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TRADE IN FINANCIAL SERVICES

Note by the Secretariat

This note presents some factual background information which may be relevant for the examination by the Group of Negotiations on Services of the implications and applicability of concepts, principles and rules in the financial services sector. In particular, the note focuses on the two main components of the financial services sector:

The analysis contained in the note consists in both cases of four main parts: firstly, a description of the activities comprising banking and securities-related services as well as insurance services; secondly, a description of the ways in which trade in these services may occur; thirdly, an overview of the rationales, nature and possible effects of regulatory regimes governing their provision; and finally, some considerations relating to the application of the concepts, principles and rules contained in document MTN.TNC/11.

The note is followed by three Annexes which contain statistical information of relevance to the sectors under consideration (Annex I), and describe the main features of some existing international arrangements and disciplines relating to the provision of financial services (Annexes II and III).

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I. TRADE IN BANKING AND SECURITIES-RELATED SERVICES

A. Introduction

1. Financial institutions and markets around the world have undergone profound changes in recent years. Reforms have been undertaken in international as well as domestic financial markets and have resulted in increases both in cross-border financial flows and in foreign participation in domestic markets. An added result has been the intensification of competition in financial markets: domestically, between institutions that previously operated in segmented markets and between foreign and domestic financial institutions; internationally, between countries, as money and capital markets have become increasingly integrated.

2. Trade in financial services has expanded rapidly over the past decade. Between 1978 and 1988, for example, net international bank lending exhibited an average yearly growth rate of some 15.0 per cent, a rate far in excess of the 8.5 per cent observed for the volume of world trade.[1] This trend was most pronounced in respect of developed market economies, international bank lending and net issues of international bonds having grown two and a half times faster than GNP during the period.

3. The growing importance of international finance is reflected in the proliferation of financial activities taking place in the markets of both developed and developing countries as well as in the rise in the share of foreign loans - and of purchases of foreign securities - in the transactions of banks. The greater participation of foreign financial institutions has, moreover, been evident in most major markets, the ratio of the assets of foreign financial institutions to the assets of all financial institutions having risen significantly in many countries.

4. Marked progress in the integration of world financial markets and in the internationalization of finance can be attributed to a number of factors. These include: (i) a simultaneous process of domestic financial deregulation/re-regulation and international liberalization, including the growth of new entrants - domestic and foreign - and increased authority for financial institutions to carry out a broader range of activities (this has been tempered, however, by growing concerns over the need for converging

[1]The process of internationalization of the markets for financial services - hence of the expansion of international trade in the sector - can be illustrated in various ways depending on the focus of analysis. One frequently used indicator in this regard is net international bank lending which, however, cannot be used even as a proxy because of its coverage which is rather limited as compared with the multitude of activities and services that make up the totality of financial service markets. Conceptually, international trade in financial services should be measured on a value-added basis; this is, however, not possible at present in view of a lack of adequate statistics.

standards of prudential supervision (see Annex III)); (ii) the multinationalization of business activities and of financial intermediaries; (iii) the need to finance large world payments imbalances; (iv) financial innovation (such as the development of complex hedging techniques as well as the increasing securitization of financial instruments), itself a by-product of interest- and exchange-rate volatility; (v) rapid advances in telecommunications and information technologies, allowing financial innovation to be implemented rapidly and facilitating the transmission of asset price movements across markets and countries; and (vi) a progressive liberalization of exchange and capital controls in developed and developing countries alike.

5. As there has been a gradual erosion in some of the obstacles faced by financial institutions operating at the international level, attention has in recent years focused on the potential impediments stemming from the implementation of government policies and regulatory regimes. This has come at a time when the incentives for expansion by financial institutions into foreign markets - particularly in developed countries but also in some developing countries - have also been growing. This process has heightened interest in how national policies affect both the direction and magnitude of trade in financial services.

B. Activities in the provision of banking and securities-related services

6. Banking and securities-related services represent a sector of economic activity that has become, in the light of differences in the pace of the changes earlier described, multi-faceted, highly complex and subject to regulatory treatment which varies significantly across countries. The markets for these services consist of a large number of sub-markets or groupings of sub-markets, each of which may differ in terms of the characteristics of the financial instrument being provided, the competitive structure prevailing in given markets, the conditions governing market access, the number of market participants, etc.

7. Given the constantly evolving nature of the sector, attempting to classify banking and securities-related services into discrete, separately identifiable, categories of trade is a difficult task. The various activities performed by firms engaged in the provision of such services may, nonetheless, be broken down into the following five categories[2]: (i) retail banking services; (ii) wholesale banking services; (iii) securities-related services; (iv) inter-bank services; and (v) international financial services.

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[2]The functional categorization contained in this note differs - albeit not in coverage - from that contained in MTN.GNS/W/50 under the heading of financial services. The current categories were chosen with a view to facilitating both the description of activities comprising banking and securities-related services and the relevant regulatory considerations governing their provision.

(i) Retail banking services

8. Retail banking comprises services such as the supply of saving instruments as well as the intermediation of financial savings and related securities business, the supply of consumer loans and housing finance, payments services and a wide range of advisory services. It has become a central element within the financial services industry of most countries and plays a key role in the mobilization of financial resources. Traditionally amongst the most heavily regulated services provided by banks, retail banking has emerged, in the wake of the worldwide trend towards financial market deregulation, as a major element in the expansion strategies of many banks. Product competition in retail banking has become particularly intense in developed and higher income developing countries, as increasingly large pools of household savings have attracted a widening range of competitors - domestic and foreign - from within and outside the banking system: commercial banks, savings banks, building societies, credit co-operatives and credit unions, trust and mortgage companies, finance companies, life-insurance companies and pension funds, collective investment funds as well as a wide range of issuers of securities, including governments. As well, in the distribution of retail banking services, department stores and other retailers have become significant competitors of banks and other retail banking institutions, particularly in regard to the supply of consumer credit.

(ii) Wholesale banking services

9. The markets for wholesale banking services are highly competitive as corporations generally enjoy greater flexibility than private households in the choice of their banking operations. The recent years have witnessed an increasing demand for sophisticated asset and liability management services, the provision of which has led to a significant degree of financial innovation making increased use of computer and information technologies. In providing wholesale banking services, banks have increasingly faced competition from large corporations setting up their own financial management operations. The market for corporate financial services has also seen banks provide an increasing array of investment banking services involving the financial and organizational restructuring of firms, mergers and acquisitions, management buy-outs, as well as general advisory and information services for enterprise management. Significant resources have also been expended in developed and developing countries alike towards developing markets for risk capital for small- and medium-sized enterprises. This has generally involved both the creation of venture capital funds and the introduction of new segments in the organized securities markets making it possible for smaller firms to raise risk capital in the "first" or "listed" segment of the equity market.

(iii) Securities-related services

10. The market for securities-related financial services comprises activities such as the new issuing business, brokerage services, securities trading, portfolio management, investment advisory and information services, market research services as well as services linked to the development of new financial products. It has become, in recent years, the

most dynamic segment within financial services markets, prompted by the general trend towards the securitization of financial market activity resulting from the combined effects of financial innovation and the increasing integration of money and securities markets. A growing number of banks, including subsidiaries of banks which in their home countries are prevented through regulation from conducting any or the full range of securities-related activities, have in recent years developed their securities departments at a rapid pace and have, in competition with specialized securities firms, expanded their presence in foreign securities markets, most notably in the major international financial centres. Several developing countries have recently taken steps towards establishing and invigorating domestic equity markets. Such markets now exist in more than forty developing countries. Moreover, as Table 3 in Annex 1 reveals, the market capitalization of stock exchanges (i.e. the total value of listed shares) in some developing countries represents a greater proportion of GNP than in some developed countries. It remains true, nonetheless, that equity markets in most developing countries are small and still at an early stage of development.

(iv) Inter-bank services

11. The market for inter-bank financial services comprises activities which are crucial to the efficient functioning and interaction of national financial systems. These include inter-bank deposit and other money-market transactions, payment services, foreign exchange and securities trading and brokerage services, the development and operation of the technological infrastructure of financial markets such as clearing and settlement systems, as well as a host of information services. The internationalization of banking and finance has greatly expanded the scope for the provision of inter-bank services and has given rise to co-operative efforts in the development of the hardware which underpins the interaction of national financial systems. It has also led to efforts on the part of the regulatory and supervisory communities to develop, formulate and harmonize the conditions governing the provision of - and access to - inter-bank services.

(v) International financial services

12. The quickening pace of internationalization in banking and securities-related activities has led to the rapid growth of the market for international financial services. These services include traditional activities such as import and export financing, foreign exchange trading as well currency and bond operations in the euro-markets. Starting in the early eighties, and owing in part to the exposure of the major banks to country and liquidity risk as a result of direct lending to a number of countries in payment difficulties, there has been a marked shift toward securities-related activities, in particular the underwriting of international bond issues and brokerage services in connection with cross-border transactions in domestic securities. In addition, there has been a vigorous growth for some banks of new forms of off-balance-sheet activities, especially in respect of the international issuing of various money-market and hedging instruments (note issuance facilities, currency

and interest-rate swaps, options and futures, etc.) These developments have taken place mainly in the financial markets of developed countries but also in some emerging developing country markets.

