Adopting international financial standards in Asia: Convergence or divergence in the global political economy?[1]

Andrew Walter

The last major wave of emerging market crises triggered a global reform project, led by the US and UK, to bring financial regulation in emerging countries into line with the regulatory standards and practices prevailing in the major countries. As noted in the introductory chapter, emerging market and developing countries had little input into the development of these international standards. Although such standards therefore lacked substantive input legitimacy, the asserted and increasingly widely perceived superiority of the Anglo-Saxon approach to financial regulation and governance gave them a wider degree of output legitimacy. This was certainly the assumption of the G7 countries and the major international financial institutions (IFIs), which put considerable effort into the global dissemination and implementation of international standards and codes on the assumption that this would strengthen the weakest link in the global financial system.[2] This assumption was also shared by many important actors in emerging countries, notably in Asia, who saw the adoption of

[1] I wish to thank participants in the Garnet conference, the editors, and various colleagues who participated in the political economy workshop at the London School of Economics for helpful comments on a first draft of this paper. This chapter draws on a larger research project on East Asian compliance with international financial regulatory standards, published in Walter (2006, 2008).

[2] The Financial Stability Forum (FSF), established by the G7 in 1999, referred to twelve 'key standards' listed on its website as 'the various economic and financial standards that are internationally accepted as important for sound, stable and well functioning financial systems' (Financial Stability Forum, 'About the Compendium of Standards', http://www.fsforum.org/compendium/about.html, accessed 2 May 2008).

international standards as a means of importing superior regulatory practices and restraining what they saw as destructive behaviour in their domestic political economies. How successful has this ambitious regulatory reform project been?

In this chapter, I argue that the quality of financial regulation in some emerging market countries has improved considerably since the 1990s, but that there has *not* been systematic convergence upon western regulatory standards. As in the area of exchange rate policy – where researchers have unearthed a large gap between official policies and actual behaviour (Reinhart and Rogoff 2002) – there is often a similarly large gap between words and deeds in financial regulation. Regulatory convergence has in practice been gradual, limited and variable across countries and areas of regulation, and often superficial rather than substantive (what I have elsewhere called 'mock compliance').[3] This is largely because the legitimacy of international standards and associated behavioural practices are often highly contested in the countries that have imported them. The costs of substantive compliance for some actors in developing countries in particular can be high, encouraging these actors to resist compliance. Often, such actors are sufficiently influential that governments have found solutions that fall somewhere between purely formal and substantive compliance but which can be difficult for outside observers to detect.

[3] Walter 2008. In what follows, I use the terms convergence and compliance interchangeably. In a stricter sense, convergence refers to a process by which previously different practices and institutions in national financial systems become more alike, whereas compliance signifies that the behaviour of actors who are the targets of an international rule or standard conforms to its prescriptions.

This argument has three main implications for the broader debates addressed in this volume.[4] First, the relationship between input and output legitimacy in global financial governance is more complex than is sometimes supposed. While developing countries had little input into the standards and codes, there has been less resistance to formal adoption than might have been expected from the low degree of input legitimacy. Formal adoption appeared consistent with best (western) practice, but the considerable scope for de facto domestic adaptation acts as a counterbalance to the undoubted dominance of the major western countries and global financial firms in the process of global financial governance. The assumed mechanisms promoting convergence – specifically market and official incentives – have proven much weaker than the G7 and the IFIs, along with various scholars, initially assumed.[5] If the pressures for convergence were as powerful as some have claimed, we would likely see much more resistance to this form of westernisation at global and regional levels. Second, the formal adoption of international standards has not eviscerated national 'policy space' in financial regulation, either because international standards are flexible in their application or because enforcement by international actors is of limited effectiveness. Regulatory forbearance remains an important option for policymakers; so does window dressing for many private sector actors. At the same time, fuller convergence remains an option for those actors who perceive gains from substantive compliance. Third, it suggests that national-level private sector actors with little influence in global forums can constrain, modify, and sometimes block the implementation of international standards at the domestic level.

[4] See pp.??-??.

[5] For official claims about the role of both official and market incentives, see FSF 2000. For academic claims of this kind, see Ho 2002; Simmons 2001; Soederberg 2003.

None of the aforementioned points constitute grounds for complacency since the approximate political equilibrium produced by national adaptation need not be economically optimal. Indeed, a long historical view casts considerable doubt on the idea that anyone can know what constitutes (or will produce) optimal financial regulation.

The rest of the chapter proceeds in three steps. First, I sketch briefly the unevenness - both across standards and across countries - of convergence upon international regulatory standards.[6] I begin with evidence of convergence at a global level before focusing in more detail on East Asian countries. Second, I discuss some theories that do not adequately explain this outcome, before offering my own. Third, I ask whether this divergence in patterns of financial governance can continue. A final section briefly concludes.

