This chapter is an overview of the field of international finance from the perspective of law and regulation. It is organized as follows. First, it examines what the field of international finance is, with respect to law, regulation and policy. Second, it discusses the degree of integration of national financial markets, a matter affecting a multiplicity of issues. Third, it looks at the sources of international financial law and regulation—both national and international. Fourth, it evaluates the overall costs and benefits of the increasing globalization of international finance. These four sections are all introductory to the fifth section, the burden of this Chapter, which analyzes, with respect to securities and banking regulation, the decision as to what rules, e.g. of the home or host country, or international, apply in particular cases of regulation. The chapter then further examines this issue in the context of sovereign debt.¹

The Chapter concludes that, as a positive matter, there has been and will continue to be a progression toward harmonized rules created and supervised by supranational authorities in the field of international finance because this approach minimizes global financial instability and maximizes efficiency. It also concludes that various schemes to allocate authority between host and home countries will fail to accomplish these ends satisfactorily.

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1. **What is International Finance?**

   For economists, international finance has traditionally meant the study of exchange rates but for policy makers and lawyers it means much more. Generally, it involves the study of international financial transactions, transactions that have some cross-border element with respect to payment, credit or investment, or a financial contract (Dufey and Chung 1990).

   The cross-border aspect of finance can arise from the fact that the activity of the provider and the user of funds may be located in two different countries. A lender can market and transfer funds to a borrower in another country, or the borrower can seek and attain funds from the lender in the lender’s country. Similarly, an issuer of securities can market and distribute securities to investors in another country, or foreign investors can make investments by coming to the issuer’s country, as when a foreign investor buys U.S. equity on a U.S. stock exchange.

   Economic definitions of international transactions would normally exclude cases where foreign citizens resident in a country engage in transactions in that country, for example a U.S. citizen resident in Japan buying securities in Japan. Nevertheless, such transactions may pose concerns for countries like the U.S. that believe in protecting their citizens abroad through extraterritorial reach.

   More generally, definitions of international transactions almost never include purely domestic activity, e.g. a Japanese citizen in Japan borrows from a Japanese bank in Japan. Nevertheless, in an increasingly integrated financial system and world economy what happens in one country may have substantial impact on other countries. It is clear that the lending practices of Japanese banks and the forbearance of their regulators were important factors in the “lost decade” of the Japanese economy. This financial depression directly affected the entire
international financial system. In this lens, what happens in any country that impacts the rest of the world is the proper subject of international finance.

Generally, concern with other countries’ domestic policies is mainly a matter of mutual concern for the most developed countries, the countries with the most tightly linked economies. Nonetheless, we have seen an expansion of international concern in recent years to the domestic economies and financial systems of almost all countries. There are a variety of reasons for this expanded concern—political (a stagnating country may ferment radicals), foreign aid consequences (a stagnating country may require more foreign aid) or debt subsidies (a stagnating country may borrow more from the developed countries and the International Monetary Fund).

In short, international finance is very broad. It may effectively include any transaction or issue that involves more than one country.

2. **Globalization of Financial Markets**

There are difficulties in defining and measuring the globalization of financial markets. There appear to be four main approaches. First, one can look at the correlation of prices between markets. The higher the correlations in rates of returns on similar assets across countries, arguably the more integrated the markets. One might also look to integration across asset classes internationally as compared to domestically.

A second approach looks at quantity. For example, one can look at portfolio diversification. The evidence here is that investors overweight domestic securities in their portfolios. This so-called “home bias” effect is prevalent to various degrees in all local markets. “For example, in 2001, the portfolio share of foreign equities of U.S. investors was 22 percent of what it would have been had these investors held the world market portfolio, so that the home
bias measure was 78 percent. The measure averaged 63 percent in 2001 for a sample of 18 developed countries” (Stultz 2005). There is continued debate as to whether this home bias is due to transactions costs, information availability, or just a preference for what investors are familiar with (Portes and Rey 2005).

A third approach looks at the links between savings and investment levels within countries. Feldstein and Horioka (1980)\(^2\) have showed that there is a very tight link between domestic savings and domestic investment levels. However, as investors diversify internationally, these domestic links should relax but recent studies have shown that these domestic links continue to be strong.

A fourth approach looks at formal barriers to trade in financial assets. Quinn (1997) has shown, for example, based on an index of openness with values of 1-12, that most developed countries became fully open by 1997. However, this index (and others like it) only deal with explicit barriers rather than implicit ones. For example, the U.S. may be fully open to foreign banks, but may calculate their capital adequacy differently, or be fully open to foreign companies listing in the U.S., but require them to reconcile their accounts to U.S. GAAP. Further, implicit barriers may be created just because two countries have different rules. For example, integration of global equity markets is impeded because the U.S. has different rules for distributing securities than do other countries, thus making global offerings more expensive than they would be if all countries had the same rules.

3. **Sources of Law and Regulation**

Law and regulation in the field of international finance is mainly the purview of national governments, but multilateral institutions are becoming more important over time.
A. National Governments

National governments are the principal regulators of international financial transactions and the formulators of international policies. Every country has an international dimension to its domestic economic regulation. Consider for example, the issues posed by the establishment of branches of foreign banks in a country. The host country may be concerned about protection of its depositors who may place funds with such banks, the competitive impact on domestic banks, or the systemic impact of failure of the foreign bank. In the case of branches, the home country is charged with keeping the bank safe and sound, but the cost of the home country not doing so may impact the host country. Another example may be taken from the capital markets. If a foreign issuer issues securities to the public in a host country, the host country investors may be at risk. This is why host countries generally require such offerings to be registered in the host country. Moreover, certain risks of the offering, for example tax consequences, may well differ for different markets, requiring special legislation in the home country.

A variety of different regulators within a single country may be involved in regulating foreign transactions or institutions. For example, transactions within and outside the European Union may be regulated by both national and European Union regulators. Moreover, the regulators of banks, insurance companies, and securities firms or issuers of securities, may be different. This poses a major problem for countries seeking to coordinate policies with each other.

B. Multilateral Institutions

(1) IMF and World Bank

For international finance, the IMF and the World Bank, established in 1944, are quite important. The IMF, which is effectively controlled by developed countries, with the United
States as primus inter pares, was set up to help member countries maintain agreed exchange rates. However, with the abandonment of fixed rates in 1972, its mission has shifted to dealing with the financial problems of developing countries and the promulgation of international standards.

(2) Intergovernmental Groups, the G8.

There are also a number of important inter-governmental groups that formulate policies that lay the foundation for internationally coordinated law and regulation. The most important of these is the G8, which is composed of the major democratic industrial countries—Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States. The G8 holds annual economic summits at the head of state level and preparatory meetings at the finance minister level. These summits formulate important policies, such as debt forgiveness for heavily indebted poor countries at the meeting in 2005, which get translated into action through international institutions or sovereign initiatives.

(3) Functional Regulators

Increasingly important for international finance are functional international regulatory bodies that operate at more technical levels than the G8. The most important of these are the Banking Supervision Committee (the Basel Committee) of the Bank for International Settlements, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the International Accounting Standards Board (IASB).

The Basel Committee is the most influential of the international functional regulators as a result of its formulation of the Basel capital adequacy standards. First formulated in 1988, and revised in substantial measure in June 2004, for the internationally active banks of the G10
countries (Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States), these standards have been adopted by more than 100 countries worldwide. In addition, the Basel Committee has formulated “core principles” for effective banking regulation and Concordats that allocate supervisory responsibility between home and host countries. IOSCO has formulated basic financial disclosure requirements for publicly issued securities, modeled after U.S. requirements, which have been adopted in the U.S., E.U. and Japan. The IAIS has also adopted core principles and standards for insurance companies and products that have been implemented worldwide. Implementation of the core principles of these functional regulators in developing countries is done largely through the IMF. The IASB has formulated international accounting standards that have been adopted in 2005 by the E.U. and will likely be adopted in the future by other countries, at least as an alternative to local GAAP rules for foreign issuers.

One should also include in this group the Organization of Economic Cooperation and Development (OECD), composed of 24 industrialized countries. Although its scope is much broader than finance, it has been influential in formulating international corporate governance standards and tax policy. Two other important entities are the Financial Action Task Force (FATF), an organization of 31 countries, including the United States, concerned with preventing money laundering and terrorist financing, and the Paris Club, an informal group of 19 permanent member countries, with no formal legal status, whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor nations.

(4) Coordination Among Functional Regulators

The work of the functional regulators of course overlaps, as financial institutions increasingly offer all financial products (so-called universal banks). In addition, there are
important overlaps between the functional regulators and the IMF and World Bank. As a result, the Financial Stability Forum (FSF) was established in 1999 to enhance cooperation in the area of financial market supervision and surveillance. It has 42 members consisting of 26 national representatives from 11 countries, plus 13 representatives of the multilateral institutions, plus 2 representatives from committees of central bank experts, a representative of the European Central Bank, and the Chairman, currently Roger Ferguson, Jr., the Vice Chairman of the U.S. Federal Reserve Board. Beyond the efforts of the FSF, multilateral organizations may work together on specific projects, for example in 1999 the Basel Committee and IOSCO issued a joint report on disclosure (Basel Committee on Banking Supervision and Technical Committee of the International Organization of Securities Commissions 1999).

(5) The Special Case of the European Union

The Commission of the European Union, together with the European Parliament and Council of Ministers, is probably the most influential of all multilateral institutions, although it is often regarded as a quasi-national actor (representing the 25 member states of the E.U.). The Commission has formulated important Directives in many areas of finance that are implemented through national legislation, particularly measures seeking to enhance the operation of the E.U. “single market.” Implementation of these Directives is coordinated through E.U.-wide functional regulators, such as the Committee of European Securities Regulators (CESR). These E.U. efforts are not only important in their own right but have offered a model, and an experimental laboratory, as to how regulation might be formulated and implemented in the international system at large.
(6) Trade Associations

It is also important to mention the numerous trade associations that formulate industry contractual standards for various financial transactions, like the Bond Market Association (BMA) and the International Swaps and Derivatives Association (ISDA). Common standards for contracts are important for reducing transaction costs and for increasing liquidity through the creation of standardized instruments, e.g. credit derivatives. These organizations also coordinate activities in overlapping areas. For example, the BMA, the International Securities Market Association (ISMA) and the International Primary Market Association (IPMA), announced in 2005 that they intended to integrate their European based activities into the International Capital Market Association (ICMA) and establish a global partnership between the BMA and ICMA.

(7) The General Agreement on Trade in Services (GATS)

The GATS should be singled out for special attention because it is an international trade agreement that affects financial services. The 1994 GATS resulted from the Uruguay Round of trade negotiations that closed in December 1993. The Uruguay Round produced a new structure, the World Trade Organization (WTO), as well as the agreement on services. The core principle of GATS, expressed in Article II, is unconditional most-favored-nation (MFN) treatment: each service or service supplier from a member country must be treated no less favorably than any other foreign service or service supplier. In addition, there is a transparency requirement. The GATS includes each country’s schedule for specific commitments and a list of MFN exemptions for that country. For financial services, there is a unique additional element, namely, the Understanding on Commitments in Financial Services (Understanding).

In the GATS, market access and national treatment are “specific commitments” as opposed to general obligations. As a result, national treatment and market access do not apply
across-the-board to all services sectors; instead, they apply only to sectors, subsectors, or activities that are listed in a country’s schedule of commitments. Countries that choose to schedule commitments in accordance with the Understanding undertake commitments to market access and national treatment for all financial services subsectors. They then use a negative list approach to scheduling—that is, everything is included unless excepted. The Understanding also contains a standstill provision that limits exceptions to existing nonconforming measures.

GATS also includes a so-called “prudential carve out” for domestic regulation that permits a country to take prudential measures “for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed,” or “to ensure the integrity and stability of the financial system” regardless of any other provisions of the GATS. Disagreement over whether a particular national measure falls within the prudential carve-out is subject to WTO dispute settlement procedures and, if necessary, to a determination by a dispute settlement panel. However, most regulators do not appear to be particularly concerned about this possibility. For one thing, if a country is concerned that a particular measure might not be generally accepted as prudential, it could simply list the measure as an exception in its initial schedule of commitments.

Ensuring financial services expertise in the handling of disputes involving financial services was another issue of particular concern to financial services regulators. The concerns of financial officials were addressed by inserting a requirement in the Annex that dispute settlement panels on prudential issues and other financial matters must have the expertise necessary to deal with the specific financial service under dispute.

A final agreement on financial services was reached in 1997. Reaching an agreement does not, of course, mean that markets are truly “open.” It only means that the over 140
countries involved in the WTO have all made commitments of various kinds. The 1997 agreement “was probably notable more for its airing of issues and the consequent increased transparency concerning the sector than for its concrete achievements in terms of market opening. Many countries’ commitments simply specified rules already in place ... and in some cases less than this…” (Cornford 2004).

In November 2001, the WTO members authorized a new round of trade negotiations, the so-called Doha round, which once again includes financial services. These negotiations are still underway. The current results are disappointing. The existing offers for a new set of financial service commitments are limited in scope and scale. Also, WTO does not presently have the mandate to deal with the more difficult questions of indirect barriers to trade such as U.S. requirements prohibiting use of international accounting standards or E.U. country restrictions on acquisitions of local banks. There are a variety of these barriers, which are prevalent even more in developed than developing countries (Asian, European, Japanese, Latin American and the U.S. Shadow Financial Regulatory Committees 2004).

