, initiated in January 1999 by the IMF, provide summary assessments of countries' observance of particular standards considered to be most important by the Fund. As with FSAPs, participation in ROSC modules is voluntary, though the Fund and Bank have given consideration to making it mandatory.[ix] There is a presumption of publication but this too is voluntary. By May 31 2003, 91 countries (of 184 members) had completed 410 ROSC modules in total, of which 292 have been published for 79 countries (IMF 2003).

The East Asian countries have been especially slow to undertake and to publish ROSCs and FSAPs (though this is also true of the US). With the exception of Hong Kong, which participated in the programme at an early stage, the major East Asian economies had not published any compliance assessment reports by the beginning of 2003, more than 5 years after the crisis.[x] Korea and then Japan eventually published FSSAs and related ROSCs in 2003, but China, Indonesia, Malaysia, Singapore and Thailand are complete non-participants (Taiwan is not an IMF member). Of the nine East Asian countries listed in table 3, an average of only three countries has published ROSCs in such key areas as banking, insurance, and securities supervision and corporate governance. Although this is similar to overall publishing rates for all IMF members, it is at odds with the conspicuous post-crisis rhetorical commitment of most East Asian governments to compliance with the standards and codes.

Table 3: Published FSSAs and ROSCs, major East Asian countries, as of 4 February 2004

	FSSA	*Data*	*Fiscal*	*MPFT**	*Banking*	*Insurance*	*Securities*	*Payments*	*Corp.Gov.*	*Accounting*	*Insolvency*	*AMLTF**	*Total*	*SDDS?*
China													**0**	
Hong Kong	27-Jun-03	30-Aug-99	30-Aug-99	30-Aug-99	30-Aug-99	27-Jun-03	27-Jun-03	27-Jun-03	27-Jun-03			27-Jun-03	**10**	12-Jul-00
Indonesia													**0**	02-Jun-00
Japan**	05-Aug-03		04-Sep-01	05-Aug-03	05-Aug-03	05-Aug-03	05-Aug-03	05-Aug-03					**7**	09-Jun-00
Korea	19-Mar-03	15-May-03	23-Jan-01	19-Mar-03	19-Mar-03	19-Mar-03	19-Mar-03	19-Mar-03	19-Mar-03				**9**	01-Nov-99
Malaysia													**0**	01-Sep-00
Philippines			04-Oct-02						30-Sep-01	17-Dec-01			**3**	17-Jan-01
Singapore													**0**	30-Jan-01
Thailand													**0**	16-May-00
Total	**3**	**2**	**4**	**3**	**3**	**3**	**3**	**3**	**3**	**1**	**0**	**1**	**29**	**8**

Source: IMF website.
* MPFT is Monetary Policy and Fiscal Policy Transparency; AMLTF is Anti-Money Laundering and Terrorist Financing.
** Japan's 'ROSCs' are summary assessments contained within its FSSA report; these are not published separately on the IMF website.

Of course, compliance with standards and codes is also possible without external assessments, though resistance to such assessment inevitably raises suspicions. Before turning to the question of East Asian compliance in practice, however, the following section outlines a theory of compliance.

Compliance in theory

Definitions

Some authors assume that once international standards are promulgated, the external market and official pressures for compliance outlined above will be sufficient to ensure compliance (e.g.: Soederberg 2003). I argue below that this is mistaken and that a significant gap between formal and real compliance may occur in particular cases.

It is necessary first to distinguish between international 'rules' and 'standards', since I am only interested here in the latter.[xi] In what follows, I use these terms to distinguish between international agreements that possess legally binding status ('rules') and those that do not ('standards').[xii] *International rules* are agreed between states in the form of international legal treaties and often have some form of explicit compliance mechanism attached. *International standards*, by contrast, are voluntary, and may not relate to any specific membership or group of countries (Jordan and Majnone 2002: 15). Generally, according to the FSF, standards 'set out what are widely accepted as good principles, practices, or guidelines in a given [policy] area.'[xiii]

Nevertheless, while international standards are often made to sound like motherhood and apple pie, they can raise fundamental economic and political issues that affect compliance. Representatives from the major western economies have undoubtedly dominated the standard-setting process for the various standards and codes considered here. The perception that they are not just western but Anglo-Saxon

in origin and forced on developing countries via IFI conditionality inevitably creates what the IMF likes to refer to as 'ownership problems'.[xiv] Though I have no space here to investigate the interesting question of the legitimacy of the existing international standards, clearly where this is lacking it may increase the unwillingness of governments and private sector actors to comply.

Rather than focus on this legitimacy question here, I discuss cases in which international standards are simply more stringent and onerous than existing domestic standards, posing significant 'compliance costs' for private and public sector actors. This is generally true for most developing countries, including the more advanced ones. Two other aspects of compliance costs and benefits reinforce my expectation that compliance will often be costly for governments and hence avoided. First, compliance costs often tend to be distributionally concentrated (e.g.: banking regulatory standards raise costs for the banking sector), whilst compliance benefits tend to be widely distributed (e.g.: greater financial and economic stability). This makes standards compliance rather like trade liberalization, and rather different from 'technical standards'.[xv] Second, compliance costs are likely to be concentrated in the short run, whilst compliance benefits are likely to be more uncertain and longer run in nature.

I define compliance to mean more than just 'implementation', which occurs when organizations take the necessary steps to ensure that official policies and regulations are consistent with specific standards. But implementation is not necessarily sufficient to ensure full compliance. *Compliance* 'occur[s] when the actual behaviour of a given subject conforms to prescribed behaviour, and non-compliance or violation occurs when actual behaviour departs significantly from prescribed behaviour' (Young 1979: ???). A gap may arise between implementation and compliance if individual actors in the public or private sector fail to comply with officially prescribed behaviour. In the case of SDDS, real compliance maybe undermined if the data provided to the IMF is not provided in good faith or is of poor quality (the IMF is not in a position to check this).

