



Organisation for Economic Co-operation and Development

Publication sponsored by
the Japanese Government

**INSURANCE AND PRIVATE PENSIONS
COMPENDIUM
FOR EMERGING ECONOMIES**

**Book 1
Part 1:6)c**

**CROSS-BORDER TRADE IN FINANCIAL SERVICES: ECONOMICS
AND REGULATION**

OECD Secretariat

1999

This report is part of the OECD Insurance and Private Pensions Compendium, available on the OECD Web site at www.oecd.org/daf/insurance-pensions/. The Compendium brings together a wide range of policy issues, comparative surveys and reports on insurance and private pensions activities. Book 1 deals with insurance issues and Book 2 is devoted to Private Pensions. The Compendium seeks to facilitate an exchange of experience on market developments and promote "best practices" in the regulation and supervision of insurance and private pensions activities in emerging economies.

The views expressed in these documents do not necessarily reflect those of the OECD, or the governments of its Members or non-Member economies.

**Insurance and Private Pensions Unit
Financial Affairs Division
Directorate for Financial, Fiscal and Enterprise Affairs**

I. Introduction

Cross-border trade in financial services is becoming increasingly important in the international economy. The cross-border provision of financial services to sophisticated customers – including institutions, other financial services firms, and wealthy individuals – is well established and continuing to expand. Technological developments have reached the point where the widespread provision of cross-border services to retail customers is now both possible and commercially feasible, although these possibilities have yet to become widely accepted and used by customers and firms.

The potential for cross-border financial services to become widely used on a retail level provides the impetus for this discussion paper, which deals with the economics and regulation of cross-border trade in financial services. Moreover, the upcoming round of negotiations on financial services in the World Trade Organisation (WTO) will also focus attention on countries' current approaches to such trade.

Cross-border trade in financial services – like trade in financial services carried out through establishment of branches and subsidiaries in a host country – can benefit consumers by contributing to more competitive and efficient markets for financial services and thereby promoting economic growth and development. Liberalisation aimed at removing anti-competitive restrictions on cross-border trade in financial services is therefore an important policy objective. Sound prudential regulation is also an important policy objective.

Indeed, for cross-border trade to flourish, prudential regulation provides the essential foundation for building and maintaining vibrant markets. As a result of recent financial upheavals, the G-7 and the Financial Stability Forum have recognised the importance of sound prudential regulation in fostering financial stability – a key element in enhancing growth in cross-border trade. At the same time, regulators must be aware of the importance of minimising constraints on cross-border trade in financial services to the extent that doing so does not compromise prudential goals.

Comprehensive analysis of cross-border trade in financial services is desirable. Market structures, trading practices, financial infrastructure and regulation are important elements of the global financial stability issue. However, given the context of this discussion paper, it was decided to focus rather narrowly on the economic issues and regulatory approaches to cross-border trade in financial services. Other aspects are being dealt with in other fora. Trade policy rules, for example, are the subject of negotiations both within the WTO under the General Agreement on Trade in Services (GATS) and in the context of regional free-trade agreements. For financial services, these agreements contain a so-called "prudential carve-out" to permit national regulatory authorities to ensure adequate prudential regulation and supervision. International work on standards for regulation and supervision is being carried out in the context of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

OECD Committees undertake activities related to the liberalisation of trade in financial services. These include the Committee on Capital Movements and Invisibles Transactions (CMIT) which is overseeing the OECD Codes of liberalisation. The Invisibles Code in particular contains a comprehensive list of liberalisation obligations for banking, insurance and other financial services. The insurance obligations are currently reviewed by a Joint Group between the CMIT and the Insurance Committee. This latter Committee has been dealing with international trade in insurance issues on a regular basis.¹ In 1997, it approved 20 guidelines for insurance regulation in emerging economies, which make explicit reference to liberalisation of cross-border trade. E-commerce is the subject of a separate and detailed OECD study.

¹ Several studies have been completed on these issues. The most recent one published in June 1999, *Liberalisation of International Insurance Operations. Cross-border Trade and Establishment of Foreign Branches*, provides a survey on measures and practices restricting cross border trade in insurance.

The structure of the paper is as follows: Section II begins with a definition of cross-border trade in financial services; it goes on to review available data on such trade and analyse trends and future prospects. Section III highlights the key policy goals for financial sector regulation as well as possible approaches in pursuing these goals when financial services are provided on a cross-border basis. Section IV provides an overview of current regulation of cross-border trade in financial services, including a discussion of intra-EU regulation. Section V presents some conclusions and issues for further discussion.

II. Understanding cross-border trade in financial services

A. Definitions

For the purposes of this paper, cross-border trade in financial services is defined as the provision of financial services by a financial firm located in one country to a customer residing in another country without the establishment of a commercial presence, such as a branch or subsidiary, in the country of the customer (the "host country"). In this definition, the country in which the financial firm is "located" could be either the country in which it is headquartered or a third country in which it has a branch or subsidiary.

The following examples illustrate some of the major types of cross-border trade in financial services:

1. banking office located in Switzerland – which could be a Swiss bank or a branch or subsidiary of, say, a United Kingdom bank – makes a loan to, or accepts a deposit from, a French resident;
2. an investment firm located in the United Kingdom – perhaps a United States investment firm operating out of its London subsidiary – underwrites the issuance of securities by a company headquartered in the Netherlands;
3. the same United Kingdom investment firm trades securities for the account of a customer in Sweden;
4. the United Kingdom investment firm provides advice regarding mergers and acquisitions to a company in Spain;
5. the United Kingdom investment firm also provides asset management services to a pension fund in Ireland;
6. a firm located in the United States provides financial information services to a customer in Japan; and
7. an insurance company located in the United Kingdom provides reinsurance to an insurance company in Canada.

A list of financial services, drawn from the definition of financial services contained in the GATS Annex on Financial Services, is provided in an annex to this paper.

The definition of cross-border financial services used in this paper does not attempt to assign a geographic location to the transaction, that is, it does not attempt to determine whether the transaction "takes place" in the country of the service provider or the country of the customer. For instance, in example 1 above, the cross-border transaction could be carried out in a number of ways:

- a representative of the banking office located in Switzerland might visit the country of the customer (France) to arrange the loan or deposit;
- the French customer might visit the office of the Swiss or United Kingdom bank in Switzerland; or
- the transaction might take place through telephone, fax or the internet.

For the purpose of making specific commitments to liberalising trade in services, the GATS distinguishes between services provided to non-residents (a) "from" the country of the service supplier (called "cross-border services" in the GATS), and (b) "in" the country of the service supplier (called "consumption abroad" in the GATS). The dividing line between these two "modes of supply" in the GATS is not always clear. Indeed, because financial services are intangible, the issue of assigning a geographic site to their provision across borders – especially in the case of 3 above – is difficult and complex. The increasing importance of e-commerce will raise the issue more frequently and it might arguably make the location issue even more pertinent.

Cross-border trade in financial services should be distinguished from cross-border capital movements, that is, transactions between residents of different countries involving the creation, modification, transfer or liquidation of a capital asset. The provision of financial services across borders is often – but not always – associated with an international capital transaction. Several cases can be identified:²

- Some financial services – such as investment advisory services and financial information services – are provided across borders without any associated capital transactions.
- International capital transactions are an integral part of the cross-border provision of certain financial services such as accepting deposits or making loans.
- International capital transactions typically, but not necessarily, occur when financial services such as trading securities for the account of customers and asset management are provided across borders. The capital transaction in these examples is the transfer of ownership of the underlying instrument. The capital transaction would be international if the new owner of the instrument were a resident of a different country than the previous owner. A broader definition of international capital transactions would include cases where the owners were residents of the same country but the instrument was issued in another country.
- If a cross-border financial service involves a contingent claim, such as an insurance policy, an international capital transaction would occur only in the event of a payout.

² See Sydney J. Key, *GATS 2000: Issues for the Financial Services Negotiations*, American Enterprise Institute, Washington, D.C. (forthcoming)

B. Empirical evidence

There is a general recognition that reliable and detailed data on financial services trade are lacking.³ Typically, financial services trade flows cannot be observed directly. Instead, their value is inferred from the service and intermediation charges of financial institutions. This is the basis of the balance of payments statistics assembled and published by the International Monetary Fund (IMF).⁴

Another source of inferential information on cross-border trade in financial services is data on financial stocks and flows (e.g., in regard to bank lending, securities issues and derivatives contracts). Such data, collected and published by the Bank for International Settlements (BIS), can be interpreted to identify trends in the financial services associated with the underlying capital flow. Again, caution is required. The data do not usually indicate whether a stock or flow is resulting from cross-border trade as opposed to establishment-related (in particular, branch) activities.