(8) Bilateral arrangements

There are a variety of bilateral understandings between countries, particularly in the area of enforcement. For example, the SEC has entered into over 20 bilateral enforcement Memoranda of Understanding (MOUs) that permit the SEC and its country counterparty to obtain information necessary to investigate and prosecute enforcement matters. Each MOU is tailored to fit the particular legal frameworks of the two parties to the agreements. The MOUs set forth the permissible uses of information, including use for SEC investigations and proceedings and for assisting the Department of Justice. Apart from permissible uses, the SEC
and foreign authorities commit to maintaining the confidentiality of non-public information shared pursuant to the MOU.

Another important development in bilateral arrangements is the establishment of “Regulatory Dialogues” between particular countries that deal with areas of regulation of mutual concern. For example, the U.S. and E.U. have been engaged in such a dialogue since 2002. The U.S. is represented by the Treasury, the Federal Reserve Board and the SEC, and the E.U. is represented by the E.U. Commission. These meetings are supported by other bilateral meetings of technical regulators, for example meetings between CESR and the SEC. The meetings began due to E.U. concern with the foreign impact of U.S. laws such as Sarbanes-Oxley that made it more costly to access U.S. capital markets. Today the dialogue is focused on several issues, including the U.S. acceptance of international accounting standards, E.U. acceptance of SEC holding company regulation, and issues of financial privacy. A major concern about the Dialogue is whether U.S.-E.U. financial issues can be resolved in isolation from greater differences between the two sides, over matters like Iraq and trade. One critical issue on the economic front is whether the U.S. and E.U. will seek to compete or collaborate. For example, the E.U. might respond to increasing U.S. regulation by providing a less regulated alternative, rather than pursuing efforts to relax U.S. regulation and further the integration of the two markets.

4. Costs and Benefits of International Finance

A debate about whether the internationalization of finance—often referred to as globalization—is good or bad rages worldwide. The potential benefits of international finance are fairly clear. First, access to worldwide capital markets may allow a country to smooth its
financial needs, borrowing in bad times and lending in good times. Second, as a related matter, international markets can promote domestic investment and growth by allowing countries to import capital. Third, globalization may enhance macroeconomic discipline—capital flows may police bad government behavior. Fourth, internationalization may discipline regulators. The possibility of financial institutions changing the locale of their operations, or investors investing in foreign markets abroad, may constrain excessive domestic regulation. Fifth, internationalization may increase competition, and therefore lead to more efficient banking systems or cheaper securities offerings.

Economists debate the effect of financial integration on growth (Agénor 2003). A study of 57 countries, using many measures of financial integration, was not able to reject the hypothesis that international financial integration does not accelerate economic growth even when controlling for particular characteristics of the country (Edison et al. 2002). On the other hand, it seems clear that better financial systems do increase growth by providing information about possible investments that enable the more efficient allocation of capital, by monitoring investments and insisting on high standards of corporate governance, by facilitating the trading, diversification and management of risk, by mobilizing and pooling savings and by easing the exchange of goods and services (Levine 2004).

An active area of inquiry is the role of legal institutions in explaining financial development. Basically, the literature finds that the Anglo-Saxon countries with stronger protection of property rights have had higher levels of financial development (La Porta et al. 1998). One study finds that effective legal institutions, particularly those requiring disclosure and enforcing those requirements, also reduce firms’ cost of capital. The effects of disclosure
requirements are weakest for markets that are integrated, cases where such disclosure may be less important due to the market discipline of one market upon the other (Hail and Leuz 2004).

There are also some arguable costs of globalization. First, markets are not politically correct, so hostile or poorly performing markets may fail to attract capital, and may experience capital outflows and unemployment. Second, the volatility of capital flows can quickly destabilize an economy, as was the case in the 1997 Korean crisis, where short-term international bank lending quickly dried up. Third, the entry of foreign institutions, while increasing competition and efficiency, can lead to the demise of local financial institutions. Fourth, the integration of the world’s financial system can result in quick transmissions of economic shocks between world economies, a phenomenon often referred to as contagion (Ehrmann et al. 2005).

5. Approaches to Regulation

A major problem in international financial transactions is which countries rules should apply to a transaction. This section examines this problem in the context of securities regulation and banking. In the securities regulation context the issue is which rules apply when an issuer in one country (the home country) sells securities to investors in another country (the host country).

A. Securities Regulation

In approaching the subject of what rules to apply in the area of securities regulation, one must keep in mind that the dominating objective of regulation is to protect investors in public markets, although sometimes this objective gives way to other considerations, like maintaining the competitiveness and attractiveness of national capital markets. In open economic systems, rules that are too onerous may result in issuers and investors moving their business elsewhere.
Extraterritorial rules, like those of the SEC’s Regulation S, may inhibit this movement but it cannot stop it.

There are several basic approaches one can take to securities regulation. First, one could harmonize all securities regulation, so that the same rules applied in all markets. Second, one could allow issuers of securities to choose which regulatory regime they would prefer. Third, one could always apply host country rules, so-called national treatment. Fourth, one could always apply the home country’s rules, so called home-country approach. Fifth, as between two countries, Country A would apply Country B’s rules if Country B would apply Country A’s, so-called mutual recognition. Sixth, the host country would apply its own rules unless the home country’s rules were “equivalent” to those of the host country. Seventh, the host country would apply the home country’s rules but the issuer would have to explain how its home country rules differed from those of the host country.

(1) Harmonization

a. Harmonizing Rules Across Countries.

If rules were harmonized, issuer costs would be substantially reduced since the same rules could be applied wherever the securities were sold. Ideally, rules would not only be harmonized for disclosure, but also for the primary distribution process, e.g. registration requirements and restraints on communications, and enforcement. Harmonization is, however, very difficult to achieve. The E.U. unsuccessfully pursued this approach in the 1970s and 1980s in trying to integrate its financial markets. The E.U. Commission’s 1985 White Paper, *Completing the Internal Market*, identified 300 pieces of legislation that the Community would have to enact to remove restrictions or to harmonize laws of member states, and as a result shifted its approach to mutual recognition, discussed below. However, in the last few years, due
to limited success with mutual recognition, it has returned to the harmonization approach, at least for disclosure requirements, through the Prospectus and Transparency Directives. Rather than trying to get each member state to accept the same rules, it is basically mandating such commonality.

The power to promulgate and mandate common rules requires that states subject to such rules have ceded authority to an international authority. In the case of the E.U., this has taken place to a significant extent. But this is not the case for the greater international community where harmonization requires detailed negotiations among countries and legislative changes in many countries, a difficult task. There has nonetheless been some progress in harmonizing international disclosure rules and accounting standards.

**Disclosure Rules**

In September 1998, IOSCO issued a consultation document entitled *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*. The proposal was organized in two parts. Part I contained financial information that must be disclosed in a standardized way in all jurisdictions, as well as other information that any jurisdiction would require, e.g. business overview, risk factors. Part II dealt with “disclosure issues outside the scope of the standards,” such as materiality, projections and forward looking information, indemnification of directors and officers, and derivatives and market risk. This Part formulated no harmonized standards; instead, it discussed differences among countries on the issues.

On September 28, 1999, the SEC adopted a complete revision of Form 20-F which contains basic disclosure requirements applicable to foreign private issuers based on the IOSCO proposals (SEC 1999). This change effects no real relaxation in standards for foreign issuers
since the IOSCO proposals basically mimicked existing U.S. requirements (Tahyar and Joseph 2001). The E.U. has also adopted these standards as part of its new Prospectus Directive and other countries have adopted the rules as well. Countries have taken different approaches to implementing IOSCO rules. Whereas the U.S. and Switzerland have allowed foreign issuers a choice in using such rules, Singapore and Mexico have adopted the rules for both foreign and domestic issuers (Wolff 2001).

While these efforts at disclosure harmonization are generally applauded by the securities industry since they allow for standardized operations with reduced transaction costs, there is a serious problem of whether one size fits all. Standardization may be a particular problem for less-developed markets that do not have the professional capability to enforce detailed disclosure standards. This may lead such countries to formulate less detailed standards or to employ merit regulation, a system in which regulators decide which issuers should be given access to public markets. Another undesirable effect of harmonization may be the elimination of competing rules. With one set of rules, innovation and change may be stultified—although there could still be active efforts to change the one standard that prevails. After all, the U.S. has one set of securities regulation rules many of which are actively changed over time without international pressure, as a result of industry pressure or changes in regulatory philosophy.5

Accounting Standards

Another very significant harmonization effort is underway in the area of accounting standards. The IASB (and its predecessor the International Accounting Standards Committee) has been at work since 1973 to formulate international financial reporting standards (IFRSs) that would eventually replace the accounting standards of individual countries, so-called local GAAPs (generally accepted accounting principles). IASB has now formulated a comprehensive
set of accounting principles that have been adopted by the E.U. as of 2005 (with some notable exceptions for financial instruments) and more than 90 countries are also expected to adopt them as well. These standards, however, will not be truly international unless they are adopted by the United States. It is now possible that the U.S. may allow foreign issuers to use IFRS in the future, as a result of coordinated efforts between the E.U. and the SEC, but the U.S. has no plan to fully replace its own GAAP rules. Such rules will still be required of domestic issuers and will remain an option for foreign issuers.

There is an effort, however, to harmonize IFRS and U.S. GAAP. In October 2002, IASB and FASB (the Financial Accounting Standards Board of the U.S. responsible for U.S. GAAP) announced a short-term convergence project known as the Norwalk Agreement with the objective of reducing the differences between the two accounting standards. There has been some progress on both sides of the Atlantic. The IASB has eliminated many of the differences between U.S. GAAP and IFRSs through its Improvements project and its standards on business combinations and discontinued operations. At the same time, the FASB has changed U.S. practices on share-based payment, the treatment of idle capacity and spoilage costs in the cost of inventory and asset exchanges. Changes are also expected in the US standards on the calculation of earnings per share and voluntary changes in accounting policies to bring U.S. GAAP in line with IFRSs. However, it appears that at best, in the short-term, this will produce convergence of principles rather than detailed rules.

As in the case of disclosure, there is considerable debate in the accounting area over whether it is best to have only one set of harmonized rules. Accounting rules reflect, to a significant extent, real differences between countries. Thus, for example, rules requiring defined benefit pension plans to mark assets to market, and thus reveal funding gaps, might have more
impact in countries with defined benefit as opposed to defined contribution plans where assets are always equal to liabilities. Also, the U.S. rule-based rather than principle-based approach may result from stricter legal liability standards and class action enforcement in the U.S. Principles may offer less solace to companies looking for certain rules to follow in order to avoid liability. As with disclosure, there is also the question of whether one standard would preclude useful experimentation and the development of valid alternative models.

A very significant problem for the harmonized approach, particularly with respect to disclosure and accounting, is differential enforcement. If individual countries, as opposed to multilateral or transnational organizations, are to enforce standardized rules, the rules will be implemented differently in different countries and will not, therefore, actually be harmonized. Enforcement responsibilities could be given to an international body, but this is not a practical alternative at the present time. Even within the E.U., enforcement is left to the member states rather than the Commission, albeit there is a high degree of regulatory coordination among the member states.

Other Areas of Harmonization

Some important harmonization measures have been achieved through trade associations or think tanks. For example, the Bond Market Association (BMA) and the International Capital Market Association (ICMA, formed in 2005 from the merger of the International Securities Market Association and the International Primary Market Association) have both promulgated a number of standard agreements for repurchase or securities loan agreements (BMA 2005 and ICMA 2000). In most cases, harmonizing trade rules operate to standardize contracting practices and require no facilitation or implementation through law or regulation. One of the most notable successes in private law initiatives was the work of the Group of Thirty (a think tank sponsored
by major financial institutions) in formulating international standards for the clearance and settlement of securities, such as the famous T+3 standard, requiring securities trades to be settled no more than three days after a trade. Some of these standards were resisted by the private sector, like T+3, and required national compulsion through regulation to become effective.7

b. Effective Harmonization Through Issuance at a Single Location

Harmonization is only crucial if one is issuing securities in the territories of other countries. It is possible to avoid this problem by issuing securities in only one place and having investors come to the issue, through brokers and modern communications, rather than have the issue come to investors. This would allow an issue to be governed by one set of rules but also permit different jurisdictions to establish different rules. Thus, if one jurisdiction applied rules that issuers and investors believed were not optimal, issuers could move to a different jurisdiction.

Indeed, a 1998 report of the U.K. Treasury, “Public Offers of Securities,” found that the reason there had been so few cross-border securities offers in the E.U. was that large companies listed their securities on one member state exchange and let investors come to that exchange. This suggests that a single market could be achieved by simply insuring that member states allowed foreign issuers to disseminate information to onshore investors and then let them purchase the securities in offshore markets. In the E.U., member states have generally permitted offshore purchases, not choosing to apply their laws extraterritorially. However, certain member states have restricted onshore advertising of offshore issues. It appears such restrictions may be applied on a E.U. level under the new Prospectus Directive,8 thus making the offshore alternative more difficult in the future.
This offshore alternative would be impossible on an international level under current U.S. rules since the SEC’s Regulation S prohibits offshore issuers from engaging in “directed selling efforts” in the U.S. and effectively prevents investors resident in the U.S. from buying the securities of most offshore foreign issuers until forty days after the offering.\(^9\)

(2) Issuer Choice

Another approach to what law to apply, which is largely an academic idea not used in practice, is to allow issuers of securities to select whatever law they choose (Choi and Guzman 1998).\(^{10}\) For example, a French company could choose to issue securities in the U.S. under Nigerian law. The underlying idea is that market discipline would determine whether this was a viable strategy. If Nigerian law were too lax, investors would not invest in the French company’s securities or would only do so at an appropriate price discount. Some versions of this idea have restricted this option to securities sold to non-public investors, but then the idea has little utility since private offerings are usually completely unregulated—there is no need to authorize issuer choice, the issuer is already free to make such choices. The two major problems with the proposal, as applied to public investors, is that reliance on discounting is misplaced, because it is hard to place an appropriate discount for knowledge you might not have, and because investors would be incapable of effectively enforcing their rights against many offshore issuers.