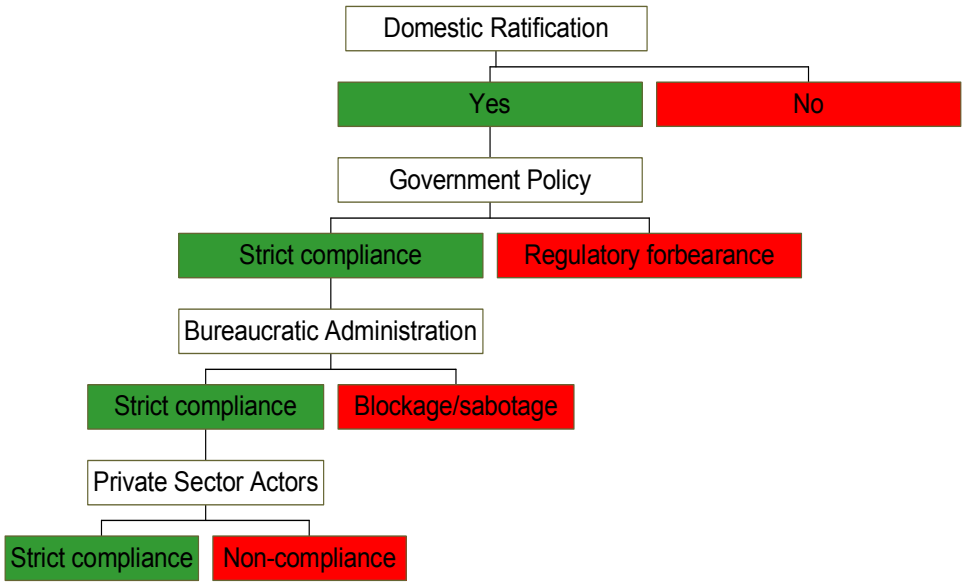
Note also that the intended 'target' for compliance depends upon the nature of the rule or standard. Some international rules and standards only require or constrain aspects of public sector behaviour (e.g.: the international law on human rights and the SDDS). Other international rules and standards have as their ultimate compliance targets private sector agents, though the mechanism through which private sector compliance is promoted may be public policy (e.g.: international accounting, corporate governance and prudential banking standards). A government could comply by adopting legislation requiring domestic companies to report according to IFRS. But insufficient domestic capacity (in firms and in the public sector) to monitor compliance and sanction non-compliance may mean that private corporations have weak incentives fully to comply.

Different kinds of compliance failure

Thinking through the 'stages' of compliance, there are four main kinds of compliance failure: failure by a country's legislative body to ratify formally an international rule or standard, failure by the government to apply adopted standards as policy, failure by implementing bureaucracies fully to implement new standards, and

failure by the private sector fully to comply with adopted standards. I term these ratification failure, regulatory forbearance, administrative failure, and private compliance failure respectively (figure 1).

Figure 1: Four Types of Compliance Failure



Using this classification, we can discern associated reasons as to why non-compliance with international standards can occur. 'Ratification failure' occurs when proposed reforms fail to be adopted by a legislature, due to organized political opposition to a given set of reforms. Even though, for example, a government may have negotiated a set of reforms with the IMF as a condition of borrowing, it may be unable to ensure the parliament adopts the agreed reforms. Such failures may be due to various reasons, but stem at bottom from an inability of the government to control the legislative chamber, due to its commanding insufficient votes, the existence of veto players, etc (Putnam 1988; Milner 1997).

'Regulatory forbearance' occurs when the government itself intentionally refrains from strictly enforcing the new laws, systematically or on an *ad hoc* basis. As in the classic 'time-inconsistency' problem in monetary policy, it may be optimal for the government to commit itself to the adoption of international standards and subsequently to engage in regulatory forbearance (e.g.: because the strict application of new prudential rules could lead to a contraction of private sector credit). Only at the implementation stage may the full costs of compliance with international standards become clear to all powerful actors, leading to a rear-guard effort to push for forbearance. Regulatory forbearance includes allowing technically insolvent banks to continue operating, temporary relaxations or non-application of rules relating to bad loan accounting or provisioning, turning a blind eye to violations of exposure rules, rapid deregulation of new lines of business to allow banks to build profits, etc (Honohan and Klingebiel 2000: 7). As such, it usually involves the government over-riding standard bureaucratic rules or procedures.

Even if legislation has passed into law and governments intend to apply the new standards strictly, compliance failure may still occur if governments cannot ensure that implementing bureaucracies and/or private sector actors comply. 'Administrative failure' may occur for a number of reasons. The government may seriously try to enforce the new laws but low bureaucratic capacity, including inadequate or insufficient bureaucratic skills and competence, may undermine effective compliance. To the extent that capacity is a matter of political choice, governments may even consciously undermine compliance by strategically under-funding implementing agencies. Public officials may also have much to gain from colluding with private agents who would otherwise find compliance costly (i.e. corruption).[xvi] Highly independent and powerful agencies may also obstruct compliance. By strictly applying regulations that force bank failures, for example, regulators may leave themselves open to accusations of past negligence or incompetence.[xvii]

The final source of compliance failure, private sector defection, may occur if hortatory standards rather than binding rules are adopted, or if legal enforcement systems are weak or corrupt. In practice, it may often be difficult to distinguish between forbearance, administrative compliance failure and private sector defection. Whether or not the government truly wishes to implement the reforms but is prevented from doing so by blocking agents (such as stubborn or corrupt bureaucracies and private actors), or whether the government in fact encourages or turns a blind eye to bureaucratic forbearance can be difficult to tell. Often it will be in the interest of a government, particularly one that has agreed reforms with an IFI as a condition of borrowing, to argue that the source of compliance failure is out of their control and defection from the agreement is 'involuntary' (cf. Putnam 1988).

