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On the  
Transfer of Real Resources to Developing Countries)



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**INTERNATIONAL FINANCIAL ARCHITECTURE  
An Update on the World Bank Group's Role**

Attached for the April 17, 2000 meeting of the Development Committee is an Update on the World Bank Group's Role in International Financial Architecture prepared by World Bank staff. As noted in footnote 4 of the Provisional Agenda, this report has been prepared following discussion of the subject by the World Bank Executive Directors on March 17, 2000. Ministers may wish to comment on this subject in their prepared statements.

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## INTERNATIONAL FINANCIAL ARCHITECTURE

### *An Update on the World Bank Group's Role*

#### I. Context

1. A Progress Report on the *World Bank Group's Role in Strengthening the New International Financial Architecture* was presented to the Development Committee in September 1999. This note gives a further progress report on World Bank activities in this area. In view of several other documents on the range of efforts underway, this note does not review the issues under discussion or the work underway in other fora.<sup>1</sup>
2. As evident from the deliberations underway in various fora, there is a broad-based and continuing agenda aimed at strengthening the international financial architecture. Several aspects of this agenda deal with weaknesses in the international financial system that became apparent after the crisis, but there is also widespread recognition that global financial stability rests on robust national systems. Lessons drawn from the financial crises of the late 1990s underscore that, in addition to macroeconomic stability, good structural and social policies and their institutional underpinnings are of critical importance to enable countries to harness the benefits, and avoid the pitfalls, of integration with the international financial system. These same underpinnings - the basic infrastructure of a market economy - are also critical to successful economic development and poverty reduction. Thus, the aspects of strengthening international financial architecture that relate to bolstering national systems and institutions are of central concern and relevance to the World Bank as a development institution.
3. Helping countries strengthen their social and structural pillars has always been at the core of the Bank's work, but there are several elements that are new in the agenda and that are shaping the Bank's response:
  - First, the recent wave of crises has highlighted the need for a much more systematic focus on the structural and social sources of vulnerability. For countries that are at the forefront of integration with the international financial system, better assessment and management of vulnerability is key to maximizing the gains from globalization. The development gains from a more systematic and holistic approach has also been underscored by the Comprehensive Development Framework.
  - Second, there has been a sharper focus on some specific elements which fall under the Bank's domain of concern and comparative advantage. This includes centrally the strengthening of financial systems, but also areas such as corporate governance, accounting and auditing, insolvency regimes, social protection, and financial and

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<sup>1</sup> In particular, see the IMF umbrella report *Progress in Strengthening the Architecture of the International Financial System*, SM/00/67 March 27, 2000.

corporate restructuring. This, in turn, has called for a substantial expansion of the Bank's activities in these areas.

- Third, the Bank is being called upon by the international community to contribute to global efforts in these areas of comparative advantage, as well as to help bring developing country experience and perspectives to the discussions that are underway on reform.
  - Finally, the breadth and complexity of the agenda has placed renewed emphasis on partnerships with the Bank focusing on areas of comparative strengths and providing a supporting role in other areas. In this regard the enhanced partnership with the IMF is key, but there is a need to expand collaboration on this agenda with several other institutions including the regional development banks, the OECD, standard setting bodies and the private sector. The Bank is also intensifying and broadening its participation in several fora including the International Monetary and Financial Committee, the G-20, the Financial Stability Forum, APEC, the Manila Framework Group and other regional groupings.
4. Against this backdrop, the Bank has stepped up its efforts in support of the new international financial architecture. Given that the Bank's primary focus is to assist developing countries integrate with the global financial system, based on demand-driven country assistance strategies, there are three main ways through which the Bank is seeking to make this contribution: (a) by supporting international standard setting bodies to develop and disseminate international norms and best practices, together with the methodologies for their assessment and implementation; (b) by assisting countries to deepen their understanding of key social and structural sources of vulnerability; and (c) by assisting countries to strengthen their capacity to benefit from globalization and to achieve sustainable growth and poverty reduction. To date much of the Bank's focus has been on diagnostics, using international comparisons, norms and good practice in the Bank's economic and sector work to help countries identify weaknesses in their national systems and institutions. For the Bank and for developing countries the ultimate purpose of this diagnostic work, as stressed by the Development Committee, is to provide a better basis for future Bank assistance to countries in strengthening capacity where it is weak.
5. The remaining sections provide an update on the main activities where the Bank is contributing to the strengthening of the international financial architecture. This includes two important initiatives that have been launched with the IMF: the joint Financial Sector Assessment Program and the collaborative effort on the Reports on Observance of Standards and Codes. In addition, the Bank is expanding its programs in several other areas discussed above that have come to the fore in the wake of the recent crises, notably corporate governance, accounting and auditing, insolvency regimes, financial and corporate restructuring and social protection. All of this work will support the Social and Structural Reviews, piloted over the last year, that are aimed at providing a systematic evaluation of country weaknesses and vulnerabilities. In turn the improved diagnostic work will help

sharpen the focus of our Country Assistance Strategies by supporting and complementing the Bank's operational work.