It is interesting, however, that a version of issuer choice does operate in the secondary securities markets. Issuers can choose in which country to list their securities, effectively opting into different disclosure and enforcement regimes for secondary market transactions. Commentators have questioned whether this “bonding” strategy really works, insofar as local
regulators may not really enforce their laws against foreign issuers (Siegel 2005). But the basic fact remains that issuer choice of trading venues is permitted.

This choice regime is permitted to function in secondary markets because countries generally do not apply their laws to restrict investors from trading already issued securities—these restrictions only generally apply (leaving aside countries with capital controls) in the primary markets, as in the case of the SEC’s Regulation S. One reason why choice may be allowed in the secondary market is because traded securities have a “market” price, as compared with primary markets in which prices are fixed—even in a Dutch auction, the price is fixed at the market clearing price of the bids, not on the basis of actual trading. Another reason may be that host governments to exchanges seek to promote use of their exchanges by opposing restrictions other countries may place on their own investors’ access to foreign exchanges. It would appear that foreign issuers do not have the same political clout to open up the primary market as national exchanges have in opening up the secondary market.

Choice in the secondary market is, however, sometimes restricted, as by the U.S., to the freedom of investors to trade foreign-listed securities offshore as opposed to trading them in the host country. Steil (2002) has proposed the removal of U.S. restrictions on E.U. exchanges having trading screens in brokerage houses in the United States. Screens are only permitted for foreign exchanges registered in the U.S. and the regulatory cost of such registration has deterred foreign exchanges. Steil would also require the E.U. to provide the same market access for U.S. exchanges. This issue is on the agenda of the U.S.-E.U. Regulatory Dialogue discussed above.
(3) National Treatment

a. Better than National Treatment

The traditional default rule for which law to apply is the law of the host country, national treatment. In the absence of harmonization, the national treatment approach exposes foreign issuers to a multiplicity of rules with consequential high transaction costs. It also piles law on law, since foreign issuers may be subject, in the same transaction, to both their own law and the law of the host country. National treatment is not, therefore, equal treatment. Apart from the relatively rare “conflict” of laws that might arise—where it is not possible to doubly comply—double compliance routinely adds significant costs. The international side of a country’s securities laws focuses on when to apply domestic law to foreign issuers. Often national treatment is modified for foreign issuers through partial or complete exemptions. An examination of the approach of the U.S. to applying the 2002 Sarbanes-Oxley Act to foreign issuers illustrates the different approaches that may be taken to national treatment.

In some cases, U.S. law is fully applicable to foreign issuers (either as a result of the language of the statute or SEC rule making), for example the requirement for certification of financial statements by the CEO and CFO, the obligations of attorneys practicing before the SEC to report material violations of securities laws up the line, and most of the requirements for improved and more continuous disclosure. However, important exceptions to national treatment were made with respect to the auditing process for foreign firms. For example, while national treatment would have demanded that the audit committees of public issuers be fully independent, the SEC accommodated the German co-determination regime by allowing labor representatives who might not be considered “independent,” to serve on the audit committee. Also to
accommodate two-tier boards, the auditor independence requirements apply only to the supervisory or non-management board (SEC 2003c).

The Act also requires companies to rotate key auditor partners periodically and proscribes a one-year cooling off period before certain members of the audit engagement team may accept certain employment positions with the issuer (SEC 2003a). These rules apply to foreign accounting firms that conduct audits of foreign subsidiaries and affiliates of U.S. issuers. Between the proposal of the rules and their final adoption, several of these requirements were modified with foreign firms in mind, e.g. less strict rotation and cooling off periods, although the resulting rules do apply equally to domestic and foreign firms. Thus a single standard for domestic and foreign firms can reflect a concern with its particular impact on foreign firms.

The most significant exemption from Sarbanes-Oxley (at least temporarily) has been, after intense lobbying by the European Union and small companies, to delay until 2006 (SEC 2005a) the application of Section 404—the provision that requires management to report annually on the adequacy of a firm’s internal controls, as verified by a registered public accounting firm—to foreign listed firms (as well as small U.S. firms), and then to delay until 2007, the application of 404 to all small firms, foreign and domestic. The direct cost to companies of implementing Sarbanes-Oxley has been substantial, and compliance with Section 404, particularly the cost for the outside audit, has turned out to be the most significant area of cost. Korn/Ferry, an executive recruitment firm, estimated that the average cost for a Fortune 1000 company was $5.1 million, or $5 billion overall for those companies (Roberts 2004).

The SEC was obviously concerned with the impact the prospect of large costs could have on foreign firms seeking listings or those continuing to list in the U.S. This delay in implementation underscores an important reason why national treatment requirements may be
relaxed—to prevent foreign issuers from bringing their business to foreign competing markets like London and Hong Kong.

A major impact of Section 404 was, of course, upon foreign firms already listed in the U.S. Many of these firms are said to be contemplating delisting and moving the trading of their shares to offshore markets. However, this is easier said than done. There is no general right to delist. The NYSE requires foreign firms to obtain the approval of the Board of Directors, publish a press release announcing the delisting and notifying at least its largest 35 U.S. shareholders of the delisting. However, even if these conditions can be satisfied, the foreign firm would still be subject to the 1934 Act and Sarbanes-Oxley, as long as its shares were held by more than 300 U.S. shareholders (500 shareholders for companies with less than $10 million in assets). As a practical matter, foreign firms would have to repurchase most of their U.S. shares (Perino 2003). This aspect of the regulatory regime has been attacked by European business leaders who have proposed to the SEC that they exempt a company from U.S. reporting requirements, including Sarbanes-Oxley, if U.S. trading in its securities was less than 5 percent of global volume during a company’s fiscal year. A second proposal would be to increase the minimum number of shareholders needed to trigger reporting from 300 to 3000. A third proposal would be to base the minimum number on a percentage of worldwide investors rather than an absolute figure. The SEC is giving active consideration to changing the deregistration rules and this issue is on the agenda of the U.S.-E.U. Regulatory Dialogue. One could view the impact of the U.S.’s current no exit policy as a form of capital control—it is one thing to apply national treatment to foreign firms, it is quite another to prevent firms from leaving a market if they want to. If U.S. shareholders are concerned with losing Sarbanes-Oxley protections, they can simply sell their securities.
Outside of Sarbanes-Oxley, the U.S. has exempted foreign firms from other requirements, like compliance with proxy requirements, or from Regulation Fair Disclosure (FD) which prohibits selective disclosure to analysts. Regulation FD, as proposed, would have applied to foreign as well as domestic issuers. The effect would have been for SEC policies to govern how foreign issuers made disclosures to analysts in their own markets. Foreign regulators, like many commentators, believed that the proposal could delay the timely release of information in order to avoid selective disclosure liability under U.S. law. As adopted, Regulation FD excluded foreign private issuers (Fox 2001).

b. Worse Than National Treatment

When foreign firms are treated worse than domestic firms, at least de jure, this can be a matter of concern under GATS if such discriminatory treatment violates specific GATS undertakings, but only then. Countries like China are able to maintain discriminatory treatment of foreign firms, with respect to entry and ownership of local firms, because their commitments are limited. There is no broad automatic requirement under GATS for national treatment. The United States has entered into bilateral treaties with countries to insure national treatment for U.S. financial institutions, for example the Financial Services Agreement of 1995 with Japan.

(4) Home Country Rules

There are four variations on applying home country rules: always apply home country rules (a practical null set); only apply home country rules of another country on a reciprocal basis (mutual recognition); apply home country rules where they are “equivalent” to host country rules, and apply home country rules provided an issuer explains how its home country rules differ from those of the host country. We will examine the latter three variations.
a. Mutual Recognition

(i) The E.U. Approach

The E.U. has pioneered mutual recognition. When harmonization failed, the E.U. adopted a new strategy under which the harmonization of *essential* standards would provide the basis for mutual recognition by the member states of the equivalence and validity of each other’s laws, regulations, and administrative practices that had not been harmonized at the E.U. level.

Under a policy of mutual recognition, some member states in effect agree to offer treatment that is more favorable than national treatment to firms from another member state. This can occur, for example, when the home country permits types of transactions not permitted by the host state. This possibility then leads to convergence in rules as issuers headquartered in the state in which the services are provided (host-country state) demand to be treated at least as well as issuers located in other member states (home-country states).

The E.U. mutual recognition system is premised on minimum harmonization—an agreed level of commonality necessary for member states to tolerate differences. It is also premised on a high degree of trust among participating states, and on the Commission’s transnational authority.

A corollary of mutual recognition is home-country control: home-country rules and supervisory practices must be accepted as controlling the operations of cross-border transactions. However, the principle of home-country control adopted by the Community is not absolute. The Treaty of Rome provides, as implemented by judgments of the European Court of Justice and Commission directives, that the host country retains the right to regulate the cross-border provision of services to the extent that doing so is necessary to protect the public interest. Furthermore, as previously noted, all enforcement in the E.U. takes place at the national level.
This permits host countries to bring enforcement actions against out-of-state issuers. In a pure home country system such actions would be the exclusive purview of home country authorities. A pure home country system would be particularly unsatisfactory when host country investors have limited private remedies, e.g. no class actions, and thus would be totally dependent on the enforcement by authorities outside their country.

In a mutual recognition system, there may be a question as to the proper home country of an issuer. For example, assume that a French company wishing to issue securities in France, first issues and lists its securities in Luxembourg, and then seeks to list its securities in France under Luxembourg rules. The E.U. rules seek to prevent this kind of country arbitrage by providing that you must first list in the country of your registered office if you are listing there at all. Of course, there would still be room to maneuver if a company could select, in Delaware fashion, any country in which to incorporate. This is prevented by E.U. member state rules that require a company to have its registered office in the country where the “direction” of the company comes from, usually corporate headquarters, but these requirements have been put in doubt by a new line of cases in the Court of Justice holding that such restrictions violate the Rome Treaty’s provision of freedom of establishment (Wymeersch 2003).

(ii) The U.S. Approach

The U.S. has conducted its own limited experiment with mutual recognition with Canada. In 1991, the SEC adopted the multi-jurisdictional disclosure system (MJDS) for qualified securities transactions by Canadian issuers. The large number of Canadian firms issuing registered securities in the United States and the similarities between U.S. and Canadian securities regulation made Canada an obvious choice.
The MJDS was designed to facilitate securities offerings in both markets by subjecting the issuer to the regulations of only one jurisdiction. Specifically, qualified Canadian issuers may use disclosure documents filed with the appropriate Canadian agency to meet the U.S. registration and periodic disclosure requirements. As originally adopted MJDS filings did not require Canadian financial statements to be reconciled with U.S. GAAP, as long as they met Canada’s GAAP requirements, but that approach was changed in 1993—reconciliation is now required.¹⁴

There are also other exceptions in MJDS to the home country principle. For example, U.S. requirements on the delivery of the prospectus, safe harbor provisions on advertisements, and rules on the publication of research reports and other communications during the public offering process still apply. Also, because Canadian law does not require disclosure of indemnification provisions regarding directors, officers, and controlling persons, or disclosure of the financials of segmented business lines, MJDS issuers must supplement their registration with such information. In addition, U.S. fraud liability rules, e.g. Rule 10b-5, continue to apply, as enforced by the U.S., over and above whatever Canadian liability rules apply. Thus, the SEC topped-up Canadian rules by requiring compliance with U.S. rules where it found Canadian rules inadequate.

The SEC has chosen not to extend the MJDS approach to other countries. There have even been reports in the past that the SEC staff has favored repealing MJDS for Canada. The public justification for abolishing MJDS seems to be that MJDS represents an anomalous bilateral arrangement, at odds with the multilateral approach of IOSCO. However, some feel the real reason is the SEC’s lack of confidence in Canadian enforcement authorities. The enforcement issue is a primary concern in any mutual recognition system.
b. “Equivalence” Recognition

Under the “equivalence” approach to recognition of home country rules, the host country will only defer to the rules of the home country when it deems them equivalent to its own. Unlike mutual recognition, the approach does not require mutuality—Country A might recognize B’s rules as equivalent even though B does not do the same for A.

The use of an equivalence determination as a predicate to recognition of home country rules has begun to develop on both sides of the Atlantic. The U.S. has used the concept in determining whether to exercise control over foreign audits of U.S. companies, while the E.U. has used the concept in determining whether to allow U.S. firms to use U.S. GAAP rules in issuing securities in the E.U. and whether to defer to U.S. holding company regulation of U.S. firms operating in the E.U. Equivalence now seems the E.U.’s preferred approach toward deciding the issue of whether to apply home or host country rules (Schaub 2003).