C. Trade in banking and securities-related services

13. International trade in banking and securities-related services covers two aspects of the internationalization of finance. The first is cross-border trade in financial services, such as borrowing and depositing across national boundaries. International trade in goods and non-financial services is necessarily accompanied by cross-border financial flows which increase the need for - and scope of - the exchange of financial services. The latter exchanges also include activities not directly related to trade in goods and non-financial services, namely international trade in securities and the financing of current account imbalances. In balance-of-payments terms, cross-border trade in banking and securities-related services may be defined (excluding capital flows) as payments between residents of a given country and non-residents comprising both interest paid and received as well as fees and commissions for financial services paid and received.[3]

14. A second aspect of financial internationalization relates to establishment. Banking and securities-related services represent a sector in which this form of trade - i.e. that involving the provision of services through an entity established in the country of a client - is of particular importance for it is often imperative for a financial service firm to have a presence physically close to its client base in order to do business effectively. While a certain number of activities can be carried out through correspondent relationships or in pure cross-border fashion (in particular, activities relating to the provision of wholesale, inter-bank and international financial services), and while developments in computer and information technologies may progressively widen the scope for cross-border trade in financial services (examples include the advent of automatic teller machines, automated trading in foreign exchange and money market instruments as well as automated real-time information services on financial market developments), the increasingly sophisticated nature of financial markets, products and client needs has in many ways enhanced the importance of reliable direct relationships between users and providers of financial services. Establishment and/or commercial presence - in the form of either a representative office, a branch, a locally-incorporated subsidiary or a joint-venture - are various means through which such relationships can both be made and maintained. Establishment-related trade in banking and securities services may be defined as financial services produced by factors of production whose ownership resides in one country and sold to residents of another through some form of direct presence of the supplier in the client's country.

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[3] See Annex II for a description of the liberalization undertakings which have been negotiated among OECD Member countries covering capital movements and financial services.

15. The scope for the movement of factors of production may vary depending on the type of financial service and the way in which it may be supplied. The degree of factor movement will, on the one hand, tend to be fairly limited in the case of cross-border financial service transactions, such as the sale or purchase of some foreign securities or the provision of various international financial services. Although the latter are increasingly transacted through telematic means, their exchange nonetheless embodies a high degree of skilled labour and technological know-how. At the same time, cross-border financial flows may be facilitated by the temporary presence in the capital importing country of home country personnel using representative offices.[4] Establishment-related trade in banking and securities services, on the other hand, cannot usually take place in the absence of the cross-border movement of personnel (particularly in managerial positions but also in accounting, marketing and informatics), capital and the increasingly sophisticated technological know-how with which financial innovation may be diffused and competitive abilities maintained and enhanced.

D. <u>The regulation of banking and securities-related services</u>

16. Banking and securities-related services rank among the most heavily regulated sectors of economic activity. While regulatory regimes governing the provision of such services differ markedly across countries, considerable importance is attached by government authorities to the regulation and prudential supervision of financial institutions and markets. This is so because banks and other financial institutions perform macroeconomic functions which are essential to the stability and performance of national economies. Banks hold an important part of the money supply, create money, are the main means of implementing monetary policy, administer the payments system, and intermediate between savings and investment. To ensure that the financial system will be able to accomplish desired monetary and economic objectives, governments establish regulations concerning its institutional structure, the conditions governing competition as well as the elements of prudential management, the latter seeking to minimize risk and reduce the welfare costs of bank failures while protecting market participants (both investors and other users of the financial system). In addition, governments regulate the activities of financial institutions with a view to limiting the moral hazard costs which may be associated with the operation of safety nets.

17. Countries apply regulations to a range of specific aspects of banking and securities-related services, among which: (i) the size and structure of the sector (conditions of entry, branching, acquisition and/or

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[4]The range of activities which foreign financial institutions are allowed to conduct through representative offices is typically quite small, covering activities such as liaison and advisory services, the servicing of home country customers as well as the generation of business for a financial institution's parent company.

participation); (ii) the permissible scope of business activities[5]; (iii) the concentration of risks; (iv) liquidity requirements; (v) capital adequacy requirements; and (vi) financial disclosure requirements.

18. The extensive degree of supervision, regulation and prudential control applied to banking and securities-related services has important implications for the nature and degree of competition in financial markets, both nationally and internationally. While regulatory regimes are typically framed with a view to enhancing market conditions and pursuing legitimate national economic and developmental objectives, they may in practice restrict or discourage the supply of financial services; sometimes without regard for the nationality of the financial institution providing the service, quite often by discriminating against foreign suppliers, either directly or indirectly.

19. Measures affecting the international delivery of banking and securities-related services may be seen as answering to two broad characteristics: on the one hand, those that are quota-like in effect, restricting access to all or certain market segments; on the other, those whose effects are tariff-like, making market access more costly than it otherwise would be. These measures, moreover, can be grouped into four broad categories: (i) those affecting cross-border transactions; (ii) those relating to establishment; (iii) those relating to operating conditions and competition in markets; and (iv) those not primarily related to banking and securities-related services.

(i) <u>Measures affecting cross-border transactions</u>

20. Many countries place restrictions on the ability of their residents or firms to hold deposits at - or borrow from - foreign-based banks. The most common form of restriction consists of controls affecting foreign exchange transactions and other capital flows (inflows and/or outflows). Although primarily guided by balance-of-payments concerns and generally not intended to discriminate against foreign-based financial institutions, restrictions of this type tend in practice to apply in a discriminatory fashion. In addition, foreign institutions may encounter difficulties in supplying other financial services, such as the use of credit cards or portfolio management. Similar restrictions concern the marketing of foreign securities, which is sometimes prohibited, as is occasionally the purchase by foreigners of domestic securities. The former impediments may prove particularly onerous for foreign securities firms as they are likely to possess a comparative advantage in marketing and trading the securities of

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[5] In some countries, banking and securities-related services may not be supplied by the same institution - owing to concerns over possible conflicts of interest and the perceived greater riskiness of trading securities - whereas the underwriting and trading of securities are viewed, in countries operating universal banking systems, as extensions of traditional commercial banking.

home-country corporations or public entities with which they may have long-standing relationships. Controls on the foreign acquisition of equities typically aim at limiting foreign ownership and/or the control of domestic firms. Many countries have review procedures for monitoring acquisitions of equity in domestic corporations. These procedures usually contain a discretionary element which is sometimes argued - particularly in the financial field - to be applied more strictly to foreign interests than to domestic interests.

(ii) Measures relating to establishment

21. Restrictions of this type are the most commonly encountered as virtually all governments control to some extent the entry and establishment of foreign banks and securities firms. In some countries, there is prohibition of any foreign financial presence, particularly when the domestic financial system is nationalized. More common, however, are restrictions on the extent of foreign presence and on the form of establishment permitted. Foreign financial institutions are generally free to establish a representative office or a correspondent relationship with a local institution. However, some countries forbid or require special authorization for foreigners to establish subsidiaries or to hold an interest in a domestic financial institution. More common still is the prohibition of branches of foreign firms which - unlike subsidiaries - are not locally incorporated.

22. Conditions of foreign entry are also affected by differences among national financial systems, in particular those between countries operating universal banking systems and those with segmented financial markets. The former may take reciprocity into consideration when granting entry to non-residents, particularly with a view to securing for home country institutions access to a broader range of activities in countries with segmented financial markets. In the securities field, for example, many countries will allow foreign institutions to lead manage new issues of domestic currency securities only on a reciprocal basis, i.e. when similar opportunities are secured for domestic firms in the home country of the foreign applicant for a lead manager position.

23. Moreover, while establishment-related obstacles are not always explicitly discriminatory, they tend nonetheless to arise from administrative practices which in many countries lack an adequate degree of transparency.

(iii) Measures relating to operating conditions and competition in markets

24. Similar to establishment restrictions, operating constraints can seriously influence competition in domestic banking and securities markets, so that even if entry is possible, it is not certain that foreign competitors will benefit from equality of competitive opportunities. One common characteristic of these regulations is that they may place higher demands, usually of a financial nature (i.e. in a tariff-like manner) on foreign service providers, thereby making it potentially more difficult for

them to compete in the domestic market. Measures of this type may be applied with respect, inter alia, to minimum reserve requirements, capital-asset ratios, taxation[6] and disclosure requirements. Although different in nature to establishment restrictions, which may have the effect of restricting market entry totally, operating constraints may also aim - in quota-like fashion - at limiting the size of the domestic market available to foreign financial institutions.

25. As with establishment-related restrictions, recourse to operating constraints is more widespread in developing countries than in industrialized countries. Measures of this type may consist of restrictions placed on the kinds of services which can be offered, for instance, restricting foreign bank activities to trade financing and foreign exchange dealing; preventing the acceptance of certain types of deposits; restrictions on the types of customers which may be served, in particular individuals in the retail market or governments[7]; ceilings on the level of domestic deposit-taking or lending activities, interest rate ceilings, etc. Restrictions may also be placed on the use by foreign providers of certain facilities which form part of the financial infrastructure of an economy and on which banks and securities firms may depend to render certain services effectively: for instance, limiting access to central-bank rediscount facilities; prohibiting access to subsidized funds for export financing, limiting swap activities; restricting the scope for advertising, etc.

26. Conflicting national regulations, particularly those relating to prudential supervisory considerations and consumer protection, may also pose special problems for the foreign providers of some financial services, such as collective investments (mutual funds, unit trusts, investment trusts, etc.). Significant differences exist in national regulations concerning, for example, corporate structures for the provision of such services, reporting requirements, asset diversification requirements, etc., the combined effect of which may prove more burdensome to foreign providers.

(iv) Measures not primarily related to banking and financial services

27. Some measures which are not aimed specifically at the banking and securities services sector may nonetheless represent a handicap to foreign financial institutions. These include limits on the repatriation of

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[6]Governments, for example, may not require nationalized banks to pay out dividends.

[7]An example in the securities field consists of limitations placed on the ability of foreign firms to solicit secondary market business from individual or institutional investors. In the banking sector, regulations may stipulate that only domestically-owned banks may handle government or public-sector business, thereby assuring national banks of potentially large volumes of low-cost deposits.

interest (and commissions/charges), profits and dividends which, combined with exchange controls, may affect those banking activities involving international transactions on which foreign branches of banks and securities firms tend to concentrate. Regulations affecting the employment of foreign personnel - i.e. immigration controls, the granting of work permits, the recognition of professional qualifications, etc. - may also be categorized under this heading. Issues relating to transborder data flows, such as local data processing requirements, import restrictions on computer hardware/software, restrictions on access to foreign data bases as well as regulations affecting attachment to domestic telecommunication networks, may also present difficulties for banks and other financial institutions engaged in international activities.

