Trade liberalization and prudential regulation: the international framework for financial services

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Beginning in the mid-1990s, international efforts to open and restructure markets for financial services and to ensure adequate regulation and supervision of financial firms have taken on a new prominence. The General Agreement on Trade in Services (GATS), which was negotiated in the Uruguay Round, marks the first time that services have been covered by a global trade agreement.[1] As a result, financial services liberalization now falls within the purview of the World Trade Organization, where the next set of negotiations on financial and other services is scheduled to begin in 2000. In 1995, primarily in response to the Mexican financial crisis, the Group of Seven (G7) economic summits initiated what has now become a well-established process of setting goals and giving mandates to other fora for work on strengthening prudential regulation and supervision.[2] Previously, such issues had been dealt with almost exclusively in specialized fora such as the Basle Committee on Banking Supervision.[3] More recently, with the onset of the Asian crisis in 1997, the 'conditionality' of International Monetary Fund stabilization programmes has been extended well beyond traditional macroeconomic policy measures to encompass the financial

* The views expressed in this article are those of the author and should not be interpreted as representing the views of the Board of Governors of the Federal Reserve System or anyone else on its staff.

[1] The Uruguay Round was concluded in December 1993, with the GATS and other Uruguay Round agreements entering into force at the beginning of 1995. However, financial services was one of several sectors for which negotiations on schedules of commitments were extended; final agreement on financial services commitments was not reached until December 1997.

[2] The Group of Seven (G7) consists of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. Russia has been gradually integrated into the summit process, and the 1997 Denver summit meeting was referred to as the 'Summit of the Eight' (S8). In 1998 the Birmingham summit was officially designated as a meeting of the Group of Eight (G8). For financial matters, however, the original G7 still meets separately.

[3] The Basle Committee on Banking Supervision (known as the Basle Supervisors Committee) was set up by the central bank governors of the Group of Ten (G10) countries in 1974 in the aftermath of the failure of Bankhaus Herstatt in then West Germany. The committee consists of representatives of the banking supervisory authorities of the G10 countries; its secretariat is provided by the Bank for International Settlements (BIS). The G10 actually consists of twelve countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

infrastructure, including both liberalization and prudential regulation.[4]

The liberalization of trade in financial services discussed in this article should be distinguished from capital account liberalization, that is, removal of restrictions on capital movements. However, realizing fully the benefits of trade liberalization for financial and other services would be very difficult without the free cross-border movement of capital. Although the free movement of capital plays a critical role in allowing efficient allocation of resources on a global basis, the Asian crisis has revived a long-standing debate over the appropriateness and effectiveness of capital controls, particularly on short-term flows.[5] Nevertheless, all parties to the debate agree that controls can never be a substitute for sound macroeconomic policies and for fundamental reforms of domestic financial and legal structures. Indeed, the crisis itself has emphasized that weaknesses in domestic financial systems can create significant vulnerabilities as capital movements are liberalized.[6]

Liberalizing trade in financial services and strengthening prudential regulation and supervision, together with the new emphasis on transparency and accountability in both the private and public sectors, are prominent among the reforms necessary to create more resilient domestic financial systems. Such measures can, and should, be complementary and mutually reinforcing. For example, opening markets to foreign financial service providers can contribute to strengthening of domestic financial systems through the creation of more competitive and efficient host-country markets. At the same time, adequate prudential regulation and supervision must be put in place to enable the maximum benefits to be obtained from liberalization while minimizing the risks. That is, measures to promote competitive markets must be complemented by measures designed to ensure the stability of the financial system and to provide adequate protection for consumers of financial services.

[4] At present, the Asian countries with IMF stabilization programmes are Indonesia, South Korea and Thailand.

[5] See Stanley Fischer, Richard N. Cooper, Rudiger Dornbusch, Peter M. Garber, Carlos Massad, Jacques J. Polak, Dani Rodrik and Savak S. Tarapore, *Should the IMF pursue capital-account convertibility?*, Essays in International Finance no. 207, Princeton University, May 1998; Alan Greenspan, Statement before the Committee on Banking and Financial Services, US House of Representatives, 16 September 1998; Paul Krugman, 'Saving Asia: it's time to get radical', *Fortune*, 7 September 1998; Jeffrey Sachs, 'Global capitalism: making it work', *The Economist*, 12 September 1998; Joseph E. Stiglitz, 'Boats, planes and capital flows', *Financial Times*, 25 March 1998; Lawrence H. Summers, 'Go with the flow', *Financial Times*, 11 March 1998, and 'Repairing and rebuilding emerging market financial systems', remarks at Federal Deposit Insurance Corporation International Conference on Deposit Insurance, Washington DC, 9 September 1998.