U.S. Regulation of Auditors

The Sarbanes-Oxley Act created a new Public Company Accounting Oversight Board (PCAOB) under the supervision of the SEC. The Board is responsible for establishing auditing, quality control, attestation and ethics standards for auditors of public companies. The PCAOB has adopted a paperless registration system for accounting firms that audit U.S.-traded companies, which includes non-U.S. as well as U.S. accounting firms. As of April 2005, 567 foreign firms had registered with PCAOB. The effect of the registration requirement is to give the PCAOB oversight over foreign audit firms. The statute creating PCAOB provides that non-U.S. firms are subject to the Act and to the rules of the Board “to the same extent as a public accounting firm that is organized and operates under the laws of the United States.” The E.U.
protested this assertion of jurisdiction and threatened to retaliate by having each E.U. country assert jurisdiction over U.S. firms.

In June 2004, PCAOB issued its Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms (PCAOB 2004). The rules provide that the Board may rely—to the extent it deems appropriate—on foreign inspections under the home country’s oversight system. The extent of reliance on the foreign system would be based on the “independence and rigor” of the foreign system, as well as discussions with the foreign regulators. In judging independence and rigor, PCAOB will no doubt compare the approach of the foreign jurisdiction with that of the U.S., an equivalence determination (PCAOB 2004).  

Acceptance of U.S. GAAP in the E.U.

The E.U. has required foreign companies to state their accounts in IFRS as of 2006. This is of direct concern to U.S. companies that currently issue their securities in the E.U. under U.S. GAAP. U.S. and other non-E.U. companies will only be able to use U.S. GAAP if the E.U. Commission determines that such standards are “equivalent” to IFRS.

The Commission asked the Committee of European Securities Regulators (CESR) to assess this equivalence, which CESR did in its report of April 2005 (CESR 2005). CESR concluded that U.S. GAAP was on the whole equivalent to IFRS, but that in some areas U.S. companies would have to use IFRS rather than the U.S. GAAP rules, for example, expensing of stock options. The U.S. had adopted option expensing under FASB Accounting Standard No. 123 (revised 2004), Share-Based Payment, but on April 14, 2005, the SEC permitted companies to implement the requirement at the beginning of their next fiscal year (the first quarter of 2006 for a calendar-end reporting company) rather than in their next reporting period, which would have been after June 2005 (smaller companies were given more time) (SEC 2005c). The SEC
attributed the delay to the need of companies to have more time to implement changes but it was unusual for the SEC to override FASB’s implementation date (BNA Banking Report 2005). The SEC’s action was perhaps related to the political challenge to options expensing being mounted by some firms in the U.S. Congress.

CESR has indicated that while the E.U. should generally accept U.S. GAAP, the home country rule, where that rule is unacceptable, it will continue to insist on its own rules—in effect topping up areas of inadequacy or non-equivalence, much as the U.S. topped-up MJDS. CESR’s recommendation may or may not be accepted by the Commission or ultimately the Council of Ministers or Parliament. Acceptance may turn on whether there is sufficient progress in meeting the terms of the “roadmap” by which the SEC will accept IFRS.

European Commissioner McCreevy suggested in December 2005 that one way to proceed would be delay the E.U. equivalence decision until such time as the SEC made its decision on IFRS—in the meantime the status quo would be preserved, allowing U.S. companies to issue in the E.U. under U.S. GAAP (McCreevy 2005).

In the case that the SEC were to accept IFRS and/or the E.U. were to accept U.S. GAAP, the enforcement issue of any home country rule system would remain. It does not seem feasible for the IASB to enforce IFRS in the U.S. or for the U.S. to enforce U.S. GAAP in the E.U. Local regulators will have to enforce the foreign standards, e.g. FASB and the SEC will enforce IFRS in the U.S. This leads to the possibility of non-uniform application of the home country rule through differential standards of enforcement in the home and host countries.

The E.U. Conglomerates Directive

In April 2002, the E.U. adopted a Directive to deal with financial conglomerates. The Directive was aimed at insuring the capital adequacy and controlling the risk exposures of groups
of companies. The Directive caused significant problems for the U.S. since the E.U. applied the Directive to subsidiaries of U.S. and other foreign holding companies who were not subject to equivalent holding company regulation in their own countries. This was not a problem for U.S. financial services holding companies, such as Citigroup—a holding company that includes a bank—since these companies were comprehensively regulated at the holding company level by the Federal Reserve Board. In particular, Basel capital rules were applied to these firms at the holding company level. But U.S. holding companies that did not own banks but engaged in other financial services, such as securities firms like Goldman Sachs, were not regulated in the U.S. at the holding company level (there were no holding company capital requirements) even though many of their subsidiaries, e.g. broker-dealers, were regulated.

In response, in June 2004, the SEC for the first time formulated new holding company regulations for U.S. securities firms, which included capital requirements, albeit in more lenient form than those of Basel (SEC 2004). Whether such regulation was adequate was left to the group’s lead supervisor (or “coordinator”) in the E.U. For most U.S. firms, this was the U.K. and the determination fell to the Financial Services Authority (FSA), the U.K. regulator of all financial firms. If the FSA decides that these U.S. firms are subject to effective consolidated supervision under the SEC’s proposed regulation that would be the end of the matter. If the FSA decides that is not the case, it has indicated it could: (1) itself undertake worldwide supervision, or (2) “look to the group to organize itself in such a way that the objectives of group-wide supervision can be achieved by other means, such as establishment of a European holding company and restrictions of exposures between the European sub-group and the worldwide group (‘ring fencing’)” (FSA (U.K.) 2003).
In 2005, the U.K. was working with the SEC to determine whether the new SEC rules were equivalent to those of the E.U. (Sants 2005). Its equivalence review was broken down into two parts, capital adequacy and information exchange. With respect to capital the remaining issue appears to be whether the SEC’s net capital rules satisfy the equivalence test, given that E.U. securities firms are subject to Basel capital rules. The more difficult issue seems to be the extent to which European regulators would have access to SEC information about the entities regulated in the United States.

The three cases discussed here, auditing procedures, accounting standards and holding company regulation are all highly technical areas where there is no easy answer to equivalence. Whether this approach will emerge as the dominant one to rule allocation remains to be seen.

c. Disclosure of Differences

A third variation on reliance on home country rules can be called the disclosure of differences approach. The idea is that one can rely on home country rules as long as host country investors are informed about the difference between their domestic rules and those of the home country. This disclosure approach obviously only works where one is regulating transactions, as in the issuance or trading of securities, as opposed to where one is regulating firms, e.g. the auditing and holding company regulation issues discussed above.

Both the New York Stock Exchange and NASDAQ have adopted new corporate governance listing standards which in some cases go farther than the requirements of Sarbanes-Oxley, for example independent directors must comprise a majority of a company’s board, boards must convene regular executive sessions in which the non-management directors meet without management and the chair of the audit committee must have accounting or financial management expertise. Foreign companies are not required to comply with these rules—
except for the requirement for a financial expert on the audit committee—but if they do not comply, they must disclose any significant ways in which their corporate governance practices differ from those required of domestic companies by the NYSE (NYSE 2002). This is similar to the corporate governance approach within the U.K. The U.K. Combined Code and listing standards require that at least half the board of directors be independent, excluding the chairman. This policy is not compulsory, however. Companies must either follow this policy or explain why they are not doing so (Smerdon and Hazell 2003), a disclosure rather than a mandatory approach. Most other countries in Europe also take a comply or explain approach to governance.

The disclosure of differences approach plays a small role in overall securities regulation policy—in the U.S., it is only an exchange rule applicable to corporate governance requirements for foreign issuers. It is conceivable that with added experience and analysis of the new mandatory governance requirements (some work suggests that some of the new independence requirements may not improve corporate performance) the U.S. will be more open to a wider application of the disclosure approach in the future, at least with respect to foreign companies whose governance is centered in another jurisdiction.

B. Banking Regulation

Banking regulation issues are fundamentally different than those of securities regulation. In banking, the focus is on firms rather than transactions. There are consumer protection issues in banking that are somewhat analogous to investor protection issues, but there is very little cross-border banking that involves consumers. And in securities regulation, there are issues dealing with the cross-border operation of firms, but there is less concern with regulating these firms than there is with banks because the failure of a securities firm is unlikely to have the same systemic consequence as a failure of a bank. In banking, the major justification for regulation is
the systemic risk of bank failures, the chain reaction of bank failures that can arise from the failure of a major bank.\(^{21}\) This has been a major concern in the international context, since the 1991 failure of BCCI. That case demonstrated that the failure of the bank in its home country necessarily entails the failure of its foreign branches, and may affect as well the solvency of its foreign subsidiaries and affiliates (Scott 1992).

Apart from systemic risk, the second major concern in cross-border banking is competition, as foreign firms compete with domestic firms for business. There is a concern that more light regulation—particularly with respect to capital—may give foreign firms an “unfair” advantage. A major objective of the Basel Capital Accord of 1988 was to insure an even playing field between U.S. and Japanese banks (the latter having lower capital requirements at that time).

Keeping these regulatory concerns in mind, we shall examine the application of home and host country rules in the cross-border banking context (Scott and Key 1991). The focus will be on branching where the most difficult issues arise. When foreign banks operate abroad through subsidiaries the host country can fully regulate the foreign bank’s domestic subsidiary in the same way it regulates domestic institutions. The host country may be concerned that it cannot exert the same pressure on a foreign bank holding company, as it can on a domestic bank holding company, to rescue a troubled local subsidiary but this is a much lower order of concern than the host country has with branches of foreign banks. When a foreign bank fails, its branches—part and parcel of the bank—fail with it, and the host country has little control over the regulation of the foreign bank by the home country. And with respect to competition, since both foreign and domestic-owned subsidiaries face the same regulatory regime, there should be little regulatory distortion.
I examine below the following approaches to dealing with the selection of home or host rules for cross-border branch banking: (1) harmonization; (2) mutual recognition of home country rules; and (3) conditional recognition of home country rules combined with self-protection measures. Note that certain approaches to securities regulation are omitted—issuer choice is only relevant in transactions and national treatment is impossible to apply to foreign branches because, by necessity, they must generally be regulated by the home country.

One additional point is important in any discussion of home and host country rules for banking—it may not always be clear as to what country is the home country. Is it the country where the bank is incorporated or where the bank has most of its deposits? In the case of the 1991 failure of BCCI, the two failed banks were incorporated in Luxembourg and the Cayman Islands, whereas virtually all of the deposits of these banks (as well as assets) were located in the BCCI foreign branches in other countries. Post-BCCI host countries have required a clear identification of the home country and assurances that this country is capable of effective regulation.

(1) Harmonization

The centerpiece of harmonization in banking regulation is the Basel Capital Accord of the Basel Committee on Banking Supervision. In addition, there are the “core principles” of the Basel Committee implemented through the IMF.

a. The Basel Capital Accord

The Basel Accord of 1988 (Basel I or the Basel Accord) established mandatory capital requirements for banks with significant international operations—“internationally active banks”—but countries could choose to apply them to all of their banks. Both the U.S. and the E.U. did so. The Basel Accord, while formulated by a supranational organization, is
implemented and enforced at the national level. The Basel Accord is not binding on any of the participants—it rather represents an agreement of the supervisors that are parties to the agreement to implement the agreement nationally. In some cases, as with the E.U., this agreement required additional legislation in the form of a Directive, while in other countries, like the U.S., bank supervisors already had adequate statutory authority to implement the Accord through regulation. The 1988 Accord was substantially revised in 2004 (Basel II).

Banks from about 120 countries have adopted the Basel I rules, far more than the G10 countries that were actually parties to the Accord. Other countries were motivated to do so by a number of considerations. To some extent observance of Basel standards had become a mark of respectability for many developing countries. In addition, the IMF has prodded countries to adopt the Basel standards, and monitors them for compliance. For developed countries outside of the G10, observance of Basel standards is a virtual necessity since many countries, most notably the U.S., require compliance with Basel as a condition for foreign banks to establish branches.

The Basel Accord had the twin goals of insuring the safety and soundness of banks operating across borders and evening the competitive playing field. It is far from clear that either objective was achieved. With respect to safety and soundness, the issue was (and remains under Basel II) whether any standardized capital rules make sense for all banks, particularly those from different countries. The objective of establishing an even playing field across many countries may be thwarted by the many factors that shape international competition. A comparison of Japan and the United States by H. Scott and S. Iwahara (1994) argued that identical rules may have a very different effect in countries with different accounting, tax, legal rules and government safety nets. For example, Scott and Iwahara found that the stronger Japanese safety
net had a substantial impact on capital ratios. While the Basel minimum capital ratio was 8 percent, banks in both countries held more capital than the required minimum because the market demanded more. In this sense the 8 percent requirement was not binding. They also found that the capital on the books of the 10 largest Japanese banks in 1993 was substantially lower than that of the top 10 U.S. banks: 9.67 percent and 13.60 percent of assets for Japanese and U.S. banks, respectively. Japanese banks could hold lower levels of capital than U.S. banks because they enjoyed a more ironclad safety net.\textsuperscript{22}

One virtue of the Basel I was that rigid and relatively simple rules did not permit much distortion by national regulators implementing the Accord. Of course, at the same time this made the Accord less flexible. In Basel II, the rules are far more nuanced and technically complicated, and more discretion is given to regulators in implementing the rules. Indeed, there are three versions of the rules, each applicable to banks of different sophistication. While this might make the rules more useful in principal, they will no longer be as standardized, as regulators implement them in different ways. The progression from Basel I to Basel II indicates the trade-off between flexibility and standardization in using harmonized rules internationally.