E. Considerations relating to the application of concepts and principles

(a) Transparency

28. The pervasive and complex nature of regulations applying in banking and securities-related services, and the potential scope for administrative discretion in their application, suggest that transparency may be of considerable importance in promoting progressive liberalization in the sector. Although information on rules and regulations governing access by foreign-based firms to national financial services markets exists in most countries, it appears that in some cases there has been no systematic collection, translation, classification and dissemination of such information at the international level. Consideration could be given to the possibility on the part of governments to provide, through national enquiry points, information to foreign enterprises concerning requirements and procedures for establishment as well as other measures affecting operating conditions and competition. Consideration might be also given in respect of transparency to the possible establishment of notification procedures concerning those measures which possible obligations under an agreement might require changes to. Modifications to existing regulations and administrative practices, as well as the introduction of new ones, might also need to be notified on a continuing basis.

(b) Progressive liberalization

29. Banking and securities-related services are sectors of economic activity in which a significant degree of deregulation and liberalization has in recent years been progressively achieved - both domestically and internationally - in developed and developing countries alike. In many countries, interest rates have either been fully liberalized or are now managed more flexibly than before. Competition among financial institutions has been promoted by opening domestic markets to foreign banks and securities firms and by licensing new domestic banks and non-bank financial intermediaries. In particular, several countries, among which many developing countries, have attempted to broaden and deepen their money and capital markets by creating intermediaries such as leasing companies and contractual savings institutions. Similarly, many countries have curtailed their directed credit programmes. As well, several

centrally-planned economies have announced - or have begun to implement - plans to stimulate competition and promote economy-wide efficiencies by extensively restructuring their financial systems.

30. An important consideration in respect of the recent trend toward financial market reform in developing countries is that, with few exceptions, such reforms have been undertaken in periods of economic stress and as part of stabilization and structural adjustment efforts. This might suggest that the scope for progressively liberalized trade in banking and securities-related services is uneven among countries and will likely be conditioned by the ability of individual countries to restore overall macro-economic stability. Progressivity may therefore prove to be a central element of the liberalization process in view of the difficulties which some developing countries might initially face in liberalizing their financial markets as extensively as some industrialized countries. More generally, countries which start from a position in which financial institutions have been shielded from competition for many years may need a longer period for adapting their financial systems to a competitive environment than countries in which market forces have played a prominent role for quite some time.

31. As a means of promoting liberalization, progressivity could be applied to measures affecting specific banking and securities-related services or to particular forms of trade. For instance, some countries might wish to encourage the complementarity which often exists between domestic and foreign banks, drawing for example on the expertise of foreign institutions in wholesale banking or securities trading before liberalizing, at a later stage, the provision of retail banking activities. Similarly, signatories might wish to give consideration initially to liberalizing the provision of cross-border financial services before applying framework principles and rules to activities involving establishment. Some countries, in addition, might prefer to adopt a gradual approach in dismantling exchange controls, given that such actions often need to proceed in parallel with structural adjustment efforts whose aim may also be to deepen and strengthen domestic financial institutions and markets.

(c) National treatment

32. Under national treatment, locally-operating foreign-owned banks and securities firms would be accorded treatment no less favourable than that given to domestic institutions with respect to laws, regulations and administrative practices affecting their operating conditions in like circumstances. In this respect, the question arises of how equality of competitive opportunities between foreign and domestic institutions can be assured given the heterogeneity of national regulatory regimes. Such a question typically arises when financial institutions which have developed in one regulatory environment gain access to markets operating under different regulatory regimes. For instance, the application of national treatment by countries having an institutional separation of banking and securities activities tends to be viewed as an obstacle by institutions from universal banking countries and other countries which do not maintain

such a separation. As with market access, therefore, national treatment may not be altogether unrelated to considerations of bilateral or plurilateral reciprocity.

(d) Most-favoured-nation treatment/non-discrimination

33. A non-discrimination commitment vis-à-vis all parties to an agreement would allow foreign suppliers to benefit equally from existing conditions of trade in banking and securities-related services as well as from any liberalization undertaken in the future. As a means to achieving non-discrimination, the granting of unconditional most-favoured-nation treatment would preclude the application of reciprocity in the treatment of foreign-based banks and securities firms. By giving rise to regulatory asymmetries, differences in the pace of domestic financial market liberalization across countries have prompted some countries to seek reciprocal arrangements in the sector.

34. Questions of reciprocity have recently arisen in the context of regional integration efforts. In particular, the issues of reciprocal market access and of the degree of market access afforded by the application of national treatment have arisen at the point where regional liberalization is complemented by the development of a common policy toward third countries.

35. While recourse to reciprocal arrangements may appear attractive in the face of widely varying regulatory regimes and as a possible means of stimulating faster liberalization by partner countries, its pursuit in a multilateral context would oblige signatories to apply different policy stances vis-à-vis each trading partner. It might, in addition, run the risk of retaliation and delay liberalization and its associated efficiencies in a global market context.

(e) Market access

36. Virtually all impediments to market access in banking and securities-related services take the form of restrictions on entry and operations. Improved market access would enable foreign financial institutions to supply services in a given market either directly from abroad or through a local presence. This could refer both to access to activities (through licensing or authorization) as well as to the exercise of activities (through operating conditions).

37. The meaning of market access may well differ depending on the way in which trade takes place in this sector. Rapid technological change in telecommunications and data-processing, for example, has vastly expanded the scope for cross-border financial transactions. In cases where foreign firms must be established - either because of preferred mode of delivery considerations or because governments require it - in order to service markets under conditions equivalent to those applying to domestic firms, it may be necessary for the concept of market access to encompass certain aspects of establishment and/or of commercial presence as well as freedom in choosing the form of establishment.

38. The option of non-establishment could also be envisaged in circumstances where domestic regulations discriminate against the cross-border servicing of financial markets by requiring establishment. In addition, market access considerations may relate to access to national distribution and advertising systems, as well as to domestic telecommunications and payments networks.

(f) Increasing participation of developing countries

39. The internationalization of banking and securities-related services has important implications for developing countries, both as hosts and providers of international financial operations. Many developing countries have been active participants in the changing international financial landscape. Forty-one banks headquartered in developing countries ranked among the top 300 banks in the world in 1987, up from twenty-two at the end of 1975. The active participation of developing countries in international banking and securities transactions has also been reflected in the proliferation of offshore centres based in developing countries and the significant share of euro-market activity conducted in them. Participation in international credit and capital markets has provided some developing countries with opportunities for meeting growing requirements for external resources, resulted in the transfers of managerial skills and technological know-how, allowed for an improved management of external assets and liabilities and enlarged the scope for export possibilities in the field of financial services.

40. The participation of developing country institutions in the world market for financial services has, however, been highly uneven across countries and has generally involved the branches and subsidiaries of banks and (to a lesser extent) securities firms of a relatively small number of (mostly newly-industrialized) developing countries. The financial systems of most other developing countries remain on the whole small and undeveloped, with international operations typically confined to the financing of countries' foreign trade. In addition, financial institutions in many developing countries - including those countries whose financial institutions have been most active internationally - have recently experienced significant liquidity and solvency problems. The latter considerations may suggest that in seeking to enhance the international competitiveness of their financial systems, developing countries may face a highly differentiated set of issues and needs. In turn, this may suggest that the scope for - and the modalities of - increasing their participation in world financial markets may differ markedly across countries.

41. Policies designed to strengthen the international competitiveness of national financial systems may comprise more general measures aimed at improving overall macro-economic performance as well as more specific measures aimed at promoting international financial service activities in domestic markets. Measures which countries can pursue - to varying degrees and in different combinations depending on national contexts and priorities - may aim, inter alia, at attracting new market participants, domestic and foreign; increasing the range of financial instruments and services in response to the changing needs of internationally active firms; developing an efficient technological infrastructure (telecommunications and payments networks; information, trading, clearing, settlement and depository systems, etc.); developing human resources for managing

increasingly complex financial techniques and operations; strengthening domestic systems of prudential regulation and supervision; and integrating domestic and international markets through strengthened linkages at the levels of market organization and supervision.

(g) Exceptions and safeguards

42. Banks and other financial intermediaries play a central role in fostering and orienting national economic development. Given the crucial fiduciary responsibilities which they assume, and in view of the negative externalities which can accompany financial failures and crises, it may be felt that the pursuit of certain national policy objectives could warrant specific exceptions in the sector. Exceptions might also be envisaged for reasons of national security, which might appear endangered were confidence in a country's banking system to weaken sharply or a country's financial system (or important segments within it) to come under foreign control. Economic development objectives could also be accommodated, as countries might wish to promote the development of indigenous financial capabilities or engage first in a process of domestic liberalization before progressively opening up domestic financial markets to foreign competitors.

43. With respect to possible safeguard provisions, one justification might relate to balance of payments concerns. It may be noted that payment for the services provided by foreign financial intermediaries is not generally a significant source of balance of payments disequilibrium; difficulties rather arise from the capital movements which these services permit. Financial liberalization may, nonetheless, generate indirect effects on a country's balance of payments, particularly since the speed of adjustment in the capital market is typically faster than in the goods market.[8] A second possible justification for safeguard action might relate, as in goods trade, to the economic difficulties caused by the inability of domestic financial institutions to meet foreign competition effectively as a result of liberalization. In instances where possible commitments under an agreement might require some degree of restructuring of domestic financial intermediaries, safeguards may be warranted so as to ensure that the process of progressive liberalization does not translate into excessive disintermediation by potentially higher-cost local banks and securities firms.

