INTERNATIONAL STANDARDS AND CODES AND THEIR IMPORTANCE FOR FINANCIAL STABILITY

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Issues of financial stability have worldwide been the subject of economic research and analyses and are a burning topic for financial market regulators, central bankers and private business subjects. The aim of this article is to widen awareness of international financial and economic standards and codes, an initiative of supranational financial institutions and sectoral organisations whose main role is to support the stability of the international financial system. This initiative naturally reflects ongoing changes in global financial markets and thus contributes to the new architecture of the international financial system.

Financial stability is the state where individual components of the financial system (financial markets, financial institutions, payment and settlement systems, clearing systems) function smoothly, without any disruption to their activity, and are able to resist potential shocks. In other words financial stability is a state without systemic failures, such as the bursting of financial bubbles, excessive asset price volatility, liquidity shocks, bankruptcy of financial institutions, etc. Under these circumstances nothing can prevent the efficient allocation of resources made by the financial system (inter alia) by means of directing the flow of free financial resources into investment projects ensuring their productive use.

Macroeconomic and financial stability

The relationship between macroeconomic and financial stability is very close and bilateral. Macroeconomic stability is an essential condition for ensuring the stability of the financial system and its development. Stability of the financial sector may be disrupted even by the inappropriate use of macroeconomic policy instruments (tax measures, monetary policy instruments). On the other hand, it is clear that only a stable and efficiently functioning financial sector is able (by means of mobilising domestic savings, through the transfer of domestic and foreign free funds into efficient investments, through the control of these funds' utilisation, pressure on the good corporate governance, through transfer of risks, through the generation of information on resource prices, etc.) to create the conditions for sustainable economic growth and the efficient use of macroeconomic instruments of individual policies.

For transforming, or new market economies it is therefore important to concentrate efforts and resources on:

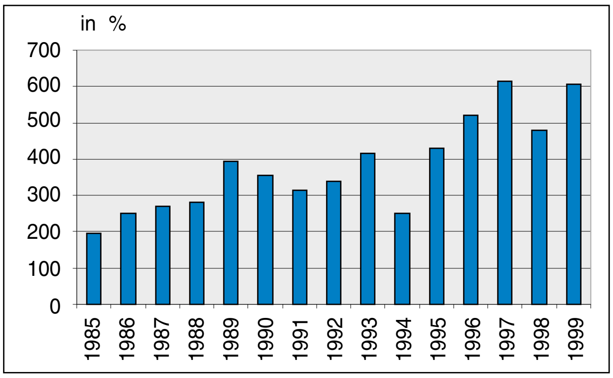
- building and reforming infrastructure and legislation that ensures financial stability and reduces the level of risk in the business environment (enforceability of contracts, a functioning judiciary, efficient bankruptcy and liquidation, protection of creditors and minority shareholders, publication of information, correct corporate governance, accounting and auditing standards),
- constructing a framework for financial regulation and supervision and its effective enforcement (accounting and auditing standards for financial institutions, publication of information by financial intermediaries, prudent conduct rules, issues of supervision infrastructure, safety nets – depositor protection with minimal implications for moral hazard, etc.),
- creating conditions for improving the management of banks and other financial institutions (abilities of management, know-how in the field of evaluating client creditworthiness, risk management, determining responsibilities of managerial staff and owners, etc.)
- implementing macro-economic policies aimed at stability and growth.

Stability of the international financial system and international financial standards and codes

In consequence of technological advances, financial innovations and the trend of liberalising the international movement of capital and the provision of financial services national financial systems are becoming interconnected to the international financial system. The international financial system is characterised by a growing volume of capital flows (see graph) and mainly a rapid growth of private financial flows in relation to developing economies[1]. However not only has the volume of capital flows grown, but also their volatility, evidence of which has been the recent financial crises in Mexico, South-East Asia, Russia, and Brazil, etc. Mutual financial interconnection of national financial systems furthermore creates the possibility of a

[1] According to the World Bank (World Bank Global Development Finance 2000) the total volume of net capital flows to developing countries in 1990 represented USD 98.5 billion, of which USD 42.6 billion was private and USD 55.9 billion were official funds. In 1999 the total volume was USD 290.7 billion, of which USD 238.8 billion private and USD 52 billion official funds. 1997 prior to the Asian crisis these values peaked and net capital flows reached the level of USD 343.7 billion, with 88% share of private funds (USD 303.6 billion).

