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Enhancing International Financial Market Integration

By Joint Shadow Financial Regulatory Committees

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I.

As the World Bank has noted in a recent report: "There is now a solid body of research suggesting that improvement in financial arrangements precede and contribute to economic performance. In other words, the widespread desire to see an effectively functioning financial system is warranted by its clear causal link to growth, macroeconomic stability, and poverty reduction." The Shadow Financial Regulatory Committee of Asia, Europe, Japan, Latin America

and the United States believe that individual countries' growth and world-wide economic development can be accelerated by competitive and open financial markets, both domestically and internationally. Therefore, the Committees recommend the reduction and ultimate elimination of distortionary restrictions that interfere with the free provision of financial services across borders.

One can reasonably ask: if these substantial benefits flow from competitive and open financial markets, why don't we see around us a world in which such markets are universal? There are a number of fundamental answers to this question. First, governments tend to protect their local industries, often in the name of consumer protection, and to some extent protect their own powers and prerogatives–both of which would be eroded by competition from financial firms entering from abroad. Second, some countries resist further opening of their financial systems because they do not have a satisfactory supervisory and regulatory infrastructure that requires financial transparency, sufficient for effective market discipline, as well as effective bankruptcy laws. In addition, in developing economies, policymakers may resist complete opening of their financial systems because of the perceived instability arising from highly volatile international capital flows. Lastly, countries have legitimate concerns about the solvency of foreign institutions and the protection of their consumers and investors from fraud or deceptive practices.

Moreover, there are political dimensions associated with opening financial systems. First, while the benefits are widely spread throughout the economy, the costs are highly concentrated in a few groups. Second, in the long term, great benefits can be expected from open and competitive financial markets, but in the short term there are firms and governments that lose economic rents and much treasured

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authority to control important elements of their economies.

Obstacles to the achievement of competitive financial markets can take many forms. The most visible and pernicious are direct barriers to the entry of foreign firms to do domestic business, as will be discussed in Part II. More numerous are the many forms of regulation that raise the costs of operating financial firms across borders that are discussed in Part III.

II. Market Access

Direct restrictions on the ability of foreign firms to establish a local presence impede international financial integration in both advanced industrial and in emerging markets. Such restrictions may include overtly discriminatory measures, such as restrictions on foreign ownership or on the number of financial institutions that are allowed to operate in a country. Even when foreign institutions are permitted to enter their activities may be severely constrained by limitations on market share, corporate form, special regulatory or prudential requirements or restrictions on products they may offer and customers they may serve. Such restrictions also include impediments to the immigration of key personnel or cross-border flows of information.

Local policies that have the effect of restricting the acquisition of domestic banks by foreign institutions are also undesirable. The argument against such restrictions is exactly the same as the argument against explicit restrictions–they are discriminatory, and deprive local financial systems of needed competition, innovation and transfer of expertise. We have in mind the policies of certain countries in Europe, and of Japan, that protect “national champions” in the banking sector. We believe that

developed countries cannot credibly advocate the removal of explicit prohibitions on foreign ownership in developing or emerging markets if developed countries maintain indirect prohibitions, with exactly the same effect, in their own countries.

Our recommendations against direct restrictions extend not only to banks, but to insurance companies, securities firms, asset management companies, finance companies, credit card companies, and venture capital and private equity firms. Market access by foreign financial institutions in all of these fields would be a very effective means of accelerating financial modernization, as well as often providing preferable alternatives.

Some would argue that countries should not allow foreign institutions to operate domestically until they have put in place an improved regulatory and supervisory infrastructure and strengthened domestic institutions to withstand foreign competition. Too often this becomes a rationale for postponing reforms indefinitely. Moreover, it ignores the useful role that foreign financial institutions can play in improving market practices, enhancing technology and upgrading skills in the financial sector as part of the modernization process. Many of the gains can be achieved by liberalizing direct restrictions on market access (e.g., direct investment in the financial sector) even if restrictions on portfolio capital flows remain in place. While countries need to be concerned about the potential vulnerability inherent in short-term capital flows, this risk is in no way reduced by restricting foreign ownership in the financial sector and can be mitigated by appropriate supervision of financial institutions. Development of capital and money markets will ultimately depend on relaxation of controls on portfolio capital.

Given these restrictions and the potential gains from liberalization, what mechanisms can promote progress? Current initiatives range from formal negotiations within the World Trade Organization (financial services sectoral trade negotiations), to bilateral and regional free trade areas, international efforts to formulate and promote compliance with international standards and codes, regional collaborative efforts and informal dialogues among official and private sector participants.