The Basel process differs fundamentally from the attempt to achieve harmonized rules in the field of securities regulation. Basel did not set out to harmonize existing national rules, as is the case in securities regulation (particularly with respect to accounting issues). While existing rules informed the Basel process, the G10 supervisors sought to devise what they thought were the best set of rules, international rules, to replace the myriad national rules. Basel’s success in adopting these new rules—putting aside their desirability or effectiveness—made this process the crown jewel of international regulation. The process may be breaking down, however.
While Basel II like Basel I was only to be mandatory for internationally active banks, the working assumption was that the standards would be applied to all banks, at least in the U.S. and E.U., as was the case with Basel I. The U.S. decided, however, in 2003, that the standardized Basel II methodology that would apply to most banks was unduly complicated. As a result, the U.S. decided it would only adopt that part of Basel II that was designed for the most sophisticated banks, the top 10 U.S. banks, and perhaps 10 more (Ferguson 2003). The E.U., however, will apply Basel II to all of its banks. U.S. regulators have further decided to delay even the partial implementation of Basel II due to concerns as to whether the new rules may make too large reductions in the required capital of big banks (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision 2005). These developments raise serious questions about the viability of future international rulemaking. One senses, however, the U.S. will in the end apply Basel II to its largest internationally active banks. U.S. concerns will be outweighed by the desire to avoid an even more significant parting of ways with the E.U.

One further point about Basel II bears noting. Given that Basel II provides three methodologies for different banks, depending on their sophistication, it is probable that banks in the same holding company, but in different countries, could use different methodologies to calculate their capital. For example, the U.S. subsidiary of German bank might use the most advanced methodology while the Nigerian subsidiary of the same bank would use the least advanced approach. This will make it difficult for the banks and its supervisors to coordinate these different approaches. In addition, where sophisticated bank subsidiaries in different countries use the same model to calculate their capital, as permitted by Basel II, the question arises as to which supervisor shall take the lead in validating the model. This has been a
particularly difficult problem in implementing Basel II even within the E.U., as countries are reluctant to defer to other supervisors in validating such models.

The most difficult cross-border issues arise with respect to capital required for operational risk. Basel’s most advanced approach to calculating this capital (the so-called Advanced Management Approach) permits the bank to calculate capital on a consolidated holding company level. However, regulators of particular subsidiaries will be concerned about the capital supporting their particular bank, rather than the holding company as a whole. This follows from the fact that an individual bank within a holding company that fails will not necessarily have a claim on consolidated capital or the capital of other affiliates. The Basel Committee (2004) has proposed that “significant” subsidiaries should calculate stand-alone operational risk capital requirements while other subsidiaries can use an allocated portion of the group-wide requirements—but supervisors of less “significant” subsidiaries may not accept this.

The home-host problems with Basel demonstrate that one does not fully eliminate the home-host rule choice problem when one is operating under harmonized international rules. While the rules may be harmonized, they must still be implemented by national regulators. These problems could only be eliminated by delegating implementing powers to a supranational authority, powers that the Basel Committee does not now have.

b. Standards and Principles

In April 1997, the Basel Committee on Banking Supervision issued a Consultative Paper on Core Principles for Effective Banking Supervision. It formulated 25 general “Core Principles” under the headings of Licensing and Structure, Prudential Regulations and Requirements, Methods of Ongoing Bank Supervision, Information Requirements, Formal Powers of Supervisors and Cross-Border Banking. The first principle requires, inter alia, that supervisors
“should possess operational independence and adequate resources,” and “a suitable legal framework for banking supervision.”

The basic problem with the principles is that they mimic supervisory systems in developed countries, yet are intended to be applied in both developed and developing countries. The standards assume a well-trained body of supervisors and sophisticated bankers, and thus are inappropriate for many countries. Moreover, standards that give government officials such tremendous powers may increase corruption in many countries. It may be far better to design mechanisms that give a bigger role to market discipline, such as disclosure requirements and the facilitation of the entry of foreign banks. These were the findings of a survey of regulatory and supervisory policies in 107 countries (Barth et al. 2005).²⁴

While the Basel Committee has taken the lead in promulgating standards, since 1999 the IMF and World Bank have undertaken to assess whether the Basel Core Principles are being complied with. These are called Core Principles Assessments (CPA). These surveys have found a wide range of compliance with particular Core Principles. Performance on standards is taken into account by the Fund in making lending and other decisions regarding country assistance.²⁵

The Core Principles were only the beginning. The IMF now also conducts a financial sector adjustment program (FSAP) that assesses compliance with a wider set of standards than just the Basel Core Principles. Codes, formulated by international bodies now cover 12 areas, including the IMF’s Code of Good Practices on Transparency in Monetary and Financial Policies, the Basel Committee’s Payment and Settlement Systems’ Core Principles for Systematically Important Payment Systems, and insolvency and creditor rights standards developed by the World Bank. Voluntary assessments of member countries’ observance of
standards and codes are made by member countries in the form of Reports on the Observance of Standards and Codes, or ROSCs.

A basic issue with harmonization through standards and principles is why this kind of harmonization is so necessary for the developing countries at which it is principally aimed. Unlike capital standards, which are mainly concerned with cross-border bank operations of banks from developed countries—where low capital standards of one country can damage another or create unfair competition—these standards and principles are aimed at mostly domestic banking operations. Bank failures in most developing countries will have little impact on other countries, and certainly virtually no impact on the developed countries that are behind the development and implementation of the core principles.

A more likely justification for the application of such standards to some developing countries is that bank failures in some countries may play a critical role in financial crises, as in the case of South Korea in the Asian financial crisis in 1997 or the Turkish financial crisis of 2000. These crises may trigger demands for IMF resources that are funded by developed countries. Thus, better regulated banks may reduce the demands for IMF assistance.

(2) Mutual Recognition of Home Country Rules

This approach, as with securities regulation, is followed within the European Union. Under the so-called single passport system, banks authorized by a home member state are entitled to establish branches in other member states and to offer the same services in these host states as they do in their home states, if such services are on an agreed E.U. list. This system assumes a high degree of confidence by host states in the adequacy of regulation of the home state. Within the European Union this is assured by active cooperation among banking supervisors, as through the Committee of European Banking Supervisors (CEBS), as well as by
the supranational structure of the E.U. itself. These conditions cannot easily be replicated in the international system as a whole.

Even within the E.U., not all regulation of banks has been lodged with the home country. Host states can adopt measures “in the interest of the general good.” These measures must be equally applicable to domestic and foreign entities. The European Court of Justice, in its landmark decision in *Cassis de Dijon*, held that such clauses did not allow host states to set their own technical or qualitative standards for imported goods where the home states (member states of origin) had already set essential minimum standards. The Commission has tried to constrain general good requirements by host states by formulating the following conditions for their use: (1) the measure must not be discriminatory; (2) the measure must not impose higher requirements than those of a Harmonization Directive covering the subject; (3) the measure must have a general good objective; (4) the general good objective must not already be safeguarded in the country of origin; (5) the measure must be capable of guaranteeing that the objective will be met; and (6) the measure does not go beyond what is necessary to achieve the objective pursued. The last criterion, “proportionality,” may often be the hardest to satisfy.

In October 2004, the European Court of Justice held in *Caixa-Bank France v. Ministère de l’économie* that France was required to allow its banks to pay interest on current accounts despite arguments by France that such measures protected consumers against higher cost accounts and encouraged long-term savings. The Court held that prohibitions on interest payments were a serious obstacle to foreign banks seeking to do business in the French market. It also found that consumers could be protected by being offered a choice between higher cost accounts with interest and lower cost ones without interest. The court further stated that longer-term savings could be encouraged in other ways.
The general point is that the E.U. mutual recognition system, based on deference to home country rules, still permits host country rules in defined, albeit narrow, circumstances.

(3) Conditional Recognition of Home Country Rule

The dominant approach to the home-host problem in banking is for the host country to recognize home country rules on a conditional basis, which often amounts to an appraisal as to whether the home country rules are equivalent to those of the host country. This contrasts with securities regulation where the dominant approach is national treatment, with some exceptions—the Sarbanes-Oxley approach. The reason for the difference is that broad home country recognition is a matter of necessity if a host country permits a foreign bank to operate in its territory—branches of a foreign bank are part and parcel of the foreign bank and thus regulated by the foreign regulator of the bank.

In order to protect itself from the failure of the foreign bank (and the failure of adequate regulation by foreign regulators), the host country has two principal policy tools. First, it can condition entry of foreign branches, and their continued presence, on certain commitments of the foreign bank and/or foreign bank regulator. Second, the host country can minimize the impact a foreign bank failure might have on its financial system. These protective policies risk being viewed by foreign banks and their regulators as attempts by host countries to protect their banks from foreign competition.

These host country policies are not entirely unconstrained. The Basel Committee has established certain baseline principles for allocating responsibility between home and host countries, the Basel Concordats. The remainder of this section discusses the Concordat approach and then discusses the policies the U.S. uses to minimize the impact in the U.S. of foreign bank failure. The U.S. approach is not unique; most developed countries employ similar policies.
a. The Basel Concordat

The original Basel Concordat was formulated in 1975, entitled “Report to the Governors on the Supervision of Banks’ Foreign Establishments.” The Concordat was revised in 1983, “Principles For the Supervision of Banks’ Foreign Establishments,” and this revision was supplemented in 1990, “Information Flows Between Banking Supervisory Authorities.” In 1992, following the failure of BCCI, the Basel Committee converted certain of its 1983 principles into minimum standards, “Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments” (Minimum Standards). The Minimum Standards did not, however, supersede the 1983 Concordat, as they provide that the principles of the 1983 Concordat and its 1990 Supplement “are still viewed as being sound” and “certain of these principles have been reformulated as minimum standards….”

The Minimum Standards emerged out of concern with the shortcomings of how the BCCI affair was handled, particularly the use of the so-called “College of Supervisors” to deal with BCCI. The college had representation from the major countries in which BCCI operated, such as the U.K. and Pakistan, as well as its home countries, Luxembourg for the holding company and one of its banks, and the Cayman Islands for its other bank. But this college had no clear leadership and had difficulties in cooperating to get complete and consolidated information about the banking organization as a whole. McCarthy (2005b) has suggested the college approach can work if done correctly, pointing to the fact that for Hong Kong Shanghai Bank Corporation (HSBC), now headquartered in the U.K., the U.K. Financial Services Agency now chairs a “college” for HSBC by bringing regulators together from the U.S., Canada, Switzerland, Hong Kong, France, and the U.K., where HSBC holds 80 percent of its assets. It remains to be seen
whether this college can surmount the college problems in BCCI, particularly in a financial crisis.

The four Minimum Standards are:

(1) All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision;

(2) The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank’s and, if different, the banking group’s home-country supervisory authority;

(3) Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor; and

(4) If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

These standards are consistent with the needs of the host country, insofar as they insist on adequate home country supervision (Principle 1), the right to approve entry (Principle 2), and the right to impose “restrictive measures” including prohibition on entry (Principle 4). In addition, the home country is given the right to inspect its foreign branches (Principle 3). This inspection right is important to the home country because its ability to assure the safety and soundness of the entire bank is dependent on its having adequate information about the operations of its branches. U.S. and Japanese supervisors both inspect their foreign branches.

Two matters specifically covered by the 1983 revised Concordat, but not by the Minimum Standards, deserve some comment. The 1983 revised Concordat specifically legitimizes the imposition by host countries of capital requirements on branches—requirements that branches hold a specified percentage of their assets in local liquid assets, thus permitting
host countries to use such assets to cover local liabilities in the event the bank fails. The 1983 revised Concordat also points to the joint responsibility of the home and host supervisors to make sure the bank has adequate liquidity. The host authority is to monitor the liquidity of the branches, while the home authority is to monitor the liquidity of the bank as a whole. The Basel Committee is also careful to state that “[r]efereces to supervision of liquidity…do not relate to central banks’ functions as lender of last resort….” The question of who is the lender of last resort to a multinational bank, a quite important question, has yet to be resolved. Both the host and home countries have an interest in the continued operation of a foreign bank. While, in principle, it should seem that lender of last resort obligations should be lodged with the home country, which is responsible for the safety and soundness of the entire bank, the host country central bank may have to provide liquidity if the home country central bank does not.

The Concordat and the Minimum Standards are noteworthy insofar as they establish an international framework for resolving home-host issues. No such framework exists for securities regulation, where the issues may be more difficult to resolve. McCarthy (2005b) has argued that not all financial services are the same and thus different approaches to the home-host issue are required in different circumstances, e.g. compare the problems of dealing with a foreign bank with a large retail business in the host country with a stock market with operations in two countries (as would have happened had Deutsche Börse bought the London Stock Exchange).

b. U.S. Regulation of Foreign Banks

(i) Conditional Entry and Continued Presence.

In 1991, in the wake of the BCCI scandal, the U.S. Congress enacted the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), which was designed to strengthen federal supervision, regulation, and examination of foreign bank operations in the United States.
FBSEA prohibits a foreign bank from establishing a branch without the prior consent of the Federal Reserve, regardless of whether the branch is chartered under state or federal law. This meant that a foreign bank could no longer avoid federal scrutiny by obtaining a state charter, which is what most foreign banks had done prior to FBSEA.