[6] Prior to the crisis, a number of Asian countries had been gradually lifting capital controls; subsequently, in August 1998, Malaysia reimposed extensive capital controls. The October 1998 communiqué of the IMF interim committee endorsed the overall principle of free movement of capital, although it asked the IMF board to review experience with the use of certain temporary controls. The communiqué emphasized the need for appropriate sequencing of capital account liberalization and reiterated the importance of sound macroeconomic policies, strong domestic financial systems, and effective prudential regulation and supervision. See Board of Governors of the International Monetary Fund, Communiqué of the Interim Committee, 4 October 1998; also Group of Seven, Chairman's statement, Birmingham Economic Summit, May 1998; *Strengthening the architecture of the global financial system*, Report of G7 finance ministers to G7 heads of state or government, Birmingham economic summit, May 1998; and G7 Leaders' statement on the world economy and Declaration of G7 finance ministers and central bank governors, 30 October 1998.

For this reason, the relationship between liberalization and 'regulation' for the financial services sector has two very different dimensions. On the one hand, liberalization requires reducing or removing regulations that form barriers to trade in financial services; on the other hand, liberalization requires increasing the strength and quality of prudential regulation and supervision. Thus the process of liberalization involves, *inter alia*, reaching a consensus on where to draw the line between regulations that are barriers to trade and regulations that are necessary for prudential purposes.[7]

This article begins with a discussion of liberalization of trade in financial services in the GATS and the WTO and the different types of barriers that need to be addressed. Next, it examines continuing work in various international fora to strengthen national regulatory and supervisory systems and to enhance cooperation and coordination among supervisors, across both borders and financial subsectors. The concluding section highlights some of the future challenges facing international efforts to liberalize trade in financial services and ensure adequate regulation and supervision.

Liberalization in the GATS and the WTO

The General Agreement on Trade in Services (GATS) brings trade in services into a multilateral framework of rules and disciplines broadly comparable to that provided for trade in goods by the General Agreement on Tariffs and Trade (GATT), originally negotiated in 1947.[8] In contrast to the GATT, however, the GATS covers foreign direct investment as well as cross-border trade. Parties to the GATS have undertaken certain obligations and commitments that are subject to enforcement through a strong dispute settlement mechanism under the auspices of the WTO.[9] Once made, commitments cannot be withdrawn without compensation of trading partners.

A country's participation in the GATS does not, however, necessarily mean that it has made strong commitments to market opening. Indeed, both the number

[7] The issue of short-term interbank flows provides an example of the difficulties in drawing the line between liberalization—in this case, of capital flows—and prudential regulation. Overall restrictions on the quantity of such flows could be viewed as unnecessary barriers to the free movement of capital. However, measures aimed at ensuring that banks take into account the riskiness of short-term interbank flows would generally be viewed as legitimate prudential regulation. For example, home countries might apply higher capital requirements that more accurately take into account the risk of such lending. Similarly, host countries might impose measures aimed at ensuring that a bank's reliance on foreign-currency-denominated interbank funding is commensurate with the rest of its balance sheet from a prudential viewpoint.

[8] See Sydney J. Key, *Financial services in the Uruguay Round and the WTO*, Occasional Papers 54 (Washington DC: Group of Thirty, 1997); and Masamichi Kono *et al.*, *Opening markets in financial services and the role of the GATS*, Special Studies (Geneva: World Trade Organization, 1997).

[9] All WTO members are parties to the GATS. The reason is that, as part of the so-called 'single undertaking' of the Uruguay Round, WTO members must be parties to *all* of the multilateral Uruguay Round agreements: (1) the GATT and other multilateral agreements on trade in goods; (2) the GATS; and (3) the Agreement on Trade-related Aspects of International Property Rights (TRIPS).

of services sectors for which commitments were made and the strength of commitments within a sector vary substantially among countries.[10] The GATS requires periodic negotiating rounds to improve commitments and thus achieve a 'progressively higher level of liberalization'.[11] The WTO is now engaged in preparatory work for the next set of services negotiations, known as 'Services 2000'.

'Binding' liberalizing measures in the GATS

Once a liberalizing measure that a country has introduced or plans to introduce has been 'bound' in the GATS, that is, locked in through binding commitments, future backsliding is effectively precluded.[12] Precisely because GATS commitments are virtually irrevocable and subject to dispute settlement, some developing countries have been reluctant to bind liberalizing measures already in effect, let alone plans for future liberalization. Thus capturing continuing liberalization as formal GATS commitments remains a challenge for the WTO.

Some commitments to financial services liberalization made by individual countries as part of the conditionality in recent IMF stabilization programmes are potential candidates for inclusion in the GATS. Indeed, South Korea undertook to improve its GATS financial services commitments as part of its 1998 IMF programme.[13] However, Korea specified as a benchmark its commitments to financial services liberalization made in the Organization for Economic Cooperation and Development (OECD), as opposed to the stronger and more rapid liberalization required by its IMF commitments.