Finally, anecdotal evidence and survey data provide added detail to the picture. Many of the most recent developments in financial services cross-border trade are not observable in the aggregate data. Electronic commerce, involving financial institutions targeting retail clients cross-border, is one example.

The remainder of this sub-section reviews available empirical evidence for trends in aggregate cross-border trade in financial services as well as for major sub-categories. A key distinction to be made is that between wholesale market segments (which involve sophisticated customers and investors) and retail market segments (generally involving less sophisticated customers and investors). The sub-categories discussed are:

- Wholesale commercial banking (e.g., corporate lending, project financing, trade finance, and correspondent banking);
- Investment banking and other wholesale investment services (e.g., underwriting, distribution of securities, mergers and acquisitions (M&A) advisory services, institutional brokering and dealing);
- Retail commercial banking (e.g., personal services such as home mortgages, car loans, and credit cards; small business banking; trust services);
- Wealth management (e.g., investment advisory services, financial planning, mutual funds, discount brokerage);
- Insurance services (e.g., retail products, insurance of large risks, reinsurance);
- Operational services (e.g., custodial, clearing and settlement services); and
- Financial information and data processing.

³ See, e.g., Masamichi Kono et al., *Opening Markets in Financial Services and the Role of the GATS*, (WTO, 1997), p. 7; Wendy Dobson and Pierre Jacquet, *Financial Services Liberalisation in the WTO*, (IIE, 1998), p.114.

⁴ The IMF statistics must be used with caution, however, due to the varying quality of the national systems on which they are based.

Aggregate data on cross-border trade in financial services

The IMF produces balance of payments data on cross-border financial services transactions. Bearing in mind the limitations to which such data are subject⁵, the data are consistent with the notion that cross-border trade in financial services is growing (see Table 1).

Wholesale commercial banking

BIS data on international financial activity and banks' external positions allow one to draw inferences about the growth of cross-border wholesale commercial banking.⁶ Net international bank lending grew steadily from a recent low of USD 165 billion in 1992 to USD 465 billion in 1997 before falling off in 1998 due to financial crises in emerging market economies (see Table 2). Average lending through the decade, however, was not much different from that of the 1980s. The data suggest strongly that the recent growth in bank cross-border lending has (1) been driven by cyclical factors, and (2) been constrained by the much more rapid growth in net international securities issues (as indicated in line C in Table 2). Syndicated credits are reported to be among the most rapidly growing sources of international finance. New credits grew from USD 280 billion in 1993 to USD 960 billion in 1998.

As one would expect from the flow data, cross-border bank positions have increased significantly over recent decades, including relative to economic growth (see Table 3.A and 3.B). This is the case in regard to lending to non-banks as well as to other banks. (Bank positions of BIS reporting banks relate largely, but not exclusively, to wholesale banking.) The importance of European banking centres such as the United Kingdom, Switzerland, Belgium/ Luxembourg and the Netherlands stands out. Also of note is that Canada and the United States have low cross-border banking positions.

Investment banking and wholesale investment services

Although there are no direct data on cross-border investment banking activity, BIS and ISDA data suggest that it is growing rapidly.

- Table 2 reveals the huge growth in net international securities issuance from the recent low of USD 111 billion in 1992 to a high of USD 670 billion in 1998.
- Table 4 records the growth in the outstanding notional value of exchange-traded derivatives. No data are available on the nationality of the traders of these instruments. It is generally believed, however, that the growth in the market is related to international investors' efforts to hedge risk, including that related to international securities issuance.

These statistics suggest similar growth in the related cross-border investment banking services (e.g., underwriting fees, trading commissions). Informal discussions with industry representatives support this view and extend it to other areas such as M&A advisory services. M&A activity, both cross-border and national, has grown markedly in recent years (outward M&A from OECD countries reached USD 555 billion in 1998⁷). Almost all international M&A transactions – alongside with an increasing number of purely domestic ones – are advised by investment banks located in major banking centres. This is in part due to the fact that the bulk of this M&A flow is from countries hosting these centres – the United States

⁵ See note to Table 1.

⁶ BIS data on cross-border bank claims cover direct cross-border claims as well as claims through branches. They do not include the claims of subsidiaries.

⁷ Data provided by KPMG.

and United Kingdom alone accounted for USD 252 billion in 1998. It is also true, however, that enterprises in other countries are turning increasingly to the investment banks in the major centres for M&A advice.

Retail commercial banking

Cross-border trade in retail banking services has been traditionally much less important than in wholesale banking. According to the BIS, retail-banking services in Europe continue to be “overwhelmingly provided by national corporate entities”.⁸ Similarly, there is very little cross-border retail banking activity in North America. This situation may change in the future, however, particularly with the greater use of the Internet (to be discussed more fully in section II.C).

Nonetheless, anecdotal evidence suggests that cross-border retail banking has picked up in a number of areas in recent years.

- With the increased mobility of individuals, technology (for example, through the use of automated teller machines (ATMs) and bank debit cards) is allowing banks to serve their existing clients on a cross-border basis in regard to certain basic current account operations (i.e. funds withdrawals).
- In Europe, efforts to complete the internal market has encouraged the growth of credit card services, personal and mortgage lending, and cross-border deposit taking within Europe.
- In North America, a United States based bank has chosen to enter the Canadian market without establishing a commercial presence, providing credit lines to targeted individuals and small businesses.

Wealth management

Private banking, historically wealth management for the wealthy, is one of the oldest and most established of cross-border financial services. In general, the largest internationally active banks have private banking affiliates, often located in offshore banking centres (such as the Channel Islands or the Bahamas). One piece of evidence of the extent of international private banking activity concerns the volume of private capital under management of banks in Switzerland which, according to the Swiss National Bank, was in the range of SF 3,000 billion by the end of 1998. Of that volume, more than half was foreign.

Insurance services

Evidence of a growth in cross-border trade in insurance is mixed – possibly due to an acute scarcity of data. The OECD Insurance Statistic Database provides a high-level coverage of insurance overall, but data on premia underwritten abroad by insurers registered in the larger economies are scarce, and a separation between branches abroad and actual cross-border business is rarely possible. The available data do however recognise the importance of the United Kingdom and Switzerland as centres for cross-border insurance activity.

⁸ William R. White, “The Coming Transformation of Continental European Banking?”, *BIS working paper No. 54*, June 1998

Existing cross-border contracts, to a large extent, relate to civil aviation and maritime insurance, re-insurance and direct insurance of larger corporate clients. As for reinsurance, arguably the most “wholesale” and most international market segment in insurance, in many of the larger economies cross-border transactions make up for around one third of the non-life premia underwritten abroad in recent years – in some cases even as much as half.⁹

Operational services

International custody services are increasingly offered on a cross-border basis. In its 1998 survey of world-wide custody services, Global Securities Consulting Services reported that USD 7 trillion of USD 24 trillion in custodied assets are cross-border. The market is scale sensitive, and dominated by a limited number of global players.

The most notable development in cross-border clearing and settlement services is occurring in Europe. As a result of the introduction of the euro and the growing integration of markets, European clearing houses are repositioning themselves to compete on a European-wide basis.¹⁰

Financial information and data processing

An area of particularly rapid growth within the last decade is the provision of financial information and advisory services. Advisory services include products such as credit ratings and risk analysis, performance of companies and industries, as well as corporate and personal finance. Information services cover areas like proprietary information, news and analytics (e.g. Dow Jones, Reuters and Bloomberg), data generated by market-trading subsidiaries or partners (e.g. United News and Media’s Money) and the provision of raw data from the exchanges at a delay.

Several attempts have been made to assess the market size, especially as regards financial information services. A recent estimate assesses the global market for real-time data used in financial trading to be worth at present about USD 11 billion, growing to USD 15 billion by 2002. The market for historical and analytical data used by fund managers to make investment decisions is reportedly up to ten times larger, and growing even more rapidly.¹¹

C. Trends and future prospects

The financial services industry is going through a major restructuring. While there is a broad consensus that this transformation will continue for some time, views differ about the pace of change and what shape the sector will have once the restructuring is completed. Many of the forces at play in this transformation will have an impact on cross-border trade in financial services.

As noted before, a fair amount of wholesale financial services are provided on a cross-border basis. Cross-border activity in this segment of the business is expected to grow further, spurred by globalisation and removal of the few remaining impediments. Global players active in wholesale business tend to consolidate many of their activities in regional centres or platforms and provide services into other countries in the region from that office. Financial service providers may be expected to continue using regional centres or platforms as economies and markets further integrate (very few global financial service

⁹ OECD Insurance Statistics Yearbooks – various issues

¹⁰ BIS Quarterly Review, June 1999

¹¹ “Assessing Barriers to Trade in Services: Financial Information and Advisory Services”, *Report by the Working Party of the Trade Committee*, TD/TC/WP(98)51/REV1

providers – if any – have the critical mass necessary to establish a commercial presence in each and every country in which they are active).

