Regulatory Harmonization and the Globalization of Finance

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Scholars have considered the convergence of financial regulation across jurisdictions to be at times a precondition of market integration, at times a consequence, but always a key feature of financial integration.¹ In recent decades the relationship between financial integration and regulatory harmonization has changed because of the accelerating pace of financial globalization. Not only have capital flows increased enormously, but the provision of financial services across different jurisdictions has also grown. This growth is a result of the expansion of financial intermediaries internationally and of the direct supply of financial services to foreign entities, as in the case of foreign listings. Some observers argue that the increased provision of financial services and products across national boundaries has already exercised a disciplining effect through stiffer competition; however, the integration of financial products and services and of financial regulatory frameworks represents two different aspects of the same process, namely, the globalization of finance, that move together, but often at different speeds.

Even though market forces can promote regulatory harmonization, regulatory developments should not be left to market forces

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alone. Market forces and self-regulating institutions share well-known problems. Coordination failures associated with market-led initiatives can generate negative systemic externalities, attracting capital toward less regulated systems and institutions or generating forms of competition that may undermine financial stability. In addition, the costs of financial regulation and supervision may be too high for small countries, a potentially critical issue in the development of sound standards in a world where the number of independent jurisdictions has almost trebled since World War II. Overall, welfare considerations related to the presence of systemic externalities and to the high cost of public goods suggest that regulatory harmonization should not be left to market forces alone.

From the perspectives of national policymakers and analysts of international financial relations the relevant question then becomes how countries should pursue financial regulatory harmonization. How should a specific country overcome the tension between its own national policy and its global economic interests?

This chapter will explore the regulatory dynamic that has emerged as a result of a period of unprecedented internal and external financial liberalization and banking and financial crises around the world. It argues that the globalization of finance has altered the relationship between trade and financial integration and that this has affected the methods and procedures of integration, charting new paths of regulatory harmonization and convergence.

This chapter compares the ongoing dynamic of financial integration with the situation after World War II to assess whether we are moving on familiar ground or into uncharted territory and whether reviewing experience will prove useful. It then explores the role of government-led and market-led initiatives in the transition from segmented to integrated capital markets. Finally, using a deliberately stylized characterization of the ongoing process of regulatory harmonization, it focuses on the main strengths and weaknesses of the emerging international trend in the globalization of finance represented by the worldwide dissemination of codes and standards of best practice.

The How and When of Financial Integration

Countries facing the many policy questions raised by the integration of financial markets are likely to look to experience for guidance. Thus a logical first step is to characterize the current process in terms of its similarities to or differences from past instances of financial integration and regulatory harmonization.
For this purpose we shall consider three aspects of the regulatory process over the last 50 years: the interaction between the financial regulatory process and other components of the overall legal and regulatory framework, the nature of the rule-setting institution, and the level of cogency of the rules. Looking at the dynamic of the regulatory process we shall consider what sequence of regulatory events (trade versus financial integration), of the rule-setting institutions (political versus technical authorities), and of rules (binding versus indicative) has best characterized the evolution of financial regulation in the past and now.

While the sequence trade → finance may have characterized past episodes of economic integration, it is losing relevance today. In the 1960s and 1970s economic integration between countries followed a relatively standard pattern, with trade liberalization coming first as a necessary precondition for the prospective integration of productive sectors. Financial integration was the outcome of increased provision of foreign financial services associated with the trade of goods rather than as an independent phenomenon (Aliber 1984). The provision of financial services across jurisdictions has traditionally been viewed as performing an ancillary function, reflecting the general perception that successful commercial integration was the first and most relevant policy objective, while financial integration played at best a supporting role. The European integration process followed this pattern, moving from a restricted number of goods markets (steel and coal) to the entirety of goods and then of financial markets. However, the current globalization of international finance markets is depriving the trade → finance sequence of its relevance. Financial integration takes place independently from the level of economic integration and, even though evidence still supports the notion that trade liberalization is “essential to reap the full benefits of capital account liberalization” (IMF 2002, p. 131), the traditional trade → finance sequence appears to have been increasingly substituted for in practice by a new finance → trade sequence.

One effect of this new course of events is the observed diffusion and adoption of financial codes and standards of good practice across economies at different levels of development and of openness. This is a process that considers finance as instrumental to the process of economic integration instead of residual, and that therefore tries to anticipate the timing of desirable regulatory harmonization to limit the destabilizing effects of international capital movements.

A second feature of interest concerns the difference in the involvement of rule-setting governmental and nongovernmental institutions, where the notion of nongovernmental institutions is
extended to include technical bodies such as supervisory authorities. Traditionally governments have set the rules for more intense economic cooperation among countries, both at a bilateral and at a multilateral level, through treaties, memorandums of understanding, or other official agreements. In the past official agreements usually paved the road for closer interactions between private sector actors and institutions, but since the 1970s initiatives by the nongovernmental sector have often taken the lead in setting the pace of, and even forcing, government interventions in the financial area. Thus with increasing frequency initiatives stemming from the private sector and technical and professional bodies have tilled the ground to be sown by political authorities. The best known and one of the first of these nongovernmental technical institutions is the Basel Committee of Banking Supervision, created after the failure of the Herstatt bank in 1975 (an event that affected correspondent banks operating in several different jurisdictions) to coordinate and strengthen the supervision of internationally active banks.