This approach may reflect the concern of developing countries about so-called 'cross-conditionality', which, at its strongest, would require that a commitment to liberalization made under an IMF or World Bank assistance programme be incorporated in a country's schedule of commitments in the GATS or other multilateral trade agreements. In this regard, developing countries point out that the WTO, in contrast to both the IMF and the World Bank, is a contractual trade institution where all countries are supposed to have the opportunity to participate on an equal basis in the negotiating process.

The importance attached to 'binding' liberalizing measures for financial services in the GATS is illustrated by one of the last-minute cliff-hanger issues in the December 1997 financial services negotiations. The question was whether

[10] See Aaditya Mattoo, 'Financial services and the GATS: liberalization in developing and transition economies', preliminary draft, 1998; Roger Kampf, 'Financial services in the WTO: third time lucky', *International Trade Law and Regulation* 4: 3, July 1998.

[11] A country may, however, strengthen its GATS commitments at any time without waiting for another negotiating round.

[12] The GATS does, however, contain a balance-of-payments safeguard that allows a WTO member to impose temporary restrictions that suspend its commitments in the event of 'serious balance-of-payments and external financial difficulties or threat therof.' Besides being temporary, such restrictions must adhere to the most-favoured nation (MFN) principle, be consistent with the IMF Articles of Agreement, be no more stringent than necessary, and avoid unnecessary damage to the economies of other WTO members.

[13] Letter of Intent, with Memorandum on the Economic Programme, from the government of Korea to the International Monetary Fund, 7 February 1998 (http://www.imf.org/external/np/loi/020798.html). Korea also announced in the WTO its intention to improve its GATS financial services commitments.

Japan would bind in the GATS the commitments it had made in bilateral financial services agreements with the United States. Japan's bilateral commitments were, in accordance with the GATS, already being applied to all WTO members on a most favoured nation (MFN) basis.[14] Nevertheless, the United States and other WTO members considered it essential for Japan to include the measures in its GATS schedule of commitments so that they would become formal multilateral commitments directly and fully subject to WTO dispute settlement. In the end, Japan agreed to do so.

Discriminatory and non-discriminatory barriers

The negotiations on financial services liberalization in the GATS focused mainly on reducing or removing discriminatory barriers and other barriers that, in economic terms, have a similar effect.[15] A host country might, for example, discriminate against foreign financial firms by refusing to grant licences for their branches or subsidiaries, imposing limitations on their aggregate market share, or prohibiting them from engaging in certain activities that are permissible for their domestic counterparts. A host country might also impose certain other restrictions, such as an economic needs test for a banking licence or quantitative restrictions on the total number of new licences, that may appear to apply equally to both domestic and foreign banks but are often used in practice to keep foreign banks out of the market. In the GATS, discriminatory barriers to entry and operation and other similar barriers to entry are dealt with using the widely accepted principles of 'national treatment' and 'market access'.[16]

Liberalization of trade in services can also be aimed at reducing or removing non-discriminatory structural barriers. Such barriers arise from aspects of national regulatory systems that do not discriminate between foreign and domestic services and service suppliers. For example, fundamental differences between nations in the rules governing permissible activities for banking organizations or the types of products that may be offered can create significant barriers to trade. Thus, for example, the European Union finds it difficult to

[14] The most favoured nation (MFN) principle precludes a country from discriminating among different foreign countries. Literally, no foreign country can be accorded treatment less favourable than that accorded to the most favoured nation. However, parties to an economic integration agreement, such as the treaty establishing the European Community or the NAFTA, are not required by the GATS to extend its benefits to non-participants, provided that the agreement meets the stringent standards set out in the GATS.

[15] This section and the following section on the prudential carve-out draw upon the author's study, *Financial services in the Uruguay Round and the WTO*.

[16] National treatment means that foreign services and service suppliers may be treated no less favourably than their domestic counterparts with respect to entry and operation in a host-country market. Market access, as used in the GATS, deals with barriers—regardless of whether they are overtly discriminatory—that are typically used to keep foreign firms from entering a host-country market. In the GATS, national treatment and market access do not apply across the board to all services sectors; instead, they apply only to sectors, subsectors or activities that a country lists in its schedule of commitments. This is widely regarded as a structural weakness of the GATS. See Key, *Financial services in the Uruguay Round and the WTO*, pp. 10–11, 14–17.

accept the current US prohibition on affiliations between banks and insurance companies in the United States.