## **II. Financial Sector Assessment Program**

6. The joint IMF/World Bank Financial Sector Assessment Program was begun in May 1999, on a pilot basis, to identify financial system strengths and vulnerabilities and to reduce the potential for crises. The joint program was seen as a vehicle to optimize the use of scarce expert resources by reducing duplication of efforts and avoiding conflicting advice in financial sector work. The program is responsive to calls by the international community for closer cooperation to reduce the likelihood and/or severity of financial sector crises. The emphasis of the FSAP program is on prevention and mitigation rather than on crisis resolution.
7. The FSAP is intended to encourage the early detection of financial system weaknesses and to develop appropriate policy responses, to support a more effective dialogue with national authorities, and to provide both institutions with a common platform for policy advice and technical assistance. The program aims also to identify key priorities for financial sector development and improve the design and delivery of support for strengthening financial systems.
8. The program has been designed to operate as a pilot for a one-year period. During this time 12 country assessments are to be carried out in order to develop experience in how it could best be structured on a permanent basis. Participation in the pilots is voluntary. In seeking countries to participate, a group has been sought which represents a reasonable cross section of member countries' financial systems, as well as a geographic spread. Countries which have recently experienced economic crises were not included in the pilot, as in these countries' financial systems vulnerabilities typically already were apparent and programs were often in place to deal with them.
9. To date, four of the pilot cases have been completed. Summary reports on three have been provided to the Bank's Board for information. A further eight cases are in various stages of completion.
10. A joint progress report on the program has been prepared and will be reviewed shortly by both Boards. It examines experience with the FSAP pilots and the lessons learned. It draws on the views of country authorities, Bank regional staff and Fund area departments. It indicates how the FSAP reports have been integrated into other financial sector work of both institutions and propose a structure for, and the scale of, the future FSAP. The report also summarizes issues of confidentiality that have arisen concerning information provided by country authorities and documents produced by FSAP mission teams.

## **III. Reports on Observance of Standards and Codes**

11. In recent years it has become increasingly clear that economic and financial stability can be affected by developments in a range of areas. In this light, the international community has

placed increasing focus on the development and implementation of international standards and has called for experimentation with the preparation of “transparency reports” – summaries of the degree to which an economy observes international standards.

12. IMF staff have completed two rounds of such Transparency reports. In September 1999, the IMF Executive Board requested the preparation of a third round of experimental case studies on members’ observance of international standards, and renamed the reports “Reports on the Observance of Standards and Codes”.
13. The Fund Executive Directors also indicated a preference for a shared ownership approach to preparing ROSCs and invited the World Bank to experiment in preparing particular modules in areas where the Bank has a comparative advantage. The Bank accepted this invitation, given its focus on assisting countries in strengthening the underpinnings for successful financial integration. The Bank has agreed to experiment with undertaking assessments of standards in a number of areas. Moreover, in December 1999, G-20 members agreed “to undertake the completion of Reports on the Observance of Standards and Codes (“Transparency Reports”) and Financial Sector Assessments within the context of continuing efforts by the IMF and the World Bank to improve these mechanisms”. This collaborative approach has been welcomed by the International Monetary and Financial Committee and by the Development Committee.
14. The preparation of summary assessments of the observance of standards is proceeding on a modular basis. ROSC modules will be collected into a ROSC “binder” that will be made available to the Boards of the Bank and the Fund. Fund staff are preparing modules assessing observance of standards in the area of data dissemination and fiscal transparency. Modules for the financial sector are being derived as by-products from the joint Bank/Fund FSAP process. The FSAP teams prepare a series of detailed assessments of selected standards in the broader context of assessing financial sector vulnerabilities and developmental priorities. Standards are selected by the FSAP team, in conjunction with national authorities. To date, assessments have covered monetary and financial policy transparency, banking supervision, securities and insurance regulation, payments systems and deposit insurance. Staff anticipate producing between two and five ROSC modules from each FSAP currently underway.
15. Bank staff have identified three areas in which they plan to experiment with standards assessments and contribute to ROSC modules.
  - The Bank has developed an approach to be used for experimenting with corporate governance assessments that is being discussed with partner institutions, including the OECD and the Fund. Around half a dozen corporate governance modules should be produced by June 2000; discussions are currently underway on country selection.
  - The Bank is also in the process of developing a template for systematically assessing accounting and auditing practices in consultation with relevant national and

international institutions and private sector bodies. However, it is recognized that developing a successful methodology is likely to involve extensive iteration and the involvement of the private sector. By September 2000, an initial set of modules should be available as the basis for further discussions with relevant parties.