The fiduciary nature of many financial services (e.g., deposit-taking, or life insurance policies) demands a certain level of consumer trust, particularly at the retail level, that may more easily be met by an institution located in the market. A number of considerations may continue to make a local commercial presence a preferred option for conducting certain kinds of business. These include the nature of the relationship between the customer and the financial service provider, and institutional differences in areas such as regulation, legal regimes and tax systems. The fiduciary nature of many retail financial services (e.g., deposit-taking, or life insurance policies) demands a certain level of consumer trust that may more easily be met by an institution located in the market. Easy contact with a bank or insurance company underpins a customer's confidence. Even more sophisticated consumers, comfortable with technology and shopping around for best prices, will be reassured by a local presence.

As reviewed in more detail in Section IV, regulatory requirements are far greater in the retail segment than in the wholesale segment of the business (reflecting the fact that retail customers and investors are less sophisticated than wholesale customers and investors). The difficulties for unsophisticated customers in pursuing legal rights in foreign markets that arise from the complexity of different legal regimes constitutes a key element impeding them from dealing with foreign-based firms. Also, some countries provide preferential tax treatment on savings plans that are not available if the funds are invested abroad. Finally, retail customers and investors are typically not well equipped to understand and manage currency risk.

It should also be noted that financial service providers might take the view that there are commercial advantages in having a local presence.¹² Such a presence allows the provider to be closer to its customer base, and to enlist local expertise and market knowledge – particularly in the retail area.

Having said that, there are important developments under way that may change the dynamic in certain segments of the retail market. One of these developments is technological progress, which affects just about every facet of a financial transaction from product development to marketing and delivery to the customer. Progress toward regulatory and currency convergence (in countries that have adopted the euro) could also provide a significant boost to cross-border activity.

Technology

Technological progress in computing and communications is having a profound effect on the way the business is conducted as well as on price, cost and risk structures. Technological progress also has the potential to greatly expand the reach of financial service providers, including across borders, to an extent not witnessed before. While technological change could affect cross-border operations through a number of channels, two are deemed particularly important: (i) the increased ability to access, manage and disseminate information; and (ii) the development of new delivery systems.

Increased access to information: Technology allows providers of financial services to better access, manage and disseminate financial information. This enables financial services providers to expand their business significantly while, at the same time, having a better control of their risk profile. They can access and process needed information – such as a customer's risk profile, fees and revenues generated by a particular account – without having a physical presence in the market where the customer is located.

¹² A financial service provider wishing to enter a market has a number of options. It can: i) establish a *de novo* local presence through a subsidiary and/or branch; ii) acquire a local firm; iii) enter into co-operative arrangement with a local provider; or iv) provide the service on a cross-border basis.

Technology also makes it easier for financial services providers to market their products – for example, by targeting clients of a certain age group in a given income bracket. Once a successful target marketing strategy has been implemented within a national market, it may not be that difficult to extend this strategy across borders. The location of the customer is becoming less relevant.

Technological penetration and, in particular, the development of the Internet as well as user-friendly websites by financial institutions and third parties also mean that customers can also access huge amounts of financial information – including prices for services, such as rates for deposits and loans, rates of returns on investments, insurance premiums. At the same time, consumers are increasingly looking for more competitive prices, better service and convenience, and no longer hesitate to shop around for the best deal, which need not be confined to national providers of financial services anymore.

New delivery systems: Declining computing costs coupled with rising computer power have led to the emergence of new computing and communications systems which permit financial service providers to deliver their products at a distance, with little or no human interaction and at lower cost.

The development of interactive voice response technology has promoted the development of “telephone banking” which allows financial institutions to provide automated services over the telephone covering a wide range of services, such as providing account balances, transferring funds between accounts and effecting bill payments.

PC banking, through either personal computer-based systems or the Internet, allows customers to make a broad range of transactions that include bill payments, funds transfers, loan and mortgage payments, stock trade transactions and access to stock quotes. Some institutions permit clients to apply for loans and mortgages or to buy mutual funds on-line.

Card based systems, such as ATMs, credit and debit cards, and smart cards provide a new payment medium that extends beyond national borders. In the case of credit cards for instance, electronic communication technology has replaced the manual processing of credit card slips, and need for telephone authorisations. With international smart cards, funds are transferred from one’s bank account, stored on the smart card and can be used anywhere.

In the general insurance sector, interactive voice response technology is used by some providers to sell policies. Paper securities are becoming less common, and stock and bond trading is conducted mostly on an electronic book; stock exchanges are closing trading floors in favour of computer-based order entry and execution systems.

All these developments are not, by themselves, sufficient to foster the growth of cross-border trade in financial services. Consumers’ behaviour toward remote delivery systems is also an essential driving force. And, there is evidence that consumers are willing to embrace these new technologies, at least within national markets.

As the population becomes more technology literate and confidence in the security of the technology increases, consumers are likely to rely to a greater extent on non-traditional delivery channels, such as banking on-line. In addition, as consumers become more sophisticated (from greater involvement in planning their own investments), they are likely to become increasingly accepting of non-traditional delivery systems.

The growth of cross-border trade not only depends on the willingness of consumers to use alternative delivery systems, but also on their willingness to transact with foreign financial services providers. The necessary change in behaviour may occur as providers find new ways to foster a climate of trust between themselves and their customers. This may be easier to develop with respect to “straightforward” financial

products with easy-to-compare, standard features (and where the customer can determine the suitability of the product without having to seek professional advice). Some payment products, car and travel insurance as well as financial information services are all examples of products that could flourish in a cross-border setting.

At the same time, many financial products will remain quite complex and are typically accompanied by an intensive advisory process. Providing services at a distance and/or without face to face contact is not conducive to advice intensive financial services.

Other considerations

Two key institutional developments likely to encourage cross-border trade in financial services in the future are worth highlighting: regulatory convergence and the introduction of the euro in Europe.

Differences in financial sector regulation are still a significant impediment to the cross-border provision of services, particularly in the retail area. Regulatory convergence over the past decades has facilitated the growth of cross-border trade. Several international fora have successfully contributed to the harmonisation of high-quality regulation (see Section IV.B). Efforts have generally focused on harmonisation and co-ordination of solvency supervision. Convergence of consumer protection and conduct of business rules is, however, much less advanced.

The adoption of a single currency is expected to encourage the provision of financial services on a cross-border basis within euro-countries. Financial service providers no longer need to manage currency risk, while corporate and retail customers can more easily compare rates/fees for different products across borders.

D. Summary

Cross-border activity is concentrated in wholesale business and financial services for relatively sophisticated customers. Technological developments and regulatory accommodations will likely encourage further growth in this area.

While cross-border activity remains limited in the retail area for a number of different reasons, it could expand significantly in the future in some segments of the market through the development of cheaper and more rapid delivery channels and as consumers become more willing to embrace these new technologies. However, the establishment of a commercial presence is expected to continue to be the preferred means of operation for segments of the retail market that are more advice intensive or where the consumer/investor entrusts funds to a financial firm.

Finally, on a more general note, cross-border activity is expected to get an extra boost from developments such as financial sector regulatory convergence, the introduction of the euro in Europe and the general trend toward globalisation of economies and markets.

III. Regulating cross-border trade in financial services

A. Key policy goals of financial sector regulation

The financial services sector is one of the most heavily regulated sectors in an advanced economy. This is due to i) the central economic role of the financial system, and ii) the risk that problems arising in

particular institutions or markets may, if allowed to spread, lead to a loss of confidence in that system. The primary objective of financial regulation, therefore, is to preserve confidence in the financial system. A second, and related, objective is to protect consumers and investors. A third, and broader, public policy issue is the objective of promoting efficiency in the sector through competition.

The following section discusses in more detail the specific goals of the various areas of financial regulation as well as the key instruments used by authorities to achieve their objectives. It also provides an overview of the key regulatory concerns arising from cross-border activity. It should be noted that these regulatory concerns vary depending on the nature of the financial services – for example, whether consumers and investors have entrusted their funds to the financial service provider – and with the degree of sophistication of the consumer or investor. With respect to the latter consideration, regulatory authorities tend to be cautious and generally consider retail consumers or investors as “unsophisticated”.

Prudential regulation

The term “prudential regulation” may take on different connotations depending upon the country and context in which it is used. For the purposes of this paper, the broad definition used in the GATS is followed: the range of policies or measures adopted to protect consumers of financial services (such as investors, depositors and policy holders) and to maintain the integrity and stability of the financial system.