The unevenness of financial regulatory convergence

The focus is on four main areas of financial regulation: the Basle Core Principles for Effective Banking Supervision (BCP), the OECD's Principles of Corporate Governance (PCG), the International Financial Reporting Standards (IFRS),[7] and the IMF's Special Data Dissemination Standard (SDDS). Note that these standards range in degree of specificity from the very general to the relatively detailed. At the very general end of the spectrum are

[6] For those interested in a more detailed account of financial regulatory reform in East Asian countries after the crisis, see Walter 2006, 2008.

[7] Strictly speaking, since 2001 the International Accounting Standards Board (IASB) issues IFRS, but existing International Accounting Standards (IAS), issued by the IASB's predecessor, the International Accounting Standards Committee (IASC), remain valid until replaced or withdrawn.

the PCG; the BCP include a mixture of general principles and more detailed standards, while IFRS and SDDS are both relatively detailed.

Table 1 measures formal compliance with SDDS, IFRS, and with one key aspect of the BCP, the 'Basle I' capital adequacy standard, for different groups of countries just before the recent crisis. It is restricted to these three areas because IMF and World Bank data on compliance with the BCP and the PCG (collected through the Financial Sector Assessment Programme, or FSAP) is not publicly available, and because there is no generally agreed measure of compliance in these latter two areas.

Table 1: Formal compliance with SDDS, IFRS, and Basle I standards: percentages by country group, end 2007

	Percentage of group formally compliant with:		
	SDDS	IFRS	Basle I **
% IMF members *	36%	43%	99%
% OECD members	97%	80%	100%
% Emerging market countries (IMF definition) ***	81%	35%	96%
% Thirteen major crisis-hit countries (since 1990) ****	92%	0%	100%
% Ten major East Asian economies *****	80%	20%	90%

Source: IMF, *Global Financial Stability Reports*; Deloitte-Touche Tohmatsu; Barth, Caprio and Levine (2007)

Notes: *The figure for the 'IMF' group for Basle I compliance is for those 143 countries on the Barth et al. database, which probably overestimates compliance in this category. **Basle I figures generally are as of end 2007, updated from Barth et al. by the IMF's *Global Financial Stability Report, April 2008*. ***The IMF lists twenty-six emerging market countries. ****The thirteen major crisis-hit countries are Argentina, Brazil, Hungary, India, Indonesia, Japan, Korea, Malaysia, Mexico, Russia, Thailand, Turkey and Venezuela (non-compliant). *****The ten major East Asian economies are China (non-compliant), Hong Kong, Indonesia, Malaysia, Japan, Thailand, Singapore, Taiwan Province of China, South Korea and the Philippines.

Three things stand out about table 1. First, OECD countries exhibit fairly high levels of formal compliance across these three sets of international standards. Second, formal Basle I compliance is almost universal, whereas the pattern for SDDS and IFRS is more variable. Third, among emerging markets (for which the SDDS was primarily intended), formal compliance is high for SDDS and Basle I, but low for IFRS.

Because compliance is a continuous rather than a binary variable, these formal indicators do not fully capture either the reality of legislation or regulatory and private sector practice. For example, although most emerging market countries have not yet adopted IFRS in full, some claim that their domestic accounting standards are ‘largely’ though not completely based on them (e.g. Korea and Thailand). Even if we could pinpoint where international standards and national regulations diverge, there is the more complex question of whether regulators, banks, companies, and internal and external auditors actually behave in ways that are consistent with national rules. Mock compliance occurs when actors formally signal their adoption of specific international rules or standards but behave inconsistently (see Raustiala and Slaughter 2002: 539; Shelton 2003: 5). In effect, mock compliance can occupy a range of outcomes between the extremes of formal non-compliance and substantive (behavioural) compliance, though it does not exhaust all the possibilities on the compliance spectrum (figure 1); it is analogous to the now widely recognised phenomenon in exchange rate policy where there is often a large divergence between announced and de facto policies (Reinhart and Rogoff 2002). Mock compliance can occur for numerous reasons, including deliberate regulatory forbearance by the government or its agencies, low bureaucratic enforcement capacity or corruption, and behaviour by private sector actors inconsistent with the intent of the rules.

Figure 1: The spectrum of compliance

We can be reasonably sure that the level of mock compliance with SDDS is low in most cases. This is because the macroeconomic data that SDDS subscribers are obliged to post on the IMF's bulletin board are based upon publicly available national statistics and must be internally consistent. In addition, the IMF publicly declares whether or not a country posting data meets the requirements of SDDS.[8] The only other financial regulatory standards for which categorical official judgements about (country-level) compliance are made are those for money laundering and terrorist financing.

In other areas, the IMF-World Bank FSAP, which laboriously assesses countries' compliance with all international financial standards, produces reports from which very critical and quantitative judgements about compliance are (at member countries' request) often excised.[9] A quarter of all reports are never published, and many important countries have simply refused to participate in the FSAP (though the recent G20 collective commitment to participation may change this). In areas like corporate governance, bank regulation, and accounting, reaching judgements about degrees of compliance is difficult and often

[8] The SDDS is sometimes criticised as insufficient and outdated (e.g. IIF 2006), though the question of its optimality – or indeed that of the quality of the underlying data – is different to that of compliance.