Table 4: Characteristics of types of compliance failure

Type of failure:	***Manifested by:***	***Compliance: key actors:***
Ratification failure	Legislative failure	Legislature (veto players)
Administrative failure	Administrative corruption/sabotage/incapacity	Very strong, very weak, or corrupt bureaucracies
Regulatory forbearance	Government-led non-compliance	Key ministries (subordinated bureaucracies)
Private sector defection	Private sector non-compliance strategies	Private agents (though these may lobby or bribe public sector agents)

Table 4 summarizes the main characteristics of the three types of compliance failure. Of course, a political system may suffer from all at once, at least in different areas of policy. It should also be noted that even if legislation fails to pass the legislature, this may not rule out other forms of compliance failure. Even if new rules fail to become formal law, it may be that bureaucracies nevertheless adopt, perhaps with government encouragement, new rules to guide their behaviour. For example, a number of central banks have moved to adopt best practice regulatory and supervisory standards in recent years when governments have not formally adopted these standards. In such cases, all forms of compliance failure could potentially co-exist. In practice, we would expect domestic interests opposed to compliance to direct their attention elsewhere if implementing legislation is passed by the national legislature.

Compliance costs, monitoring, and the 'real compliance gap': the implications of private information

As mentioned previously, I focus here on cases in which existing domestic standards are less onerous than new international standards and where the compliance costs are substantial. Also, although there are a number of factors that potentially affect compliance, I only focus upon the relationship between two such factors here, compliance costs for 'targets' and compliance monitoring costs for third parties.[xviii]

Compliance costs are indeed likely to be high for the private sector in East Asia in the case of the various prudential standards, as family ownership is predominant across Asia and pyramid ownership structures often result in opaque ownership and control, along with relationship-based bank lending (Capulong et al 2000: vol.1, 23-28). Low levels of bank capitalization and poor corporate profitability, especially after the crisis, mean that higher prudential and disclosure standards will be costly for banks and for their customers. Furthermore, the bureaucratic compliance costs are likely to be substantial in the short run (Bebchuk and Roe 1999; Pistor 2000). As noted above, compliance benefits tend to be more widely spread and longer term, mitigating against compliance in such countries.

Even if the private sector is largely opposed to compliance in such cases, governments and the private sector themselves may still be under considerable pressure from international investors and the IFIs to comply. The main argument presented here is that actors may try to square this circle via formal or 'observable' compliance without 'real' or substantive compliance. They will do so *if* they believe it will be difficult or costly for private markets, foreign governments, or the IFIs to monitor levels of real compliance and/or to punish real non-compliance. Domestic banks and highly leveraged firms may therefore be able to support formal adherence to international standards if they can be assured that (relatively) non-observable regulatory forbearance or administrative failure will in practice be substantial and that the costs of non-compliance will not fall heavily upon themselves.

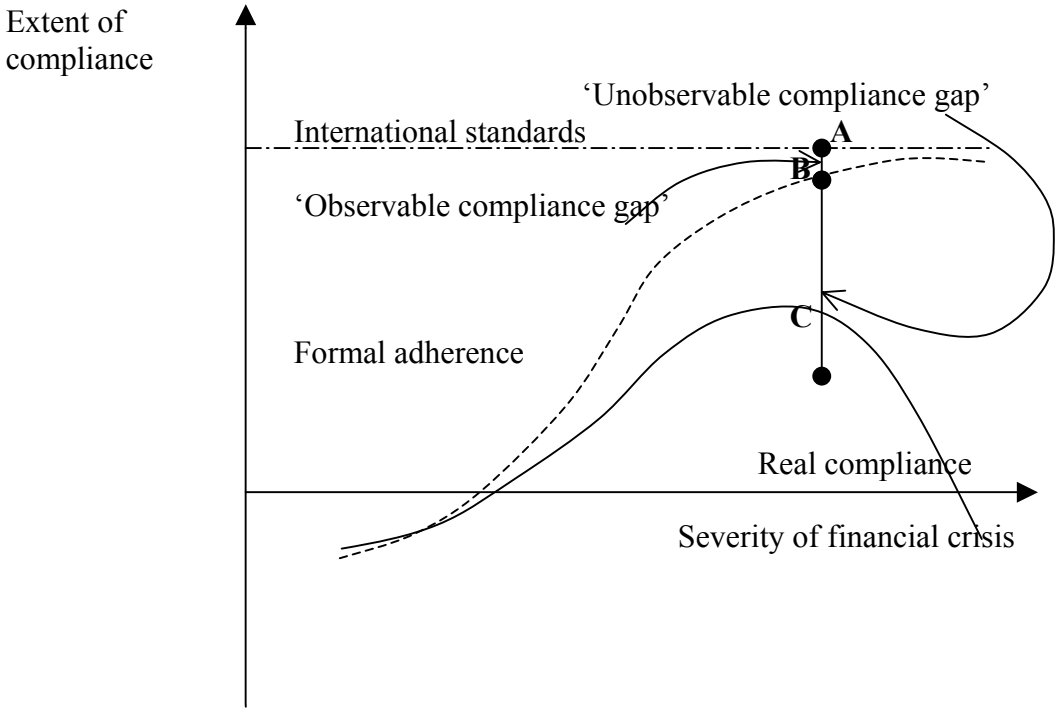
The difficulty of third party monitoring of compliance will vary by international standard. In the case of the SDDS, for example, monitoring is easy and relatively costless. Whether countries meet the SDDS requirements is publicly disclosed in a simple yes-no manner on the IMF's Dissemination Standards Bulletin Board (DSBB).[xix] By comparison, monitoring the level of country compliance with the Basle Core Principles, corporate governance principles, or IFRS is very difficult and costly for third parties. ROSCs and FSAPs are not compulsory, do not necessarily lead to publicly reported assessments of compliance, and even when made publicly available private sector analysts routinely respond that they are 'untimely, outdated, and too dense to be useful' (US GAO 2003: 22). 'Market-sensitive' information may be deleted from published reports; they tend not to make explicit statements such as 'regulatory forbearance is extensive in this country'. In such areas, then, it may make sense to combine formal commitment with real non-compliance.[xx]