(h) Regulatory situation

44. There is wide agreement over the sovereign right of governments to regulate their financial markets with a view to attaining legitimate national objectives and priorities. Indeed, a degree of regulatory and prudential control can be considered as a necessary precondition for promoting the overall efficiency (i.e. in national welfare terms) of financial markets. Given, however, that a majority of impediments to trade in banking and securities-related services stem from the application of

[8]For instance, the liberalization of interest rates may result in capital inflows and in the appreciation of a country's exchange rate, with potentially important implications for the overall process of trade liberalization.

national regulations, parties to an agreement might give consideration to the development of procedures and/or criteria for assessing whether and how national regulations affect the ability of banks and securities firms to do business abroad.

45. Two issues might emerge in this context: first, the avoidance of regulations that are more onerous than underlying concerns warrant, and second, the avoidance of discrimination where alternative non-discriminatory but still effective approaches are available. These may not be easy issues to address, particularly as regulations may primarily be intended to implement national monetary and macro-economic policies, maintain stability and confidence in the financial system and protect the interests of consumers, objectives whose legitimate pursuit the Montreal text reaffirmed.

46. As developments in financial markets have shown in recent years, financial regulations - particularly those relating to prudential supervisory considerations - may need to be made stronger in the context of liberalization. The process of gradually opening up the provision of financial services to foreign competition may indeed involve as much re-regulation as deregulation. Significant differences persist among countries as concerns the degree of development of national regulatory regimes, these being most pronounced in respect of developing countries. As foreseen in MTN.TNC/11, the latter countries may need, in the context of progressive liberalization, to devote significant resources to enhancing domestic regulatory regimes and developing better systems of prudential supervision.

II. TRADE IN INSURANCE SERVICES

A. Introduction

47. The primary purpose of insurance is to cover the risk of uncertain losses by providing individuals and organizations with financial protection through the collection of a payment (premium). As this requires the spreading of risks as widely as possible, there is a clear international dimension to the insurance industry. This applies in particular to international transport insurance and reinsurance in which the original insurer lays off part of its liability by reinsuring elsewhere thereby diversifying the risk portfolio. Very large risks may also be covered through joint participation by a number of companies where a major disaster (e.g. aircraft or nuclear power plants) could bankrupt a single insurer. The underlying principle of non-life insurance is the mutualization of risks transferred by a wide range of insured persons or institutions. In life insurance, the principal functions are the cover of life risks and the management and investment of savings. The latter function has grown significantly in importance with the development in recent years of new savings instruments by insurance companies.

48. Insurance enterprises engage in international business by establishing or acquiring affiliates, by selling policies across borders notably through authorized agents among domestic insurers in the foreign market, or by entering the reinsurance market. Due to the fact that foreign established firms play a significant role in international insurance transactions, this note will cover a broad definition of trade in insurance services which includes both international sales by non-established insurers and establishment-related business.

49. As with banking and securities, the insurance sector is subject to varied and stringent regulation. Two broad arguments are commonly used to support the large number of regulations found in the insurance sector, one concerning the need to protect consumers and the other relating to the wider significance of insurance in any economy, particularly as a source of investment funds. With a few exceptions, the provision of reinsurance services has been traditionally much less regulated, both in domestic and international markets, than that of direct insurance. As cross-border trade in insurance services is often excluded by regulation, most regulations concern services provided through establishment rather than a temporary presence, determining both whether a foreign insurer is admitted to market its services and the terms on which it may carry out its business.

50. The ratio of premium expenditure to gross national product is the measure which is commonly used to evaluate the size of national insurance markets. The ratios vary from under 1 per cent in many developing countries to over 8 per cent in some large industrial economies. Whereas in 1987 the United States accounted for 46 per cent of total world non-life premiums and 30 per cent of life insurance premiums, the premium income of developing countries together was around 5 per cent for each category.

There are large differences between national insurance markets in terms of structure and competition. The markets of most industrialized countries are made up of considerable numbers of domestic and foreign enterprises, although the main business segments tend to be dominated by a relatively small number of larger domestic competitors. In a number of developing countries, however, there are state-owned insurance monopolies and in others foreign and foreign-owned enterprises are excluded from the domestic market or are allowed only in the form of locally incorporated subsidiaries with substantial local shareholdings.

B. <u>Activities in the provision of insurance services</u>

51. In examining trade in insurance services it might be helpful to differentiate between four different sectors of the international insurance industry.

(a) Reinsurance and international transport or cargo insurance are the most inherently international parts of the insurance industry. Reinsurance is the transfer of risk from one insurance company to another and fulfils two main purposes: to spread individual risks that are too big for direct insurers to underwrite (e.g. a satellite launch) and to allow smaller companies to accept more business than their capital could safely support in direct insurance. The need for risk-spreading through reinsurance is greater in non-life insurance than life insurance because of larger risk concentrations and hence the greater need for capital support. It is estimated that over 90 per cent of all reinsurance premiums worldwide (both within national markets and across borders) are related to non-life insurance business. Transport or cargo insurance is a necessary complement to transportation and is usually provided by the seller under the usual terms of trade. It is international in the sense that it relates to risks which change locations and thus require the capacity to make international transfers.

(b) A segment of the industry which is not as inherently international as reinsurance relates to the insurance purchased both at home and abroad by large business enterprises against liability, casualty and property risks. The development of "in-house" insurance activities, usually established by multinational corporations to cover their international risks, can lead to international insurance operations.

(c) General insurance which includes a wide variety of business in the industrial, commercial and personal sectors. The main categories include: fire, product liability, professional negligence, loss of profits, third party public risk, employers' liability, householder, house-owner, motor vehicle (personal injury and damage to vehicle and property), travel, sickness and accident. Much of this insurance is usually purchased locally from insurance companies that have established themselves in the national market subject to the applicable national regulations. Foreign enterprises are generally obliged to acquire local facilities in order to sell to this part of the market.

(d) Life insurance which is considered by many countries to be an important source of savings to be channelled into domestic investment projects. Life insurance comprises operations based on capitalization, including: survival or death insurance, permanent health insurance, annuities, supplementary insurance against special personal injury or sickness, capital redemption operations, management of pension funds, etc.

52. A number of activities are involved in the insurance production process, from the payment of premiums to the receipt of benefits. These activities include the following: (i) underwriting which consists of selecting, categorizing and rating risks presented for insurance with large industrial and commercial risks and for which the services of actuaries, surveyors or other specialists are required; (ii) loss appraisal and claims adjustment to verify and settle all claims made (as this is the largest cost item, expert claims handling is a key element in effective cost control); (iii) financial and investment management to maximize the investment return generated by an insurance company on the funds it holds; (iv) reinsurance which may, in the case of proportional reinsurance, take the form of "quota shares" (where the reinsurer agrees to pay a fixed proportion of any loss), or "excess of loss" (where the reinsurer agrees to pay losses over a fixed limit and up to a certain amount); (v) pre- and post-sales servicing to enable consumers to select the mix of insurance products best fulfilling their needs; the character of the service, including other related services such as risk management, consulting, loss prevention and detailed client and market research usually necessitate local representation.

C. <u>Forms of trade in insurance services</u>

53. International trade in insurance occurs both through cross-border movements of insurance services (where there is no requirement to establish or to maintain funds in the importing country), as well as through cross-border movements of production factors such as that involved in the establishment by insurance enterprises of production and marketing outlets in foreign markets. More specifically,

(a) Insurance sold directly from abroad, apart from that involving international transportation, generally relates to large or accumulated risks which cannot be placed locally, to reinsurance, or to the worldwide insurance of multinational businesses operating abroad. In such cases, the number of actors on either side of the market tends to be sufficiently small that prospective insurers have limited need for a continuing foreign presence. Professionals may be sent abroad to analyse risks and establish contract terms which enter the balance of payments under the item "travel". When claims arise, the insurer may choose to have them examined and validated by a local claims agent or may send an employee from its home office to the site. Thus, the volume of international trade in insurance services is determined to some extent by the corporate practices of the companies involved. Cross-border trade is

mainly limited to non-life insurance business which has increasingly taken the form of reinsurance. It has been estimated that overall cross-border trade accounts for around 4 per cent of total global non-life premiums.

(b) Other than for reinsurance, some form of foreign presence through branches, agencies or subsidiaries is often necessary for firms to be able to market most kinds of insurance policy on a significant scale. Frequently, such a situation derives from government regulations which prohibit firms from canvassing and selling policies to residents from a base abroad. Typically, government regulations specify the minimum capital the foreign insurer must hold within the country's borders in order to enjoy some form of local presence in that market. The type of foreign commercial presence can vary depending on the nature of establishment chosen or permitted. Account may also be taken of the fact that a branch can relate its risks to the parent company's reserves rather than maintain a separate solvency margin in the importing country. On the other hand, subsidiaries which are incorporated under local laws and may have domestic majority ownership may be preferred by licensing authorities for reasons relating to security and/or the development of local industry. Even though foreign insurers may be wholly excluded from a market, the market share of foreign insurance firms established in certain economies may vary widely, in a few cases reaching over 50 per cent in some segments of the market. Overall, however, it has been estimated that the market shares of foreign insurers with local presence are relatively limited, averaging 9 per cent of total world non-life insurance premiums and 4 per cent of total world life insurance premiums.

D. Motivations for government regulation of the insurance services sector

54. There are two broad arguments used to justify regulation in the insurance sector, one concerning the need for consumer protection and the other relating t the broader importance of the role of insurance in national economies, particularly as a source of investment funds.