[9] For the Reports on the Observance of Standards and Codes (ROSCs), see http://www.imf.org/external/np/rosc/rosc.asp (accessed 3 May 2008).

controversial. The FSAP acts as an interlocutor with public sector regulators, but the quality of compliance is at least as much a question of private sector behaviour. For all these reasons, published FSAP reports offer a poor guide to patterns of compliance.

Nevertheless, some FSAP reports are relatively candid and additional anecdotal evidence often does emerge that helps to give a better picture of compliance. Taken together, this can show that formal non-compliance in some areas is considerable and that mock compliance is even more significant. To illustrate, regulatory officials in Korea, among the most avid adherents of the international standards project in Asia, claimed that the country had met or exceeded most international standards by 2002 (FSS 2002: forward). But the FSAP review team in 2003 argued that the new Korean financial regulator was insufficiently independent from government and industry, as required by the first BCP. Considerable evidence also emerged of regulatory forbearance for banks willing to lend to those large, distressed corporations important to the Korean government's industrial restructuring objectives. For example, foreign-controlled Korean banks complained of government pressure after 2000 to roll over loans to Hyundai, including to its semiconductor affiliate, Hynix. From May 2000 to June 2002, Korean financial institutions, mostly state-controlled, provided new credits to Hyundai group. Half of this financial support went to Hynix, even though it was then uncreditworthy (US ITA 2003: 18). The new financial regulator had allowed banks to classify their Hynix loans through late 2001 as 'normal' or 'precautionary', a relatively lenient treatment that required them to set aside only small provisions (Fitch Ratings 2002: 2-3). Later, in September 2004, once Hynix's prospects had improved, its senior management and auditors were indicted for fraudulent accounts over the whole period 1996-2003.

Evidence of regulatory forbearance can be found in other Asian countries five years or more after the crisis began. One of the main areas of forbearance, as in the Korean case, was loan classification. Singapore's Monetary Authority (MAS) thought so little of Thailand's supposedly improved loan classification regime that it consistently required Singapore-based parent banks with Thai subsidiaries to re-estimate their reported Thai non-performing loans (NPLs) and to make additional provisions against these exposures. MAS' estimates of Thai NPLs were larger than official Thai figures by a factor of five over 2001-2003.[10] Lax loan classification means that required provisions are lower than they would otherwise be, artificially inflating net income, retained earnings, shareholder's equity, and hence Basle capital ratios. According to Thai generally accepted accounting principles, Thai Danu Bank had positive net assets but by Singapore's standards it was technically insolvent.[11] Indeed, had most governments in East Asia applied the Singaporean (or US) regulatory regime to their own banks in the period up to 2003-2004, additional costly public bailouts would have been inevitable. This applies as much to Japan as to countries like China, Indonesia, Korea and Thailand (Walter 2006, 2008). Given the political and economic constraints on further bailouts, it is small wonder that Asian governments turned a blind eye to low NPL recognition and provisioning – a phenomenon being repeated in some advanced countries today. However, it meant that many Asian banks at the time were compliant with the minimum eight per cent capital to risk-weighted asset ratio (CAR), the core of the Basle regime, in only a very formal sense. It also means that official CARs and NPLs are not comparable across countries (though such comparisons are often made). Regulatory

[10] The affected banks were DBS, which controlled Thai Danu Bank, and UOB, which controlled Radhanasin Bank.

[11] See DBS Group, *Annual Report 2001*, p. 126, and *Annual Report 2002*, p. 80. MAS' relatively strict regulatory treatment probably contributed to DBS' decision to sell its stake in Thai Danu Bank in 2004.

forbearance in Asia, though arguably justified on various public policy grounds, tended to be hidden rather than admitted because of the perceived need of governments to appear to conform to key international regulatory standards after the crisis. Given the widespread perception that weak or discretionary regulation caused the crisis, forbearance became the sin that dare not speak its name.

Similar outcomes can be found in areas such as corporate governance and accounting standards. In corporate governance, one of the major policy reforms after the crisis was to adopt western-style rules for independent directors on the boards of listed companies and various protections against the exploitation of minority shareholders. Various studies have shown that supposedly independent directors in practice rarely constrain incumbent management or major shareholders – who in Asia are still mostly families and governments – and that minority shareholders can still suffer systematic abuses.[12] As one Asian multi-country survey of public and private sector behaviour concluded in 2005:

> A few years ago regulators were praised for tightening up on rules and regulations; today it is apparent that many of these rules have only a limited effect on corporate behaviour. Where implemented, they are often not carried out effectively (CLSA Emerging Markets 2005: 3).