The finance ministry (MOF), assuming it is especially concerned about the government's fiscal position, may support compliance if this can be achieved without placing excessive strain upon government finances (i.e. if the NPLs or higher corporate bankruptcies that higher standards will crystallize can easily be absorbed

without the need for large public sector borrowing, etc). If not, the MOF may oppose full compliance, but not necessarily formal compliance. Bank managers and owners with weak compliance intentions may calculate that they have no other option than to demand extensive regulatory forbearance, which might allow them over time to restore the position of the bank while simultaneously not disadvantaging them against better capitalized competitors. Well-capitalized and managed banks will prefer the gap between formal and real compliance to be smaller, even if not necessarily zero. However, poorly capitalized banks threatened with their very survival have greater incentives to lobby (or bribe) against full domestic compliance than well-capitalized banks have to lobby for it.

Thus, formal compliance with hidden regulatory forbearance is more likely as compliance costs *and* compliance monitoring costs rise. Note that commitments to international standards under IFI conditionality do not resolve the monitoring problem for third parties, since they obscure a government's true compliance intentions (cf. Rodrik 1989). For good reasons, market participants have little faith in the willingness of the IFIs to 'blow the whistle' on countries that fail to observe core standards (FSF 2000b: 20-31). The above prediction is reinforced by the consideration that financial crises effects that push in different directions. Crises raise the external compliance pressure on governments and domestic banks.[xxi] At the same time, they often substantially raise the compliance costs for key private sector groups and/or the public sector. This will in turn raise the gap between formal and real compliance, which I term the 'unobserved compliance gap'.[xxii] I define the 'real compliance gap' as the difference between international standards and the extent of actual compliance with a particular standard (AC in figure 2).

Figure 2: Effects of severity of financial crises on the nature of government compliance (*given high compliance monitoring costs)*



A 2X2 matrix clarifies this relationship (figure 3) and produces the prediction that as the private sector compliance costs *and* the third-party compliance monitoring costs of international standards rise, the size of the real compliance gap will also rise (i.e. governments will be more likely to choose formal compliance and real non-compliance).[xxiii]

Figure 3: Private sector compliance costs and third-party monitoring costs

		Compliance Costs	
		Low	High
Monitoring Costs	Low	1 SDDS, GDDS	2
	High	3 Other macroeconomic transparency standards	4 Prudential regulation, corporate governance standards, IFRS, money laundering standards

Compliance in Practice

In what follows, I briefly assess the prediction of the previous section in two ways. First, I compare compliance with SDDS (where private sector compliance costs and monitoring costs are low) and IFRS (where both costs are high) globally and in East Asia. Second, I assess compliance across East Asian countries in one key standard of the Basle Core Principles for which private (and public) sector compliance costs and third party monitoring costs are high: the Basle capital adequacy regime.

SDDS vs. IFRS

Table 5 shows that on average, SDDS compliance amongst IMF members is 29%, similar to the level of compliance with IFRS/US GAAP for countries for which there is available information.[xxiv] Compliance with SDDS, as one would expect, is much higher for the major emerging market countries on JP Morgan's EMBIG database, but compliance with international accounting standards is much lower for this group (58% vs. 29%). Of course, it is true that a number of countries have moved towards international accounting standards in recent years, even if only partially, or have signaled their intention to do so. Of the EMBIG countries, 50% allow or require some companies to report according to IFRS/US GAAP, and many have recently revised their national GAAPs to bring them more closely into line with IFRS and/or US GAAP. However, this underlines the point that convergence upon international accounting standards, though significant, is much more partial than convergence upon SDDS for this group, and also difficult to assess.

Table 5: Compliance with SDDS and IFRS/US GAAP, end 2003

	SDDS	IFRS/ US GAAP
% IMF members (SDDS), known countries(IFRS)	29%	30%
% emerging market countries (EMBIG database)	58%	29%
% countries with banking crises within last 5 yrs	47%	22%
% 58 banking crisis countries (last 10 yrs)	50%	29%
% 18 major banking crisis countries (last 10 yrs)	78%	6%
% 10 major East Asian economies	80%	0%

Source: GAAP 2002; IAS Plus website (http://www.iasplus.com/country/country.htm), SDDS website (http://dsbb.imf.org/Applications/web/sddshome), Caprio and Klingebiel 2003.
Notes: SDDS compliance is measured by whether a country is deemed by the IMF to have met SDDS specifications. Banking crises are defined as 'systemic' (Caprio and Klingebiel 2003). Emerging market countries are those on the JP Morgan Emerging Market Bond Index Global (EMBIG). The 18 major banking crisis countries are Argentina, Brazil, China, Czech Republic, Egypt, Hungary, India, Indonesia, Japan, Korea, Malaysia, Mexico, Philippines, Poland, Russia, Thailand, Turkey, and Venezuela. The 10 major East Asian economies are China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

Compliance patterns are similar for countries (developed and developing) that were hit by systemic banking crises in recent years. Of 18 major banking crisis countries over the past decade, 78% are SDDS subscribers but only 6% (one country) has converged upon IFRS/US GAAP. The situation for the 10 major East Asian economies, all of whom except Singapore and Hong Kong have had systemic banking crises in the last five years, is starker: 8 are SDDS subscribers of the total possible 9.[xxv] Most Asian countries, with the exception of Korea, posted economic metadata on the SDDS website before the crisis. As for other countries, however, it has taken 3-5 years for the IMF to confirm that they had met SDDS specifications (again, with the exception of Korea, which met the requirements relatively quickly, by 1 November 1999, and was the first Asian country to do so).