Safety and soundness, and financial integrity: The main purpose of safety and soundness regulation is to minimise the risk of loss to consumers and investors arising from the failure of financial service providers. Safety and soundness regulation is institution-oriented and covers matters that may have an impact on the financial condition of the financial service provider. For example, supervisory authorities will typically adopt rules covering the following areas: i) capital adequacy; ii) large exposures; iii) currency matching; iv) permitted activities; v) financial reporting; and vi) risk management and management information systems.

Systemic risk: The goal here is to limit the potential for problems affecting one financial service provider to spread to others and eventually throughout the financial system. By promoting the ongoing health of financial service providers, safety and soundness and financial integrity regulation supports the objective of minimising systemic risk. Because problems experienced by a participant in a market (e.g. inter-bank) or system (e.g. clearing and settlement) can have serious repercussions for other participants and be disruptive to other parts of the financial system, rules governing participation in such markets or systems are also established. These rules are specifically designed to limit systemic risk. For example, finance ministries or central banks regulate who can participate in clearing and settlement systems and limit the exposures that individual participants in such systems can create vis-à-vis others.

Cross-border activity raises new challenges for prudential regulators because financial service providers do not fall within the easy control of the supervisory authorities in the host country since they do not have a “physical presence”. This means that some supervisory authorities of the host country may choose to rely on the home country supervisor. While the degree of reliance may vary depending on how policy-makers and supervisory authorities deal with cross-border operations (see discussion in Section IV.A below), it is nonetheless greater than if the financial service provider were operating through a commercial presence.

Consumer and investor protection: Consumer and investor protection measures in the financial area fall into two broad categories. The first category relates to the protection of consumers and investors in their dealings with financial service providers. Consumers and investors are, among other things, protected against unfair, improper and fraudulent behaviour of financial service providers as well as violations of

contract law.¹³ The second category relates to arrangements set up to provide financial compensation to consumers and investors who have incurred loss either as a result of failure or misconduct of a financial service provider.

With respect to the first category of consumer and investor protection, the regulation can be described as governing the conduct of business and will generally focus on the following three aspects (albeit to a varying degree depending on factors such as the type of services and the level of sophistication of the consumer or investor):

- The provider: regulation covers matters such as qualification, standards of conduct, and rules regarding compensation. This type of regulation is particularly important in the securities area. For example, investment dealers or advisors typically have to meet certain requirements and register with supervisory authorities.
- The interaction between the provider and the client: regulation covers matters such as disclosure of product characteristics, solicitation, advertisement, and anti-fraud provisions. In particular, this regards the provision of adequate information for the consumer/investor to make well-informed decisions. It also covers redress mechanisms for aggrieved consumers and investors. This type of regulation is important in all parts of the financial sector, but perhaps more so in the areas of insurance and securities. For example, there may be detailed rules relating to the content of insurance contracts to make them more understandable to unsophisticated insurance takers. Securities regulators also impose rules regarding the contents of prospectuses and regarding their delivery.
- The product: although not as frequently regulated as the previous two categories, product characteristic covers matters such as the maximum interest rate that can be charged on a credit card and maximum penalty for mortgage prepayment.

In securities market regulation, a related set of measures focuses on market integrity, i.e., ensuring that the market is fair and efficient and warrants public confidence. This objective is usually achieved through a variety of rules for fair play and transparency in the market and sanctions for misconduct or abuses. Two examples of measures to protect market integrity are rules against insider trading and anti-manipulation rules. Effective enforcement is also an essential component to protect the integrity of the market.

While the objective and the nature of consumer protection regulation may differ from safety and soundness and systemic risk policy, the challenges posed by cross-border activity for supervisory authorities are similar. Again, foreign financial service providers do not fall within the easy control of the host country supervisory authorities. Host country consumer protection regulation, however, will often apply (in principle) to financial services provided on a cross-border basis as the foreign financial services provider interacts with host country citizens.

Consumer and investor protection issues are brought to the fore by the rapid growth in e-commerce. While e-commerce raises few new issues in this regard, it certainly heightens the challenges faced by regulators as consumers and investors gain ready access to information from financial service providers around the globe. Another challenge faced by regulators as e-commerce grows is the speed with which securities transactions can be conducted. Regulators also have to deal with the challenges raised by fraud on the Internet and other forms of electronic communication. The ease and speed with which information can be disseminated broadly and quickly is also facilitating the ability of fraudsters to victimise unsuspecting investors.

¹³ In addition, the legislation in some countries includes provisions to protect the “general interest”.

Cross-border activity also raises issues for compensation arrangements. To the extent that financial service providers operating on a cross-border basis are not subject to host country regulation, national authorities will typically not extend compensation coverage for customers and investors dealing with them. A depositor in the host country may benefit from deposit insurance in the home country of a bank (assuming there is no discrimination). However, in practice, it may prove difficult for the depositor to recover or it may fall short of what the depositor would have received had he/she dealt with a domestic bank.

Promoting competition

The goal of promoting competition in the financial sector is shared to varying degrees in national regulatory regimes. In some cases it is an explicit part of the regulator's mandate. In others, it is a consideration to be taken into account in pursuing the primary objective of maintaining confidence in the financial system. In many instances, the primary responsibility for promoting competition in the financial sector rests with the competition policy authorities.

While the cross-border provision of financial services may provide a welcome boost to domestic competition, it may also raise concerns related to the maintenance of a level playing field. Two types are worth noting. The first arises when a foreign provider is subject to weaker or lighter regulation in the home market. In either case, this may lead to a competitive advantage for the foreign firm in the host market. (This in turn might lead to pressure for watering down prudential standards.) The second arises when host countries impose requirements on domestic firms with a view to pursuing specific social goals (e.g., ensuring adequate access to banking services in rural areas, or for low-income families). Foreign firms not established in the host market might not have to comply with such requirements, giving them a competitive advantage in the domestic firms' more profitable lines of business (sometimes referred to as "cherry-picking").

B. Possible approaches to address regulatory concerns

There are a number of approaches that policy-makers and supervisory authorities may adopt in addressing the regulatory concerns arising from cross-border activity

1. The given cross-border activity or activities may be prohibited.
2. Activities may be permitted, subject to the (non-discriminatory) application of host country rules and supervision.
3. Activities may be permitted, with implicit or explicit reliance on the home country's regulation and supervision.
4. Activities may be permitted, subject to reliance on a combination of host- and home country rules and supervision.

The following provides a more detailed discussion of the four possible approaches and the factors that may be taken into consideration by policy-makers and supervisory authorities in deciding which one to pursue. It also reviews some of the key implications – in terms of regulatory concerns, competition in the marketplace and implications for market participants – of each of the approaches.

Approach 1: Prohibition of some cross-border activities

Authorities may decide to prohibit the sale of certain financial services on a cross-border basis, ensuring their provision through a commercial presence. Host countries are more likely to require a commercial presence in situations where unsophisticated consumers and investors entrust their funds with a financial service provider (such as deposits or life insurance policies). This approach ensures the host regulator's maximum direct involvement in regulating the activity.

Approach 2: Host country rules

The application of host country rules on a national treatment basis also ensures maximum involvement by the host jurisdiction. It is attractive for supervisory authorities because they have expertise in interpreting their rules, their scope and how effectively they can be enforced. This approach is compatible with regulation that is most directed toward consumer and investor protection, and is in keeping with the notion that "the nation must look after its citizens".

However, the host country approach may not be as attractive with respect to safety and soundness regulation. In particular, it may prove difficult for the host jurisdiction to enforce such rules because the financial service provider has no "physical presence" in the country. Yet workable mechanisms for the regulation of foreign-based service providers operating on a cross-border basis do exist. As a condition of licensing, for example, the foreign-based entity may be required to provide information directly to the host supervisor. Additionally, regulators are increasingly co-operating to facilitate onsite supervision of foreign-based entities.

Another consideration is that this approach adds another layer of regulation to that already faced by the foreign financial service provider in its home market, resulting in added cost. Even where activities are permitted on a non-discriminatory basis, they may be limited by the specific regulations that may apply. The limitation is the cost of compliance. A financial service provider, already subject to home regulation, faces additional costs in complying with differing regulatory requirements and in dealing with different jurisdictions and supervisors.¹⁴ Such additional costs will be more strongly felt by smaller firms and firms that are unusually dependent on foreign markets. These costs are exacerbated under regulatory regimes that lack transparency and rely on discretion instead of clearly stated rules. Foreign firms, less familiar with local customs, institutions and laws, will be particularly disadvantaged. Cross-border service providers lacking a local commercial presence will be all the more so.¹⁵

Approach 3: Home country rules

Under this approach, the regulatory regime of the home country of a foreign financial service provider governs the provision of cross-border services to host country residents. (This approach can occur either by law, under which the host country explicitly defers to home country regulation, or on a de facto basis, that is, as a result of the absence of host country regulation of the cross-border activity.) The financial service provider is subject to the rules of its home jurisdiction and is supervised exclusively by the home country authorities. Because host country regulators have to rely on home country regulators under this approach, they must have confidence in their ability to provide effective supervision. Reaching the

¹⁴ Learning and conforming to different rules take time and money (legal fees, adjusting corporate culture and processes to meet the rules abroad). Even when rules are substantially the same, having to deal with multiple jurisdictions and supervisors adds to the cost of doing business – showing the same books to different regulators, paying multiple fees and, sitting for extra exams.