A third feature of economic integration relates to the regulatory tools used to promote integration. In the past government involvement was primarily limited to bilateral or multilateral treaties. The time needed to negotiate and approve international treaties compared with the speed of financial innovations in the marketplace has made these traditional tools of international diplomacy ineffective in the financial domain. Now nongovernmental bodies stemming from both the private and official sectors have taken the lead in defining new rules of behavior. Sometimes these new rules take the form of codes of conduct or of benchmarks against which to compare and assess individual behavior. Governments have also used this approach, for example, compiling lists of noncompliant tax havens or offshore financial centers. These rules are quite different from traditional treaties in that they are intended to shape common behaviors without necessarily affecting the legal framework. The sequence of integration rules has changed from the traditional sequence treaties \(\rightarrow\) codes of conduct to codes of conduct \(\rightarrow\) treaties.

The dynamics of global financial integration and the related process of regulatory harmonization have taken a considerably different form than in the not so distant past. The tremendous growth of capital movements related to technological developments and to current and capital account liberalization has made the when of financial integration less dependent on other aspects of economic integration than in the past. In turn, the change in the when has inevitably affected the how, making replicas of past solutions of limited use and requiring a new pragmatic approach to regulatory harmonization that is based on a process of trial and error, and in which
the received wisdom is constantly tested against the new emerging reality. Few features of past approaches to regulatory integration have survived this reality check. The next two sections single out such features from past episodes of government- and market-induced regulatory harmonization as a step toward characterizing the emerging approach to regulatory harmonization, namely, the standards and codes approach.

Government-Induced Regulatory Convergence

Between World War I and the early 1980s capital controls largely insulated national economies, reflecting the lack of interest in financial integration and the ease with which capital flows could be controlled compared with today. In the few cases where governments actively pursued integration among different financial systems, this was largely the result of political decisions. Recent experience has shown that government-induced integration has been significant under three clearly defined sets of circumstances.

Probably the most economically important set of the three is the trade-induced case. This refers to those countries where a tight network of trade relationships has induced governments to promote a stronger form of integration by partly waiving their national sovereignty in deference to a supranational regional authority. The typical example is those Western European countries that, building on strong commercial ties, have successfully moved toward an economic and a monetary union. Similar objectives and ambitions have been pursued by governments elsewhere less successfully, for example, the Latin American countries of the Andean Pact and the Southern Cone Common Market.

The second set of circumstances can be labeled as the dominant neighbor case, where a country’s economy is significantly affected by the proximity of a large neighbor that dominates the region in economic terms. In this situation national governments are induced to harmonize their financial laws and regulations with those of their large neighbor to improve domestic firms’ and financial intermediaries’ access to larger and more liquid foreign financial markets. Such a pattern characterizes the relationship between Western Hemisphere countries and the United States and between Eastern European and North African countries and the European Union (EU).

The third set of circumstances, more nuanced but still relevant, is represented by the common colonial heritage case. The colonial heritage generally persists in the legal and regulatory frameworks of former colonies, but in some cases it also extends to the selection of
monetary arrangements similar to those that prevailed during the colonial period. This is the case of the West African Monetary Union and of the Central African Monetary Union among former French colonies and of the Eastern Caribbean Currency Union among former United Kingdom colonies. A significant feature of these monetary unions is that, contrary to the European Monetary Union, they have not always been preceded by full trade liberalization. Tariffs may still apply to trading between countries that share the same currency and monetary authority, which is an example of the inversion of the traditional sequencing.

While government-induced integration has presented specific challenges in each of these three cases, the European experience is probably more instructive given its complexity, the number and size of participating countries, and the extent of financial integration. It is also a context in which the criteria for government-induced regulatory harmonization across countries have been spelt out more clearly than anywhere else.

The current convergence of macroeconomic and financial conditions throughout Europe should not obscure the strong initial differences, both structural and economic, that prevailed among the 12 EU countries. Different regulatory frameworks, degrees of capital market openness, roles of commercial banks (universal versus specialized), and corporate governance arrangements (bank-based versus market-based control) were the norm among Western European countries until the 1980s, and to some extent still are. To fully appreciate the extent of regulatory harmonization note that all four legal families made popular by the current debate on the interaction between law and financial systems (La Porta and others 1998) were and still are represented among the EU member countries.

These deeply rooted structural differences showed no sign of diminishing between the 1950s and the 1970s, when the EU pursued an objective of full harmonization. Starting in the mid-1970s EU members embarked on a new strategy based on the principles of subsidiarity and minimum harmonization. The subsidiarity principle implies that supranational authorities should limit their rule-making activity only to those areas that national jurisdictions cannot cover. The minimum harmonization principle requires that two ancillary principles be in effect: the mutual recognition of foreign regulatory systems (a recognition of the validity of foreign regulation) and the principle of home country control (a recognition of the validity of foreign supervisory authorities).