The Act further provided that the Fed could not approve a foreign branch unless the foreign bank was “subject to comprehensive supervision and regulation on a consolidated basis” by its home country authorities. The foreign bank must provide the Fed with information necessary to make this assessment. FBSEA also established additional discretionary standards that the Fed may take into account when assessing an application. These include the consent of the home country supervisor, the nature of the cooperative relationship between the Fed and the home country regulator as to sharing of material information, various assurances of the foreign bank, compliance with U.S. laws, the needs of the community, and the relative size of the bank in its home country. The Fed may impose additional conditions on its approval, as it deems necessary (for example, cessation or restriction of certain activities).

FBSEA places the ultimate regulatory sanction of an organizational “death sentence” (termination) in the hands of the Fed. The Fed may order a foreign bank operating a state chartered branch to cease operations if the foreign bank is not subject to “comprehensive supervision or regulation on a consolidated basis” by its home country authorities. In addition, there must be reason to believe that the foreign bank has violated the law or engages in an “unsafe or unsound banking practice.” The Fed may also recommend to the Office of the Comptroller (OCC), the chartering authority for federal branches, that it revoke the license of a federal branch, if the Fed has reason to believe that such foreign bank or any affiliate has engaged in conduct for which the activities of any state branch or agency may be terminated.
Finally, the Act gives the Fed authority to examine all U.S. branches of foreign banks—this supplemented the existing authority of the OCC and state chartering authorities to examine the branches they had chartered.

A striking application of the “death sentence” authority occurred in 1996 when it was discovered that the state-chartered New York branch of Daiwa Bank of Japan, the world’s 19th largest bank, lost $1.1 billion from trading U.S. treasuries between 1984 and 1995. When the bank’s management discovered the losses in July 1995, they did not promptly report them to U.S. bank regulators (the Federal Reserve and New York State Banking Department). In addition, it appears that in 1992 and 1993 Daiwa management falsely assured Federal Reserve Board examiners that trading and custody had been split (this reduces the possibility of concealed losses), whereas they had in fact both remained under the control of Mr. Iguchi, the trader responsible for the losses. There was no threat to Daiwa’s solvency from the losses, as the bank had more than a sufficient amount of capital.

As a result, Daiwa’s branch license and other U.S. banking operations were terminated by consent orders effective February 2, 1996 (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and New York State Banking Department 1995). Daiwa also faced U.S. criminal charges, brought on November 2, 1996, and entered into a plea bargain under which it pled guilty and was fined $340 million. Daiwa also suffered consequences in Japan. In September 2000, a Japanese court ordered the executives and former executives of Daiwa to pay $775 million to the bank for the losses caused by the New York branch management. This was then the highest damage award in the history of Japan (BNA Banking Report 2000).
Before Daiwa, the Japanese neither examined nor required audits of the foreign branches of their banks. MOF announced in December 1995 that overseas branches of Japanese banks would be encouraged to obtain external audits and that the Bank of Japan would inspect branches in New York and London.

The Daiwa case indicates the delicate balance between home and host country authority over branches of foreign banks. One can legitimately ask whether the Federal Reserve Board and the U.S. government overreacted to Daiwa. No U.S. depositor lost any money because Daiwa honored all of its debts—it was not insolvent. The bank did violate U.S. law by apparently lying to regulators but did the punishment fit the crime? The Japanese Ministry of Finance (MOF) did not protest (at least openly) Daiwa’s expulsion, perhaps, some thought, because MOF was complicit in the cover up of the losses.

It is interesting to compare the U.S. treatment of Daiwa with the Japanese treatment of U.S. banks that have violated Japanese law. The Japanese have generally not imposed death sentences but rather have temporarily suspended business operations, as in the case of Credit Suisse First Boston (CSFB), which assisted Japanese banks in covering up bad Japanese loans. These CSFB actions resulted in much larger losses than did the Daiwa case. CSFB’s “structured finance” assistance prevented timely action from being taken to avoid even greater future losses, and the losses that were incurred were paid for by the public when it became necessary to inject capital into failing Japanese banks.

The Japanese did impose a partial death sentence in 2004, however, when the Financial Services Agency (FSA, the successor bank regulator to MOF) ordered Citibank to close its private-banking operations in Japan. The regulators accused Citibank of failing to prevent transactions that may have been linked to money laundering or stock manipulation, and for
failing to make adequate disclosure to its clients of the risk of investments. FSA also accused Citibank officials of trying to obstruct its investigations (Financial Services Authority (U.K.) 2004, Securities and Exchange Surveillance Commission (Japan) 2004, and Citigroup, Inc. 2004). In April 2005, the FSA ordered Cititrust Banking Corp., the Japanese trust unit of Citigroup, to suspend indefinitely all new business operations effective May 2, following Cititrust’s failure to comply with Japanese mutual fund registration requirements. But these regulatory actions, serious as they may be, did not suspend or terminate all of Citigroup’s Japanese operations, as did the U.S. in the case of Daiwa.

(ii) Minimizing the Impact of Failure

There are three principal ways in which U.S. regulators seek to limit the impact of the failure of a foreign bank. First, branches of foreign banks are prohibited from taking insured deposits, deposits under $100,000. Second, as specifically permitted by the Concordat, branches of foreign banks are required to backup their deposits by liquid assets. Third, in the event of failure, the U.S. “ring fences” the assets of the foreign branches and uses the proceeds of their sale to pay off U.S. creditors.

*Prohibition on Branches of Foreign Banks Taking Insured Deposits*

Prior to 1978, deposits in branches of foreign banks were not insured by the Federal Deposit Insurance Corporation (FDIC). While this protected the FDIC insurance fund from the failure of foreign banks, depositors who chose to put deposits in these branches were fully exposed to losses—an exposure that could lead the Federal Reserve Board to become a lender of last resort to the foreign bank or the United States to bail out the U.S. depositors after the fact. Also, the unavailability of FDIC insurance arguably made the branches of foreign banks less competitive with U.S. banks.
This approach was reversed under the International Banking Act of 1978 (IBA) that required branches of foreign banks taking deposits of $100,000 or less to be insured. The major rationale for the change was to provide competitive equality for the branches of foreign banks. Ironically, all but a very few branches of foreign banks remained uninsured even after the change—limiting their deposits to over $100,000. If foreign banks had chosen the insurance option, they would have had to pay for the insurance by premium contributions to the FDIC fund, a cost that would largely be passed on to depositors in the form of lower interest. Large depositors were more interested in having higher interest rates than having the first $100,000 of their deposits insured.

U.S. policy changed once again in 1991 with the enactment of the FDIC Improvement Act (FDICIA), again in the wake of BCCI. FDICIA prohibited foreign banks from taking any deposits below $100,000—all such deposits in the future would have to be taken through U.S. subsidiaries. Existing insured branches, of which there were only 52 in 1991, were grandfathered. The rational for this approach was to avoid putting the FDIC fund at risk from the failure of foreign banks and the inadequacies of their foreign regulators. While this approach, in principle, limited the competitiveness of foreign banks in U.S. markets, the experience with IBA suggested that foreign banks did not really want to take insured deposits through their U.S. branches.

One could take another approach to deposit insurance—allow deposits in a branch of a foreign bank to be insured under the deposit protection scheme of the home country. This would have the advantage of having the insuring country bear the risk for its own supervisory shortcomings. However, this might be thought to introduce an issue of consumer confusion. Deposits in domestic banks would be insured similarly but deposits in the branches of foreign
banks would be insured differently, according to the various schemes in place in the home countries of these banks. One might, however, see this as a virtue, as it provides the bank depositor with more choice about the level of insurance protection. A major drawback of the home country deposit insurance system is that the host country is at risk from the failure of the home country’s deposit insurance system—when claims on the home country’s insurance fund exceed the fund’s assets. Deposit insurance funds can become insolvent as occurred in the U.S. thrift crisis in the late 1980s, and during the Japanese financial crisis in the 1990s, albeit in both cases the injection of public funds averted defaults on the funds’ obligations.

The E.U. adopts still another approach. The E.U. provides that depositors in branches of all foreign banks within the E.U. must be provided a minimum insurance of €20,000 by their home country. It also permits, but does not require, a bank from a E.U. home country with limits below the host’s country to top up its insurance by joining the host country’s scheme. However, a foreign bank cannot provide a higher level of insurance than available in the host country.

Here is an example of how this works. Suppose Country X, the host country of a branch of a bank from Country Y, had an insurance scheme at the level of €40,000, while home Country Y had a scheme at the level of €30,000. The Country Y bank would have two options. It could either furnish the lower €30,000 deposit insurance of its home country Y or join Country X’s scheme and offer €40,000. This system has the advantage of generally placing the deposit insurance with the home country (the regulating country). However, by allowing the foreign bank to provide the same level of insurance as the host country by joining the host country scheme, it puts the host country at risk for the regulatory failures of the home country. This result is clearly more acceptable within the E.U. than internationally. Note that the E.U. does not seem bothered by the fact that foreign banks may have a lower level of insurance protection than
a domestic bank (if it does not top-up) but it does not permit a foreign bank to have a higher level of insurance than a host country bank, a result that seems protective of the competitive position of banks in countries with low levels of insurance protection.

Quasi-capital Requirements for Branches of Foreign Banks

Under the IBA, foreign banks with insured federally chartered branches are required to pledge assets equal to 10 percent of the average of the insured branch’s liabilities. Qualifying assets consist of a variety of interest-bearing obligations issued by banks, corporations, governmental entities and certain international organizations. State-chartered branches are subject to similar requirements. In addition, the FDIC requires that all insured branches (federal and state-chartered) maintain eligible assets (generally safe and liquid) payable in U.S. dollars in an amount at least equal in book value to the amount of the branch’s liabilities. These requirements once again raise competitive concerns insofar as foreign banks are subject to more onerous capital requirements than domestic banks.

Ring-fencing

Ring-fencing of the assets of a branch of a failed foreign bank, to cover its liabilities to host country depositors, is another important self-protection mechanism for host countries. The major policy question is whether these branch assets should more properly be part of a consolidated bankruptcy of the entire bank under the control of the bank’s home country receiver. This issue arose in the failure of BCCI.

When BCCI failed, its U.S. agencies (the only offices it had in the U.S.), offices that took uninsured deposits over $100,000, failed with it. While BCCI agencies in New York and California were legally prohibited from taking deposits from individual U.S. citizens or residents, it appears that the BCCI agencies did so anyway. The U.S. assets of the failed BCCI
banks, estimated at $550 million, consisted only in minor part of the agencies’ assets. Far more important were their alleged stockholdings in several U.S. banks and correspondent accounts at the Bank of America and other banks. Claims against U.S. assets included less than $20 million owed by the agencies to third parties (non-BCCI entities), as well as a $200 million fine which the Federal Reserve Board levied against BCCI for illegally acquiring certain U.S. banks. There was also the prospect of additional fines as a result of criminal prosecutions by federal and state authorities.

The liquidators of the BCCI Luxembourg holding company and its two subsidiary banks, incorporated in Luxembourg and the Cayman Islands, first sought to consolidate these assets as part of the foreign insolvency proceedings, pursuant to Section 304 of the U.S. Bankruptcy Code. However, U.S. bank bankruptcies are not subject to the general bankruptcy laws so it was unlikely that this attempt would have been successful. In any event, a settlement was reached under which the U.S. bank liquidators agreed to remit any surplus remaining, after the satisfaction of U.S. claims, to the U.S. bankruptcy court for the benefit of the foreign liquidators.

The net effect of the United States proceedings was that $275 million in U.S. assets was not consolidated with the worldwide receivership assets of the BCCI banks in the Luxembourg and Caymans proceedings and thus was not available to creditors of those banks. It appeared that the U.S. creditors of the BCCI agencies received full payment of their claims.

If U.S. or other country assets of failed foreign banks are not fully consolidated in home-country foreign insolvency proceedings, and such assets are substantial, the ability of a foreign receiver to reorganize a failed bank will be severely limited. While this was not a practical alternative in the BCCI case—earlier efforts to reorganize the bank with an infusion of capital from Abu Dhabi had foundered—it could be a problem in future bankruptcies of multinational
banks. Indeed, the possible need to reorganize a failed company is a significant rationale for the U.S. Bankruptcy Code’s section 304 proceeding. In fact, it was this concern that was behind the decision of U.S. authorities to assert jurisdiction over the London branch assets of Franklin National Bank when that bank was in danger of failing in 1974. The fact that the U.S. authorities had control over all of Franklin’s assets was an important factor in their ability to sell the troubled bank to European American Bank.

The failure to consolidate may also result in the inability of non-U.S. creditors to obtain recovery of the same pro rata share of all of the bank’s assets that they would have obtained if the assets were consolidated. While the creditors of BCCI’s U.S. agencies were fully paid off, creditors in the foreign insolvency procedures were not.