55. Regarding protection of the consumer, the fiduciary argument is similar to that existing in the banking and securities sector. It is widely accepted as particularly important in the undertaking of business for insurance firms to provide sufficient guarantees of their solvency and business integrity. Thus regulations in the insurance sector generally stipulate that licences be granted only to insurance companies which conform to financial requirements intended to ensure their solvency. The underlying rationale is that consumers should not be expected to make accurate judgements about the financial viability of companies serving them in a market as complex as insurance. In addition to ensuring the solvency of insurers, the supervisory role of governments may comprise aspects such as the suitability of owners and managers, reinsurance arrangements, permitted investments, marketing practices and the terms of insurance contracts. Concerning types of establishment, branches are usually less welcome than subsidiaries and are sometimes subject to special deposit requirements designed to protect policy holders.

56. Among the economic grounds for regulation in the insurance sector, a primary concern of governments is to seek to strengthen local capital markets by retaining the funds generated through insurance operations. In particular, life insurance, which can be one of the main sources for personal savings, can play a major role in deepening financial markets. The mobilization of capital by insurance companies is made possible as a result of the time lag existing between the collection of premiums and the settlement of claims which in effect permits the investment of insurance funds by these companies. In many countries, insurance companies are required to purchase government bonds or called upon to intervene as institutional investors, managing large volumes of assets, holding participations in other companies, buying equities in stock markets and also acting as major property owners. The value of the assets of the insurance industry is of key significance in both the industrialized and developing countries. For all these reasons, foreign firms might be required to invest a considerable share of their funds in the country where the premium originates. Another motivation for the regulation of insurance activities is the granting of support to other sectoral activities. It has also been noted (e.g. in related UNCTAD discussions) that insurance services can play an important role in sectors of special interest to countries with a lesser level of economic development. Agricultural insurance, for example, can exert significant indirect effects on the development of new farming techniques, the diversification of crops and/or the financing or rural activities.

57. Other economic motivations for regulation in this sector relate to a number of aspects including efforts to minimize the impact of insurance and reinsurance imports on the balance of payments and to stimulate the placement of international transport or cargo insurance with domestic insurers. Some countries justify regulations which may have trade restrictive effects by the need to develop or maintain domestic insurance industries against foreign competition in order to promote local employment and economic diversification. Finally, some governments may wish to maintain present market structures in order to avoid undue or excessive competition between insurance enterprises which could entail the insolvency of some insurers.

E. Regulations and measures affecting trade in insurance services

58. On the grounds of consumer protection and domestic control over the economy virtually all governments impose laws, regulations and practices which have restrictive effects on market entry and operation with regard to foreign insurers. Several such measures directly restrict the supply of foreign insurance services by means of local establishment or across national frontiers, or impede residents from purchasing their insurance abroad. Other measures and practices indirectly limit the foreign provision of insurance services by making it more onerous for foreign insurers to sell their services and more costly for nationals to buy them. Significant regulations and measures in this regard have been summarized as follows:

(a) Measures affecting cross-border trade

59. Many countries restrict or prohibit residents from placing any insurance contracts with non-established insurance companies - i.e., insurers not licensed to carry out insurance transactions within that country. This is particularly the case with compulsory insurance such as for motor vehicles which is generally purchased only from domestically authorized insurers. Several countries also stipulate that imports are locally insured and may give a national reinsurer the exclusive right to place reinsurance abroad. Furthermore, a number of measures with restrictive effects on market access for foreign non-established insurers relate to the prohibition for such insurers from selling insurance without a locally established broker, to restrictions on local brokers assisting in the placement of insurance services by non-admitted insurers as well as to restrictions on advertising by such insurers. In some countries, residents may not be able to enforce in domestic courts law insurance contracts sold by non-licensed insurers.

(b) Measures relating to establishment

60. Investment controls in the insurance sector are similar to those in the banking and securities sector and are implemented for essentially the same reasons, namely the concern that foreign firms could gain a dominant share of a key sector of the national economy. In some countries restrictions on establishment business take the form of complete nationalization of the domestic insurance industry and of regulations and measures which exclude foreign insurance enterprises from establishing in the national market by means of an agency, branch office or local subsidiary. Most countries, however, do not completely prohibit establishment but require that insurers obtain prior authorization usually in the form of a licence for each class of insurance they wish to sell. In this regard, a number of countries require an institutional separation between companies engaging in different classes of insurance activities. The establishment of foreign insurance affiliates can also be subject to reciprocal agreements. In the granting of licences, the treatment accorded to domestic and foreign companies may differ considerably depending on the degree of discretion used in the licensing procedure. Thus licences may be withheld completely, delayed or restricted to certain lines of business which may constitute the small or less attractive segments of a particular market. Where establishment is allowed, branches are generally less welcome than subsidiaries and are sometimes subject to special deposit requirements designed to protect policy holders. Some countries apply policies that require foreign insurers to operate only through locally incorporated subsidiaries whereby a majority of the shares must be held by a government agency or nationals.

(c) Measures relating to operating and competitive conditions

61. Certain measures may affect the financial conditions under which insurers operate in foreign markets. Exchange control regulations, by delaying or allowing remittances abroad only at unfavourable rates of exchange, can have adverse effects on the repatriation of profits of foreign insurers. Furthermore, they may interfere with risk coverage in

the sense that, since much of the business of international insurance relates to claims occurring outside the country where the insurance is written, controls may impede the international movement of funds to cover losses in various countries.

62. Other measures that may have discriminatory effects are those relating to minimum capital, solvency and deposit requirements as well as investment regulations which may be more stringent than those applying to domestically-owned insurers. Furthermore, account is sometimes not taken of the reserves which the foreign parent corporation maintains in the country of origin. This may reflect the attitude of the supervisory authorities regarding the capacity of the foreign insurer to mobilize reserves held abroad when needed.

63. Taxation policy may sometimes be used to discourage nationals from placing insurance with foreign controlled enterprises. In this regard, some countries levy a special tax on insurance policies placed with foreign-controlled insurers which is higher than those applying to locally placed insurance or reinsurance. In certain cases policy holders are not permitted to deduct premiums paid to foreign insurers from their taxes. Sometimes, claims received from insurance policies placed with foreign controlled enterprises are taxed as income in some countries.

64. There are a number of other measures and practices that may have restrictive effects on market access and on competition in the market. In some countries, certain types of insurance are provided by state or state-sanctioned monopolies, precluding competition from occurring in certain areas (e.g. social insurance). In some instances, public monopolies may benefit from government insurance procurement programmes which require that government and other public agencies place their insurance exclusively with state-owned affiliates or other locally owned insurance enterprises. In other instances, regulations stipulate the compulsory cession of reinsurance to a state-owned reinsurer, completely excluding the participation of both private foreign and domestic firms. In countries where governments maintain strong control of the economy in general and employ a significant proportion of the working population, such requirements may apply to substantial parts of the insurance market. In addition, some countries impose restrictions on the employment of non-national staff which may render it difficult for foreign insurers to compete with domestic insurers who have more comprehensive knowledge of local conditions and practices. In some cases, foreign insurance enterprises may be prohibited from becoming members of local market associations.

(d) Measures affecting international insurance transactions

65. As already mentioned above, two aspects of insurance which have traditionally been internationally traded are the insurance of international transportation and reinsurance, the latter being generally subject to less control than direct insurance. Restrictions on reinsurance, measured in terms of the proportion of reinsurance which must be ceded to domestic insurance institutions, vary considerably from country to country. Some countries reserve a minority proportion, others may

stipulate the maximum amount that may be reinsured with foreign companies while others require that all reinsurance must be ceded to a state corporation. With regard to the insurance of transport, some countries impose restrictions which reserve the insurance of imports, and sometimes also exports, to domestic companies.

F. Considerations relating to the application of certain concepts and principles

(a) Transparency

66. Pending agreement on the definition of trade in services, transparency commitments could potentially apply to measures affecting cross-border trade and those relating to the provision of insurance services through a local presence. In this respect, licensing regulations, which tend to be vague or in many cases unpublished, can in effect constitute a form of discriminatory practice against foreign providers who, unlike national providers, do not have the local experience and administrative links necessary to obtain a license in the most rapid and efficient manner. Even where a relatively high degree of transparency exists with respect to formal regulations, foreign providers may still be at a disadvantage due to their lack of experience in certain informal practices.

67. If transparency provisions were to apply to measures relating to operating and competitive conditions of foreign firms, it might be envisaged that they would not extend beyond formulations which were explicitly set out to affect market access and competition in the market. Prudential regulations, for example, may affect market access and competition. That effect, however, is often not the ultimate aim of these regulations. Considering the importance of certain practices in the international insurance services sector, transparency commitments might also apply to non-governmental regulation and administrative guidelines.

(b) Progressive Liberalization

68. As set out in MTN.TNC/11, progressive liberalization should be pursued through rules, modalities and procedures in the multilateral framework agreement with due respect for national policy objectives and taking account of the level of development of individual signatories. The text also states that the adverse effects of all laws, regulations and administrative guidelines should be reduced. Progressivity could be contemplated with respect to forms of trade, modes of delivery, specific activities or transactions, etc. In cross-border trade, for example, it could be envisaged that certain restrictions relating to the taxation of insurance business underwritten by foreign, non-established firms could be gradually phased out. Liberalization measures could also be initially directed towards regulations - both cross-border and establishment-related - which may discriminate against foreign insurers before applying to measures relating to transactions or lines of business where foreign participation was already permitted. Progressivity could furthermore be applied to the licensing process. Licenses to establish locally, for example, could be granted to a progressively larger number of foreign firms. Licenses to engage in certain lines of business could be granted in a similar fashion.

(c) <u>National Treatment</u>

69. The implications of national treatment in the insurance services sector may vary depending on whether it applied only to cross-border transactions or to services produced locally by a foreign firm. In the former case (i.e. the direct placement of insurance contracts abroad), national treatment could apply to taxation measures affecting consumers placing their insurance with foreign, non-established firms. Other aspects of relevance to cross-border transactions would be competition for government contracts and the ability to make transfers in accordance with business expediency.