The strategy's longevity from a regulatory point of view is indicative of its effectiveness, even if the integration of financial markets may not have followed suit. The key feature of this new approach
has been the substitution of the traditional top-down process—based on compulsory compliance with a detailed list of centrally issued regulations— with a new process whereby only a minimum number of common rules had to be defined while further harmonization was left to market forces. Competition among regulations and regulatory systems was allowed to operate while the minimum set of rules prevented a "competition in laxity." Note that minimum harmonization has been successful where it has been inclusive, that is, all the participants in the harmonization process have participated in defining the minimum standards. Harmonization of regulatory systems is not an easy process at the best of times, and often proves illusory where distorted by asymmetries in size and influence (Greene, Braverman, and Sperber 1995; Scott 2000).

Finally, a new set of issues has recently entered the European debate on regulatory harmonization that concerns the need for different standards for wholesale and retail markets. The EU has determined that an approach focused uniquely on defining minimum regulatory standards for the three main actors in the marketplace—banks, insurance companies, and securities intermediaries—is inadequate unless it is tailored to the size of the transactions and of the intermediaries involved (European Commission 1998). With the inception of the euro and the progressive despecialization of financial intermediation, distinguishing between the requirements applicable to large players—be they corporations, asset management companies, or payment systems—or to retail investors in the furtherance of consumer protection has become increasingly important.

Thus to summarize, two main lessons from the European experience may be applicable to financial integration more broadly. First, the principle of minimum harmonization, together with mutual recognition principles, underlines the potential for leaving integration to market forces once national legal and regulatory frameworks share common minimum standards. Second, in a financially integrated world size matters both for regulated entities and for regulators, and the same set of rules may not be efficient and equitable for both large and small players.

**Market-Induced Regulatory Convergence**

All regulatory convergence must start with markets, but markets themselves are institutions that represent a shared set of rules whose existence rests on some initial agreement or shared regulatory principles. This implies the existence of a more intimate relationship between private forces and the rule-making process than is frequently
perceived. Private contracts have almost invariably shaped the initial development of most financial institutions up to the point where the emergence of externalities of some sort has required intervention by the public regulator. Notwithstanding the emphasis that the analysis of regulatory convergence in financial markets, and in particular capital markets, has put on formal regulation, the role of private legal rules as a factor in regulatory convergence remains relevant.

The relationship between private contracts and formal regulation should not be viewed as static, but as a dynamic continuum (Jordan and Lufrano 2002). The same rule can take multiple forms and over time swing between the two extremes of private legal rules based on a contract or convention and formal legislation. For example, fairly standardized private legal solutions found in shareholder agreements or private company bylaws have taken the form of regulatory requirements embedded in commercial codes or securities regulation. Several contractual governance mechanisms developed in the context of private companies, such as tagalong rights for minority shareholders in the event of a change of control, were adapted and crossed over to the realm of public corporations. Their outlines can be seen, for example, in the 1964 Williams Act in the United States, the source of U.S. tender offer rules. In turn, legal restrictions have determined the appearance of new variants of the original contracts.

Overall, market-induced regulatory harmonization has operated in two ways: first, through the dissemination of best practices by opening markets to new players and new products consistent with these practices and, second, through the creation of new contractual standards. Some have argued that opening domestic markets to qualified foreign institutions has favored the interaction of supervisory agencies in disseminating good-quality supervisory regulation and practices (Levine 1996). Analogously, the attractiveness of listing on foreign stock markets has resulted in good quality accounting standards being disseminated across different jurisdictions without the imposition of formal regulatory requirements.

Moreover, market-led initiatives can help define new contractual standards. New contractual arrangements motivated by regulatory arbitrage have not always survived the removal of the arbitrage opportunity, but in a few cases new market standards have brilliantly outlived their originating cause, as in the case of the standardized practices underpinning the development in the 1960s and 1970s of the so-called Euromarket (a banking and securities market mainly centered in London for business denominated mainly in U.S. dollars) and of the placement standards for American depository receipts (ADRs).
The Euromarket has sometimes been erroneously characterized as an unregulated market. In reality it is a highly specialized wholesale market, originally tailored to U.S. issuers raising debt financing from European investors, that over time has attracted issuers of other nationalities and has diversified into different instruments, such as derivatives and equities. Taking advantage of the difference in the fiscal and legal characterization of the transactions between the United States and Europe, market practitioners have skillfully flown below the radar screen of formal national regulation. U.S. regulators looked at the nature of the transaction, and if it was centered in Europe they let it go. European regulators looked at the nationality of the issuer, and non-European issuers did not trigger a regulatory response. The Euromarket flourished in the interstices.

The Euromarket, like the derivatives markets it fostered, has operated for decades on the basis of standard contractual forms and industry association rules and practices without indications of egregious market abuses. When the threat of formal regulatory intervention loomed in the early 1990s in the form of the European Commission’s Investment Services Directive, industry associations and practitioners quickly closed ranks, beefed up their rule book, and bolstered their industry oversight. The Euromarket has demonstrated all the usual virtues of private legal rules—responsiveness to market conditions and participants, flexibility, and consensualism—virtues of contract that make private legal rules especially suited to regional or supranational specialized markets. Of course, this approach is not suitable for every market or for every aspect of a market but is highly effective given the right conditions.