Multi-country surveys also show most Asian countries lagging behind the major developed countries in the quality of their financial reporting despite the claimed adoption of IFRS-consistent domestic financial reporting standards.[13] Although it would be wrong to claim that mock compliance does not exist in the US and UK, particularly after the recent crisis, these

[12] CLSA Emerging Markets 2005; Gomez 2004; IMF 2003; Nam and Nam 2004; Nikomborirak 2004; Standard & Poor's 2004a, 2004b, 2004c; World Bank 2005.

[13] See World Bank (2004: 11); World Economic Forum (2003: 610), and later issues.

surveys suggest that the quality of corporate compliance in countries like China, Indonesia, Korea and Thailand lags well behind that in the US, UK and regional leaders such as Singapore (CLSA 2005; Standard & Poor's 2004d).

To summarise, there has been a widespread trend in Asia towards formal convergence upon a variety of international standards that were seen as a solution to the perceived gross failures of financial regulation prior to the crisis of the late 1990s. But beneath this apparent process of convergence lies a more complex pattern. Across standards, the average level of substantive compliance is much higher for SDDS than for those in areas such as banking supervision, financial reporting, and corporate governance. In areas like banking supervision, mock compliance with certain core standards such as those on minimum bank capitalisation was extensive in some countries for extended periods. There are also large differences in the level of substantive compliance between countries, with countries like Singapore and Hong Kong at the top and China, Indonesia and Thailand towards the bottom. Beneath these country averages lie even larger variations in the degree of corporate compliance with international and domestic standards.

Explaining uneven convergence

What explains this large variation in the degree of real convergence on international financial regulatory standards? Three related theories claim that external forces promote regulatory convergence, but they overestimate the strength of these forces and do not adequately explain the variation that we see in practice.

One prominent theory is that market forces, facilitated by the globalisation of finance, produce powerful incentives for countries and firms to converge upon western regulatory standards and practices.[14] Incentives for *formal* compliance can be significant, with Basle I and II being the best examples. But in other areas, market incentives for formal compliance are much weaker; for example, national rules on accounting and corporate governance vary greatly. Moreover, market incentives for substantive compliance are often weak even when formal compliance is ubiquitous, as is the case for Basle I. Sometimes market incentives can even be perverse: once foreign capital inflows into Asian stocks revived after 2003, the stocks of companies with *worse* corporate governance practices tended to perform better than average (CLSA 2005). The one area where market incentives for substantive compliance have been important is macroeconomic data transparency. Here, there is accumulating evidence that compliance with SDDS lowers sovereign borrowing costs marginally, giving both governments and the private sector an incentive to comply.[15] For countries that host large international financial centres, market pressure seems to promote substantive compliance in other areas like banking regulation and accounting standards. Singapore and Hong Kong are important examples, but also rather exceptional: for most countries, domestic political pressure appears to trump the desire to appeal to global financial market actors.

Another, related theory is that global convergence on the leader's regulatory standards and practices is produced by financial globalisation and, where necessary, hegemonic coercion (Simmons 2001). There is little doubt that the US has taken a leading role in the negotiation and promotion of international financial standards in a range of areas and that international standards are often closely related to American national standards (though not always – the

[14] See Hansmann and Kraakman 2000; Soederberg 2003; Soederberg, Menz and Cerny 2005.

[15] See Cady 2005; Christofides, Mulder and Tiffin 2003; Glennerster and Shin 2003.

PCG and IFRS are cases in point). Simmons' theory, which focuses on the strength of market incentives to follow the leader's regulation and the negative effects of non-followership for the leader, helps to explain why formal compliance is largely voluntary in some cases (e.g. Basle I) and coerced in others (e.g. anti-money laundering rules). But the theory is not well-equipped to explain why the *degree* of compliance in areas where market incentives to emulate the leader are supposedly high (banking regulation, financial reporting) varies considerably across countries. Nor can differential hegemonic pressure explain cross-country variations in compliance: Singapore, Hong Kong and Malaysia have been much less subject to US pressure than have the IMF-intervened countries of Indonesia, Korea and Thailand – but the former have better overall compliance records.

A third common claim is that international institutions promote regulatory convergence. International institutions, both public and private, have been essential to the elaboration and promulgation of international standards. But like market forces and hegemonic states, the standard setters and the IFIs enjoy limited influence over substantive compliance. As noted earlier, even when governments have agreed to participate in an FSAP review of their regulatory practices and have allowed reports to be published, these are often shorn of the most sensitive material. This is not only due to member state reluctance; the IFIs also fear that greater frankness could jeopardise their relationships with member states or trigger capital flight. The reluctance to submit to compliance reviews is apparent in the refusal of many major emerging market countries to participate in a FSAP review (or perhaps to make public its results); as of mid-2008 they included Argentina, Brazil, China, India, Indonesia, Malaysia, South Africa, Thailand and Venezuela. Furthermore, the idea that explicit non-participation has serious negative consequences is implausible as many of these countries have been among the most favoured by international investors in recent years. These nonconformist countries are also in good company: the US, alone among the G7 countries, refused until very recently to subject its regulatory practices to international review.[16] While IFIs have provided considerable technical assistance in this area in recent years, mock compliance stems more from the deep politicisation of regulation and compliance-avoidance strategies by *private* sector actors.