70. Application of national treatment to delivery through local presence could imply the elimination of discrimination against foreign insurers regarding deposit, taxation and other requirements, with a view towards allowing them to operate in the market on the same terms as domestic insurers. In some cases, however, granting the same treatment to foreign as to national insurers might not imply equal or equivalent competitive opportunities between them. In the case of branches, which are not locally incorporated companies but belong to the parent entities, requirements commonly applied to national insurers may have differential effects when applied to foreign insurers. The requirement for the maintenance of a certain level of assets locally to cover expected liability to policy-holders, for example, may impose greater costs on foreign than on national firms due to the geographical fragmentation of reserves. As with cross-border transactions, providing for the ability for individual established firms to compete for government contracts and to make financial transfers may be relevant. Also, national treatment could be envisaged to imply the ability for foreign firms to participate in domestic trade associations.

(d) <u>M.f.n./Non-discrimination</u>

71. Laws, regulations and administrative practices which may be discriminatory include those regarding licensing, financial guarantees and taxation. Of the laws and regulations imposing discrimination on foreign providers, some are not sector-specific in nature such as mandatory local incorporation, restrictions on profit remittances, government procurement policies and employment restrictions. In some cases, regulations may not contain explicit discriminatory elements but their enforcement may be subject to high degrees of discretion on the part of local authorities. In addition to traditional insurance services, the application of m.f.n./non-discrimination could also affect competition in the markets for co-insurance, reinsurance and transport insurance services.

72. The application of m.f.n./non-discrimination has been affected in some cases by regional economic integration arrangements which have provided for preferential treatment being granted to member countries with respect to establishment, the placement of contracts with insurers from other member countries and the harmonization of legal and supervisory conditions relating to different types of insurance. Bilateral treaties have also limited the scope of application of m.f.n./non-discrimination (e.g. treaties dealing with tax treatment). Another important consideration is

the extent to which the application of m.f.n./non-discrimination to insurance services would achieve a significant level of liberalization given the asymmetries existing among different markets. It has been the practice in some cases to rely on the concept of reciprocity in the undertaking of liberalization commitments. For instance, the granting of licenses would only be the same for foreign as for national insurers if certain conditions were met reciprocally by the trading partner.

(e) Market Access

73. Preferred mode of delivery considerations in the insurance services sector could potentially include cross-border trade and/or transactions through local presence. If applied to the former, increased market access could imply the reduction of restrictions or prohibitions relating to the placement by residents of insurance contracts with non-established, foreign-controlled insurance companies. For example, a provision on market access for insurance services could affect the levy by certain countries of a special tax on policies placed with insurance firms established abroad. In accordance with MTN.TNC/11, increased market access could be achieved through greater access to domestic distribution networks and could imply, for example, a commitment towards the relaxation of laws and regulations requiring foreign providers to sell insurance through local brokers or, conversely, prohibiting local brokers from assisting foreign providers in the placement of insurance contracts in the local market.

74. Considerations relating to market access through local establishment might cover the outright exclusion of foreign insurance firms from national markets or the requirement of prior authorization for the undertaking of business in certain classes of insurance. Also, allowing foreign providers the right to supply services according to their preferred mode of delivery might in some cases conflict with regulations which require foreign firms to establish locally as a condition to undertake local business. In such cases, modes of establishment may also be covered by market access commitments as regulations often require that firms be established as locally incorporated subsidiaries and not as branches or agencies. Measures such as minimum capital, solvency, deposit and investment regulations might affect access to a market and could be relevant in the context of market access commitments.

75. Regulations which affect market access by foreign providers to national markets both through cross-border trade and local establishment include government insurance procurement policies which require that a certain share of government insurance be placed with state or locally-owned affiliates. Considering the internationalization of reinsurance activities which has already taken place, the concerns relating to market access exposed in this section might be more pertinent to insurance than to reinsurance services transactions and firms.

(f) Increasing Participation of Developing Countries

76. The insurance services sector and the overall economic activity existing in an economy are mutually supportive: on the one hand, the sector relies on underlying economic conditions for its development; on

the other, it contributes itself to economic growth and development. The economic impact of the sector is widely felt through the different functions it performs in the economy. These include: spreading of risks in the production and transportation processes; promoting and allocating savings; stimulating the development of new technologies, materials and agricultural products embodying relatively high risks of loss; and encouraging non-traditional exports of goods and services through export credit insurance programs. Two aspects of insurance transactions are of special relevance to the development of developing countries: capital formation and support for specific sectors or fields of activity.

77. Due to the important role of insurance services in the development process, many developing countries have in recent years implemented policies with a view to strengthening their domestic capacities in the sector. In many cases, increased retention of insurance premiums in the domestic market has been encouraged through, for example, resort to discriminatory taxation to deter the placing of reinsurance abroad. These measures have also been influenced by the perceived threat to the balance of payments which placement of insurance abroad represents in some cases. Even though such policies have in some cases had a considerable impact on existing market structures, many other policy options may be envisaged with a view towards strengthening not only domestic capacity but also domestic efficiency and competitiveness. For example, greater efficiency and competitiveness in the provision of insurance services might result from policies which aim to absorb know-how and expertise not available domestically, whether through incentives for an increased flow of technology (e.g. through training) or through favourable conditions for the formation of joint ventures, for example. In that context, consideration may also be devoted to access to distribution systems, given that the insurance market might operate more efficiently if foreign insurers are allowed to sell policies and carry out other activities through domestic brokers. In relation to efforts to "strengthen domestic services capacities" in the insurance sector, the following points have also been made: the investment outflow of premiums and reserve funds may be more than offset by an inflow against claims; the promotion of domestic insurance capacity involves a certain cost in terms of resource allocation; reduced reliance on foreign insurance firms where domestic firms are not internationally competitive might ultimately be translated into an increased reliance on foreign reinsurance firms.

(g) Exceptions and Safeguards

78. Exceptions and safeguards might be relevant with respect to consumer protection, capital formation and the protection of the balance of payments. Measures relating to the promotion of indigenous capacities might particularly warrant broader exceptions covering economic development in general. Balance of payments difficulties may require safeguard action, which may not necessarily result from insurance-related transactions but rather originate in broader economic disturbances and/or developments. In some cases, particularly when transactions take place as a result of large contractual obligations, short-term variations in the balance of payments might occur as a result of insurance transactions, thus invoking the need for safeguard action.

(h) Regulatory Situation

79. As mentioned previously, insurance regulation may reflect the objectives of consumer protection and/or the improvement of the overall functioning of the national economy and may relate to various aspects of business activity in the sector, including licensing, solvency requirements, control of investment funds, etc. Regulations affecting insurance services transactions might not be sector-specific, at times pursuing broader objectives relating, for instance, to the balance of payments.

80. The recognition set out in the Montreal text that asymmetries exist with respect to the degree of development of services regulations in different countries is also of special relevance for the insurance services sector. Whereas some countries might, for example, require specialization in certain lines of insurance business, others might not. A difference among countries exists with respect to the degree to which insurance services are provided by state, or state-sanctioned monopolies. In many countries public monopolies are involved in the provision of social insurance (medical, unemployment, retirement, social security) and other types of insurance endowed with high levels of political risk (e.g. war damage insurance). Another element where asymmetries are evident among countries is in the respective competence of national and sub-national regulatory authorities. Regulatory competence can vary widely, ranging from full federal competence over most aspects of insurance transactions to full provincial or state competence over certain activities or lines of insurance business.

ANNEX I

BACKGROUND STATISTICAL INFORMATION

TABLE 1

Estimated net lending in international markets

	Stocks at end-1983	Changes[1] 1984	1985	1986	1987	1988	Stocks at end-1988
	in billions of U.S. dollars						
Total cross-border claims of reporting banks[2]	2,107.7	124.7	232.0	510.3	597.5	419.4	4,485.3
Local claims in foreign currency	450.6	27.5	63.4	147.7	162.6	75.0	1,019.7
minus: double-counting due to redepositing among the reporting banks	1,318.3	62.2	190.4	463.0	460.1	269.4	3,115.0
A = Net international bank lending	1,240.0	90.0	105.0	195.0	300.0	225.0	2,390.0
B = Net new Euro-note placements	0.0	5.0	10.0	13.0	23.3	19.5	72.1
Total completed international bond issues		105.6	161.9	219.6	181.2	219.4	
minus: redemptions and repurchases		24.6	38.9	59.3	71.1	81.5	
C = Net international bond financing	320.0	81.0	123.0	160.3	110.1	137.9	1,085.4
D = (A+B+C) = Total international financing	1,560.0	176.0	238.0	368.3	433.4	382.4	3,547.5
minus: double-counting[3]	60.0	31.0	58.0	78.3	53.4	67.4	347.5
E = Total net international financing	1,500.0	145.0	180.0	290.0	380.0	315.0	3,200.0

[1] Non-dollar flow banking data are converted into dollars at constant end-of-quarter exchange rates, and non-dollar bonds at rates ruling on announcement dates. Stock data are converted at current exchange rates.

[2] Banks in the Group of Ten countries plus Luxembourg, Austria, Denmark, Finland, Ireland, Norway, Spain, the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles and Singapore, as well as the branches of U.S. banks in Panama.

[3] International bonds taken up by the reporting banks, to the extent that they are included in the banking statistics as claims on non-residents; bonds issued by the reporting banks mainly for the purpose of underpinning their international lending activities.

Source: Bank for International Settlements (1989). 59th Annual Report.