ADRs represent another interesting example of standardized practices that have led to the creation of a cross-border market. ADRs have provided a means for U.S. investors to diversify internationally from the comfort of home while providing some U.S. banks with a tidy fortune in fees for their services as intermediaries and custodians. The popularity of ADRs soared during the 1990s. During 1990–99 the number of ADR programs grew from 352 to 1,800 and the number of countries involved from 24 to 78 (Claessens, Djankov, and Klingebiel 2000). The ADR market, like the Euromarket, began as a private market based on regulatory arbitrage. The receipts, carefully named to avoid characterization as a security, were issued in the United States by a number of U.S. banks, backed by the deposit of non-U.S. issuer securities. As a result of negotiations between the industry and the Securities and Exchange Commission, ADRs were a compromise solution in terms
of regulation and disclosure requirements, which exceptionally avoided U.S. bank liabilities under U.S. securities law.\textsuperscript{8}

The critical lesson of the previous examples is that markets have the capacity not only to spread existing standards across jurisdictions, but also, and more important, to develop contractual and regulatory standards through arbitrage and competition. Financial innovations, frequently devised to circumvent regulatory inconveniences such as prospectuses or taxation as in the case of euroloans and ADRs, often address more general financial needs and achieve significant and stable development. Market-induced regulatory convergence can therefore be characterized as a process that operates through competitive selection and refinement of contractual standards.

Market forces alone are not always able to successfully enforce the standards that they have helped to set, however. Market discipline is exerted through the pricing mechanism and is as good as the quality of the available information or of the incentives to price risk properly. Where these conditions are not attained, the traditional mechanisms of public censure and reputation costs—the traditional forms of sanctions levied in cases of market abuses—may lose their effectiveness. Nevertheless, for markets characterized by a limited number of large players, reputational costs have provided a relatively effective disciplining instrument as confirmed by the lack of episodes of market abuse over extended periods of time.

The New Consensus on Minimum Standards and Codes

As noted earlier, government-induced regulatory convergence has led to different forms and models of regulatory harmonization. In a few but significant areas of the world it has allowed the establishment of monetary unions, as in the case of Western European, Eastern Caribbean, and African franc zone countries. In other regions the gravitational pull of one or more large and successful countries has acted as a catalyst, prompting a process of regulatory alignment. Experiences in these regions have shown that the difficulties of top-down harmonization, whereby a political authority imposes common rules across jurisdictions, can be reduced by invoking the principles of minimum harmonization. It is difficult to overestimate the importance of the minimum harmonization principle for the process of global financial integration.

Market mechanisms have also had some success in developing and enforcing financial standards through reputational discipline.
Reputational discipline has been important where market-determined standards prevail and where a limited number of large institutions dominates the marketplace. In these cases standardized market practices have proved to be effective for extended stretches of time, even in the absence of public administrative or penal sanctions.

These principles—minimum harmonization and mutual recognition on the one side and reputationally induced discipline on the other—represent probably the most effective lessons that past episodes of financial integration carry over to a world of integrated capital markets. Both play a major role in the regulatory response to the globalization of capital that is currently represented by the standards and codes approach. This approach has taken the form of a minimum set of rules embedded in codes of best practice voluntarily adopted by national policymakers to improve the strength and reputation of their financial systems in the international marketplace. Reputationally induced discipline has been strengthened by such “official” incentives as the “name and shame” practice associated with the Financial Action Task Force’s lists of noncooperating jurisdictions or with the Organisation for Economic Co-operation and Development list of offshore financial centers responsible for harmful tax competition.  

The combination of these two components has favored the unquestionable popularity of the approach for at least three reasons. First, its hybrid nature, which combines elements of both market and regulatory discipline, appeals to a potentially large constituency within each national financial system, including market regulators and market practitioners. Second, its generality has favored receptiveness on the part of countries with different histories, levels of development, and geographical locations. This has proved to be tremendously important during a period characterized by the largest process of regulatory and legal reforms in history, both in terms of the number of countries involved and of the extension and pervasiveness of the reforms. Finally, the relative conceptual simplicity of minimum harmonization approaches may have conveyed the fallacious impression that the standards and codes approach could represent an easy solution to complex issues posed by financial regulatory reforms and that compliance with standards and codes could act as a means of signaling good conduct.

The popularity of an approach whereby countries have pursued national adherence to a set of international standards and codes on a voluntary basis raises several questions. Are we observing a wholly new pattern? How effective is this regulatory approach? What are the approach’s potential shortcomings?
The process is by no means a new one. The presence of norms of behavior that fall short of having the binding force of legislation has been commonly observed at a national level, especially in Commonwealth countries. Such conventions or standards have generally been referred to as soft law because of the lack of a codified procedure for their definition and lack of means of legal enforcement (Giovanoli 2001). The ongoing process of disseminating international standards and codes represents an adoption of the notion of soft law at the international level. As in the case of national soft law, the adoption of codes of best practices is purely voluntary and is the expression of a social consensus that, at the international level, has taken the form of nontreaty international pronouncements such as “codes of conduct, guidelines, recommendations, declarations, and resolutions of international organizations” (Kim 2001, p. 3). Even though soft law shares common advantages over formal law both at the domestic and at the international level, such as greater flexibility and timeliness, a few important differences persist between their national and international versions.