Removing such barriers goes far beyond ensuring that foreign services and service suppliers can enter a host-country market as currently structured and enjoy equality of competitive opportunities *vis-à-vis* their domestic counterparts. Instead, it represents an effort to create maximum potential competitive opportunities in a host-country market, often referred to as 'international contestability of markets'.[17] Achieving it would require reform of domestic regulatory structures, including areas such as competition policy.

Liberalization aimed at achieving maximum potential competitive opportunities in host-country markets would necessarily involve some degree of convergence of national regulatory systems, which could occur de facto or through a more formal process. The internal market programme in the EU represents the most far-reaching effort to date to remove non-discriminatory structural barriers among a group of nations. However, that effort, in addition to being predicated on political agreement on goals for economic liberalization, is being carried out in the context of the unique supranational legislative, judicial and administrative structure of the European Community.[18]

The GATS addresses certain types of non-quantitative and non-discriminatory barriers. Governments must fulfil a general 'transparency' requirement for their actions involving trade in services. Specifically, they must make public statutes, regulations and general administrative decisions that are relevant to trade in services. The GATS also requires countries to apply domestic regulations in a 'reasonable, objective and impartial manner' to avoid undermining commitments to trade in services. The GATS mandates further work to develop disciplines to ensure that domestic licensing requirements or technical standards do not constitute unnecessary barriers to trade in services.[19] Meanwhile, countries have agreed to refrain from adopting rules or standards that are so burdensome, restrictive of trade or lacking in transparency that they undermine their commitments to market access and national treatment.

The GATS deals with additional non-discriminatory structural barriers in provisions applicable only to specific sectors. The most far-reaching is the establishment of pro-competitive regulatory principles for dealing with the telecommunications sector. For financial services, most of the OECD countries

[17] See Edward M. Graham and Robert Z. Lawrence, 'Measuring the international contestability of markets: a conceptual approach', *Journal of World Trade* 30: 5, 1996, pp. 5–20; Americo Beviglia Zampetti and Pierrs Sauvé, 'Onwards to Singapore: the international contestability of markets and the new trade agenda', *The World Economy* 19: 3, 1996, pp. 333–42; and Robert Z. Lawrence, 'Towards globally contestable markets', in *Market access after the Uruguay Round: investment, competition, and technology perspectives* (Paris: OECD, 1996).

[18] The supranational European Community—together with the European Coal and Steel Community (ECSC) and European Atomic Energy Community (Euratom)—forms the first of the so-called three pillars on which the European Union is founded. The two other pillars—common foreign and security policy ('second pillar') and police and judicial cooperation in criminal matters ('third pillar')—are intergovernmental.

[19] To date, work under this mandate has led to adoption of non-binding guidelines for WTO members to use in negotiating mutual recognition of qualifications for accountancy services.

addressed non-discriminatory structural barriers simply by making a general 'best efforts' commitment to remove or eliminate any significant adverse effects of such barriers. The United States and the EU included lists of specific best efforts commitments to remove non-discriminatory barriers. Japan, under great pressure from its trading partners, went further and made binding commitments regarding removal of certain non-discriminatory barriers covered in the bilateral financial services agreements with the United States mentioned above.

With regard to freedom of capital movements, the GATS contains provisions aimed at ensuring that a country does not apply restrictions on payments and transfers that would undermine its commitments to market access and national treatment. The provisions refer to and are consistent with the IMF's responsibilities in this area. Prior to the Asian crisis, active consideration was being given to strengthening the IMF Articles of Agreement to include formal responsibility for capital account convertibility.[20] However, the crisis has made these discussions more difficult.

The prudential 'carve-out'

In dealing with financial services liberalization in the GATS, negotiators had to face the question of where and how to draw the line between measures that primarily have the effect of imposing barriers to trade—and should therefore be eliminated—and measures that are necessary for other public policy goals, such as ensuring the stability of the financial system or protecting depositors. Indeed, when the idea of including financial services in the Uruguay Round was first proposed, financial regulators were concerned about the possibility of a trade agreement interfering with their ability to regulate and supervise financial institutions. They made it clear that inclusion of financial services in the GATS would be unacceptable without a specific exception for prudential regulation and supervision.

The result is that the GATS contains a so-called 'prudential carve-out' for domestic regulation to ensure that the opening of markets that the agreement is intended to achieve will not jeopardize prudential regulation and supervision. Now it is taken for granted by everyone involved that such a provision is necessary whenever financial services are included in an international trade or investment agreement. For example, a prudential carve-out is included in the North American Free Trade Agreement (NAFTA).