TABLE 2

The institutional structure of selected financial systems, 1985

Country	Assets[1] as a percentage of total gross assets of the financial system						Net financial assets as % of GNP
	Central banks	Deposit banks	Specialized lending institutions	Contractual savings institutions	Collective investment institutions	Long-term debt securities and equities[2]	
Developed countries							
Australia	5	31	14	17	1	33	..
Canada	1	33	2	26	8	30	165
France	6	56	10	7	5	16	109
Germany, Fed. Rep. of	4	41	14	9	2	30	158
Japan	2	45	9	6	7	30	300
Sweden	4	27	18	16	1	35	..
United Kingdom	1	35	1	26	3	34	188
United States	2	28	7	19	4	40	210
Average	**3**	**37**	**9**	**16**	**4**	**31**	**188**
Developing countries							
Argentina	32	43	11	5	0	10	..
Brazil	27	32	12	2	4	23	59
Chile	14	44	1	11	1	28	75
India	10	47	6	12	1	24	65
Korea, Rep. of	9	53	14	4	10	10	66
Malaysia	7	34	12	13	3	32	247
Nigeria	23	46	2	3	7	19	49
Pakistan	21	65	1	2	1	11	45
Philippines	30	38	14	3	3	14	38
Portugal	20	72	1	2	1	4	124
Thailand	16	55	12	1	0	17	89
Turkey	33	54	4	6	0	3	27
Venezuela	20	46	25	1	0	8	65
Average	**20**	**48**	**9**	**5**	**2**	**16**	**79**

[1] Total financial system assets are the assets of all the institutions shown in this table plus the stock of outstanding securities and equities. To eliminate double-counting caused by the assets of one institution being the liabilities of another, net financial assets have been approximated by the sum of total liquid liabilities plus securities and equities. To deflate these stocks by the flow of GNP, five-quarter arithmetic averages were constructed from year-end data for 1984 and 1985, assuming constant exponential growth during the year.

[2] The sum of government bonds, corporate bonds, and corporate equity.

Source: World Bank. World Development Report 1989.

TABLE 3

Equity market indicators, 1987

Country	Average market capitalization[1] (percentage of GNP)	Turnover ratio[2] (percentage of average capitalization)	Number of companies listed
Developed countries			
Japan	92	93	1,912
United Kingdom	80	72	2,135
United States	58	93	7,181
Germany, Fed. Rep. of	21	161	507
France	18	56	650
Developing countries			
Jordan	60	15	101
Malaysia	58	23	232
Chile	27	11	209
Korea, Rep. of	19	111	389
Portugal	10	44	143
Zimbabwe	10	4	53
Thailand	9	114	125
Mexico	8	159	233
Brazil	7	43	590
Philippines	7	62	138
Venezuela	7	8	110
India[3]	6	19	6,017
Greece	5	18	116
Pakistan	5	9	379
Nigeria	4	1	100
Colombia	3	8	96
Turkey	3	6	50
Argentina	2	16	206

[1]Average market capitalization is a five-quarter average of the total value of listed stock, based on year-end data, assuming constant exponential growth during the year.

[2]Turnover ratio is the value of stocks actually traded as a percentage of the average total value of listed stock.

[3]Bombay exchange.

Source: World Bank. World Development Report 1989.

TABLE 4

World Total Insurance Premiums, 1987

	All insurance		Non-life Insurance		Life Insurance	
	Total Premiums (dollars)	**World Share** (%)	**Total Premiums** (dollars)	**World Share** (%)	**Total Premiums** (dollars)	**World Share** (%)
North America	429,539	40.14	253,048	48.21	176,491	32.37
Latin America	6,418	0.60	5,108	0.97	1,310	0.24
Europe	338,636	31.65	179,010	34.10	159,626	29.29
Asia	270,191	25.24	74,924	14.27	195,267	35.81
Africa	12,422	1.16	4,804	0.92	7,618	1.39
Oceania	12,894	1.21	8,006	1.53	4,888	0.90
World Total	**1,070,100**	**100.00**	**524,900**	**100.00**	**545,200**	**100.00**
OECD[1]	982,235	91.79	482,168	91.86	500,069	91.72
Group of Seven[2]	885,522	82.75	428,635	81.66	456,887	83.80
EEC	258,612	24.17	138,506	26.39	120,108	22.03
EFTA[1]	39,865	3.73	19,635	3.74	20,229	3.71
COMECON[3]	38,167	3.57	19,431	3.70	18,736	3.44

[1] Excluding Iceland.

[2] Germany Fed.Rep., Canada, United States, France, Great Britain, Italy, Japan.

[3] Excluding Bulgaria, Romania and non-European member countries.

Source: Swiss Reinsurance Company, Sigma, March 1989.

TABLE 5

Total insurance premiums in selected countries, 1987

Country	World Ranking (Total Premiums)	All Insurance		Non-life Insurance		Life Insurance	
		Total Premiums (dollars)	World Share (%)	Total Premiums (dollars)	World Share (%)	Total Premiums (dollars)	World Share (%)
Developed countries							
United States	1	406,652	38.00	241,238	45.96	165,414	30.34
Japan	2	241,069	22.53	62,725	11.95	178,344	32.71
Germany, Fed.Rep.	3	81,353	7.60	44,962	8.57	36,391	6.67
United Kingdom	4	63,820	5.96	23,665	4.51	40,155	7.37
France	5	50,000	4.67	28,764	5.48	21,236	3.90
USSR	6	29,215	2.73	13,693	2.61	15,522	2.85
Canada	7	22,887	2.14	11,810	2.25	11,077	2.03
Italy	8	19,741	1.84	15,471	2.95	4,270	0.78
Switzerland	9	16,005	1.50	7,128	1.36	8,877	1.63
Netherlands	10	15,271	1.43	8,188	1.56	7,083	1.30
Developing countries							
South Korea	11	11,142	1.04	1,937	0.37	9,205	1.69
India	24	3,281	0.31	1,215	0.23	2,066	0.38
Brazil	29	1,522	0.14	1,285	0.24	237	0.04
Malaysia	32	963	0.09	481	0.09	482	0.09
Mexico	33	901	0.08	612	0.12	289	0.05
Argentina	35	832	0.08	766	0.15	66	0.01
Egypt	38	660	0.06	541	0.10	119	0.02
Yugoslavia	39	656	0.06	635	0.12	510	0.09
Singapore	44	583	0.05	312	0.06	271	0.05
Hungary	47	473	0.04	336	0.06	137	0.03
Nigeria	54	229	0.02	182	0.03	47	0.009
Peru	59	193	0.02	186	0.04	7	0.001

Source: Swiss Reinsurance Company, Sigma, March 1989.

TABLE 6

Premium density and share of GDP in selected countries, 1987

Country	World Ranking (Total Premiums per capita)	Total Premiums per capita (dollars)	Non-life per capita (dollars)	Life per capita (dollars)	Total Premiums/GDP (%)	Non-life/GDP (%)	Life/GDP (%)
Developed countries							
Switzerland	1	2,447.2	1,089.9	1,357.3	8.02	3.57	4.45
Japan	2	1,974.5	513.8	1,460.7	8.69	2.26	6.43
United States	3	1,668.2	989.6	678.6	9.07	5.38	3.69
Germany, Fed.Rep	4	1,329.9	735.0	594.9	6.40	3.54	2.86
Ireland	5	1,145.5	434.5	711.0	12.24	4.64	7.60
United Kingdom	6	1,121.8	416.0	705.8	8.35	3.10	5.25
Norway	7	1,083.8	651.6	432.2	5.08	3.05	2.03
Finland	8	1,074.6	400.2	674.4	5.31	1.98	3.33
Netherlands	9	1,041.7	558.5	483.2	6.29	3.37	2.92
Denmark	10	953.2	582.2	371.0	4.30	2.63	1.67
Developing countries							
South Korea	22	264.8	46.0	218.8	8.85	1.54	7.31
Singapore	26	223.3	119.5	103.8	2.78	1.49	1.29
Malaysia	34	58.2	29.1	29.1	2.98	1.49	1.49
Hungary	35	44.5	31.6	12.9	1.79	1.27	0.52
Yugoslavia	42	28.0	27.1	0.9	1.48	1.43	0.05
Argentina	43	26.4	24.3	2.1	1.80	1.66	0.14
Egypt	51	13.0	10.7	2.3	1.05	0.86	0.19
Mexico	53	11.1	7.5	3.6	1.02	0.69	0.33
Brazil	54	10.8	9.1	1.7	0.86	0.73	0.13
Peru	56	9.3	9.0	0.3	1.08	1.04	0.04
India	59	4.2	1.6	2.6	1.29	0.48	0.81
Nigeria	61	2.3	1.8	0.5	0.88	0.70	0.18

Source: Swiss Reinsurance Company, Sigma, March 1989.

TABLE 7

Changes in the structure of insurance markets by continent, 1968-1985

	Domestic companies		Foreign companies		% of foreign companies	
	1968	1985	1968	1985	1968	1985
Europe	3,590	3,419	1,580	1,086	28.6	24.1
North America	4,967	5,791	360	302	6.8	5.0
Latin America	749	690	257	82	25.5	10.6
Africa	229	334	674	115	74.6	25.6
Asia	382	543	705	367	64.9	40.3
Oceania	408	289	195	145	32.3	33.4

Source: Swiss Reinsurance Company, Sigma, July 1983 and November/December 1985.

TABLE 8

Concentration of the world reinsurance market in 1986

Number of companies	Countries of origin[a]	Share of world market[b] (percentage)
3	Fed.Rep. of Germany (1), Switzerland (1), United States (1)	30.3
8	Fed.Rep. of Germany (1), Switzerland (1), United States (4), United Kingdom (1), Sweden (1)	40.7
16	Fed.Rep. of Germany (5), Switzerland (1), United States (5), United Kingdom (1), Sweden (1), Japan (3)	53.6
32	Fed.Rep. of Germany (6), Switzerland (2), United States (11), United Kingdom (1), Sweden (1), Japan (7), France (3), Italy (1)	70.6

[a]Numbers in parentheses indicate number of companies from each country of origin.