The first difference between the role of soft law in the international and national financial context is that international soft law represents a substitute for and not a complement to hard law provisions, given the substantial absence of international hard law (Giovanoli 2001). As a consequence, international soft law is deprived of the opportunity, available for national soft law provisions, to find formal expression in national hard law and regulations over time. Instead, soft law provisions pertaining to finance tend to percolate down from the international to the national level, often transforming themselves into national hard law and formal regulations rather than international treaties. This differs from practices in the international trade domain, where the traditional hard law strategy is still followed, for example, the World Trade Organization. We shall refer to the interaction between international soft law and domestic hard law as the complementarity issue.

A second difference is represented by the proliferation of international standards and codes. One possible explanation for this is that standards and codes are a substitute for legal provisions at the international level, that is, they fill the void left by the absence of international laws. As a result, the system of international codes and standards has reached a complexity that is a source of concern. An effort to coordinate the different codes is required to avoid potential inconsistencies or simply different scopes of coverage across standards. Lack of coordination is one of the main shortcomings of market-led development, and if not adequately dealt with may ulti-
mately reduce the effectiveness of a soft law approach. We shall refer to this problem as the coordination issue.

A third difference that is common to soft law provisions both at the national and at the international level is related to the inclusiveness of the process. Nongovernmental bodies are ill suited to address and regulate the consequences of their own actions when they fall outside their constituency. Soft laws are similar to club arrangements and are therefore not well suited for effectively addressing the impact of club members' actions on external constituencies (externalities). The question then becomes what weight should be given to nonclub members in the decisionmaking process? Or alternatively, how can the soft law approach become a more inclusive process? The issue is one of legitimacy (Giovanoli 2001), and we shall refer to it as the fair representation issue.

The following subsections provide a more in-depth discussion of these three issues to focus on the challenges the standards and codes approach currently faces and on some gray areas where further research is needed to refine the current course of action.

The Complementarity Issue

The process of transforming consensus views into national laws—the complementarity between soft and hard law—is particularly complex at the international level. Consistent interpretation of standards and codes across jurisdictions with different cultural and legal backgrounds cannot be taken for granted, and this has been the main difficulty with the application of the subsidiarity principle in the EU. In addition, compliance with different standards and codes is purely voluntary. These factors have led to institutions that represent a large number of national jurisdictions and are mandated to promote conditions for economic stability and development internationally, such as the International Monetary Fund (IMF), the World Bank, and the regional development banks (the international financial institutions or IFIs), taking on the responsibility for disseminating and monitoring codes and standards (see IMF and World Bank 2002).

Observers claim that the dissemination activity performed largely, although not exclusively, by the IFIs has triggered substantial national legislative and regulatory activity (Kim 2001). The case of the Republic of Korea provides an example of the complementarity of international soft law and national hard law, as well as of some of its disadvantages. Following the 1997 Asian financial crisis, the Korean government revised its financial sector legislation to
give legal force to several international best practices. The Basel capital requirements for commercial banks were adopted by law and regulation; mutual funds, previously not present in the Korean market, were introduced; and corporate governance criteria were revised and regulated by law. The laws that were revised included the Korean Banking Act; the Law on Merchant Banking Companies, amended to adapt it to the Basel capital requirements; the Korean Stock Exchange Act, revised to ensure compliance with sound asset management procedures and to protect small shareholders; and the Securities Investment Company Acts, which led to the introduction of mutual funds (Kim 2001).

Critics of the process in Korea have questioned the timing and sequencing of the reforms more than the relevance of the process itself. Park (2001, p. 2) summarized the concerns as the dilemma of "restructuring out or growing out," suggesting that if countries cannot pursue recovery and reform simultaneously, they must decide whether to intensify structural reform efforts at the risk of interfering with the ongoing recovery or to give priority to the fragile recovery, even if doing so means derailing the reform process. According to this view, "Due to the speed of recovery it is now not so easy to argue that the legal changes and institutional reforms have significantly contributed to the rebound of the Korean economy" (Kim 2001, p. 16).

Criticism has not prevented the dissemination of international standards and their incorporation into national law. The phenomenon has become widespread and has not been limited to crisis countries, where IFI conditionality may have played a significant role. Assessments of compliance with the major codes and standards performed by the IMF and the World Bank as part of the Financial Sector Assessment Program (FSAP) and for the Reports on Observance of Standards and Codes indicate a truly worldwide interest in aligning national legal and regulatory frameworks with international best practices."

The number of countries that have voluntarily participated in the FSAP also confirms the attractiveness of the soft law approach. As of December 2002, three-and-a-half years after the launch of the program, more than 60 countries had already participated in the program, equally split into one group of high- and upper-middle-income countries and a second of low- and lower-middle-income countries. The initiative's popularity is even more remarkable given that (a) reforms of legal and regulatory systems have traditionally been an exclusively national domain, and (b) most international standards have been drafted in the past five years and represent
first-generation efforts that have yet to undergo revisions and refinements as experience with their application accumulates.