In the GATS, the prudential carve-out for domestic regulation permits a country to take prudential measures 'for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed' or 'to ensure the integrity and stability of the financial system' regardless of any other provisions of the GATS. This provision may not, however, be used to avoid a country's

[20] See Fischer *et al.*, *Should the IMF pursue capital-account convertibility?*

obligations and commitments under the agreement. Disagreement over whether a particular measure falls within the prudential carve-out is subject to WTO dispute settlement procedures and thus potentially to determination by a dispute settlement panel.

Most regulators, however, do not appear to be particularly concerned about this possibility. For one thing, prudential issues are dealt with intensively in other fora, as discussed in the following section, so there is some basis for assuming that certain types of rules will always be considered prudential. Moreover, if a country was concerned that a particular measure might not be generally accepted as prudential in the future, it listed that measure as an exception in its schedule of commitments. Another very important reason for the apparent lack of concern is that only governments—not private parties—may bring claims to dispute settlement in the WTO; and, in the absence of a truly egregious action, governments may prefer to respect each other's ability to determine which rules may be prudential. In the event that a prudential issue did reach dispute settlement, the panel would have appropriate financial services expertise, something on which finance officials insisted.

International efforts to ensure adequate prudential regulation and supervision

The ultimate responsibility for regulating and supervising banks and other financial institutions lies with national authorities.[21] However, the consequences of lax regulation and weak supervision within a particular country can have an impact far beyond the nation's borders. Because of the phenomenon of 'systemic risk', problems with one bank can be transmitted to unrelated banks, both within and beyond a single country. For example, a chain reaction of problems could be triggered through imitative runs as depositors lose confidence in a banking system, through default on domestic or international interbank obligations, or through domestic or international payment systems. Problems in a country's financial sector can also affect the real economy, both domestically and internationally, through declines in output and shifts in trade flows.

In addition, the existence of global financial firms, with activities falling within many different national jurisdictions, requires cooperation and coordination between home- and host-country supervisors to ensure that there are no gaps in

[21] Even within the EU, the European Central Bank (ECB) is provided with only advisory and consultative powers in bank regulation and supervision. An enabling clause in the treaty would allow other powers to be transferred to the ECB, but such a transfer would require a unanimous decision by the Council of Economic and Finance Ministers (ECOFIN). See Johannes Priesemann, 'Policy options for prudential supervision in stage three of monetary union', and Sydney J. Key, 'Comments', in Paul J. J. Welfens and Holger C. Wolf, eds, *Banking, international capital flows, and growth in Europe* (Berlin: Springer-Verlag, 1997); ECU Institute, *Banking supervision in the European Community: institutional aspects*, report of a working group chaired by Jean-Victor Louis (Brussels: Institute of European Studies, University of Brussels, 1995); and Karel Lannoo, *From 1992 to EMU: the implications for prudential supervision*, CEPS Research Report no. 23 (Brussels: Centre for European Policy Studies, May 1998).

the supervision of such firms. Increasingly, these global firms are financial conglomerates, which means that supervisory cooperation and coordination are necessary across not only borders but also financial subsectors.

For all of these reasons, countries have a stake in the quality of each other's regulation and supervision of the financial sector and in ensuring cooperation and coordination between supervisors. In this regard it is useful to distinguish between prudential *regulation*, which refers to capital and other requirements designed to ensure the safety and soundness of financial institutions or to protect consumers, and *supervision*, which involves ensuring that such requirements are adhered to by financial institutions. The importance of strong, effective supervision cannot be overemphasized; without it, the best prudential rules on paper can be meaningless in practice.

An array of institutions and fora are involved in international efforts aimed at ensuring adequate prudential regulation and supervision. To date, these efforts have been concentrated in sector-specific fora and have been relatively informal, that is, conducted without legally binding international agreements. Their influence has been based on a common recognition of the need to address the issues collectively and on peer and market pressures to develop and adhere to internationally accepted norms.

The earliest efforts to formulate minimum standards and best practices were in the banking sector, where the principal forum is the Basle Supervisors Committee, which consists of officials from central banks and supervisory authorities of the G10 countries.[22] Perhaps its best-known effort is the 1988 Basle Risk-based Capital Accord, an informal agreement between supervisory authorities of the G10 countries that sets out capital standards for internationally active banks.[23] The accord has been widely accepted by supervisors beyond the G10.

The Basle Supervisors Committee has also done extensive work on supervisory policies and practices, including standards for effective consolidated supervision of internationally active banks and the allocation of responsibilities between home- and host-country supervisors.[24] In 1997, as part of the mandate from the G7 summits, the committee published the Core Principles for Effective Banking Supervision (known as the Basle Core Principles), which were developed in collaboration with supervisory authorities from 15 emerging market

[22] See note 3 above. See William R. White, 'Promoting financial stability: the role of the BIS', paper prepared for a conference on 'Coping with financial crises in developing and transition countries: regulatory and supervisory challenges in a new era of global finance', De Nederlandsche Bank, Amsterdam, 16–17 March 1998.