None of the major East Asian economies, by contrast, have fully adopted international accounting standards. Certainly, China and Hong Kong have partially adopted IFRS and others (Singapore and Malaysia) have indicated they will converge upon IFRS in the future. Furthermore, most countries in the region have revised existing national accounting standards in recent years, so that these figures underestimate the extent of convergence upon IFRS. However, important areas of divergence between national and international accounting standards usually remain, though the extent of convergence is difficult even for experts to assess.[xxvi]

Moreover, it is one thing to have modified national accounting standards to bring them more closely into line with international standards, but it is another thing for firms and internal and external auditors to abide fully by them. Few believe accounting transparency in most of East Asia (with the possible exception of Singapore and Hong Kong) to be on a par with that, say, in the US and UK. On balance, then, it is safe to say that compliance with SDDS is much greater in the region than is compliance with IFRS/US GAAP. This is consistent with the prediction presented in section 3.

Basle CARs

By comparison with SDDS and even IFRS, assessing the degree of country compliance with the Basle Core Principles is horrendously difficult. Published FSSAs and ROSCs, as already noted, are in very short supply: only Hong Kong, Japan and Korea have so undergone such public assessments. These reports are also qualitative and often pull punches, though the Japanese assessment is, unusually, sharply critical in places. Furthermore, there are many Core Principles and the detail in each is often substantial, making cross-country a very complex task. As argued earlier, this difficulty of third party assessment provides governments and private firms with an incentive to collude in signaling formal compliance while engaging in regulatory forbearance/administrative blockage. Is there evidence that the real compliance gap is indeed high in this area?

In order to simplify the task in this section I consider only East Asian convergence upon the capital adequacy provisions of the Core Principles. In terms of formal compliance, fully 90% of countries surveyed by the World Bank have signaled that they have adopted the Basle minimum 8% risk weighted capital ratio (Barth, Caprio and Levine 2002). This is a much higher formal compliance figure than for any other international standard discussed here and is consistent with my prediction that market pressure upon banks, and more indirectly upon governments, for convergence upon international capitalization standards will be particularly strong.

Table 6: Basle CARs in selected Asian countries and the US

Country	Official average capital adequacy ratios*, quarter 1, 2002 (%)	Moody's Bank Financial Strength Ratings,** March 2003
Hong Kong	16.0	C+
Indonesia	19.3	E
Japan	10.5	D-
Korea	10.8	D-
Malaysia	12.6	D+
Singapore	27.4	B
Thailand	13.1	D-
United States	12.4	B

Source: National regulatory authorities, bank annual reports, Moody's, Bank Risk Monitor, March 2003.

* Computed as the unweighted average of main banking institutions.

** Moody's BFSR ratings explicitly do not take into account the probability of public sector assistance in the event of potential default. Ratings are from A (strongest) to E (weakest).

As table 6 shows, official Basle capital adequacy ratios (CARs) in the major Asian crisis-hit developing countries were comparable with and often above those in the US by early 2002. Indeed, there is a clear tendency for banks to maintain official CARs in excess of the regulatory minimum. To conclude from this, however, that Asian banks are often better capitalized than US banks would be mistaken. Indeed, as table 6 also shows, Moody's bank credit risk department, which sensibly does not take Basle CARs very seriously, ranks only Singapore's banks on average as comparable with US banks in terms of overall financial strength, and the main crisis-hit countries' banks as in the lowest two categories of E or D-.

There are many reasons why official CARs are not comparable across countries and why they may be wholly misleading as indicators of bank financial strength. The 1988 Basle regime is notoriously weak as regards rules on loan loss provisions and the components of bank capital, with the result that official ratios often hide a multitude of sins.[xxvii] I provide some illustrations below in three main areas, though these do not exhaust the problems with official CARs.

First, loan accounting standards and practices are often opaque, particularly for 'restructured' non-performing loans (NPLs), which make up large proportions of bank assets in countries like Indonesia and Thailand. Since the crisis, most countries in the region converged upon the standard 3-month past due rule for calculating NPLs.[xxviii] In Thailand after the crisis, debt classified as 'doubtful' or 'loss' could be reclassified as 'substandard' when a debt restructuring agreement was signed. Substandard or ''special mention' debt remained those categories until 3 months of repayments or 3 installments were fulfilled, after which they are upgraded to the pass (i.e. accrual) category. This less conservative standard (compared to the US, which requires 6 months of repayments) was further relaxed on 10 April 2000, allowing the immediate reclassification of restructured loans to accrual status that satisfy certain criteria. Nor are Thai banks, unlike their Indonesian counterparts, required to report the total amount of such restructured debt in accrual status. From the high levels of 're-entry NPLs' reported by the Bank of Thailand (BoT) in recent years, it is clear that many restructured loans turn bad again.[xxix]

Lax loan accounting has the result of reducing required loan loss provisions, increasing stated profits and inflating official capital. Direct evidence of this is given by DBS (Singapore) Group's consolidated accounts for 2001 and 2002. This group has a Thai subsidiary, DBS-Thai Danu Bank. DBS Group is required by the Monetary Authority of Singapore (unfortunately for the Thais!) to note in these accounts that Thailand's loan classification standards are much laxer than Singapore's, and that if the latter's classification standards were used instead, Thai Danu Bank's NPLs would be about five times higher. Indeed, DBS explicitly notes that according to Thai GAAP, Thai Danu Bank (TDB) has positive net assets, but that according to Singapore accounting standards it is technically insolvent.[xxx] If this difference is representative of Thai classification standards, this implies substantial regulatory forbearance by the BoT.[xxxi]

Second, Asian banks usually require collateral when lending, particularly property collateral, and a large percentage of the value of the collateral attached to NPLs can usually be offset against required provisions. Lax collateral valuation practices are a problem in a number of countries, with the effect of further inflating official (as opposed to real) capital. In Thailand, the BoT defines the market value of collateral as 'the probable price on the date of the collateral asset valuation or appraisal *under normal market conditions* with no transaction costs (nor taxes).'[xxxii] According to many analysts, the 'normal market conditions' clause, and the poor quality of valuation firms in Thailand, means that collateral is often overvalued. Furthermore, in countries like Thailand and Indonesia, where most collateral is in the form of illiquid real estate and where the legal foreclosure regimes are dysfunctional, a best practice (conservative) approach would not allow such netting practices regarding required provisions (Song 2002: 21).