Whether the popularity of the approach hides some weaknesses remains to be verified. The question of implementation is, of course, important given the differences in countries' cultures and legal backgrounds. In addition, some national governments might even perceive compliance with international codes as a signaling reputational device, and this may actually mitigate pressures to fully enforce changes to law on the books. Poor enforcement and its potential causes could well be among the central issues to be addressed by the next generation of standards and codes. In this context two elements may prove to be particularly relevant: (a) the degree of effectiveness of legal transplants in countries with different legal infrastructures and different levels of development, and (b) the role that the size of the financial sector plays in the design of an effective regulatory infrastructure.

The popularity of various international standards and codes has resulted in the proliferation of transplanted legal concepts into national legal systems, which has attracted the attention of legal commentators (see, for example, Berkowitz, Pistor, and Richard 2000; Jordan and Lubrano 2002). The debate on the effectiveness of legal transplants suggests that insofar as they represent transformations of national practices, institutions, and legal concepts prevailing in industrial countries, international standards may not travel well to emerging or transition economies (Pistor 2000). Some of these transplants thrive; some are patently ineffective. They may be incompatible with the underlying domestic legal system (for example, common law fiduciary duties in Roman law legal systems), be introduced by "special" legislation that is inconsistent with and superseded by civil or commercial codes, or be implemented in a form that the particular domestic legal system does not recognize.13

The most common difficulty in the area of financial regulation is the absence of a broad concept of fiduciary duty under Roman law legal systems. Fiduciary duty is indigenous to the Anglo-American legal system and supports a wide range of institutions and regulatory structures. It is the "hidden assumption" upon which much of capital markets regulation and corporate governance rests in the common law world. As a legal concept, fiduciary duty is difficult to replicate under Roman law systems for a variety of reasons; however, Roman law legal systems are the most prevalent in the world, found across Europe; North, West, and South Africa; Latin America; and many parts of Asia. Thus the adoption of the institutions and regulatory
structures proposed by international standards rooted in the Anglo-American legal tradition, without a compensatory mechanism to mimic fiduciary duties, may be creating a widespread regulatory hazard. The widespread looting of newly privatized entities in Central and Eastern Europe, and the subsequent collapse of capital markets in small countries like Slovakia, were partly attributable to this phenomenon. A more recent example would be the difficulties Korea encountered with investment trust company structures.

Whether standards developed in and designed for large, industrial economies fit small, emerging countries—which account for the majority of jurisdictions around the world—equally well is also questionable. Even aside from the level of development, the size of an economy is by itself an important determinant of the desirable structure and size of its financial and regulatory system. The fixed costs in setting up a regulatory structure, a market, and a banking system are such that few countries can be expected to have all the required financial intermediation services and regulatory structures the standards and codes currently in circulation call for.

In many countries the classical division into banking, insurance, and securities markets may not be conducive to a proper assessment of financial systems' strengths and weaknesses, and such a distinction is too elaborate for small economies and too blunt for larger ones. Drawing again from the EU's experience, where the European Commission (1998) presented a financial services action plan that focused on the distinction between wholesale and retail markets, alternative schemes may pay more attention to the role that size plays in the production of financial and supervisory services. For example, for countries with small, illiquid stock markets, assessing the conditions for establishing regional markets or for firms to access liquid foreign markets may be more useful than assessing national compliance with International Organization of Securities Commissions standards, which reflect regulators' experience with markets of average size and liquidity. One of the weaknesses of the standards and codes approach and of its operational legs (the FSAP and the Reports on Observance of Standards and Codes programs) is to consider small, emerging economies as Lilliputian replicas of large, industrial ones.

The Coordination Issue

As noted earlier, the proliferation of international standards and codes may exemplify the lack of coordination that often precludes "first-best" approaches to market regulation. The establishment of the Financial Stability Forum (FSF) was specifically directed toward
preventing such an outcome. The FSF was established to assess the vulnerabilities of the international financial system and to enhance coordination among the many different authorities responsible for financial stability (banks, insurance companies, securities markets).

One of the FSF's first initiatives was to evaluate and rank the different best practice codes proposed by various industry and regulatory bodies. As of February 2000 the FSF had identified 43 different codes and was considering 23 more for inclusion. Of this list the FSF defined 12 codes as being of high priority, of which 5 (the Basel Core Principles on Banking Supervision, the International Organization of Securities Commissions principles, the International Association of Insurance Supervisors principles, the Committee on Payment and Settlement Systems principles, and the IMF Code of Transparency in Monetary and Financial Policies) are typically assessed by the IMF and the World Bank as part of the FSAP.

A serious difficulty that dogs efforts to coordinate standards and codes is the relative absence of empirical evidence demonstrating a relationship between compliance with standards and financial stability. The initial evidence that linked indicators of legal and regulatory structures to the stability of banking and financial systems is based on extremely aggregate indicators of structure (Demirgüç-Kunt and Detragiache 1998; Rossi 1999). Only recently has new empirical work started to test the nature of the relationship between specific and more detailed specifications of regulatory structures and financial development and stability (Barth, Caprio, and Levine 2002). Generally, however, the empirical evidence that links indicators of efficiency and stability to legal and regulatory frameworks (see Schleifer and Wolfenzon 2000 for the effects on the cost of capital) has been based on indicators that have only an indirect relationship with the degree of compliance with international standards and codes.