¹⁵ In addition, confusion regarding which laws apply, whether specific cross-border activities are permitted, or over which courts have jurisdiction, increases the risks facing the foreign firm.

necessary comfort level is particularly important with respect to retail consumers and investors who are less sophisticated, lacking the means to fully understand the suitability of certain financial products or to seek redress when they do not obtain satisfaction. Conversely, the more customers and investors are able to look after themselves, the more likely host authorities will be willing to rely on home country regulation and supervision.

Approach 4: Hybrid approach

Under this approach, the cross-border provision of financial services may be permitted, subject to reliance on a combination of host- and home country rules and supervision depending of various factors. These include the type of financial services (e.g. whether it is the provision of credit or raising deposit), the degree of sophistication of the consumers or investors, the home residence of the financial service provider and, finally, the amount of business carried out in the host country.

C. Considerations in relying on home country rules

a) Key elements to build comfort level:

At least three fundamental elements must all be present to achieve this necessary level of comfort. These relate to the quality of the rules, the quality of supervision and the sharing of supervisory information.

Quality of rules: The convergence of rules, underpinned by the widespread adoption of internationally accepted high quality standards, is critical to the home country approach. Although the rules need not be exactly the same, when there is a high degree of convergence it becomes easier for host regulators to rely on home regulators. Convergence beyond the minimum standards can be achieved through deliberate harmonisation (unilateral or negotiated). Convergence can also come about through a less formal, evolutionary process whereby rules become more similar over time. It should, however, be noted that divergence can similarly occur over time.

Quality of supervision: Even if the rules are similar, a separate but related issue is their administration. By whom and how effectively rules are administered is important because harmonisation of, say, capital standards, does not ensure the quality of supervision. Indeed, without strong, effective supervisory authorities, stringent regulations can be meaningless in practice. Another important supervisory issue involves increased co-operation and co-ordination among supervisors, both across national borders and across financial sub-sectors. Regardless of whether host- or home country supervisory authorities have primary responsibility, a major issue is the extent to which supervisory practices are harmonised. The ability and willingness of supervisory authorities to take action in a timely fashion is also critical to effective supervision.

Sharing of supervisory information: It is important for host supervisors to be informed in a timely fashion of material adverse changes in the global condition of a financial service provider operating in their jurisdictions. Regulators also need to be informed if fraudsters are likely to become active in their markets. In that regard, memoranda of understanding between supervisory authorities are useful vehicles to enhance co-operation between supervisory authorities.

b) Types of processes that can help build comfort level:

The following describes processes that do not deal specifically with cross-border activities but are the kinds of processes that could help build the comfort level necessary to move toward greater reliance on home regulation of specific cross-border activities. Some of these processes relate to improving the quality of the rules, some relate to improving the quality of supervision, while others relate to exchange of supervisory information between regulatory authorities. They have been organised according to the degree of formality: from *de facto* convergence to “conditionality” under adjustment of programs of the IMF or the World Bank; some processes are multilateral, others are bilateral.

***De facto* convergence** does not result from any organised international effort or agreement but from unilateral decision by national authorities to harmonise their rules with those of other jurisdictions. For example, this can happen when a jurisdiction revises its legislation and consults other jurisdictions on their experience in dealing with issues that are similar to the ones they are facing. This convergence process can be enhanced by factors such as shared heritage (e.g. legal system) and geographical proximity.

Voluntary accords establishing minimum standards and best practices have become an increasingly common method of harmonisation in the financial sector. The best known example is the 1988 Basel Risk-based Capital Accord, an informal agreement among supervisory authorities of the G-10 countries that sets forth capital standards for internationally active banks. That accord, which has been widely accepted by supervisors beyond the G-10, is now in the process of being revised and updated. International efforts have also been directed toward ensuring effective supervision. For example, the Core Principles for Effective Banking Supervision are designed to provide a generally accepted set of principles and practices for effective supervision of national banking systems and have been widely endorsed by supervisory authorities from both industrial and emerging market economies.

Ensuring that national authorities not only adopt but also effectively implement voluntary standards is a major issue. In the case of the Basel Core Principles and comparable standards established by IOSCO and IAIS for securities and insurance supervisory authorities, respectively, international efforts, which are directed primarily toward emerging market economies, are focusing on facilitating and co-ordinating technical assistance utilising supervisory officials and on surveillance of implementation. The International Monetary Fund (IMF) is expected to play a major role in surveillance. This year, the IMF began a comprehensive peer review process of national financial systems (the “Financial System Stability Assessment”) which is conducted by an international group of experts in the context of the Article IV surveillance activities of member countries.

These agreements also carry with them a secondary advantage - the establishment of rules under which all players must compete. It is generally accepted that regulatory requirements and the enforcement of these requirements can have an impact on the relative competitiveness of financial institutions. By establishing common rules and/or standards of regulation, this issue of competitiveness becomes less of a concern when opening markets to cross-border activity.

Binding international agreements relating to financial sector regulation and supervision are extremely rare and existing ones are quite limited in scope. For example, the mutual recognition agreement between Switzerland and Liechtenstein that recently came into force allows insurance companies from both countries to provide insurance services either through subsidiaries or branches or on a cross-border basis, subject to home country authorisation and supervision. However, there are binding trade and investment agreements that have a bearing on financial sector regulation. While these agreements contain a “prudential carve-out” that is fairly broad in scope, it does not mean that no financial regulatory measure is subject to trade discipline. Rather, it means that when a given measure might otherwise violate the trade agreements, it must be for prudential reasons. Although prudential measures are not defined, there are mechanisms to deal with challenges from signatories regarding actions taken by trading partners under the

“prudential carve-out”. The general obligation of “transparency” in the GATS is another example of a binding agreement covering financial services, albeit in very broad terms, that makes non-discriminatory structural barriers more visible and may lead to their removal.

Supranational legislative process – the only example is provided by the European Community (discussed in Section IV.B below).

“**Conditionality**” can also be used to improve the quality of financial regulation. For example, in the Asian stabilisation programs, the IMF extended the reach of its conditionality well beyond traditional macroeconomic policy measures to encompass the financial sector infrastructure, including both liberalisation and prudential regulation. Issues in designing such programs include the choice of appropriate benchmarks for regulation and ensuring that the measures remain in effect beyond the duration of the program.

D. Summary

Cross-border activity, especially in an era of fast and reliable communications, represents a fundamental departure from traditional modes of operation and raises new challenges for policy-makers and supervisory authorities alike because foreign financial service providers do not fall within the easy control of supervisory authorities in the host country. The potential for increased cross-border activity points to the need for strong prudential regulation because such regulation is the cornerstone for building and maintaining vibrant markets. The conditions necessary to deal with legitimate regulatory concerns arising from cross-border activity – particularly with respect to dealing with unsophisticated consumers and investors – have not yet been fully achieved.

While some perceive regulation as a barrier to trade, it should be recognised that sound domestic financial regulation is critical to financial stability, long term growth, and (indirectly) increasing the scope for cross-border trade in financial services. The importance of sound regulation has been an issue discussed by the recently established Financial Stability Forum. International efforts to improve national regulatory standards focus on regulating domestic financial service providers and markets, not cross-border activity per se. Strengthening national and international supervisory standards will, however, contribute to a favourable environment for cross-border trade.

IV. Existing approaches to cross-border activity

The previous section described the characteristics of the four main approaches to regulating cross-border trade in financial services: i) prohibiting the provision of services on a cross-border basis; ii) permitting the provision of services, subject to host regulation; iii) permitting the provision of services, subject to home regulation; and iv) permitting the provision of services, subject to a combination of host and home rules.

This section discusses the incidence of these approaches within the OECD membership. The first part reviews regimes of countries outside the European Economic Area (EEA) and those of the EEA countries with respect to non-EEA financial service providers. It is based on the results of an informal survey of CMF members.¹⁶ The second part delves into the special case of the approach followed within the EEA for providers established and licensed in the area.