If a combination of global market forces, hegemonic state power, and international institutional pressure and assistance has been insufficient to promote substantive convergence on many international regulatory standards and practices, it provides a strong hint that domestic political resistance to convergence has often trumped external pressure. But why is domestic political resistance to substantive convergence strong in some areas and countries but not in others? Clearly, we need a theory that explains this variation.

One domestic political economy argument is that variation in regulatory outcomes is primarily a product of administrative capacity (Hamilton-Hart 2002). Without denying this can sometimes be important, particularly in the least developed countries, I prefer to view administrative capacity as endogenous to the political process: governments often underfund regulatory agencies or subvert regulation in other ways if the political incentives favouring mock compliance are strong. Moreover, we sometimes find similar outcomes in cases of relatively low (Indonesia) and high institutional capacity (Korea, Japan).

Another argument focuses on the impact of new ideas on convergence. Hall (2003) argues that the crisis delegitimised the old model of financial regulation in Asian countries and

[16] The US government argued, implausibly, that its need to implement Basle II prevented its participation in the FSAP until 2009 (IMF 2007: 19).

favoured domestic elites who deployed a new, neo-liberal ideational discourse, which in turn promoted global regulatory convergence. It is true that emerging market financial crises promoted the adoption of western-style regulatory standards and the ideological delegitimation of previous modes of economic governance. This has made it harder for governments to avoid formal adherence to the international standards agenda (even for countries like Malaysia, which have been harshly critical of other aspects of IMF crisis conditionality). But this ideational theory aims to explain convergence rather than divergence and variation. Moreover, Hall ignores the often large gap between policy rhetoric and behavioural reality. Actors, especially those in the private sector, are often much more innovative and less brainwashed than this argument implies, especially when compliance costs are high and when they believe they can hide mock compliance from outsiders. Even committed neoliberal reformers can favour turning a blind eye to private sector mock compliance if substantive compliance would have serious negative consequences for favoured firms, growth, or employment (as in Korea and Thailand for some years after the 1997 crisis). It would also be wrong to believe that cross-country variations in compliance can be explained by the degree of commitment to liberal market norms. Singapore, Hong Kong and Malaysia arguably have the best compliance records in Asia, but adhere only superficially to market liberalism: alongside their Anglo-Saxon legal traditions and trade openness, there has been persistent extensive government intervention in the economy, the dominance of state and family ownership in the private sector, limited policy transparency, and an unwillingness to accept the norm of politically independent regulators and central banks.

My own explanation is that public and private sector actors are likely to prefer mock compliance when visible non-compliance *and* substantive compliance are both costly to powerful domestic actors. Emerging market crises in the 1990s favoured the formal adoption of international financial standards, by strengthening both the external forces discussed above and those domestic groups that favoured regulatory reform and international convergence. But formal adoption is only part of the battle. Once achieved, much depends on the interaction between the domestic private sector costs of substantive compliance with particular standards and the difficulty that outsiders encounter in monitoring the quality of compliance.[17]

The private sector costs of compliance depend upon the content of standards, including their scope and degree of specificity. Very specific standards such as the now standard accounting requirement that listed companies report all significant related party transactions is costly to corporate insiders who have previously used such mechanisms to exploit minority shareholders. Strict compliance with more stringent bank capitalisation standards is very costly for weak banks and their dependent borrowers. More general principles, such as the recommendation in the PCG that '[corporate] boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest' (OECD 2004: 65) are only potentially onerous: the generality of the recommendation and the difficulty of defining board independence mean that mock compliance with this standard is easy in practice. The costs of substantive compliance are likely to be high and concentrated in financially distressed economies and in those where entrenched insiders will lose from greater transparency and more stringent regulation – even when, as in all of the Asian crisis hit countries, there are also politicians, reformers, investors, and civic activists pushing hard for full convergence. Resistance to substantive compliance is likely to overwhelm the political case for

[17] Outsiders include the IFIs as well as most market actors. For elaboration, see Walter 2008, chapter two.

compliance, since the latter derives from its relatively uncertain and more broadly distributed benefits (which possibly include lower systemic financial fragility and gains for minority shareholders). When the costs of compliance are also high for the economy in general, politicians are more likely to listen and put pressure on regulators to exercise regulatory forbearance. By contrast, when private sector compliance costs are low, resistance to substantive compliance will also be low.