The only available empirical evidence of the effectiveness of international codes refers to the Basel Core Principles and shows the existence of a weak and indirect link between the degree of compliance with the Basel Core Principles and financial instability (Sundarajan, Marston, and Basu 2001). The compliance of bank supervision with the Basel Core Principles may therefore be read as an indicator of a system's degree of resilience to financial crises rather than of its vulnerability to financial crises (Chen and Majnoni forthcoming). Thus the dissemination of international standards and codes may represent a strategy directed at promoting the overall efficiency of financial services by means of an improved quality of supervisory infrastructures rather than a specific crisis prevention tool.
A second coordination issue concerns the resolution of divergences that are holding back international consensus on such relevant issues as international best practices in relation to accounting procedures, an area where the lack of agreement among large industrial countries—exemplified by the different positions of the International Accounting Standards Board and the United States Financial Accounting Standards Board—has impeded the definition of an international consensus view. In general, the reconciliation of different views at the international level has proven to be harder for those standards and codes more heavily conditioned by the prevailing legal framework, such as those related to corporate governance, accounting rules, and securities markets.

Clearer empirical evidence of the impact of best practices on economic stability would strengthen the credibility of the approach. In addition, there are certain controversial aspects on which consensus has not yet been reached. Progress on these two fronts should help address a list of unanswered questions. Are, for instance, all five standards typically assessed by the FSAP equally relevant from the perspective of economic growth or stability? Do they always represent a priority with respect to accounting or corporate governance standards? Should a standard be defined for the role of competition authorities in promoting access to financial services for different economic sectors (retail, small and medium enterprises, corporate)? These are questions that the next generation of codes and standards should answer, not only to improve the approach’s internal consistency, but also, and more important, to avoid arbitrariness in the selection of key standards, which may weaken consensus in relation to the approach itself.

The Fair Representation Issue

The fair representation issue is a general feature of soft law, but it may have particular characteristics at the international level. Soft laws, as an expression of conventions, not of laws, often materialize in the form of understandings or guidelines. Soft law represents consensus within a particular social or professional group of individuals, and therefore cannot be expected to fully address the issues and problems that fall outside the group’s scope. As an expression of the views and opinions of specific constituencies, they do not regulate potential externalities.

The fair representation issue has two aspects. The first is best described by Giovanoli (2001, p. 30):

Fair representation of all parties is crucial for the acceptance of standards with no legally binding character. On the other hand, it must be recognized that rules are much easier to draft
in relatively small and manageable groups, as broad groups, especially if they are not homogeneous, move slowly and may fail to achieve the necessary degree of consensus. Reconciling at the international level the conflicting requirements of legitimacy and effectiveness is akin to squaring the circle.

A second fair representation issue is not related to the country composition of major international groups, but rather is inherent to the composition of groups of standards setters. Standards setters may pay insufficient attention to the impact of their decisions outside the areas of concern facing their profession. A typical example is the frequently raised concern that bank regulators represented in the Basel Committee devote too little attention to the procyclical effects of new banks' capital discipline (Borio 2002). While the Basel Committee has renewed its attention to the problem, modifying some of the most procyclical features of the new capital discipline, the different emphasis placed on stability and liquidity issues by different constituencies (namely, financial supervisors and economic policymakers) remains a generally pertinent policy issue.

Full integration of the work on standards and codes with systemic considerations requires a macro-prudential approach to financial regulation (IMF 2001). However, the debate on the systemic implications of the dissemination of codes and standards has focused more on financial systems’ ability to withstand macroeconomic shocks (IMF and World Bank 2002) than on the macroeconomic effects of new regulatory standards. For example, while considerable attention has rightfully been devoted to evaluating financial intermediaries’ capital adequacy by means of appropriate stress testing exercises, to date only a modest effort has focused on assessing the effects of new solvency ratios on the allocation of credit.

Another example of issues likely to fall outside the domain and interests of professional standards setters is the definition of standards for financial crisis management and resolution (Giannini 2001). Responding to the lack of guidelines in this area the World Bank, together with the IMF and other interested parties, has recently begun to formulate principles for dealing with bank and corporate insolvency at both the individual and systemic levels.

Conclusions

The formulation of a new discipline for an international financial system has proven to be harder than in the past. The process of financial globalization has shifted the balance of power from governments to markets and has made the traditional solution,
resorting to international treaties, less viable. Historic references are often lacking, and new institutional solutions are being tested through a process of trial and error. The dissemination of international codes and standards supported by IFIs represents an innovative and constructive effort to coordinate national regulatory dynamics. It combines some of the key features of the most successful instances of regulatory harmonization—minimum harmonization and reputationally induced discipline—and, despite its limitations, represents a structured approach to the problems raised by the globalization of capital markets.

The ongoing adaptation of financial regulation in transition economies and the reforms of financial systems in crisis countries and in countries exposed to different degrees of financial contagion have generated a worldwide wave of financial reforms, which probably has no historical antecedent in terms of geographical coverage and extension within each financial system. In this unprecedented environment, the standards and codes approach has come to play an important role in promoting regulatory harmonization and reducing the risk of instability related to weak regulations and regulatory arbitrage.