¹⁶ The countries that responded to the questionnaire are: Australia, Belgium, Canada, Czech Republic, Finland, Germany, Italy, Japan, Korea, Mexico, Netherlands, Norway, Poland, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

A. Approaches other than the intra-EU approach

In general, the rules applied by OECD members to cross-border trade in financial services stem from the key policy goals discussed in Section III A. Yet there is a notable degree of variation in these rules, both between countries as well as between sectors. While these differences make it difficult to generalise, some broad observations may be made.

Banking

There appear to be two main approaches followed, with some variation in detail. In general, cross-border banking services are either prohibited (by requiring that such services be provided through a commercial presence) or they are permitted subject to home prudential regulation. Three distinctions are particularly important for regulators/supervisors. These are: whether the service is wholesale or retail; if retail, whether it involves deposit-taking or offering credit; and whether the service involves solicitation or not.

A limited number of countries prohibit the provision of banking services on a cross-border basis. These include Australia, Finland, Japan, Mexico, Norway, Poland and Turkey.

The approach to wholesale banking most commonly followed within the OECD (e.g., by Belgium, Germany, the Netherlands, Switzerland, the United Kingdom) is to permit the provision of wholesale banking services on a cross-border basis, with no host country regulation and/or reliance on home country regulation. (Very few countries, if any, have consumer protection regulation applying to wholesale business.) Some countries (e.g., Canada, Switzerland, Sweden and the United States) follow this permissive approach provided that the foreign bank does not engage in the business in a way that could be construed as having a “permanent” presence in the country. Different factors enter into consideration in determining whether the foreign bank has a “permanent” presence, including whether and how solicitation is involved.

Turning to retail banking services, one finds a higher degree of regulatory involvement in regard to consumer protection. Some countries, for example, subject foreign banks to their rules for consumer protection matters (especially regarding advertising and solicitation). While none of the countries surveyed regulate foreign banks for safety and soundness, some have processes in place to satisfy themselves that a given foreign bank is in good financial condition before allowing it to raise retail deposits on a cross-border basis.

The United Kingdom, the Netherlands and Canada are among the OECD countries that distinguish between a foreign bank providing credit and one raising deposits. If the foreign bank wishes to provide credit only, then the supervisory authorities take a “hands-off” approach. With respect to consumer protection, the Netherlands and the United Kingdom subjects the foreign bank to host country consumer credit rules, while home country rules apply in Belgium and Canada.

If the foreign bank wishes to raise deposits from the public, then both the Netherlands and the United Kingdom authorities will want to satisfy themselves with the bank’s safety and soundness. This assessment is made on a case-by-case basis; usually, the supervision by the home country is a relevant factor. In Netherlands, an approved bank will be subject to home country rules for solvency regulation, and host country rules, if any, for consumer protection. In the case of the United Kingdom, home country requirements are taken into account in addition to United Kingdom authorities’ own requirements. Canada, on the other hand, prohibits (solicited) deposit-taking activity on a cross-border basis.

As noted above for wholesale business, some countries only allow the provision of retail banking services as long as the activity does not rise to the level of maintaining an office or undertaking the business of

banking. In such an event, the foreign bank would be required to seek a license and provide the service through a commercial presence.

Direct insurance services

With very few exceptions, the insurance of large risks and reinsurance and retrocession¹⁷ are allowed on a cross-border basis within OECD countries. In some cases, the host regulator may impose specific requirements. For instance, the insurance of large risks (“surplus lines”) in the United States generally requires registration/notification and collateralisation. Moreover, the economic capacity of individual insurers to provide coverage against large risks (e.g., marine, transport, air/spacecraft and nuclear disaster) or to reinsure is limited. The market for such insurance products is genuinely international, involving the world-wide pooling of such risks.

The pattern of regulation observed for retail insurance services is similar to that for banking. Countries either prohibit the activity (requiring commercial presence) or they allow it on a home country rule basis subject to country-specific variations.

The Czech Republic, Japan, Mexico, Norway, Poland, Switzerland, United States and certain EU member countries¹⁸ generally prohibit the selling of retail insurance products on a cross-border basis. Canada and Sweden prohibit the activity if solicitation is involved, as does the United Kingdom for life insurance except where the insurer is from a designated territory (i.e., one with equivalent protection).

In general, those countries that permit cross-border retail activity rely on the home country prudential supervisor. Some countries supplement this reliance with a requirement of notification/registration (e.g., Australia) or process to satisfy themselves that a given foreign insurance provider is in good financial condition (e.g., Belgium, the Netherlands, the United Kingdom for non-life).

To a greater extent than observed for banking, cross-border retail insurance provision is subject to consumer (policy-holder) protection in the host country (e.g., Australia, Belgium). This relates, for the most part, to advertising and promotion.

Securities services

Compared to banking and insurance, the securities sector appears to be subject to the greatest degree of host country regulation of cross-border activity. The consumer/investor protection issues are particularly acute, in part due to the market risk associated with securities products and the sophistication required to understand them.

A significant minority of OECD members do not permit cross-border securities services, requiring a commercial presence by foreign securities service providers – Belgium (retail), Canada, Japan, Mexico, Norway, and Turkey. Italy does in principle have similar rules, but grants case-by-case exemptions on the basis on criteria such as the applicants’ size and operations in other countries.

Virtually all other OECD countries permit cross-border activity, subject to some form of licensing/authorisation as well as compliance with host country rules (e.g., Australia, Belgium (wholesale), the Czech Republic, Finland, the Netherlands, Poland, Spain and the United States). The limited number of countries that permit cross-border activity on a home rule basis include Switzerland. Germany allows cross-border securities business of firms domiciled abroad without requiring German licensing. However,

¹⁷ The act of retrocession essentially consists of the re-insurance of re-insurance contracts.

¹⁸ According to questionnaire responses, these include Germany and Spain. .

German rules of conduct have to be observed, especially in the case of retail investors. The United Kingdom allows a limited amount of cross-border securities business free of any licensing requirements, provided that solicitation rules are observed in the case of retail investors. Inter-professional business is generally free of restriction.

Exceptions and exemptions apply in both cases (i.e., to either prohibition, or full compliance with host country rules). A key distinction is made in this regard – that between wholesale/sophisticated investors (where transactions are subject to fewer restrictions) and retail/unsophisticated investors. Examples of countries that relax the prohibition or host country regulatory requirements for activity involving sophisticated investors include Belgium, Canada (Ontario), Germany, Italy¹⁹, Japan and the United States.

B. Intra-EU approach

The EU single market program deals with all aspects of financial services liberalisation and regulation among the Member States – including liberalisation aimed at removing non-discriminatory structural barriers as well as discriminatory barriers, liberalisation of capital movements, and establishment of minimum standards for prudential regulation.²⁰

The EU model relies on the (minimum) harmonisation of essential rules in combination with the (mutual) acceptance of the rules of the home member state – these rules at least include the harmonised rules, but may also include other (home) rules. Prudential rules are generally administered by the home country authorities. In a number of key areas, conduct of business rules are administered by the host country. In terms of the approaches discussed in Section III.B, the EU model can be characterised as being hybrid.

The relevance of the EU model for this paper is twofold. First, it raises the question of the extent to which the intra-EU approach of mutual recognition and home-country control can be used elsewhere without the supranational legislative, judicial, and administrative structure of the European Community and the broad scope of its harmonisation of essential rules.²¹ Second, the obstacles that are proving most difficult to remove within the European Union provide insight on the areas that are likely to be most difficult internationally.

Under EC financial service directives, a financial firm incorporated in any Member State may provide services across borders, or through the establishment of branches in any other Member State, on the basis of a "single license". The firm may provide such services under home country authorisation and supervision, given that home member state rules comply with the harmonisation required by Community legislation. There is, however, a "general good" exception to the home country approach; subject to conditions established by the Court of Justice of the European Communities, a host-Member State may apply its own rules "for imperative reasons relating to the general good".

Reaching political agreement on goals for regulatory convergence and legislated harmonisation of minimum standards are important elements in the EU's home country approach. *De facto* harmonisation

¹⁹ Italy grants less stringent provisions to professional investors as a general rule in the field of financial regulation.

²⁰ Sydney J. Key, GATS 2000: Issues for the Financial Services Negotiations, American Enterprise Institute, Washington, D.C. (forthcoming). Three members of the European Free Trade Association (EFTA), Norway, Iceland, and Liechtenstein, benefit from the single market program through their participation in European Economic Area (EEA). The discussion of the EU model in this section encompasses these countries.

²¹ The European Community, together with the European Coal and Steel Community and the European Atomic Energy Community, is part of the supranational "first pillar" of the European Union. The other two pillars of the European Union are intergovernmental: the common foreign and security policy ("second pillar"); and police and judicial co-operation in criminal matters ("third pillar").

resulting from market forces also plays an important role; it both builds upon and facilitates the home country approach and the legislated harmonisation. In addition, with regard to the practical implementation of home country supervision, the EU also relies on informal agreements among supervisors.