- In the area of insolvency regimes, priority is being given to developing a set of principles to underlie successful systems. Work on experimental ROSC modules will commence only after these principles have been considered by the Executive Board of the World Bank and by the Development Committee. This phase of the work should be followed by development of methodologies for assessment and by a series of pilot assessments.

#### **IV. Corporate Governance**

16. The Bank Group's corporate governance work is part of a broader effort to establish policy frameworks for private firms and investors, so as to tap private initiative for effective economic and social development. For example, the corporate governance work complements initiatives to improve competition policy, to combat corruption and to safeguard stakeholder interests. In this context, the main goal of the corporate governance work is to promote the development of equity markets with a view to improving the risk profile of corporations and the stability of financial flows (within countries and across borders). Therefore, the focus at this stage is primarily on shareholders' rights and the role of boards in publicly traded corporations. In doing so, the corporate governance agenda is being aligned with parallel efforts to improve governance systems more generally (e.g. financial sector reform, corporate responsibility, corruption etc.).
17. There are three main components in the Bank's work program to help developing countries strengthen corporate governance:
  - **Corporate Governance Forum.** Together with OECD, the Bank is setting up the Corporate Governance Forum at arm's length and under a multi-year donor funding arrangement that includes the Forum secretariat. The Forum will provide a mechanism for coordinating and channeling technical assistance to help design and implement reforms. The Forum will include the Private Sector Advisory Group (PSAG), whose role will be defined more precisely once the Forum is properly constituted.
  - **Roundtables.** The Bank will continue to collaborate with OECD in conducting dialogue on corporate governance matters through a series of "roundtables". This year roundtables are being organized in Russia, Hong Kong and Brazil.
  - **Assessments.** As noted above, the Bank has developed a template for corporate governance assessments which is being discussed with the OECD, IMF and others, and which will be used for a pilot program of assessments as part of joint ROSC exercise with the IMF.

## V. Accounting and Auditing

18. The East Asian financial crisis has highlighted that sound accounting and auditing practices are essential underpinnings for good governance and well functioning national and international markets. In addition to their broader developmental role, improved financial reporting and governance are also important in managing fiduciary risks associated with the Bank's own lending, especially adjustment and programmatic lending. The Bank recognizes the need for improving accounting and auditing practices in both the private and public sectors of client countries. The Bank has stepped up its efforts to strengthen accounting and auditing practices more broadly, at the national and international levels. The objective is to help strengthen countries' underlying systems for improving financial transparency and accountability in both private and public sectors, as well as to contribute to building a sound international financial architecture.
19. Accounting and auditing reform and development form an important part of the Bank's efforts to strengthen individual countries' financial governance structures. These efforts have several elements:
  - Although the Bank is not itself a standard-setting body, it supports the work of international standard setting bodies in accounting and auditing. In addition to financial support, the Bank's collaboration with these professional bodies includes identifying key issues encountered by member countries, serving as observer on standard-setting committees and providing comments and inputs for the development of new standards. Implementation of internationally recognized accounting and auditing standards will help achieve global comparability of financial information, and help ensure that minimum quality levels are attained.
  - In addition, the Bank has played a leadership and catalytic role in pressing for concerted actions to improve the accounting and auditing profession and practice, both internationally and in developing countries. The Bank has met on several occasions with the five largest international accounting firms and has persuaded the International Forum on Accountancy Development (IFAD) to move forward with an agenda of international action. The Bank is also working with national Supreme Audit Institutions and the International Organization of Supreme Audit Institutions (INTOSAI) to implement sound accounting and auditing practices in the public sector of individual countries.
  - In collaboration with others, the Bank is developing diagnostic tools that can help detect weaknesses in national accounting and auditing systems, and assess the degree of compliance and enforcement. In this context, the Bank is refining its Country Financial Accountability Assessments to cover both private and public sector accounting and auditing more thoroughly. Once finalized, these templates will be used for a pilot program of assessments in partnership with others. These assessments, in line with the principle of country-ownership, will draw to the extent feasible on country self-assessments.



- The Bank continues to provide technical and financial support to many countries for developing the accounting profession, as part of its country assistance programs. The accounting and auditing components of Bank projects are also being strengthened as part of the institution building agenda for development of each country's regulatory framework. As more country assessments are completed, their results will be more systematically reflected in the Bank's Country Assistance Strategies.