The standards and codes approach aims to offer regulatory benchmarks for individual countries embarking on the process of reforming their financial systems, and for this reason faces the difficult tradeoff of pursuing a general objective without disregarding the needs of countries of different sizes, legal traditions, and levels of financial development. The simple transposition of rules across different institutional frameworks may lead to unintended consequences, as demonstrated by the implementation of privatization schemes in transition economies during the last decade. The standards and codes approach has faced only an initial set of tests, and the process of revision based on initial experience has just begun.

A refinement of standards and codes appears to be warranted—and is under way in some cases—to accommodate different legal traditions and to deal with the specific needs of financial systems of different sizes and complexities. For small developing countries, which represent the majority of independent jurisdictions, the costs of financial regulation may require different regulatory structures than those prevailing in larger economies. A clearer definition of the role different standards play in promoting economic growth and financial stability would also help set priorities among different regulatory reforms and would improve the overall effectiveness of the standards and codes approach. Finally, the application of international standards and codes may benefit from further development of the macro-prudential approach, which considers not only the effects of systemic shocks on financial stability but also the effects of different regulatory strategies on macroeconomic stability.
The approach’s success will ultimately depend on its capacity to add operational content to its basic underlying principles of minimum harmonization and reputational discipline, and to address not only conditions for access to international capital markets but also conditions for access to finance, whether provided locally or internationally.

Notes

1. Regulatory harmonization has been pursued as a preliminary step to the single market for financial services in the European Union. Financial reforms have, instead, accompanied or followed the liberalization of financial services in most Latin American countries.

2. Rousseau and Sylla (2001) find that trade integration in the postwar period was not affected by financial integration.

3. Countries that deliberately liberalized capital movements more than or before trade are concentrated in Latin America. An International Monetary Fund report (IMF 2002) finds that the region has the highest concentration of countries that are closed to trade but are financially open and the largest vulnerability to episodes of financial instability.

4. More generally, financial integration was a concern given the additional constraints imposed by greater capital mobility on the pursuit of objectives of monetary policy different from those of balance of payments objectives (Eichengreen 1998).

5. The inversion of the sequence trade → finance has not been limited to financial regulation. Coffee (2001) reports the case of new Israeli firms, which after accessing U.S. markets for funding purposes eventually decided to move their entire productive activity to the United States. In this specific case production has followed finance.

6. Note that a parallel shift from multilateral (formal) to noninstitutional (informal) forums, such as the Group of Seven, the Group of 10, and the Group of 20, has characterized international economic cooperation since the mid-1980s (Padoa-Schioppa and Saccomanni 1999).

7. A second threat has loomed with the proposed European Prospectus Directive. In July 2001 the U.K. Law Society warned that the proposed directive risked killing the only truly pan-European securities market, and accommodations were subsequently made to the proposals.

8. Three tiers of ADR programs are recognized, with graduated disclosure requirements ranging from an exemption from formal Securities and Exchange Commission filings to full U.S. prospectus registration (see SEC 1991).

9. Additional “official” incentives also play a role in the standards and codes approach and are related to the surveillance activity performed by the
international financial institutions. They do not, however, appear to be as central to the characterization of the approach as the reputation factor.

10. “English common law system demonstrates a surprising aversion to law as legislation, to ex-ante public legal rules. Large and complex swathes of English law are found in no written legislated form. Trust law, from which is derived the concept of fiduciary duties is a prime example; its fundamental principles remain judge-made, their source being ex-post public legal rules. England is a country with no written constitution for example” (Jordan and Lubranon 2002, pp. 27–28).

11. The Reports on Observance of Standards and Codes can be found for a growing number of countries at http://www.worldbank.org/ifa/rosc.html.

12. The confidentiality of the assessment of compliance conducted during FSAP reviews has favored full cooperation between national governments and the IFIs, giving the assessments the nature of an external audit for use by national authorities to determine institutional weaknesses and define policy priorities. However, the IMF and World Bank encourage national governments to make the main findings of the FSAP public.

13. The reliance of Commonwealth countries on judge-made (ex post) legal rules, which differs from the reliance of the non-Commonwealth world on written (ex ante) laws, has often facilitated the implementation of voluntary codes of conduct in the first group of countries while creating problems of legal compatibility of voluntary standards in the second group (Jordan and Lubranon 2002).

14. Only 16 of the more than 150 stock exchanges worldwide (Coffee 2001) have an annual equity trading volume that exceeds 75 percent of the equity market capitalization, as reported by Shah and Thomas (chapter 6 in this volume).

15. The prevailing uncertainty about the effects of international standards and codes is best expressed in a recent empirical paper on the effectiveness of bank regulation, according to which “there is no evidence that best practices currently being advocated by international agencies are the best ones for promoting well-functioning banks. There also is no evidence that successful practices in the United States, for example, will succeed in countries with different institutional and political environments” (Barth, Caprio, and Levine 2002, p. 1).

References

The word processed describes informally produced works that may not be commonly available through libraries.