The harmonisation within the European Union is much broader than that which has been achieved beyond its borders. For example, EC banking legislation, in addition to capital standards, deals with activities covered by the "single license", bank ownership of non-financial institutions, major shareholders and changes in share ownership, large exposures, consolidated supervision, accounting standards, deposit insurance, consumer credit, and money laundering. Moreover, harmonising measures in other areas, such as competition policy and company law, also affect the banking sector. In addition to the harmonisation of essential rules, sector-specific fora for banking, securities and insurance facilitate co-operation and co-ordination with regard to regulation and supervision and thereby play an important role in making the home country approach work

The creation of the single European market is an ongoing process. There are significant implementation issues and remaining barriers. Many of these barriers are created by non-discriminatory host-Member State rules (e.g., concerning solicitation) imposed in the interest of the "general good" exception to the home country principle mentioned previously. Another type of barrier involves the notification requirements of the Second Banking Directive (SBD) and the Investment Services Directive (ISD) for conducting cross-border business. For a bank or investment firm to provide services across borders, not only must the cross-border activity be covered by the home Member State license, but the bank or investment firm must also notify its home Member State supervisory authority that it intends to conduct that activity in another Member State.

Another barrier involves the ISD's approach to Member State conduct of business rules. While the directive sets out the principles that such rules must implement, responsibility is assigned to the host, as opposed to the home, Member State. Thus, an investment firm with a "single license" still faces the burden of complying with different, and possibly conflicting, conduct of business rules imposed by each host Member State. A related issue involves distinguishing the degree of protection appropriate for wholesale versus retail investors. Although the ISD requires each Member State, in applying its conduct of business rules, to take into account "the professional nature of the person for whom the service is provided," some Member States do not make this distinction.

The EU single market for financial services is not yet complete. In June 1999, the European Council (EU summit) endorsed the Commission's Action Plan to improve the market over the ensuing five years. The plan focuses on three areas: (1) completing a single wholesale market; (2) developing "open and secure" markets for retail services (where progress has been much slower than on the wholesale side); and (3) ensuring the continued stability of EU financial markets through improved prudential rules and increased supervisory co-operation. The treatment of wholesale and retail financial services as two separate areas reflects the strong concerns of Member States about consumer protection for retail customers and the concomitant difficulty of reaching agreement on liberalisation based on the home country approach. *Inter alia*, the plan invites the Council and the European Parliament to adopt as soon as possible the proposed E-Money Directive and the proposed Distance Selling Directive for Financial Services. The latter is, in general, based on the approach of full harmonisation (i.e., a single set of consumer protection rules to be applied by all Member States.)

V. Conclusion

Developments in cross-border trade in financial services

The evidence on the incidence of cross-border trade in financial services cited in this paper is largely circumstantial and anecdotal. This is because the data are meagre and difficult to interpret (in part due to a lack of consensus on what constitutes cross-border trade in financial services). It is to be hoped that, with the imminent launch of a new round of multilateral trade negotiations, national and international statistical bodies will make further headway in this area.

In general, cross-border trade is found to be most prevalent and longest established in the sophisticated end of the market: wholesale commercial banking; investment banking, private banking, insurance (large risks, and reinsurance), and operational and financial information services. Regulatory accommodation, technology, sophisticated clients, the integration of national economies and the globalisation of business activity have all contributed to this outcome. Further growth in cross-border trade in these market segments is to be expected.

On the other hand, the provision of retail banking and wealth management services for less sophisticated individuals and small business has been overwhelmingly through local commercial presence. The incidence of cross-border provision of these services appears extremely low. Factors contributing to this include: heightened regulatory concerns (pertaining both to safety/soundness and market conduct/consumer protection issues), and the traditional importance of a direct relationship between the service provider and the customer.

Nevertheless, there are signs of a pickup in retail cross-border activity in specific product lines related to the provision of credit (e.g., credit cards, credit lines). This development illustrates the potential impact of technology, growing technological literacy, and changing attitudes on the broader retail market.

Indeed, technological developments make the widespread cross-border provision of retail financial services both possible and commercially feasible. Two important elements in this regard are economies of scale in information management, and the development of low-cost methods of delivery at a distance.

A number of elements will, however, constrain and condition the expansion of cross-border retail activity. First and foremost is the set of acute regulatory concerns at play. Second is the willingness of individuals to use information technology and to transact business with financial institutions in foreign countries. Third is the value to a financial institution of locating directly in the foreign market. These considerations are most relevant to transactions involving deposits, trusts, investments in securities, or insurance policies.

The regulation of cross-border trade in financial services

The cross-border provision of financial services poses particular challenges to regulators and supervisors in pursuing their policy objectives. The lack of local commercial presence means that the foreign financial service provider falls outside the easy control of local authorities. The local authorities may respond in four basic ways: prohibit the activity; subject it to host country rules and/or supervision; rely on home country rules and/or supervision; or apply a mix of host and home country rules and supervision (the hybrid approach).

There are two dominant approaches in banking, with considerable variation in detail across members: prohibition, and reliance on home prudential regulation. Few countries prohibit cross-border banking outright. Some will prohibit specific retail banking activities when these entail “doing business” in the

host market. Reliance on home supervision is dominant in wholesale banking. Countries that rely on home supervision for cross-border retail banking may also require compliance with specific host consumer protection rules.

The prohibition of cross-border activity is more common in the retail insurance sector. Those countries that do permit it generally rely on the home prudential supervisor, with greater recourse to host country consumer protection rules.

Most members that permit cross-border securities activity subject it to licensing/authorisation requirements as well as full compliance with host country rules. The main exceptions occur in the wholesale/sophisticated segment of the market.

Within the OECD, the EU has gone far in reducing the impediments to cross-border trade in financial services among its member countries. The EU approach to regulating intra-EU cross-border trade is a hybrid one. It mixes harmonisation of basic rules, home country rules (including home country supervision), and host country rules (especially in the areas of conduct of business, and consumer protection). The EU approach is, however, based on a political/legal structure that makes it largely unreproducible for the rest of the OECD.

Concluding remarks

Cross-border provision of financial services can make domestic financial sectors more competitive and efficient. It also poses unique problems to regulators and supervisors in pursuing their policy objective of preserving confidence in the financial system and protecting consumers. The challenge for policy makers and regulators is thus to minimise the constraints on cross-border trade in a manner consistent with these policy objectives.

Sustained progress in developing and adopting high quality standards and best practices in financial sector regulation and supervision is essential if the economic potential of liberal cross-border trade is to be realised. Similarly, international co-operation and information sharing arrangements and agreements among supervisors can help to build the confidence necessary for greater reliance on home supervision.

Table 1. Cross-border trade in financial services (excluding insurance)¹

Panel A: Receipts (Exports)				
	1987	1990	1995	1997
	In billions of US dollars			
Canada ²	0.41	0.49	0.87	1.16
France ³	...	7.01	2.54	1.68
Germany	0.56	0.75	2.43	2.57
Italy	1.55	2.46	2.62	3.77
Japan	...	...	0.31	1.85
Mexico	...	...	...	...
Netherlands	0.23	0.22	0.36	0.49
Switzerland	3.30	3.24	5.63	...
U.K.	...	5.37	5.26	7.47
United States	3.73	4.42	7.03	11.06

Panel B: Expenditure (Imports)				
	1987	1990	1995	1997
	In billions of US dollars			
Canada ²	0.73	0.73	1.29	1.63
France ³	...	7.27	2.35	1.61
Germany	0.13	0.30	0.56	1.15
Italy	2.50	3.80	4.45	4.98
Japan	...	...	0.46	2.68
Mexico	...	...	0.23	0.31
Netherlands	0.19	0.22	0.42	0.52
Switzerland	...	...	...	...
U.K.	...	...	...	...
United States	2.08	2.48	2.47	3.91

Notes:

1. The data contained in this table are derived from the current account positions for individual countries. Insurance services and pension funds are not included. According to the IMF methodology, "financial services" cover financial intermediation service and auxiliary services conducted between residents and non-residents. Included are commissions and fees for letter of credit, lines of credit, financial leasing services, foreign exchange transactions, consumer and business credit services, brokerage services, underwriting services. Auxiliary services include financial market operational and regulatory services, security custody services, etc.

2. From Statistic Canada cat. 67-203. Data are in billions of Canadian dollars for receipts and expenditures.

3. The 1990 figure appears anomalous. This may be due to a change in the reporting methodology.

Sources: IMF Balance of Payments Statistics Yearbook (1995), (1998).