Third, the definitions of the allowable components of capital vary considerably by country. In Thailand, regulators allowed banks to issue expensive hybrid debt instruments (so-called CAPs and SLIPS) and to include these in Tier I capital, contrary to practice in the US and elsewhere.[xxxiii] In Japan, more than half the Tier 1 capital of major banks now consists of deferred tax assets (DTAs), most of which are past tax losses carried forward.[xxxiv] For two of the top seven banks, DTAs made up all of Tier 1 capital in March 2003 (Fitch Ratings 2003: 17). The Japanese rules on DTAs are lax by any standard. DTAs may be carried forward for up to five years, as opposed to only one year (or a maximum of 10% of Tier 1 capital) in the US, the only other major country in which DTAs are important. Since the value of DTAs is often in doubt due to poor bank profitability, and since in particular they are not generally available to cushion large losses, there is a strong case for their use as core capital to be sharply constrained (IMF 2003b: 8, 18).

Thus, there is considerable evidence of substantial regulatory forbearance in some major Asian countries relating to bank capitalization. The weakness of internal and external auditors is another problem that allows banks and regulators to collude in regulatory forbearance.[xxxv] Given the banking system distress in countries like Indonesia, Japan, Korea, and Thailand in recent years and associated massive public bailouts of failed banks, forbearance is hardly surprising. In many ways, it is also justifiable. Though Japanese banks and regulators, for example, continue to deny forbearance occurs, adopting the US rule alone on DTAs would probably require the recapitalization, nationalization, or closure of most important banks in Japan (Fitch Ratings 2003: 2).

Forbearance may be the only viable strategy in such cases, but it can have negative longer-term effects. The Korean authorities' willingness to allow the rapid expansion of banks into retail lending (particularly via credit card subsidiaries) to help rebuild bank profits and capital in the wake of the crisis may be seen in this light. Unfortunately for Korean banks, the bursting of the consumer credit bubble has since created a new NPL problem that threatens the stability of the financial system anew.[xxxvi]

Evidence of strong post-crisis pressure upon Asian countries to adopt a dual strategy of formal compliance with quiet regulatory forbearance supports the theory offered in section 3. It is also evident that the size of the real compliance gap is much lower in Singapore and Hong Kong (and to a lesser extent, Korea). This is not because these countries are rich (cf. Japan) or because they have independent regulatory authorities (Singapore does not).[xxxvii] Rather, higher compliance with Basle has been possible for Singapore's and Hong Kong's banks because their economies were less affected by the crisis and their banking and corporate sectors accordingly much less distressed.

Much fuller compliance in Singapore than in Indonesia or Thailand is possible because banks, corporations, and government there could afford it in the former but not in the latter two. Indeed, as predicted, there are clear signs of an intent in Singapore and Hong Kong to signal their strong compliance intentions through explicit over-compliance. Both Singapore and Hong Kong have minimum CARs of 12%, well over the 8% minimum to which their neighbours mainly adhere (including Japan). For Singapore, of the 12% minimum required CAR, banks have since

December 1998 been required to maintain at least 10% in Tier 1 capital. Singapore banks maintain much higher CARs than even this (in one prominent case, it is over 40%).

Conclusion

What explains different levels of compliance across Asian countries? Much depends on the international standard in question. In the area of SDDS, the pressure upon Asian countries to converge has been powerful, but this was in evidence before the crisis of 1997-8. Pressure for formal compliance with IFRS, by contrast, appears to have been relatively weak, while the private sector compliance costs have been unacceptably high. The result is that most countries have adopted a policy of moving towards allowing IFRS reporting for some companies (usually those that are foreign-listed and for whom compliance costs are low), whilst more incrementally modifying national accounting standards for the rest.

In the case of the Basle capital adequacy rules, deep financial crisis has tended to produce formal compliance for almost all countries, but with substantial regulatory forbearance in some. In contrast to the SDDS standard, the Basle regime is complex and full of room for manoeuvre for national authorities and private banks alike. Since declaring banks undercapitalized is potentially highly costly for governments, banks and corporations, and for the IFIs, the external compliance mechanisms have proven inadequate. This in turn creates incentives for individual countries (e.g.: Singapore) and individual banks in the region to signal strong compliance intentions via over-compliance (in this case, maintaining very high levels of capital). Of course, such over-compliance can be costly.

Implications for reform

What are the implications of the preceding analysis for the regulatory reform process? I am not arguing that it is wrong for the IFIs to promote regulatory upgrading by its members, particularly when obvious weaknesses persist. Clearly, the pre-1998 financial regulatory regimes in Indonesia, Korea, Japan and Thailand had major failings that contributed to the depth of the crisis these countries suffered in the late 1990s. The issue is what kind of regulatory reforms should be undertaken and how.

Representatives from the major countries and their institutions have inevitably dominated the international standard-setting process. Accordingly, the new standards and codes are to a considerable degree the outcomes not just of political bargaining between countries, but also political bargaining within the major countries themselves. No doubt American bank regulatory, corporate governance and accounting standards are generally more stringent than those in most of East Asia, but as recent scandals have amply demonstrated, existing US rules are probably not ‘best practice’. What is remains unresolved. Nor is it clear that one size should fit all. What we do know is that the countries that have had least impact upon international standard setting are those for whom the costs of convergence and the required depth of institutional reform are greatest. The IFIs provide some technical assistance for regulatory upgrading to developing countries in recognition of this problem, though no doubt it is insufficient.