Global gross capital flows in relation to net capital flows



Source: IMF
Note: This is a ratio of the sum of absolute values of gross inflows and outflows to the sum of absolute values of current account balances.

crisis to spill over from one country into another. Analyses of the recent crises have confirmed that in the majority of the countries affected shortcomings arose in the policies implemented and their transparency, in the financial infrastructure (mainly in the quality of regulation and supervision), insufficient access to information for a correct assessment of risks and in other fields not by then covered by generally accepted principles of correct conduct, which contributed to the increased vulnerability of their financial systems.

One of the initiatives for averting the occurrence of financial crises through strengthening the macroeconomic and financial stability of countries is the work on international standards and codes. International financial standards and codes represent a set of internationally accepted economic and financial principles. Experts from developed, as well as developing countries have been involved in drawing up these standards via international institutions, such as the International Monetary Fund, the World Bank, the OECD, international groupings of financial regulators and supervisory authorities.

The Financial Stability Forum (FSF)[2] in its first report of March 2000 summarised 12 key standards that are principal for stability in the international financial system. These key standards and codes may be divided into three groups according to their orientation:

– macro-economic policy and transparency,
– institutional and market infrastructure,
– financial supervision.

Through the successful adoption of these standards into national legislations the domestic financial system is strengthened; a healthy domestic investment environment is built; the economy's ability to withstand external shocks (whether financial, or of a real economic nature) is increased several-fold; the overspill of crises between countries from the same geographical area or different developing economies is limited.

A stimulus for implementing the standards and codes into the national legislations of developing countries should be their participation in the creating these principles as well as in assessing countries' observance of them (FSF, for example, also accepted experts from countries that are not members of the FSF into the working group for implementation of standards). It is of a great concern of the standard and codes setting bodies to encourage market participants to take into account the assessment reports on the extend of standard and codes observance by countries in their future investment strategies and risk analysis. The publication of these assessments would thus create market incentives for developing countries for the fast and thorough implementation of codes into their legislations, which is otherwise voluntary for them[3].

The varied range of financial standards and codes in terms of its orientation corresponds largely to the abovementioned four main spheres, on the building and reforming of which developing countries should concentrate. System changes in these fields facilitate the incorporation of developing countries into the international financial system with the liberalised movement of capital, contributing to the stability of their internal environment, their economic growth and in the final result to the development of the global economic and financial system, more resistant to crisis.

Slovakia and the standards

Slovakia is in the process of legislative and institutional convergence in relation to the European Union. EU directives (including those governing financial regulation) are founded on internationally accepted standards and codes and are updated so as to be as far as possible in accordance with the regularly (depending on the changing conditions) re-evaluated standards and codes. Slovakia thus in the abovementioned fields, important for macroeconomic and financial stability, is in the process of legislative and institutional standardisation.

To this standardisation of the financial market environment in Slovakia are contributing also assessments from the International Monetary Fund and World Bank. The assessment report of the International Monetary Fund of September 2002 aimed at evaluating the stability of the financial system in Slovakia (in the framework of the Financial Sector Assessment Program – FSAP)[4] contains also an assessment of the rate of adherence to standards and codes (Reports on the Observation of Standards and Codes – ROSC)[5] in the following fields: transparency of

[2] FSF associates the leading representatives of national financial authorities (central banks, ministries of finance, institutions responsible for supervision of the financial sector), international financial institutions, international groupings of financial regulators and surveillance agencies, expert panels of central banks and the ECB. The activity of FSF is coordinated by the Secretariat, which is located in the Bank for Internal Settlements (BIS) in Basle, Switzerland.