The relative difficulty of third party monitoring will also affect the degree of pressure on the government and on the private sector to comply: when such monitoring is difficult, third party sanctions are difficult to deploy. Monitoring the quality of compliance with financial regulation, corporate governance, and accounting standards is often difficult and costly, requiring not just detailed specific knowledge of particular jurisdictions but also inside information concerning public and private sector behaviour. Monitoring the true level of compliance can be effectively impossible in these areas (Hegarty et al. 2004: 9). This is not only true for private sector monitors. As noted above, the IFIs also have difficulty obtaining inside information about compliance and have no effective means of detecting or sanctioning non-observance within the public or private sectors. In these circumstances, it will often be easier for private sector opponents of substantive compliance to pursue mock compliance strategies than to oppose formal compliance, which is by contrast easily detectable by outsiders (when even the weak can achieve formal compliance, formal non-compliance must signal deep problems!)

Figure 2: Private sector compliance costs and third party monitoring costs for different international standards

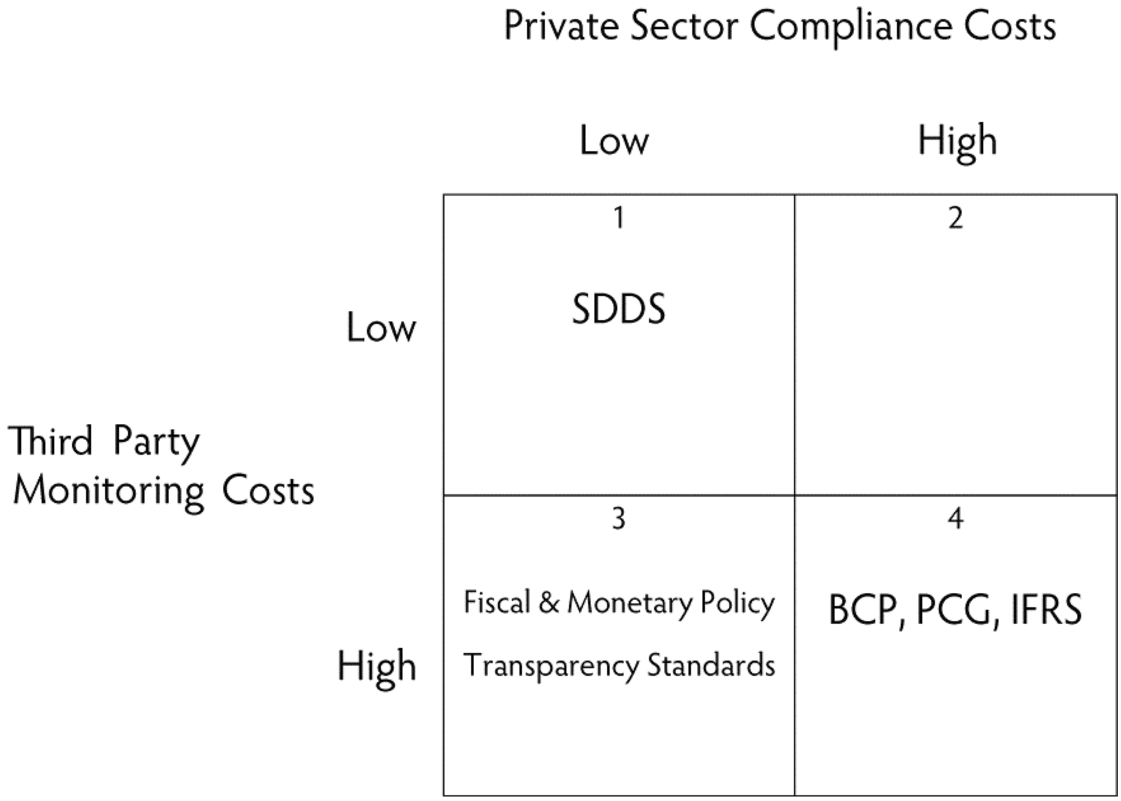

Figure 2 categorises some of the main international standards into a simple 2x2 matrix. The theory predicts that mock compliance outcomes are likeliest in quadrant four and least likely in quadrant 1, which is what we observe in practice (the other quadrants have ambiguous implications).[18] Substantive compliance with SDDS is unusually high because outsider monitoring of the quality of compliance is comparatively easy, because the public sector socialises the costs of compliance, and because compliance produces concrete private benefits (lower sovereign borrowing costs usually also reduce average private sector borrowing costs). By contrast, substantive compliance by the private sector with the stricter

[18] Examples of international financial standards in quadrant two are difficult to find, but international trade rules on non-tariff barriers may be one illustration (given the relative ease and high incentives for competitors to detect and publicise cheating). I thank Ken Shadlen for this point.

components of banking regulation, corporate governance, and financial reporting standards is much less likely in countries with high levels of private sector distress and with corporate ownership structures that privilege insiders (as in Indonesia, Korea, Malaysia and Thailand after the crisis). Perceived external pressure for compliance and domestic private sector resistance can put reformist governments in a difficult position, which can only be squared by some form of regulatory forbearance (as in Korea and Thailand). In countries like Singapore, where financial distress was relatively low and the government controlled much of the corporate sector, compliance was superior to that elsewhere in Asia. Indeed, Singapore's relatively strong banks share an interest with the government in costly *over*-compliance with international standards, a kind of 'peacock's tail' signalling of their distinctiveness from their mock compliant regional competitors.