Apart from the difficulties of preferring some creditors of a bank at the expense of others, the assets of an agency or branch of a foreign bank may have little to do with its actual business activities in the host country. For example, it appears that the BCCI banks shifted assets among branches to avoid detection of insolvency. The difficulty of properly sorting out assets between various offices of a bank may argue for the need for a consolidated bankruptcy proceeding. A further complication arises insofar as the host country asserts jurisdiction over assets of a failed foreign bank that are within its jurisdiction but are not assets of the entities (an agency or branch) operating in its country. For example, part of the U.S. assets of the BCCI banks reportedly consisted of $85 million of deposits of the Tokyo branch of BCCI Luxembourg in U.S. banks. There is no clear rationale for using these assets to satisfy claims of U.S. creditors of U.S. agencies rather than using them to satisfy the claims of Japanese creditors against the Tokyo branch or the claims of worldwide creditors against the entire bank.
The strongest argument for the host country to preserve the assets of a branch or agency of a failed foreign bank for local creditors is that the host country is at risk for the supervisory failures of the home country. This rationale is much stronger when the host country insures local depositors than when it merely seeks to protect their uninsured interests, as in the case of the U.S. agencies of BCCI. Under present law, as discussed above, the U.S. does not insure the branches of foreign banks, so the case for ring-fencing is weak.  

**c. The European Lead Supervisor Debate**

Many European financial service firms would like to see the EU adopt a lead supervisor approach to regulation of EU financial firms (European Financial Services Roundtable 2005). Under this approach one supervisor would be the lead among all supervisors that regulated any entity of a financial firm. This would go beyond the Concordat approach where authority is divided as between home and host countries in different ways for branches and subsidiaries.

Under the lead supervisor approach the home country of the holding company or bank could become the lead supervisor for the entire banking organization. Under current E.U. practices, the home country supervisor of a bank rather than of the banking organization, is usually the effective supervisor. For example, under the lead supervisor approach, if a bank in France had an Italian subsidiary, France would be the lead supervisor for the Italian subsidiary as well as the French bank—while today France would be the effective supervisor for the French bank and Italy would be the effective supervisor of the Italian bank. Calls for lead supervisors reflect the desire of the banking industry to achieve more harmonization in supervision (failing the creation of a European supervisor) through extension of the home country principle. Banks believe a lead supervisor would reduce complexity by subjecting a banking organization to only one set of supervisory rules. Regulators that lose power under such a regime are likely to oppose
it, and call for added cooperation under the existing regime. Callum McCarthy, the head of the Financial Services Agency in the U.K., many of whose regulatees are subsidiaries of foreign banks, has already opposed this approach largely on the ground that host countries cannot politically accept leaving to foreign regulators matters that can seriously affect their economies and citizens (McCarthy 2005a; McCarthy 2005b).

C. Sovereign Debt

(1) Background

Emerging market debt with over one year maturity increased from $46.2 billion to $1.5 trillion from 1970 to 2003. The composition of this debt changed significantly over this period. In 1970 bank debt was $3.6 billion as compared to bond debt of $1.8 billion, whereas in 2000, bond debt was $368.4 billion as compared to bank debt of $157.8 billion. In addition, the amount of funding from governments also increased. IMF debt outstanding increased from $800 million in 1970 to $108.7 billion in 2003 and other multilateral debt, e.g. of the World Bank, increased from $7.3 billion to $374.7 billion. Bilateral government debt increased from $25.8 billion to 430.7 billion over this period. Despite the growth of all government debt, private debt grew faster, rising from 26 percent of all debt in 1970 to 41 percent by 2003. (World Bank 2004.)

Beginning with the Mexican default of 1982, the world has experienced a number of debt defaults by emerging market country borrowers. This was largely a result of the fact that these countries had over-borrowed and could not continue to service their foreign debt, at least not without unacceptable domestic political consequences. Between August 1982 and October 1983, 28 countries including Mexico rescheduled their debt. Sixteen were Latin American. And these countries continually rescheduled new and old rescheduled debt during the 1980s.
The response to these problems was international. The IMF transformed itself from an institution created to maintain fixed exchange rates into a lender of last resort. Bank created the London Club, a forum housed in London, to help private banks reschedule their loans. These negotiations took place along side negotiations in the Paris Club about rescheduling official credit (credit from one sovereign to another).

A new approach to the sovereign debt problem was undertaken after the first Bush Administration took office in 1989. The idea was to bring permanent debt relief to borrowing countries by reducing and securitizing their debt, combined with the adoption of domestic economic reforms. The governments of the debtor countries issued so-called Brady Bonds (named after the Secretary of the Treasury) in exchange for outstanding debt in arrears to banks, at a negotiated discount to the face value of the debt or at below-market interest rates, secured by zero-coupon U.S. Treasury bonds. The Brady Bonds did substantially reduce the emerging market debt burden but this salutary effect was only temporary.

Not all holders of bank debt tendered it for discounted bond debt. Four months after the government of Peru announced its Brady Bond package in 1995, Elliott Associates, LP paid two banks $11.4 million for loans guaranteed by the government of Peru in 1983 with a face value of $20.7 million. Elliott rejected the Brady offers, and then sued Peru and the borrower in New York, asserting that New York law, which governed the bank loans, required full payment of the entire debt plus accrued interest.

Peru was not protected by sovereign immunity. Under U.S. law, there is a commercial activity exception to sovereign immunity, and under Republic of Argentina v. Weltover, issuing bonds is regarded as a commercial activity (Gulati and Klee 2001). Elliott obtained an injunction
in the U.S. restraining Chase Bank, the agent for the Brady Bonds, from using any funds it received from Peru to service the Brady Bond debt.\textsuperscript{36}

Rather than transfer funds to Chase in New York, Peru tried to service the debt through Euroclear (a clearing and settlement system) in Belgium. The Belgian Court of Appeals restrained JPMorgan as operator of Euroclear, from either accepting the money or paying it to creditors.\textsuperscript{37} Elliott successfully argued that the \textit{pari passu} clause in the loan agreement required the debtor to pay all creditors, including Elliott, pro rata.

Financial crises continued into the 1990s and beyond, the most important of which were the Asian and Russian crises of 1997 and 1998, respectively. Many of the 1990s crises were triggered, if not caused, by rapid foreign exchange rate depreciations and involved defaults on bonds as well as bank loans.

Argentina captured the title for the largest sovereign default when it defaulted on its $141 billion external debt in late December 2001 which included more than 90 financial instruments and millions of retail investors, many of which were Italian and Japanese. During the two years leading up to the crisis, the IMF repeatedly loaned Argentina funds.

In June 2004, Argentina announced its intention to make an exchange offer for $102 billion of its defaulted debt, $82 billion in principal and $20 billion in past due interest. At the time the exchange was completed, this represented about 34 cents on the dollar.

There was widespread creditor dissatisfaction with the terms of the offer, particularly given the improvement in the Argentine economy. Its real GDP grew by 7 percent in 2004 and inflation was below 5 percent. Furthermore, Argentina generated revenue from a tax on exports designed to capture “windfalls” from the devaluation.
The exchange was deemed a success by Argentina in March 2005, when bondholders with 76 percent of the old bonds accepted the exchange by tendering their new bonds. Holdout creditors owed $361 million (principal plus interest), for which they paid $114 million in the secondary market, sought an attachment of $7 billion of the old bonds that had been tendered to Argentina in the debt exchange—the $7 billion figure assumed that the old bonds were worth 5 percent of their face value.

The court denied the creditors relief. While the court appeared to accept the argument that Argentina had a property right in the bonds, it stated that part of Argentina’s rights to the bonds included its right to cancel the bonds, which the attaching creditors would obviously not do. The failure of Argentina to achieve cancellation of its old debt, would lead Argentina to pull out of the exchange entirely, which it would have a right to do under the circumstances. The Second Circuit affirmed the District Court’s denial of the attachment order on May 13, 2005 in a summary order. The court stated that the District Court had provided a sufficient and dispositive reason for vacating the attachment, quoting the lower court: “If these attachments [and restraints] are still in effect, we throw into doubt, to say the least, the conclusion of the exchange offer.” The Second Circuit also noted that the grant of attachment orders was largely a matter of discretion of the District Court and it had not abused its discretion.

(2) Reform of the Sovereign Debt Process

The sovereign debt process is primarily international. It is dominated by an international organization, the IMF, with the G7 operating in the background. The sovereign debt problem is quite different than the issues of banking and securities regulation, which principally involve the issue of the allocation between countries of regulatory authority for private cross-border transactions between private parties. In some cases, like Basel capital requirements,
international rules are adopted by international institutions, but the much more common situation has been the use of home or host country rules.

Home or host country choices are largely irrelevant for sovereign debt. The home country is the debtor, which if left to its own devices, might not honor its debt at all or do so only at deep discounts. Host countries are obviously not prepared to leave restructuring rules to the home country, and there is no single host country to turn to since the debt is multilateral. The closest parallel in the private sector is the regulation of international banks like BCCI, where a college of supervisors approach was adopted (albeit with much disagreement about how the college should operate). In the case of sovereign debt, the IMF is a permanent college with financial resources—there is no need to invent another one. Furthermore, the Paris Club, another international institution stands ready to deal with the restructuring of debt issued by one sovereign to another.

Thus, most of the important issues of sovereign debt reform involve how to change the international approach to the problem, as by reforming the IMF’s role or designing a new sovereign debt restructuring mechanism. However, an important part of the system design is the extent to which private debt contracts should be enforced, both by countries and the international system as a whole, when defaults occur. In other words, to what extent should contract rather than international regulation determine how sovereign defaults should be dealt with. We now turn to these issues.

a. The Role of the IMF

The central issue about the IMF is whether constraints should be put on its lending because of the concern with creditor moral hazard. The International Financial Institutions Advisory Commission, dubbed the Meltzer Commission for its Chairman, Allan Meltzer,
recommended in March 2000 that the IMF lend only to countries meeting minimum prudential standards, that its lending not be tied to policy reforms, and should be limited to illiquid not insolvent borrowers. A later study of the Council of Foreign Relations proposed placing softer constraints on IMF lending.

In March 2003, the IMF Board formulated specific criteria that must be met before the IMF engages in large-scale lending: (1) balance of payments pressures on capital account, (2) high probability of debt sustainability, (3) good prospects of regaining access to private markets so that IMF financing provides a bridge, and (4) good economic policies in place. In addition the IMF Board adopted the requirement that, in cases of exceptional access, a new exceptional access report has to be prepared and published by the IMF management. These are very soft constraints, however. It is difficult, for example, to see how some of these criteria were satisfied in connection with the $3.1 billion rollover of IMF debt to Argentina.

b. The Modification of Bond Clauses

Another important issue in the reform debate is whether so-called collective action clauses (CACs) should be required in sovereign bonds to facilitate rescheduling. CACs permit a super-majority of creditors to change the financial and other terms of sovereign bonds in a restructuring. Sovereign bonds issued under U.S. law traditionally required creditor unanimity to change terms. Restrictions on changing bond terms spring from a concern that a majority of creditors can abuse a minority. This fear was reflected in the enactment in 1939 of the Trust Indenture Act (TIA) restricting the use of majority action clauses in corporate issues. Although the TIA applies only to corporate and not sovereign bonds, U.S. contracting practice for sovereign bonds has followed the statutory requirements for corporate bonds.
Due largely to the urging of the U.S. Treasury, emerging countries have increasingly adopted bonds with CACs. Mexico adopted a 75 percent CAC (of all bonds outstanding) in a $1 billion bond offering in February 2003 and Brazil followed by issuing $1 billion of bonds with CACs in April 2003, using an 85 percent requirement. The consensus seems to be that there was no additional cost to countries of issuing bonds with CACs. One would think there would be some price effect—depending on whether the market viewed easier restructuring as positive or negative. If restructurings were to be more expensive for creditors, they should increase in price; if less expensive, they should decrease. Perhaps there was no price effect because the market thought they would have no impact, either because they would never really be used, e.g. there would continue to be bailouts, or because they would be difficult to use (Weinschelbaum and Wynne 2005).

The CAC solution will not work across different credit instruments. Even if the same CAC were inserted in all sovereign bonds, other major debt that would be simultaneously subject to restructuring negotiations, like syndicated bank debt or trade credit, would not have such clauses. It is also a heroic assumption to think that all bonds would have the same CACs, some might have a 75 percent requirement, others 90 percent.

This raises a very fundamental point. The very existence of corporate bankruptcy laws responds to the collective action problem of providing for a bankruptcy process through private contract. Private contract cannot itself deal with bankruptcy because different creditors, not in privity, interact with debtors over time and establish different terms in their contractual documentation for the resolution of disputes.
c. An International Bankruptcy System for Sovereigns

In November 2001, Anne Krueger, the First Deputy Managing Director of the IMF proposed adoption of a bankruptcy system for sovereign defaulters (the sovereign debt restructuring mechanism, SDRM) (IMF 2001), refining the proposal some four months later (IMF 2002). The proposal died on the vine after the U.S. Treasury announced its opposition, after intense lobbying by creditors who believed the SDRM would make it too easy for sovereigns to default and scale down their debt.

The IMF proposal envisions that at the debtor’s request a super-majority of creditors could impose a standstill on payments and a stay on creditor litigation for a fixed duration of time that was potentially renewable. The proposal also contemplates that a super-majority of creditors supplying new financing during the SDRM could subordinate existing claims, modeled on debtor-in-possession (DIP) financing in corporate bankruptcy. Multilaterals like the IMF and the World Bank would not be subject to SDRM.