[3] Countries with a developing economy may also perform their own assessment on themselves. This contributes to a better understanding of the significance of the standards at the national level, it accelerates and facilitates the assessment process performed by international organisations and enables national authorities to take measures in the case that no assessment yet has been made for the given country e.g. by the International Monetary Fund.

Key Codes and Standards for Sound Financial System

Area	Standard	Issuing body and year of standard formulation
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practice on Transparency in Monetary and Financial Policies	IMF 1999
Fiscal policy transparency	Code of Good Practice in Fiscal Transparency	IMF 1998
Data dissemination	Special Data Dissemination Standard (SDDS) / General Data Dissemination System (GDDS)	IMF 1996 / 1997
Institutional and Market Infrastructure		
Insolvency	Principles and Guidelines for Effective Insolvency Regimes and Creditor Rights System	World Bank 2001
Corporate governance	Principles of Corporate Governance	OECD 1999
Accounting	International Accounting Standards (IAS)	IASC since 1974
Auditing	International Standards on Auditing (ISA)	IFAC
Payment and settlement	Core Principles for Systemically Important Payment Systems / Recommendations for Securities Settlement System	CPSS / IOSCO 2001
Market integrity	The 40 Recommendations of FATF on Money Laundering / 8 Special Recommendations Against Terrorist Financing	FATF 1990 / revised 1996 and 2001
Financial Regulation and Supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS 1997
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO 1998 / revised 2002
Insurance supervision	Insurance Core Principles	IAIS 2000

Notes:
Countries with access to international capital markets are encouraged to participate in the stricter SDDS. Other countries are recommended to adopt the GDDS.
The International Accounting Standards Committee – IASC and the International Federation of Accountants are private sector organisations.
CPPS-Committee on Payment and Settlement Systems, IOSCO – International Organisation of Securities Commissions, FATF – Financial Action Task Force, BCBS – Basle Committee for Banking Supervision, IAIS - National Association of Insurance supervisors
Source: Financial Stability Forum (supplemented)

monetary and financial policy, banking supervision, regulation of securities and investing, insurance market regulation, correct corporate governance, supervision over systemically important payment systems and measures against money laundering and the fight against financing terrorism. Besides this, the assessment report contains also a brief summary on the assessment of the accordance of our legislation with the Principles and Guidelines for Effective Insolvency and Creditor Rights System. Slovakia's ROSC for fiscal transparency was published in August 2002 and in November 2001 the ROSC for the accounting and auditing modules was published. Apart from this, the Slovak Republic is a participant in the IMF project on the publication of data according to Special Data Dissemination Standards (SDDS) and overall has publicly available publications in all the 12 ROSC modules.

Conclusion

The complete elimination of financial crises is probably an unrealistic aim. The recent crises of a financial nature that affected developing economies however instigated debates on a new international financial architecture that would reduce the frequency and scope of subsequent financial crises. One of the solutions for preventing the emergence of financial instability is the creation and implementation of international standards and codes. This is an ongoing process, which undoubtedly consumes considerable resources before contributing in any significant extent to the strengthening of national financial systems, and increases their resilience to shocks. The advantages ensuing from reliable, smoothly functioning and efficient financial markets are, however, a great appeal.

[4] The IMF and World Bank are jointly involved in FSAP. The role of FSAP is to help countries in identifying strengths and weaknesses (risks) of their financial systems. Various instruments and techniques, including stress testing, macroprudential indicator analysis and an assessment of the rate of observance of financial standards are used.

[5] The ROSCs summarise the extent to which countries observe certain internally accepted standards and codes. The IMF differentiates 12 spheres and standards relating to these, the monitoring of which is useful for the IMF with regard to the subject of its activities. Each of these 12 spheres represents a module.