Can divergence continue?

The difficulty of third party monitoring implies that mock compliance can be sustainable over time. But how sustainable can such behavioural divergence be if evidence continues to trickle out into the public arena? In recent years we have witnessed banks that claim to exceed minimum capitalisation rules suddenly collapse after auditors decide their own reputations require that they register an objection to financial accounts (Resona Bank in Japan in 2003); corporate accounting frauds coming to light that reveal past reporting failures (some major banks and companies in Indonesia, Korea and Thailand); and the media publicising egregious cases of controlling shareholders exploiting minority shareholders in some of the region's most important companies (Samsung in Korea and Shin Corp in Thailand). When this happens, regulators may have no choice but to step in and enforce the rules. Markets also typically punish such firms by withdrawing lines of credit or by selling stock. Will market forces, after all, eventually produce convergence even if the process is slower than many first hoped?

There are various reasons to doubt that these long-run forces for convergence will be very strong. One is that governments and regulators often try to isolate intervened firms as exceptional cases, precisely because of the extensive private and public costs of demanding that all other firms meet regulatory standards in full. In the absence of information about similarly large compliance gaps in other firms, outsiders find it difficult to target them. Moreover, for highly leveraged banks – for which even unsubstantiated market suspicions of under-capitalisation can be disastrous – implicit or explicit government guarantees usually short-circuit market effects, as many advanced countries have more recently discovered. It is public knowledge that the major credit rating agencies believed many Asian banks to be close to insolvent only a few years ago, and that therefore their formal compliance with Basle capital requirements was effectively meaningless. Yet the same credit agencies rated the liabilities of most of these banks as investment grade rather than 'junk' because they judged the probability of government intervention in the event of a threatened bank failure to be almost certain. Table 2 illustrates the distinction between Moody's average credit risk ratings for Asian banks (reflected in the long term 'deposit rating') and its average 'bank financial strength rating' (BFSR) in 2003. The former is most relevant to creditors because it takes into account the probability of government support, whereas the BFSR does not. The gap between the two ratings, and the lack of relationship between deposit ratings and official capital ratios, are indicators of the variable extent of mock compliance in this sector across Asia. Perhaps most notably, Indonesian banks had the highest average CAR, but their very poor BFSRs suggested Moody's still judged them to be as financially weak as then-tottering Japanese banks (Indonesian deposit ratings were below investment grade because the sovereign rating was so poor).

Table 2: Moody's weighted average long-term deposit ratings, bank financial strength ratings, and average CARs, Asian and US banks, 2003

Banks based in:	Moody's weighted average long-term deposit rating, October 2003	Moody's weighted average BFSR, October 2003	Average CARs, mid-2003 (%)
Hong Kong	A2	B-	15.6
Indonesia	B3	E+	21.4
Japan	A3	E+	10.8
South Korea	Baa1	D-	10.4
Malaysia	Baa2	D+	13.4
Singapore	Aa2	B	17.8
Thailand	Baa2	D-	13.6
USA	Aa3	B	12.7

Source: Moody's Investor Services and IMF

Note: AAA is the highest deposit rating, C is the lowest, with the modifiers 1, 2, and 3 in declining order of quality applied to categories from Aa to Caa. A is the highest and E the lowest BFSR.

Does this also mean that the gradual elimination of financial distress in crisis-hit emerging market countries will promote regulatory convergence? There is certainly evidence that after 2004 some governments and regulators stepped up levels of enforcement and reduced regulatory forbearance as economies recovered (Walter 2008). But it would be wrong to expect too much from this process; the financial strength of emerging market banks remained well below those of advanced countries before the 2008-9 crisis.[19]

The main factor favouring continued divergence is that there are powerful forces of continuity in the political economies of emerging market countries that persist even after financial distress has been largely eliminated. Even if markets did impose costs on all firms in a given category or in a whole economy, key domestic actors may still be willing to pay them because the costs of substantive compliance can be even higher. The families behind most Korean chaebol have evidently been willing to pay the additional equity costs entailed by the 'Korea discount' for many years to retain effective control over their corporate empires.[20] Similar points could be made about the very limited concessions to improved corporate governance and full financial disclosure made by many of the ruling business families across Asia (Studwell 2007). Nor are these cases exceptional. Most countries in the world, compared to the US and UK, have concentrated forms of corporate ownership and control, especially by families and governments (La Porta, Lopez-de-Silanes and Shleifer 1998). These insiders do not necessarily share the strong interest of minority shareholders in financial transparency and strict arms-length regulation. As long as corporate ownership and control in Asia and in other parts of the developing world remain so highly concentrated, the domestic political process is unlikely to produce full regulatory convergence.