There is also a difficulty in asking countries to accept a rules-based model of financial supervision, for example, when (as in Asia) personal relationships continue to predominate. Institutionally, personal relationships compensated successfully in the past for weaknesses in the institutions that are necessary for arms-length finance: secure property rights, third party legal enforcement of contracts, etc (Yoshitomi et al. 2003: 78). The interdependence of the reforms required by the various standards and codes arguably poses an enormously difficult, complex and costly transition task for many developing countries. Moreover, whatever the nature of the standards, as I have shown above, there are good reasons to expect that compliance failures will be endemic.

Does this matter? Perhaps we should simply admit that the process of convergence in prudential standards will take time, but that some reform is better than none at all. Setting the standards bar at a fairly high level for developing countries (and Japan!) may be the best way of encouraging serious long term reform, by shifting the domestic balance of political power away from groups that oppose prudential upgrading or greater transparency. We may reasonably justify the SDDS, for example, on this basis.

The issue is more complex with the other standards discussed here. IFRS are probably a major improvement on most national accounting regimes, but we need to ask whether the costs of full compliance are worth the potential benefit. The sophisticated treatment of financial instruments required by IFRS 39, for example, may be much less relevant to most firms within developing countries. There is also the danger that powerful interest groups in the developed world, by preventing agreement on issues like the expensing of options paid to executives, will only replicate abroad existing weaknesses.

In the area of banking regulation, problems of credibility and of appropriate economic policy 'sequencing' arise. The credibility problem is obvious: despite formal convergence upon any number of higher international standards, private analysts often remain unconvinced. Indeed, even when reform is real, a past history of non-credible rejection of external criticisms that forbearance is extensive can undermine the credibility of new, real reforms. Contemporary Japan is a case in point. In any case, if reforms are not credible to market players, they are unlikely to bring with them the supposed benefits of standards compliance (such as lower borrowing costs).

As for the sequencing problem, the upgrading of prudential regulation and supervision was intended to be a solution to the moral hazard created in the process of financial sector deregulation. As some critics have argued, the Basle rules and standards and codes in general are intended to make the world safe for globalized finance. Financial deregulation, pursued by all East Asian countries to a greater or lesser degree before the crisis, was highly dangerous in the absence of regulatory upgrading. In practice what has happened since the crisis is that the IFIs have promoted further financial deregulation at the same time as promoting convergence upon the various standards and codes. The IMF programmes in Indonesia, Korea and Thailand all required further substantial financial deregulation.

However, a sequencing problem arises when compliance failures mean that there is a large real compliance gap. Domestic institutions and politics tend to favour financial deregulation because the benefits are concentrated but the potential costs are more widely spread. The opposite is true of higher prudential standards. The IFIs have compounded this domestic bias in favour of deregulation, but they are too weak to ensure countries converge upon a prudential framework that such deregulation requires. If so, the problems of moral hazard that existed in the old system may only be compounded by the 'new'. This may matter less in an environment in which banks have been unwilling to make new loans to corporations, as in Indonesia and Thailand until recently, but this is hardly an adequate basis for long term financial stability.

If compliance failures are likely to be chronic, the best solution for particular countries may be to resist substantial financial sector deregulation until adequate prudential regimes are in place and have proven effective. China, in contrast to the other crisis-hit countries in the region, seems to have pursued this strategy in the past, but is now coming under substantial international pressure for financial sector deregulation (mainly as a result of its entry into the WTO).

As for the IFIs, chronic compliance failures place them in a very difficult position. If banks in many developing countries do remain seriously undercapitalized even when they conform superficially to international standards, should the IFIs blow the whistle? Indonesian and Thai banks may require further major injections of public funds, but saying so explicitly could trigger bank runs and require fiscal infusions that these governments are not yet in a position to make. It could also jeopardize IFI relations with these governments. Thus, the IFIs themselves, despite being responsible for assessing compliance with international standards, have their own incentives to exercise regulatory forbearance.

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Endnotes

[i] Academic work that focuses upon global standardsetting as reflecting the dominance of the US and transnational capitalism seems prone to exaggerate the extent of real compliance on the ground (e.g.: Soederberg 2003).

[ii] See the background paper issued before the Halifax G-7 summit of June 1995, which included a section on 'promoting financial stability in a globalized economy', available at http://www.library.utoronto.ca/g7/summit/1995halifax/financial/5.html, accessed 4 February 2004.

[iii] However, none of these countries were judged by the IMF to have met all SDDS specifications until some years later (see section 4.1).

[iv] An alternative view blamed the crisis upon unregulated and volatile international capital flows (Radelet and Sachs 1998; Wade and Veneroso 1998). However, these authors also came to accept that failures of domestic regulation in the Asian economies contributed to the crisis.

[v] Maintained by the Financial Stability Forum, formed in 1999 and based at the BIS. See http://www.fsforum.org/compendium/about.html. The IMF refers generally to 'standards and codes'.

[vi] For example, the effective implementation and monitoring of minimum capital requirements and risk management requirements in the Basle Core Principles require banks to employ sophisticated accounting standards and disclosure practices and to adopt good corporate governance practices.

[vii] Particularly SDDS, the Codes on Fiscal Transparency, on Transparency in Monetary and Financial Policies and the Basle Core Principles (Clark 2000: 168, fn.20).

[viii] Hilbers 2001. To supplement Fund and Bank expertise in this area, external experts from international agencies such as the Basle Committee and IOSCO, and from national central banks and supervisory agencies, have been drafted into this exercise.

[ix] The US Treasury supports mandatory participation (US GAO 2003: 65). Of some relevance here is the fact that the US itself has published only one ROSC, on fiscal transparency.