At a multilateral level, the WTO is the only global institution dealing with the rules of trade between nations, including trade in financial services and products. At its heart is the General Agreement on Trade in Services (GATS) and the specific liberalization commitments relating to financial services and markets. It must be emphasized that while the GATS framework agreement is binding on all WTO members, the specific legally binding commitments to offer market access and non-discriminatory treatment to foreign financial institutions are undertaken voluntarily by individual countries in the course of negotiations. The ensuing elimination of direct discriminatory barriers constitutes a positive contribution to the cause of further integration of domestic financial markets.

We should not lose sight, however, of the limitations and inherent shortcomings of the WTO-based track of reform. WTO negotiations have largely failed to achieve the desirable outcome of limiting restrictions on market access. Thus far in the current Doha round of financial services negotiations, the existing offers for a new set of financial services commitments are rather limited in scope and scale and far from promising substantial progress towards more open domestic financial systems and markets. It is also clear that the WTO has neither the mandate nor the institutional capacity to deal with the more subtle and elusive sources of

barriers to international financial integration, namely the high costs of doing business in many different jurisdictions, each one with its own legal rules and standards governing the conduct of financial activities. In our conclusions, we propose strengthened efforts to find alternatives to the WTO in this respect.

III. Other Barriers

This section of the Statement addresses other barriers to global financial integration, focusing on banking, securities, and insurance. These are indirect barriers which have the effect of preventing or inhibiting cross-border financial transactions, thus making the provision of financial services to consumers worldwide more costly and potentially distorting the allocation of capital.

International Accounting Standards

An issue affecting the entire global financial system is accounting standards. Currently the U.S. SEC requires foreign issuers of publicly traded securities to state their accounts in U.S. generally accepted accounting principles (GAAP) or reconcile statements under foreign GAAP rules to the U.S. GAAP. On the other hand, the EU has mandated that all EU companies state their accounts under International Financial Reporting Standards (IFRS or IAS) by June 2005, and that non-EU companies do so by 2006.

The Committees recommend that all countries accept IAS or U.S. GAAP for foreign publicly traded companies, as an alternative to local GAAP rules, subject to the proviso that host countries can require additions or changes to IAS or U.S. GAAP where the country determines, based on a detailed inquiry, that these standards are deficient in some material respect. With respect to foreign issuers, we believe that in major respects U.S. GAAP and IAS are sufficiently

converged to be acceptable alternatives to each other, and that both should be acceptable alternatives to other local GAAP rules. Furthermore, they are the international product of a long-term effort of the accounting authorities of the major developed countries. This Statement builds on Statement No. 203 of the U.S. Shadow Financial Regulatory Committee issued on February 9, 2004.

Banking

Countries can admit foreign depository organizations in two ways. One is to charter a bank that is a subsidiary of a foreign-chartered bank. In this situation, the subsidiary would be subject to the same laws and regulations as are other banks, the only difference being the domicile of the owners. The other is to allow foreign banks to operate branches, a situation that often is more efficient and, hence, more likely to occur if permitted. In this event, if entry via branching were permitted, the host government should offer depositors insurance protection under the same terms as it makes available to its domestic banks. Otherwise, retail depositors particularly may mistakenly believe (or later claim that they were led to believe) that all deposits in their banks were protected.

The host country could require the branch to hold assets or provide a bond sufficient to cover the deposit insurance obligation, and impose reporting and audit requirements to ensure this protection. Or, if the host country believes that the foreign banks were sufficiently well capitalized and supervised by their home countries, it would not impose these requirements.

Thus, the United States should examine whether to permit branching by banks in countries with adequate asset protection or with acceptable supervisory systems. The EU

allows its banks to branch within the Union, with the home country being responsible for both deposit insurance and supervision. We recommend against this procedure, as some depositors are likely to be misled and harmed should a bank in an EU country with less effective capital requirements and supervision become insolvent and depositors learn the hard way that their deposits actually have less insurance coverage or more restrictive terms than they expected.

Securities

The Committees generally believe that investors in any country should be free to buy securities offered in another country, whether or not their orders are sua sponte or solicited by brokers. We are cognizant, however, of the problems of investor protection that such a policy might raise. Local investors in a host country may be defrauded by "boiler room" foreign issuers and find it difficult to pursue remedies abroad. However, among certain developed countries–the United States, the European Union and Japan, in particular–the Committees believe there is enough convergence of disclosure rules, due to recent reforms, and sufficient cooperation in enforcement through memoranda of understandings (MOUs) and similar mechanisms, to permit a mutual recognition approach. Thus, the Committees would recommend that these three jurisdictions permit issuers from the other two jurisdictions to sell publicly traded securities in their jurisdiction under home country rules. It would follow from this that we would require that the SEC permit foreign stock exchanges within the EU to establish trading screens in the U.S. that would facilitate the ability of U.S. investors to trade securities listed on foreign exchanges. As with accounting, we would permit host countries to insist on additional disclosure items, in addition to those required by the home jurisdiction, where

the host jurisdiction determined, after a detailed inquiry, that additional disclosure was required.