[23] Because it is an informal agreement among supervisors, the Basle Risk-based Capital Accord does not create any obligations in international law. The capital standards are based on broad categories of risk classification of bank assets. In 1996 the accord was amended to establish capital requirements for the market risk associated with banks' securities activities. The Basle Committee has begun work on another revision of the accord. For example, there is now general agreement that it does not adequately distinguish between different categories of risks.

[24] See White, 'Promoting financial stability'.

economies.[25] The Core Principles are designed to provide a generally accepted set of principles and practices for effective supervision of national banking systems that can be used throughout the world; they have been widely endorsed by supervisory authorities from both industrial countries and emerging market economies.

A similar effort has been made in the securities sector, where the primary forum for international cooperation on regulatory and supervisory issues is the technical committee of the International Organization of Securities Commissions (IOSCO), which, unlike the Basle structure, is a worldwide membership organization.[26] In 1997 the technical committee, together with the emerging markets committee, published the IOSCO Principles and Objectives of Financial Regulation, which are intended to be used by securities regulators around the world and were endorsed by the IOSCO membership in 1998.

The globalization of the insurance sector has, with the notable exception of reinsurance, been less rapid than that of the banking and securities sectors; however, by 1994 the International Association of Insurance Commissioners (IAIS) had been established.[27] Again in accordance with the G7 summit mandate, the IAIS adopted model principles for insurance supervision in 1997 and is in the process of developing additional supervisory standards.

As the activities and affiliations of global financial firms increasingly cross financial subsectors, cooperation between these international fora has increased. In response to a mandate from the 1996 Lyon summit to strengthen cooperation between supervisors of different types of financial institutions as well as between supervisors in different countries, the Basle Supervisors Committee, IOSCO and IAIS established a formal mechanism for cooperation, the Joint Forum on Financial Conglomerates. In 1998, the Joint Forum released for comment a series of papers dealing with issues such as ways to facilitate the exchange of information between supervisors and ways to enhance the coordination of supervision of financial conglomerates operating across national boundaries.

Besides the Basle Supervisors Committee, other committees within the BIS framework that are contributing to the overall G7 work programme to strengthen financial systems include the Euro-Currency Standing Committee and the Committee on Payment and Settlement Systems. Accounting standards are being dealt with by the private sector International Accounting Standards Committee (IASC), by an IOSCO committee and by a subgroup of the Basle Supervisors Committee. Corporate governance issues are being dealt with at the OECD.[28]

[25] The Core Principles were issued together with a compendium of rules and recommendations on banking supervision that represents the previous two decades of work of the Basle Supervisors Committee. All of the documents produced by the Basle Supervisors Committee are available on the BIS website (http://www.bis.org/publ/bcbs).

[26] IOSCO was created in 1983 and has its headquarters in Montreal.

[27] In part to facilitate contacts with the Basle Supervisors Committee, the IAIS has established its headquarters in the Bank for International Settlements (BIS) building in Basle.

[28] See OECD, *Corporate governance: improving competitiveness and access to capital in global markets*, Report of the Business Sector Advisory Group (Paris: OECD, 2 April 1998).

Even if prudential standards promulgated by the Basle Supervisors Committee and other international fora are widely accepted, how effectively they will be implemented—in terms of both the details of national regulatory regimes and day-to-day supervision—remains a major issue. Partly in response to the Asian crisis, the question has been raised whether some form of international monitoring of national regulation and supervision is necessary.[29] The need for such a process, the way in which it might be structured, how formal it should be, and the potential roles of the international institutions and fora are the subject of ongoing discussions. A recent report by a Group of 22 (G22) working group recommended that the regular IMF surveillance of the economic policies of its member countries (known as 'Article IV surveillance'), drawing upon expertise at the World Bank and elsewhere, also be used for banking system surveillance. The report suggested that, in addition, consideration be given to a process of voluntary peer review by supervisors from other countries.[30] Subsequently, the G7 expressed support for establishment of a process of strengthened financial sector suveillance, including peer review and IMF Article IV surveillance.[31]

Whatever is done at the international level, host-country bank regulatory authorities will retain powers under national law to reject applications for entry from a foreign bank for prudential reasons. In the United States, for example, under the Foreign Bank Supervision Enhancement Act of 1991, the Federal Reserve Board is required to determine, *inter alia*, that a foreign bank seeking to establish a US branch is subject to 'comprehensive, consolidated supervision' in the home country, or that the authorities are actively working towards such supervision, in order to approve the application.[32] This provision appears to have encouraged a number of countries in Latin America to move towards consolidated supervision more rapidly than they might otherwise have done.