[19] As of May 2008, Moody's financial strength ratings for Indonesian, Korean, and Thai banks still averaged D, C-, and D respectively (Moody's Investor Services 2008b).

[20] The Korea discount refers to the lower stock price-earnings ratios of most large Korean firms compared to their global competitors, and is commonly attributed to investor concerns about relatively poor corporate governance practices and weak enforcement in Korea (IIF 2003).

This points to what could be a more important source of long-term change. The crisis altered ownership structures in the financial sectors of the crisis-hit countries in Asia by substantially reducing family ownership in their banking sectors. Intervened banks were often sold to recoup some of the massive costs of public bailouts, sometimes to foreign banks or investors. Foreign banks now control about one-third of the banking sector in Indonesia, Korea and Thailand, and 80 per cent of Mexico's. For the twenty-six countries classified as emerging markets by the IMF, the percentage of banking system assets in banks that are at least fifty per cent foreign owned increased from about twenty to thirty-three per cent between 2000 and 2006, though there are large variations about the mean.[21] This not only introduced into these countries' financial systems relatively strong banks with a correspondingly strong interest in higher sectoral levels of compliance (since this would disadvantage their domestic competitors). Foreign-controlled banks have also sometimes eroded though hardly eliminated the traditional relationship-based links between banks and corporations, and increased the pressure on domestic banks to raise their own standards. Nevertheless, in Asia at least, this is unlikely to produce compliance miracles in the near future since foreign banks often focus on retail rather than corporate lending and because nationalist backlashes before 2008 against foreign banks and investors in Korea and Thailand, heavily supported by elements in the corporate sector, already suggested political limits to their transformative role. The 2008-9 crisis has already produced a degree of de-globalisation of banking, so it might be wrong to expect foreign bank penetration to transform domestic political economies in the near future.

Conclusion

[21] Calculated from the Barth, Caprio and Levine banking regulation and supervision survey, http://go.worldbank.org/SNUSW978P0 (accessed 7 May 2008).

I have argued that although the quality of financial regulation in some emerging market countries has improved considerably since the 1990s, there has been no systematic convergence upon western regulatory standards. This conclusion may be less surprising to students of comparative politics, but it differs from a common view in international political economy that the forces for convergence in financial structures are powerful, particularly for developing countries.[22] Regulatory convergence has been on average limited and variable across countries and areas of regulation. Moreover, there has been a marked tendency for public and private sector actors to engage in mock compliance. In short, this suggests that the external pressures for convergence are much weaker than many expected a decade ago and that considerable policy space remains for both public and private sector actors, though this can easily permit behaviour of a perverse kind.

I have also argued that the main reason for continued divergence in regulatory outcomes is that powerful private domestic interest coalitions have had too much to lose from the international standards agenda. But interestingly, their preferred strategy has not been to oppose the process of global financial governance for its lack of input and output legitimacy, but instead to engage in less transparent forms of behavioural dissent. Politicians and regulators – even those who have openly embraced international standards as both legitimate and appropriate – have also used the policy space that still exists between formal adoption of international standards and actual behaviour to engage in various forms of regulatory

[22] Zhang (2009) argues that financial market structures in Malaysia and Taiwan have moved from being bank-based to securities market-based, a related but somewhat different issue. I believe this claim overstates the degree of structural convergence that has taken place, as the World Bank dataset on which it is based does not

forbearance, because they too have understood that substantive compliance would often entail large political costs. This was the learning experience of even the most committed neo-liberal reformers, from the Chuan government in Thailand to the Kim Dae Jung government in Korea. The difficulty that external actors have in assessing the reality of compliance, and sometimes their desire to support domestic reformers, makes it difficult to sanction this behaviour.

The 2008-9 crisis creates considerable uncertainty in this area. Some of its effects arguably favour convergence. Governments and private actors in the major developed countries are now faced with many similar dilemmas previously faced mainly by developing countries. Regulatory forbearance, albeit of a rule-bound kind, appears to be gaining greater legitimacy in the form of a growing consensus in favour of counter-cyclical provisioning and capital requirements for banks. The entry of G20 countries into most of the major international standard setting bodies puts some emerging country governments in the potential position of being rule-makers rather than rule-takers, which might conceivably raise the political costs of non-compliance. Other effects, such as the potential for a de-globalisation of finance, may promote divergence. The crisis has also dramatically undermined the authority claims of the Anglo-Saxon regulatory model with which many international standards are still associated, which may embolden compliance opponents to be more open in their dissent in the future. In many ways, the politics of regulatory convergence is still in its very early stages.

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adjust for the high levels of bank holdings of bonds and the high levels of government and family block equity holdings that characterise Asian financial systems and differentiate them from the US and UK (pre-2008).

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