We also recommend that countries be extremely circumspect in imposing their requirements on an extraterritorial basis. It is bad enough when countries impose restrictions in their own countries impeding global financial integration. It is worse still when a country seeks to impose these restrictions on activity outside of its own country. We would, therefore, urge the United States to reexamine Regulation S which imposes restrictions on the sale of securities to U.S. investors outside the U.S. and the EU and the U.S. to reexamine the extraterritorial reach of their competition laws.

We also note another problem in international securities markets, the existence of different rules which impede global offerings. For example, the U.S. has greatly restricted the provision of information, by issuers and underwriters, to the market during a public offering. Issuers simultaneously offering securities in the U.S., EU and other developed markets have been forced to comply with this restrictive U.S. rule. While the SEC is proposing to relax this type of restriction for very large companies, they will remain for other companies. This is only one example of many where different rules in different countries impede global offerings. We suggest that international trade associations of issuers and securities firms work together to resolve such differences. An example to follow would be the work of the Group of Thirty with respect to clearing and settlement standards. These industry recommendations could then be brought to a special committee of concerned countries at IOSCO for ratification, and then adoption by individual countries.

Finally, we recommend a hard look at regulatory obstacles

to cross-border mergers of stock exchanges. Given the increasing globalization of securities trading, we would expect that there would be more consolidation of stock exchanges than there has been. We note that even within the European Union, the merger of the Frankfurt and London stock exchanges was impeded by differences in regulation between the two countries.

Insurance

The Committees believes that consumers should generally be able to buy insurance products from foreign as well as domestic providers. We recognize, however, that there is a third-party problem that cannot be solved by contract. Insurance bought by insured A from insurance company B may be intended to protect victim C, as in the case of automobile or liability insurance. If the insurance company cannot honor its obligations, C may be at risk. Local authorities thus have an interest in making sure insurance companies can honor their obligations. In the case of foreign insurance companies, the question is whether the foreign company has adequate capital and whether third parties can collect their claims. This depends on capital regulation by the home country and cooperation agreements between the host and home countries. We do not believe there has been the same convergence of capital standards or the development of a cooperation framework in insurance, as compared with banking and securities. Thus, we are unwilling to endorse a general regime of mutual recognition. Pending more international convergence, we would encourage countries to enter into bilateral mutual recognition agreements in this area.

Conclusions

The Committees offer the following conclusions about how

to proceed with further liberalization of trade in financial services and global integration of financial markets.

1. Countries should continue to eliminate direct restrictions on the entry of foreign financial institutions into other countries. Attention needs to be given to eliminating national champion protection in developed countries, as well as the explicit restrictions of developing countries.
2. There are significant shortcomings of the WTO-based track of reform. Success to date has been limited and the WTO has neither the mandate nor the institutional capacity to deal with indirect barriers to global integration of financial markets.
3. Countries should continue to pursue liberalization of financial services as part of negotiations for free trade areas. Prominent multilateral examples include the European Union (EU) and the North American Free Trade Area (NAFTA). Bilateral free trade areas include recent US agreements with Chile and Singapore.
4. Countries should encourage international organizations to harness public and private efforts to identify international best practices in insurance, securities regulation, banking regulation, clearing and settlement systems, disclosure (and transparency), and accounting and auditing standards. Compliance with these codes and standards is monitored by the IMF and World Bank in Reports of Standards and Codes (ROSCs). Parallel to this effort, the IMF and World Bank also conduct Financial Sector Assessment Programs (FSAPs), which also review compliance with some of these standards and codes. Although compliance is voluntary, a growing number of countries have submitted to an FSAP and/or ROSC. Many have agreed to publish the results. We believe this is an important step forward in

promoting international financial integration. We remain concerned, however, about the lack of transparency regarding progress in achieving the gains from financial integration. For this reason, we suggest that the World Bank and International Finance Corporation include comparisons of the costs of standardized financial products in its annual publication, Doing Business.

5. Informal dialogues among national regulatory bodies have also contributed to international financial integration. A leading example is the EU/US Informal Financial Regulatory Dialogue. Although to date most of its efforts have been devoted to dealing with specific controversies, the dialogue could be the basis for a much more ambitious effort to accelerate financial integration.
6. In the area of indirect barriers, the Committees believe that where country standards have been sufficiently harmonized or have converged, and where sufficient cooperation exists in administering and enforcing these standards, countries should mutually recognize the validity of each other's standards, subject to the proviso that host countries be permitted to require additional measures where foreign standards are found to be deficient in a material respect. Strict principles of free trade would counsel that countries accept such foreign standards even without reciprocity. However, as a political matter, it is likely that more liberalization will be achieved if reciprocity were required.

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