## VI. Insolvency Regimes

20. An insolvency initiative was launched in September 1999 with a two-day conference held in Washington. Over 200 people participated in discussions on the economic, legal and institutional dimensions of effective insolvency systems. These included, *inter alia*, design of insolvency laws; licensing and regulation of insolvency practitioners; functions of administrative agencies and courts in the oversight of insolvency proceedings; formal and informal corporate rescue mechanisms; insolvency of banks and state-owned enterprises; and limitations on the role of insolvency systems in systemic financial crises. Notwithstanding the diversity of policy choices underlying insolvency systems, the conference concluded that the preparation of principles and guidelines would provide a valuable diagnostic tool. An effective system would need to embrace specific policy choices that balance the strengths and weaknesses of different facets of the broader system.
21. The Bank has convened a coalition of international organizations and insolvency experts to develop a set of principles and guidelines. A workshop, organized in Asia by the Bank and the OECD in November 1999, was attended by officials, judges and insolvency experts. Based on the conclusions of that workshop, an initial draft of the principles and guidelines is being prepared. The draft will be revised to reflect the outcome of regional workshops planned over the next six months, as well as wider international consultations. In parallel, an assessment matrix is being developed for use in a series of pilot country assessments in FY01.

## VII. Social Protection

22. In response to a Development Committee request, the Bank prepared a paper last year entitled *Managing Social Dimension of Economic Crises: Good Practices in Social Policy*. The paper focused on dimensions of economic and social crises, and what is known about good practice in response.
23. The best approach, of course, is to attempt to prevent such problems from occurring. At the heart of prevention are good practice social policies that promote sustainable development and greater resilience to economic shocks. Present work on good practices has three key elements: enhancing knowledge and understanding of good practices in addressing the social dimensions of crises; organizing knowledge so that it is easily accessible and useful; and bringing the knowledge into Bank operations which help member countries address social issues.

24. The Development Committee welcomed the report and asked that the Bank continue to accumulate and disseminate knowledge of good practices to help guide countries seeking to create institutions and implement policies that will forestall and mitigate the social costs of economic shocks and protect the most vulnerable.
25. Among the Bank's main follow-up activities is the first Sector Strategy Paper on Social Protection which is expected to be reviewed by the Board later this fiscal year. The central theme of the report is that poor people experience many more risks but have inadequate instruments to manage them. As a result, the paper will propose a new social risk management framework.
26. Social Protection (SP) describes public interventions designed to (i) assist individuals, households, and communities to manage risk more effectively, and (ii) provide support to the very poor. This definition broadens the more traditional view of SP beyond reactive public measures to provide income security for individuals (such as labor market interventions, social insurance and social safety nets). In doing so, it treats SP as both a safety net and a spring-board to provide the poor with the capacity to bounce out of poverty, or at least resume gainful work.
27. The new definition encourages a more integrative approach in broadening the types of interventions previously considered the boundaries of SP. It puts more explicit emphasis on the interactions between informal, market-based, and public arrangements, as well as on the interactions among stakeholders.
28. Based on this framework, the Bank has prepared a social protection toolkit as part of the array of diagnostic tools available to underpin the Poverty Reduction Strategy Paper (PRSP). The toolkit helps policymakers choose the best mix of social protection programs and policies to meet poverty objectives set forth by the PRSP. The toolkit facilitates the identification of country and context relevant indicators for both the structural causes of poverty and source of risks faced by the poor. The identification of transmission mechanisms through which these influence poverty outcomes can help in the design and mix of policies and programs. Accordingly, the toolkit provides a guide on how to assess major sources of risk and vulnerability, to determine which groups are most affected, to assess efficacy of different programs and how to select indicators that would be most useful for monitoring progress. The toolkit also provides a summary of program characteristics and good practices for a range of social protection interventions.
29. The Bank has been asked to support an "APEC Finance Social Safety Net Initiative" co-led by the U.S. and Mexico. The objective of the initiative is to establish a set of guidelines to be agreed upon/endorsed by APEC Finance Ministers regarding the use of social safety net policies and programs, taking into account recent experience. The guidelines would be based on analysis of these economies' experience with both the safety nets already in place, targeted primarily to the poorest segments of society, and with the extraordinary instruments put in use in times of crisis to protect the most vulnerable.

### **VIII. Analytical Agenda**

30. As described in the previous architecture report last fall, the Bank is undertaking considerable analytical work on issues that have come to the fore in the aftermath of the East Asian crisis. Of these, three are particularly noteworthy:

- Global Development Finance 2000, which has been reviewed by the Board and will be published end-April, has a special focus on short-term borrowing and the safeguard measures that can be employed alongside longer-term measures to reduce the risks of crisis.
- The Bank has also launched a special project on East Asian Development: Lessons Learnt and Future Prospects. This study, which is expected to be completed in early 2002, will analyze the development experience and lessons of the recent crisis, and enlarge our understanding of development policy and institutional change in an increasingly inter-linked global economy. It will also examine the main forces that will drive future development in East Asia.
- The 2001/2002 World Development Report, scheduled for publication in September 2001, will focus on the institutional structures needed for a well-functioning market economy and will examine how institutional change takes place. This would encompass competition policy and regulation, corporate governance, the role of the judicial system in the enforcement of contracts, financial institutions, governance and political institutions, and the role of social institutions.