[x] Only the Philippines participated in assessment programmes but did not publish its reports (according to US GAO 2003, appendix VIII, published in June 2003).

[xi] However, although international standards only approximate 'soft' international law, in the process of implementation, they are often translated into hard rules of domestic law and procedure.

[xii] Of course, this does not mean that international rules are more often complied with than are standards.

[xiii] FSF, 'What are Standards?', http://www.fsforum.org/compendium/what_are_standards.html, accessed 22 April 22, 2003.

[xiv] This perception and the intense politicization it brings significantly lessens the likelihood of 'norm-driven' convergence, as does the often substantial conflict between international and existing domestic standards (see Underdal 1999 and Checkel 2001).

[xv] By contrast, technical standards often produce higher incentives for compliance because of high network externalities (i.e. the benefits of compliance increase as more actors adhere to the standard) and powerful market incentives to comply. International telecoms standards are an example.

[xvi] Bribes need not be direct. Japan's system of *amakudari*, a practice under which retiring MOF or other government officials 'descend from heaven' to be employed in the private sector, may have similar effects (Horiuchi and Shimizu 1998).

[xvii] In the case of the 1980s savings and loan institutions (S&L) crisis in the US, the regulator, the Federal Savings and Loans Insurance Corporation (FLSIC) gambled that the interest rate increases that were pushing many S&Ls into bankruptcy would be reversed. FLSIC regulators relaxed various accounting standards and arbitrarily allowed S&Ls to revalue some assets, on the assumption that the weakness in the industry was only temporary (Jackson and Lodge 2000: 109).

[xviii] Other factors that may affect compliance, such as political regime type/centralization, legal origin, openness/internationalization, corruption, etc, are left aside here for space reasons. I take up some of these issues in passing below.

[xix] Even here, however, assessing real levels of compliance is not straightforward, since the IMF is not able to monitor significantly the *quality* of the data placed by the country on the DSBB.

[xx] If third parties have imperfect information concerning the government's compliance intentions, the credibility of the government's commitment is likely to be low (Rodrik 1989: 757). As a result, some potential benefits such as lower borrowing costs may not be forthcoming for any actors. Nevertheless, agents with weak compliance intentions may calculate *ex ante* that they have little to lose from formal compliance and the potential to achieve other, non-market gains, such as the appearance of cooperation with the IMF.

[xxi] On the assumption that market reputation is more important for banks than for non-financial firms, given the higher leverage of the former.

[xxii] Of course, in practice, 'observability' is a matter of degree.

[xxiii] For space reasons, I focus in what follows on regulatory forbearance as a source of non-compliance.

[xxiv] For sources and definitions, see table 5. I use US GAAP (generally accepted accounting principles) and IFRS as joint benchmarks for international accounting standards because of the unresolved competition between these two different standards.

[xxv] One of the two SDDS non-subscribers is Taiwan, not an IMF member. China is the other.

[xxvi] E.g.: see the country assessments in Nobes 2001.

[xxvii] For the calculation of Basle CARs, see http://www.bis.org/publ/bcbs04.htm, accessed 11 April 2004.

[xxviii] The exceptions are Korea, which from 1999 partially instituted a US-style 'forward-looking criteria' (FLC) approach to NPL estimation, and Malaysia, which retains a dual 3 and 6-month standard.

[xxix] Korea's FLC approach, which uses cash-flow projections for large borrowers to determine bank asset quality, is certainly more sophisticated than other countries' but it also (re-)introduces considerable room for discretion.

[xxx] DBS Group, *Annual Report 2001*, p.126, and *Annual Report 2002*, p.80 (Notes to the Consolidated Financial Statements). According to Singapore standards, Thai Danu Bank's NPLs at the end of 2001 were 27.7% of total loans, whereas by Thai standards they were merely 5.8% (the figures for 2002 were 25.4% and 5.1%, with substandard loans increasing slightly from 2001-2).

[xxxi] Further evidence from another Singapore-owned Thai bank, UOB-Radhanasin Bank, gives a very similar picture to the Thai Danu Bank case (UOB Group, *Annual Report 2001*, and UOB-Radhanasin Bank monthly reports to BoT, available at: http://www.bot.or.th/bothomepage/databank/financial_institutions/npl_fi/254412/ecb.htm).

[xxxii] BoT, 'Regulations for Collateral Valuation and Appraisal,' http://www.bot.or.th/bothomepage/notification/fsupv/2541/thtm/RCVA.DOC, accessed April 1, 2002. Italics added.

[xxxiii] Confidential author interviews, regulatory officials, Hong Kong, April 2002, and Thailand, March 2002. In the US, approved subordinated debt instruments are only allowable as Tier II capital: Comptroller of the Currency 2001: 40.

[xxxiv] DTAs arise due to differences between financial reporting for accounting disclosure and for tax purposes.

[xxxv] Very unusually, the external auditors of Resona, a major Japanese bank, refused in March 2003 to accept the bank's stated value of DTAs, resulting in an overnight collapse of the bank's CAR and a further costly government bailout. Two other major banks also wrote down DTAs in FY2003, though bank analysts believe others should have done the same (Fitch Ratings 2003: 3).

[xxxvi] Government pressure on banks to bail out failed credit card companies has renewed concern of the return of directed lending in Korea, which would be Basle-incompatible ('Seoul's influence over banks wanes', *FT.com*, 5 February 2004).

[xxxvii] Contrary to conventional wisdom, Singapore's regulatory authority is headed by Deputy Prime Minister and Finance Minister Lee Hsieh Loong, son of the Senior Minister and former Prime Minister).

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The Global Economic Governance Programme
University College, Oxford OX1 4BH

Tel. +44 (0) 1865 276 639 or 279 630
Fax. +44 (0) 1865 276 659
Email: geg@univ.ox.ac.uk
www.globaleconomicgovernance.org