Both the IMF and the World Bank are expected to play a role in ensuring implementation of the Basle Core Principles and other internationally agreed principles for financial sector regulation and supervision. The IMF, as already noted, and also the World Bank and the regional multilateral development banks, are now increasingly focusing on the strength of countries' financial sectors,

[29] Canada, for example, has proposed an international supervisory surveillance secretariat. See Canadian Department of Finance press release, no. 98–039, 15 April 1998. The United Kingdom has suggested that consideration be given to establishing a standing committee for global financial regulation that would bring together the IMF, the World Bank, the Basle Supervisors Committee and other groups. See Gordon Brown, 'Steering a course for stability,' speech to the Annual Meetings of the IMF and the World Bank, Washington DC, 6 October 1998.

[30] See G22, *Report of the Working Group on Strengthening Financial Systems*, October 1998. The G22 is an ad hoc group of the G7 countries, other major industrial countries, and a number of emerging market economies. Three working groups (the other two dealt with transparency and international financial crises) were established in April 1998 at a meeting of the finance ministers and central bank governors of the 22 countries in Washington DC. The reports of the working groups can be found on the IMF web site: http://www.imf.org

[31] Declaration of G7 finance ministers and central bank governors, 30 October 1998.

[32] See International Banking Act of 1978, as amended by the Foreign Bank Supervision Enhancement Act of 1991, Section 7, 12 U.S.C. §3105.

including the quality of national regulation and supervision. The IMF is addressing financial sector issues through its current programmes in Asia and through the planned expansion of Article IV surveillance. The World Bank is continuing to address these issues through its structural lending programmes for the financial sector and its technical assistance programmes.

The Basle Supervisors Committee has set up consultation and liaison groups to address issues that arise in the application of the Basle Core Principles; the work of these groups is based on the self-assessments of supervisory authorities. In addition, in response to the need for—and importance of—technical assistance that utilizes officials with practical supervisory experience, the BIS and the Basle Committee have set up an Institute for Financial Stability with the goal of providing training and coordinating technical assistance from national supervisory authorities. The Institute envisages close cooperation with the IMF, the World Bank, and the Toronto International Leadership Centre for Financial Sector Supervision (known as the Toronto Institute), which was set up by the World Bank and the Canadian government in 1997 to provide an executive development programme for senior supervisory officials.

Ensuring strong, effectively supervised national banking systems forms an important part of current efforts to strengthen the so-called global financial 'architecture'.[33] In addition to strengthening financial systems, these efforts include helping countries prepare for global capital flows (discussed above); increasing transparency, both at the national level, including firms, markets and governments, and, equally important, at the IMF itself;[34] and ensuring that the private sector takes full responsibility for its own decisions in order to reduce moral hazard.[35] These goals are, of course, interrelated. For example, regulation and supervision complement and support, but are not a substitute for, market discipline; thus work on other elements of the architecture such as transparency, which includes disclosure of financial information by firms and by governmental authorities (including central banks) is critical for strong financial systems.

Conclusion

International efforts to ensure adequate regulation and supervision of financial firms have been proceeding on parallel, but different, tracks from efforts to open and restructure markets for financial services. Yet all of these efforts are inextricably

[33] See G7 Leaders' statement on the world economy and Declaration of G7 finance ministers and central bank governors, 30 October 1998; G22, *Report of the Working Group on Transparency and Accountability*, *Report of the Working Group on Strengthening Financial Systems* and *Report of the Working Group on International Financial Crises*; also *Strengthening the architecture of the global financial system*, Report of G7 finance ministers to G7 heads of state or government.

[34] See G22, *Report of the Working Group on Transparency and Accountability*; Declaration of G7 finance ministers and central bank governors, 30 October 1998.

[35] See G22, *Report of the Working Group on Strengthening Financial Systems* and *Report of the Working Group on International Financial Crises*; Declaration of G7 finance ministers and central bank governors, 30 October 1998.

linked, both by market developments and by the overall policy framework established with leadership from G7 summits. Moreover, for Asian countries with IMF stabilization programmes, the tracks have converged in IMF conditionality. In future, for all countries, routine IMF surveillance will be expanded to cover national financial systems, including both liberalization and prudential regulation.

Compared with other sectors of the economy, the financial services sector is unusual in having an elaborate and intensively used network of international fora both for continuing consultations on policy issues and for informal, but widely accepted, standard setting. In part this has occurred because of the special characteristics and sensitivity of the financial sector—in particular, the role of financial firms and markets in financing the real economy, the roles of banks in monetary and payments systems, and the phenomenon of systemic risk, which operates internationally as well as domestically. Against this background, the inclusion of financial services in a global agreement on trade liberalization was a major step. The prudential carve-out was essential for such a step to be acceptable to financial regulators, and special provision was also made for financial services expertise on any dispute settlement panel dealing with financial services. Moreover, because of the need for financial as well as trade expertise in the negotiating process, financial and regulatory officials in the United States and a number of other countries played a major role in the negotiations and presumably will continue to do so in future negotiations.