A restructuring plan, as under CACs, could be approved by a super-majority of creditors in each class. The final IMF plan contemplated a 75 percent requirement (by value). The approval of the plan, however, would have to be informed by the IMF’s view as to whether the remaining debt level was sustainable. The SDRM could be terminated, without a plan, upon the vote of 40 percent (by value) of the outstanding verified debt holders. An independent tribunal, perhaps a quasi-judicial organ, would adjudicate issues like lack of equitable treatment or valuation of claims.

A major drawback of SDRM is that it significantly increases the power of the IMF. The IMF continues its lending, plus is heavily involved in the SDRM mechanism. As a major “priority” lender, it has an obvious interest in seeing that its own debt is repaid which may color
its decisions on other issues. It is rather clear, however, that some central authority would be necessary to administer SDRM. This then raises the problem of finding an alternative to the IMF.

d. Strengthening Creditor Rights

As has been noted earlier, bond debt obligations are not normally protected in foreign courts by sovereign immunity as the issuance of such debt is regarded as a commercial activity, and commercial activities are outside the protection of sovereign immunity. Sovereigns normally waive sovereign immunity (Russia is a notable exception) in international debt instruments, so their assets in the U.S., in principle, are subject to attachment. 28 U.S.C. §1610(a)(1). This is true in many other countries as well.

Pursuit of court remedies will only be effective if there are assets, outside of the jurisdiction of the debtor country to satisfy court judgments. The extent of such assets has been subject to much debate, given that most sovereign assets are within their borders and effectively immune from seizure. However, there may be significant assets available for attachment abroad. Cross-border foreign payments, whether on restructured bonds, other debt, or even for the importation or export of goods and services, may be fair game for attachment by creditors. There may also be other significant assets abroad, like foreign bank and security custody accounts. Countries hold foreign bank accounts to make and receive payments and as a store of value. They also have foreign securities in custody abroad, often in connection with central bank reserve holdings.

The FSIA of the United States and similar laws in other countries, however, shelter key debtor assets from possible seizure. This is probably done for political reasons—developed countries may seek to accommodate the interests of developing countries, and all sovereigns may
share a common interest in protecting their assets from seizure. After all, historically, all kinds of countries have defaulted on debts. Even the United States refused to honor the gold clauses in its bonds after the Depression. Nonetheless, sheltering government assets from seizures seems incompatible with the fundamental principle that countries are responsible for honoring their debts and creates a significant debtor moral hazard problem. If developed countries want the market to play more of a role in limiting emerging market borrowing, they could expose sovereigns to the threat of the same creditor rights to which private borrowers are exposed. This would have to be combined with some kind of coordinated bankruptcy process to avoid races to the courthouse.

Central bank reserves are the principal liquid asset of most countries but under the U.S. Foreign Sovereign Immunities Act, property of a foreign central bank “held for its own account” is immune from attachment.\(^43\) It is unclear how necessary such assets are necessary for countries to pursue public policy concerns, particularly with countries that have, or should have, flexible exchange rates. There is also the distinct possibility that central bank reserves can be used to shelter commercial assets of the government or of influential individuals, including heads of state. In *Birch Shipping Co. v. United Republic of Tanzania*, the court held that Tanzania could not shelter commercial assets from execution by commingling them in an immune embassy account.\(^44\) And in *Weston Compagnie de Finance et D’Investissement, S.A. v. La Republica del Ecuador*, the court indicated that funds in a central bank account used to finance commercial transactions of private parties would not be immune since these were not funds “held for its account.”\(^45\)

The possibility that central bank accounts in the United States might be attachable in some cases, has led sovereigns to hold these accounts elsewhere, or to remove funds from U.S.
accounts once litigation is threatened. The preferred place to hold such funds is at the Bank for International Settlements (BIS). Article 10 of the Constituent Charter of the BIS provides: “The Bank, its property and assets and all deposits entrusted to it shall be immune in time of peace and in time of war from any measure such as expropriation, requisition, seizure, confiscation, prohibition or restrictions of gold or currency export or import, and any other similar measures.” So the major countries of the world through the BIS Charter have given all countries’ central banks a complete safe haven for all of their liquid assets, whatever the purpose for which they are held. Creditor rights could be enhanced by eliminating or narrowing such protections.

Two specific areas of creditor rights also deserve special mention, the use of the pari passu clause and the ability to seize assets of state-owned enterprises (SOEs). As concerns pari passu, we have already discussed the use of this clause in the Elliott case in Peru. Holdout creditors were able to attach payments to Brady bondholders in satisfaction of Peru’s obligations on outstanding syndicated loans. In principle, this right could be made clear in law and extended to other dollar payments made by the sovereign, as for imports or payments to other trade creditors. In fact, the world seems to be moving in the opposite direction. Belgium recently amended its law to explicitly provide that no funds to be credited to a Euroclear account can be attached.

A second area of interest is the possible seizure of the assets of SOEs in satisfaction of debts owed by sovereigns. While the doctrine of separateness would protect SOEs from being liable for the debts of their owners, assuming separateness was respected in the management of a SOE, creditors of the sovereign would still be entitled to become the owners of the SOE, since the sovereign’s stock in the SOE is an asset of the sovereign. Under the Foreign Sovereign
Immunities Act (FSIA), a U.S. court cannot attach or garnish sovereign assets located outside the United States.48 This is not true in the case of private debtors (Loeb 2004). FSIA could be changed to provide that U.S. courts could attach or garnish stock even though the stock was outside the U.S. If the sovereign or the garnishee failed to deliver the stock, the Court could assign ownership of SOE assets, at least those in the United States, to the private creditors. One would then have to work out the priority issue as between the creditors of the sovereign and of the SOE.49

6. Conclusion

In my view, there is an inexorable pressure to harmonize the rules of international finance, and to increasingly delegate power to international organizations to formulate and enforce such rules, due to concerns with international stability, economic efficiency and the drawbacks of alternative approaches. It is clear that harmonization and supranational authority have greatly increased since the end of World War II. Sovereign debt has been the leading edge of this trend, with the central role of the IMF, and banking has followed behind with the work of the Basel Committee, and the ancillary role of the IMF and World Bank in monitoring and enforcing banking standards in the developing world. Securities regulation has trailed these two other areas due to the relative absence of systemic risk concerns, but the potential efficiency savings in this area is substantial. Even with securities regulation, one can point to the work of IOSCO on disclosure standards. These trends toward harmonization and supranational authority are taking place within an accelerated pace in the European Union because of the political framework and the commitment to a single market, but portend the longer term future for the rest of the developed world. The creation of the Financial Stability Forum to coordinate the work of various global regulators is itself a testament to the trend.
The various alternative means of allocating authority between home and host countries have proved wanting in terms of the twin objectives of financial stability and efficiency. In a globally integrated world regulation itself must be global.

This is a prediction not an endorsement. There are obviously many significant costs to harmonization and increased supranational authority, primarily the surrender of sovereignty and the absence of regulatory competition. And the trends I outline are not without bumps on the road, as illustrated by the current tribulations of the Basel Accord and the debate over the IMF’s role in sovereign debt. This vision of the future will not materialize over night. We will not wake up tomorrow to find that the U.S. office of the Basel Committee has replaced U.S. regulators in regulating and enforcing capital standards for banks in the U.S. But that is where I believe we are headed.
ENDNOTES

1 This Chapter draws heavily on Scott (2005).
2 See also Kearney and Lucey (2004).
3 For a recent critique of globalization, see Stiglitz (2004).
4 Derivatives and insurance are also part of international finance but are not covered in this piece.
5 The SEC’s recent adoption of detailed changes in the way securities are offered in the United States had little to do with international pressure or the availability of competing foreign models (SEC 2005e).
6 See the SEC “roadmap” for accepting IFRS for foreign companies by 2009 (SEC 2005d). The details of the roadmap were oddly released in the form of a forthcoming law review article by the SEC’s Chief Accountant. See Nicolaisen (2005).
8 Article 15 of the Directive contains rules on advertising. Article 15(1) originally provided (Art. 13(1) of the May 2001 proposal): “Advertisements, notices, posters shall be communicated in advance to the competent authority of the home member state which shall check them before publication against the principles contained in this Article [that advertisements be fair, accurate and consistent with that contained in the prospectus]. The documents shall state that a prospectus will be published and indicate where investors will be able to obtain it.” The requirement for presubmission has now been dropped; however, a competent authority must have the power to monitor such advertising.
9 Scott proposed removing existing U.S. restrictions on offshore offerings if such offerings met minimum disclosure requirements. See Scott (2000).
10 For a similar proposal, see Romano (1998) and Romano (2001).
11 For a similar proposal, see Romano (1998) and Romano (2001).
14 58 Fed. Reg. 35367 (1993). This change was based, in part, on the result of a study of the effect of different accounting rules on the statement of income and equity between the U.S. GAAP and foreign GAAP of several countries including Canada. For Canada, the survey found that while the vast majority of registrants reported income variances of less than 10 percent from that obtained under GAAP, much larger variances did exist in some cases. SEC Division of Corporate Finance 1993.
15 “Under these rules, the degree of reliance to be placed on a non-U.S. system will be based on a “sliding scale” and will depend on the Board’s assessment of the independence and rigor of the non-U.S. oversight system. The more independent and rigorous the non-U.S. system, the higher the Board’s reliance on that system. Conversely, the less independent and rigorous, the lower Board’s reliance on that system” (McDonough 2005).
16 Shadow Financial Regulatory Committee 2004, recommending that the SEC accept IFRS in the U.S., as supplemented by U.S. GAAP where the SEC finds IFRS materially deficient.
17 Glaum and Street (2003) found that the average compliance level of companies with IAS or U.S. GAAP on the New Market was low, suggesting that German enforcement of non-German standards, either U.S. GAAP or IAS, was not high.
19 Sarbanes-Oxley does not require that the audit committee have any person with financial expertise but Section 407 does require that companies disclose why they have no financial expert on the committee, if they do not have such a person.
20 A comprehensive study before the enactment of Sarbanes-Oxley failed to find any significant correlation between board independence and firm performance (Bhagat and Black 2001). Gompers et al. (2003) found that firms with strong shareholder rights have future risk-adjusted stock returns that are 8.5 percent per year higher than those of firms with weak shareholder rights, but did not establish causality. The 2003 study also found that poorer corporate governance did not result in underperformance in operating returns, probably a better measure of governance impact. A later study, however, found that while more poorly governed (based on an index) companies have lower stock returns, these returns are not caused by poor governance since analysts predicted the lower returns in advance and that information about poor governance was impounded in advance into the stock price. It is conceivable that
bad businessmen both make poor decisions as to how to govern themselves and how to do business (Core et. al. 2004).

Concern today with the chain reaction of bank failures, caused by the failure of a foreign bank, should be significantly reduced as compared with earlier periods. One link in a possible chain is interbank credit, but bank regulators can place limits on such credit, as under Section 308 of the FDIC Improvement Act of 1991. The chain-reaction risk arising from bilateral credit exposures from overnight fed funds transactions in the U.S. are quite low—losses would not exceed one percent of total commercial banking assets when loss rates are kept to historically observed levels. A chain reaction of bank failures can also occur through payment system linkage (Furfine 2003). If one bank fails to settle its position in an end-of-day net settlement system for large value payments, other banks that do not get paid may in turn fail. Many countries have replaced net settlement with gross settlement payment systems, like Fedwire, to avoid this problem. In the U.S., there is still a net settlement alternative, the Clearing House Interbank Payments System (CHIPS), but its new continuous settlement procedures have all but eliminated the chain reaction problem. Finally, a chain reaction could occur through imitative runs, depositors withdraw their funds from their own banks because another bank has failed. However, depositors in domestic banks are unlikely to assume that their own banks would fail just because a foreign bank has failed (they are too different). In any event, the Fed stands ready as lender of last resort, at least to domestic banks, to cure such irrational runs.

See also Acharya (2003).

These principles were further elaborated in Basel Committee on Banking Supervision 1999.

See also Gros (2003).

See International Monetary Fund (2000) and International Monetary Fund Financial Sector Assessment Program (FSAP) (2000).


Case 120/78, 1979 E.C.R. 649.

Case C-442/02, Judgment of the Court, October 5, 2004.


This is the current system in Japan.


One other way the U.S. protects itself from the failure of a foreign bank is by limiting a foreign bank’s daylight overdraft capacity on Fedwire. Whereas U.S. banks’ daylight overdraft capacity is a multiple of their entire worldwide capital, the capacity for foreign banks is limited to a fraction of their worldwide capital, at most 35 percent. Board of the Governors of the Federal Reserve System, Policy Statement, 66 Fed. Reg. 64419 (December 13, 2001).


For a recent defense of ring-fencing, see Baxter, Hansen, and Sommer (2004). Thomas Baxter, Jr. is the general counsel of the New York Federal Reserve Bank.


Of course, one should not automatically assume that local courts would protect local assets from seizure where a foreign judgment was being enforced. This would depend on whether the laws of the debtor’s country shielded the sovereign from such enforcement actions and whether local courts would, in fact, respect such laws in the face of sovereign pressure.

Export receipts or import payments in connection with trade by the sovereign could be attachable, and the sovereign could lose access to short-term trade financing (Bratton and Gulati 2003).

28 U.S.C. §1611(b)(1). This immunity can be waived but only with respect to post-judgment attachment (attachments in aid of execution). This allows the debtor to withdraw assets from the U.S. once litigation is brought. Another useful addition to creditor rights would be to allow waiver of pre-judgment attachments.
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