Table 2. Estimated net financing in international markets¹

	1992	1993	1994	1995	1996	1997	1998	Stocks at end- 1998
	In billions of US dollars							
Total cross-border bank claims ²	185.5	316.4	274.9	680.1	532.7	1 142.6	331.0	9 665.4
Local bank claims in foreign currency	-39.8	-0.9	0.2	-36.0	71.4	42.1	12.1	1 382.8
<i>Minus: Interbank redepositing</i>	<i>-19.4</i>	<i>115.5</i>	<i>85.1</i>	<i>314.1</i>	<i>184.1</i>	<i>719.8</i>	<i>228.1</i>	<i>5 563.2</i>
A = Net international bank claims ³	165.0	200.0	190.0	330.0	420.0	465.0	115.0	5 485.0
B = Net money market instruments	40.4	-6.2	3.3	17.4	41.1	19.8	7.4	194.5
Total completed bond and note issues	334.7	..	504.1	536.8	859.6	1 014.0	1 167.8	
<i>Minus: Redemptions and repurchases</i>	<i>223.7</i>	<i>..</i>	<i>253.8</i>	<i>291.0</i>	<i>363.4</i>	<i>460.5</i>	<i>497.5</i>	
C = Net bond and note financing	111.1	194.9	250.3	245.8	496.2	553.5	670.3	4 121.6
D = A + B + C = Total international financing	316.5	388.7	443.6	593.1	957.3	1 038.3	792.7	9 801.1
<i>Minus: Double-counting⁴</i>	<i>71.5</i>	<i>113.7</i>	<i>38.6</i>	<i>48.1</i>	<i>197.3</i>	<i>163.3</i>	<i>227.7</i>	<i>1 456.1</i>
E = Total net international financing	245.0	275.0	405.0	545.0	760.0	875.0	565.0	8 345.0

Notes:

1. Changes in amounts outstanding excluding exchange rate valuation effects for banking data and euronote placements; flow data for bond financing.

2. Bank in the G10 countries plus Austria, Denmark, Finland, Ireland, Luxembourg, Norway, Spain, the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles and Singapore, and the branches of United States banks in Panama.

3. Excluding, on an estimated basis, redepositing between reporting banks.

4. International debt securities purchased or issued by the reporting banks, to the extent that they are included in the banking statistics as claims on non-residents.

Sources: BIS Annual Report, 1998/99.

Table 3.A External Positions of Banks in Individual Countries vis-à-vis Other Banks

Panel A: Bank assets					
	1983	1988	1993	1997	1998
	(as per cent of GDP)				
Belgium	52.3	67.7	68.1	68.6	67.4
France	17.4	22.0	31.7	31.7	30.3
Germany	6.6	14.1	17.0	20.0	23.7
Italy	8.3	7.5	12.3	13.5	13.7
Netherlands	30.6	33.9	41.6	42.1	52.5
Sweden	5.7	5.8	18.0	15.1	15.8
Switzerland	..	..	123.0	181.8	200.0
United Kingdom	73.4	81.0	76.1	88.0	91.7
Canada	10.9	7.8	5.6	11.2	12.8
Japan	6.8	20.3	15.9	19.6	21.2
United States	7.9	9.0	6.8	7.7	7.9

Panel B: Bank liabilities					
	1983	1988	1993	1997	1998
	(as per cent of GDP)				
Belgium	78.2	93.5	73.0	77.6	77.8
France	23.5	27.5	35.1	41.7	42.5
Germany	6.6	8.2	11.1	23.0	31.4
Italy	10.5	11.1	20.9	19.2	20.5
Netherlands	32.0	33.3	35.0	52.7	72.5
Sweden	13.7	20.3	21.9	21.5	31.3
Switzerland	..	..	39.5	78.0	87.9
United Kingdom	79.8	86.0	88.9	105.4	106.5
Canada	11.1	8.1	7.7	14.1	13.8
Japan	8.8	26.1	15.6	16.4	17.8
United States	6.9	10.2	9.7	10.9	10.5

Sources: BIS International Banking Statistics; OECD Analytical Data Bank.

Table 3.B External Positions of Banks in Individual Countries vis-à-vis the Non-Bank Sector

Panel A: Bank assets					
	1983	1988	1993	1997	1998
	(as per cent of GDP)				
Belgium	22.6	24.5	28.4	36.4	38.2
France	9.5	6.6	10.6	14.6	15.8
Germany	3.1	3.1	6.3	10.9	15.1
Italy	0.1	0.1	2.8	3.8	5.4
Netherlands	12.2	14.6	13.2	18.1	21.5
Sweden	1.9	2.4	6.1	4.6	6.5
Switzerland	23.2	21.5	28.5	25.7	26.0
United Kingdom	32.8	25.4	33.7	41.8	44.8
Canada	1.9	1.9	1.8	3.3	2.6
Japan	2.4	4.8	5.5	9.4	11.8
United States	3.4	2.1	1.5	2.1	1.7

Panel B: Bank liabilities					
	1983	1988	1993	1997	1998
	(as per cent of GDP)				
Belgium	10.4	14.7	19.4	31.3	32.1
France	2.9	2.8	4.4	3.9	4.1
Germany	2.1	2.7	4.7	8.7	10.7
Italy	0.5	0.7	0.9	1.6	2.0
Netherlands	8.9	11.7	14.3	14.9	14.9
Sweden	1.4	3.8	5.1	5.0	6.6
Switzerland	..	..	81.8	95.7	99.0
United Kingdom	32.9	29.9	29.2	29.7	31.3
Canada	7.5	6.3	4.3	5.9	6.3
Japan	0.2	0.3	0.4	0.4	0.9
United States	1.5	1.5	1.2	1.6	1.5

Sources: BIS International Banking Statistics; OECD Analytical Data Bank.

Table 4. Markets for selected financial derivative instruments

(Notional amounts outstanding at year-end)

	1993	1994	1995	1996	1997	1998
	In billions of US dollars					
Exchange traded instruments	7 771.2	8 862.9	9 188.6	9 879.6	12 202.2	13 549.2
Interest rate futures	4 958.8	5 776.6	5 863.4	5 931.2	7 489.2	7 702.2
Interest rate options	2 362.4	2 623.6	2 741.8	3 277.8	3 639.9	4 602.8
Currency futures	34.7	40.1	38.3	50.3	51.9	38.1
Currency options	75.6	55.6	43.5	46.5	33.2	18.7
Stock market index	110.0	127.7	172.4	195.9	211.5	321.0
futures						
Stock market index	229.7	238.4	329.3	378.0	776.5	866.5
options						
OTC instruments¹	8 474.6	11 303.2	17 712.6	25 453.1	29 035.0	50 997.0
Interest rate swaps	6 177.3	8 815.6	12 810.7	19 170.9	22 291.3	..
Currency swaps ²	899.6	914.8	1 197.4	1 559.6	1 823.6	..
Interest rate options ³	1 397.6	1 572.8	3 704.5	4 722.6	4 920.1	..

Notes:

1. Data collected by ISDA.

2. Adjusted for reporting of both currencies; including cross-currency interest rate swaps.

3. Caps, collars, floors and swaptions.

Sources: BIS Annual Report 1998/1999

Annex: GATS definition of financial services

Article 5 of the Annex on financial services:

- a) A financial service is any service of a financial nature offered by a financial service supplier of a Member. Financial services include all insurance and insurance-related services, and all banking and other financial services (excluding insurance). Financial services include the following activities:

Insurance and insurance-related services

- i) Direct insurance (including co-insurance) :

- A life
- B non-life

- ii) Reinsurance and retrocession;
- iii) Insurance intermediation, such as brokerage and agency;
- iv) Services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services.

Banking and other financial services (excluding insurance)

- v) Acceptance of deposits and other repayable funds from the public;
- vi) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction;
- vii) Financial leasing;
- viii) All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts;
- ix) Guarantees and commitments;
- x) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:
- A money market instruments (including cheques, bills, certificates of deposits) ;
 - B foreign exchange;
 - C derivative products including, but not limited to, futures and options;

- D exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;
 - E transferable securities;
 - F other negotiable instruments and financial assets, including bullion.
- xi) Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues;
 - xii) Money broking;
 - xiii) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;
 - xiv) Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments;
 - xv) Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services;
 - xvi) Advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs (v) through (xv) , including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.
- b) A financial service supplier means any natural or juridical person of a Member wishing to supply or supplying financial services but the term "financial service supplier" does not include a public entity.
 - c) "Public entity" means:
 - i) a government, a central bank or a monetary authority, of a Member, or an entity owned or controlled by a Member, that is principally engaged in carrying out governmental functions or activities for governmental purposes, not including an entity principally engaged in supplying financial services on commercial terms; or
 - ii) a private entity, performing functions normally performed by a central bank or monetary authority, when exercising those functions.