The next major steps in the WTO framework for liberalization of trade in services are 'Services 2000', that is, the GATS negotiations on specific commitments in financial and other services sectors that are required to begin by 2000, and the relevant parts of the WTO accession negotiations with Russia and China. In 'Services 2000', the United States and other major industrial countries are expected to renew their efforts to reduce or remove remaining barriers in countries that were the focus of the 1997 negotiations, as well as in some additional countries. The negotiations are also expected to try to capture as binding GATS commitments liberalizing measures that have been introduced but not yet 'bound', including measures undertaken as part of IMF programmes.

In theory, the liberalization at issue could involve non-discriminatory structural barriers as well as barriers to national treatment and market access. Although it seems unlikely that the WTO would become a primary forum for negotiating the removal of non-discriminatory structural barriers for financial services, the question of whether existing or ongoing liberalization of such barriers should be bound will need to be addressed. This raises the issue of how far into the domestic regulatory structure for financial services countries are willing to proceed with WTO commitments that are virtually irrevocable and subject to a dispute settlement mechanism.

With regard to the impact of the Asian crisis on the next set of negotiations, it is encouraging to note that the 1997 negotiations, which coincided with the beginning of the crisis, were not derailed by it. Instead, the crisis appears to have

created even greater pressure on all parties to reach an acceptable compromise. Among other things, it seems to have reinforced the recognition, which was already becoming more widespread, that market opening can not only benefit consumers of financial services but also contribute towards the resiliency of domestic financial systems. In this context, the traditional trade negotiation paradigm whereby countries trade 'concessions' of market opening which, in economic terms, are in their own interest in the first place, may be less applicable.

The Asian crisis also underlined the importance of specific GATS commitments to openness as a guarantee that there will be no backtracking in the face of domestic protectionist pressures. In addition, the WTO negotiating process per se can have an impact on domestic policy-making. For example, in preparing for and participating in WTO negotiations, national policy-makers are forced, within a set period of time, to focus on and account to their trading partners for their barriers in the financial services sector, and to explore their ability in terms of domestic political constraints to reduce or eliminate those barriers.

The international framework for dealing with trade liberalization and prudential regulation in the financial services sector is much more fragmented than that within the EU, where everything is being done within one institutional framework. That is, the European Community deals with all aspects of trade in financial services among the member states, including liberalization aimed at non-discriminatory as well as discriminatory barriers, removal of restrictions on capital movements, and harmonization of essential national rules such as capital standards or consumer protection measures.[36] Beyond the EU, international efforts must proceed without a supranational structure comparable to that of the EC and without the broad scope of its legislated harmonization of essential national rules.

All of the international fora dealing with liberalization and regulation of financial services are in the process of adapting or expanding their roles to deal with the challenges associated with the globalization of financial activity and new policy needs. New relationships and lines of communication are being established between the IMF, the World Bank and the WTO as regards liberalization,[37] and as regards regulation and supervision between the IMF, the World Bank and sector-specific fora such as the BIS and IOSCO and national supervisory authorities. There is considerable scope for developing creative interaction among the various fora to produce greater policy coherence, short of cross-conditionality. At a minimum, they should reinforce and facilitate each other's work.

The greater the role of the international fora, however, the more important the transparency and accountability of those fora become. This is particularly

[36] Regarding 'European Union' and 'European Community', see note 17 above.
[37] See Joint statement by the heads of the IMF, the World Bank and the WTO, 16 October 1998.

true for the IMF, which, although not a supranational institution to which countries have transferred sovereignty, by virtue of its leverage in providing financing exercises tremendous power through the conditionality of its stabilization programmes.[38]

In the final analysis the international fora, however inclusive, however expert, however transparent they may be, can do only so much. Whatever fora are used and whatever means are relied upon, the ultimate success of international efforts aimed at liberalization and regulation of financial services depends on the extent to which these goals are internalized by national governments and regulatory authorities. Thus a continuing challenge for the international fora is to harness, and provide support for, national efforts to achieve greater openness, to liberalize domestic financial structures, and to improve prudential regulation and supervision.

[38] The IMF is not a supranational institution; in terms of strict legality, a country could walk away from IMF assistance and its associated conditionality. By contrast, the European Community has a supranational legislative process involving the Council (with weighted majority voting in many areas) and Parliament; a supranational court of justice and, now, a central bank; and an executive body which is responsible for proposing legislation and monitoring its implementation and which has extensive administrative authority in certain areas such as competition policy.