[b]Share in world's top 100 reinsurers.

Source: UNCTAD, Trade and Development Report, 1988.

ANNEX II

The OECD Codes of Liberalization

1. Since its inception in 1961, the OECD has had the vocation of aiding its Member countries to promote the liberalization of international trade in goods and services and the freedom of capital movements. This objective is set out in the OECD Convention and finds concrete expression - in regard to services and capital movements - in the Code of Liberalization of Current Invisible Operations and the Code of Liberalization of Capital Movements. The Codes have the legal status of OECD Decisions and are thus binding on all Members.

2. While the two Codes differ in certain respects, their general principles are broadly the same. In adhering to them, Member countries undertake to remove restrictions on specified lists of current invisible operations and capital movements. The ultimate objective, broadly speaking, is that residents of different Member countries should be as free to transact business with each other as are residents of a single country, and whenever transactions are permitted the corresponding payments should be freely transferable from one country to another.

3. The approach of the Codes is to engage Member countries in a process of progressive liberalization allowing reasonable scope for countries to move towards the ultimate goal in different ways and at different speeds according to their particular circumstances. Members unable to liberalize immediately may lodge "reservations" on particular operations. Reservations are subject to periodic examination by the Committee on Capital Movements and Invisible Transactions (the "CMIT"). Examinations generally result in the withdrawal or limitation of some reservations and recommendations from the Organization that remaining reservations be narrowed or withdrawn. Once removed, however, reservations, in most cases, cannot be lodged anew, hence the so-called "ratchet effect" of the Codes. A safeguards or "derogation" clause may be invoked by a Member country facing severe difficulties, but only for limited periods and subject to rigorous review.

4. An important feature of the Codes is that liberalization measures - and remaining restrictions - must be applied to all Member countries on a non-discriminatory basis. The Codes allow an exception to the principle of non-discrimination for Member countries forming a "special customs or monetary system" such as the European Economic Community. Under this exception, OECD countries participating in such systems may undertake more rapid or more extensive liberalization among themselves than for the OECD area as a whole. They may not, however, raise new barriers to operations involving the residents of OECD Members outside the systems concerned.

5. Between them, the OECD Codes of Liberalization cover a very wide range of international operations other than trade in goods:

- The Current Invisibles Code deals with service sectors such as audiovisual works, banking and financial services, insurance, road, air and maritime transport, as well as other invisible operations, notably those directly related to international trade or arising out of income from work or capital.

- The Capital Movements Code now covers virtually all international capital movements, including direct investment and establishment, operations in securities and non-securitized claims, bank credits and loans, foreign exchange operations and personal capital movements.

6. By virtue of a Decision taken in 1984, the obligations of the Capital Movements Code on inward direct investment now include the right of establishment. Thus, Member countries are expected to allow non-resident firms to set up or acquire a business in their territory and to operate it on terms equivalent to those applying to domestic firms. In the areas of insurance and financial services, detailed provisions have been added to the Current Invisibles Code to ensure that branches and agencies of foreign firms - which may need to be treated differently in certain aspects (e.g. for the purposes of monetary policy or prudential supervision) - are nevertheless treated on terms that enable them to compete with domestic institutions on an equivalent basis.

7. In the 1980s a major review of the coverage of both Codes was launched. A review of the Current Invisibles Code was needed mainly to take account of technological change that brought to the forefront new service industries that did not exist or were of only marginal importance when the Code was originally drafted. In the Capital Movements Code, the need to update coverage arose partly from the development of new financial instruments and partly from a desire to cover more familiar operations not previously subject to the liberalization obligations.

8. The OECD announced on 19 May 1989 that its 24 Member countries had reached an agreement to liberalize the full range of banking and financial services. This agreement will be implemented by OECD Council Decisions amending the Codes of Liberalization of Capital Movements and Current Invisible Operations.

9. Amendments to the Capital Movement Code will extend its coverage to virtually all capital movements including, for the first time: money-market operations, including operations in securities and in the inter-bank market; short-term financial credits and loans; foreign exchange operations, including spot and forward transactions; operations of deposit accounts in domestic and foreign currency; swaps, options, futures and other innovative instruments; financial back-up facilities; commercial credits of more than five years; and financial credits and loans taken up abroad by non-financial resident enterprises.

10. In the Current Invisibles Code, a new section on banking and financial services will be introduced covering the provision of and access to the following cross-border service operations: payment services, including the issuance and use of cheques, travellers' cheques, cash cards and credit

cards, as well as funds transfer services; banking and investment services, notably professional intermediation in the markets for securities and other financial assets, such as underwriting, broker/dealer services, access to financial information, communication and execution systems; settlement, clearing, custodial and depository services for liquid funds and securities, non-securitized claims and foreign exchange; asset management, including cash or portfolio management, pension fund management, trust services and safekeeping of assets; advisory and agency services, including the provision of ancillary financial services such as credit reference and analysis, investment research and advice, mergers, acquisitions and restructuring; as well as fees, commissions and other charges.

11. Inclusion of all of these operations in the Code is accompanied by general qualifying remarks to ensure that liberalization will not prevent the authorities of Member countries from taking appropriate action to assure the safety and soundness of their financial systems, fair competition in orderly markets and protection for consumers, savers, investors and borrowers.

12. The Current Invisibles Code amendment also contains new undertakings regarding the establishment of branches (and agencies) of non-resident institutions. (Under the Capital Movement Code, Member countries are already required to treat the establishment of subsidiaries of non-resident enterprises in the same way as that of domestic enterprises.) In accordance with the principle of "equivalent treatment", the amendment requires that the establishment requirements for branches and agencies of non-resident enterprises shall be no more burdensome than those applying to domestic enterprises. In addition, specific provisions are introduced on the following matters: authorization; representation; representative offices; self-employed intermediaries; membership of associations or regulatory bodies; prudential considerations; and financial requirements for establishment.

13. In addition, certain governmental measures not previously considered as restrictions - including discriminatory taxes, interest penalties and deposit requirements - will now be subject to surveillance.

14. Amendments to both Codes are expected to come into force within about one year, a period during which the OECD Council will record the reservations that Member countries need to lodge. Reservations will be necessary to cover operations for which full liberalization is not immediately possible for the Member countries concerned.

ANNEX III

Basle Committee on Banking Regulations and Supervisory Practices

A. Introduction

1. The Basle Committee on Banking Regulations and Supervisory Practices (Basle Supervisors' Committee) was established at the end of 1974 by the central bank Governors of the Group of Ten industrialized countries.[1] The Committee, whose members are senior officials of the central banks and supervisory agencies of the countries of the G-10 and Luxembourg, meets four times a year at the Bank for International Settlements in Basle, Switzerland.

B. Objectives

2. The main purpose of the Basle Supervisors' Committee is to work towards improving the supervision of banks operating in international markets. It seeks to do this in three principal ways:

- by improving the general coverage and effectiveness of techniques for supervising international banking business;
- by addressing particular prudential problems affecting banks operating internationally;
- and by exchanging information on national supervisory arrangements with the object of improving banking supervision worldwide.

3. The Committee's recommendations for supervisory polices and procedures are not legally binding on the countries and institutions represented on the Committee. Instead, through discussion of supervisory issues the Committee seeks to reach consensus on best practices. The implementation of that consensus is a matter for national supervisory authorities and rests on their willingness to adopt policies in line with recommendations made in Basle.

C. Recommendations

4. The Basle Supervisors' Committee has produced public recommendations on a range of topics, including the supervision of banks' foreign establishments, capital adequacy regulation and, most recently, the prevention of money laundering. In the first two cases, the Committee formulated guidelines for the G-10 supervisors themselves to follow. In the third case, the Committee recommended a set of ethical principles for use by private banks.

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[1] Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States.

(i) The Supervision of Banks' Foreign Establishments

5. The Basle "Concordat", first drawn up in 1975 and substantially revised and extended in 1983, addressed the supervisory problems created by the expansion of banking groups with significant operations outside their home country. The Concordat has two basic objectives: firstly, to ensure that no foreign banking establishment escapes supervision; and secondly, to ensure that this supervision is adequate.

6. To meet these objectives the Concordat recommends that the international operations of a bank be supervised as follows. The host authorities (i.e. the authorities in the countries where the bank has overseas operations) should supervise the bank's establishments in their territories as individual institutions. The parent authority (i.e. the authority responsible for supervising the parent bank) should supervise the bank's foreign establishments under its general responsibility to supervise the bank's worldwide activities on a consolidated basis. Under this arrangement the responsibilities of host and parent authorities are both complementary and overlapping.

7. In specifying the detailed allocation of supervisory responsibilities between host and parent authorities the Concordat considers three types of foreign bank establishment (branches, wholly-owned or majority-owned subsidiaries, and joint ventures typically owned by a collection of minority shareholders) and three prudential factors (solvency, liquidity, and the control of foreign exchange operations).

- Solvency - The solvency of an overseas branch is indistinguishable from that of the parent bank and should therefore be primarily supervised by the parent authority. In the case of a foreign bank subsidiary, the host authority should supervise its solvency on a stand alone basis, while the parent authority should take it into account in the course of supervising the solvency of the consolidated group. For practical reasons, the solvency of a joint venture should normally be the responsibility of the authorities in the country of incorporation.

- Liquidity - The Concordat explicitly states that its reference to liquidity supervision do not relate to the function of central banks as lenders of last resort, but rather to the responsibility of supervisory authorities for monitoring the internal control systems and procedures which enable banks to meet their obligations as they fall due. The Concordat states that the primary responsibility for supervising the liquidity of a bank's overseas branch should rest with the host authority, since it is generally best placed to take account of local practices and regulations and the functioning of the domestic money market. At the same time, the fact that a branch's liquidity is frequently controlled directly by the parent bank and cannot be viewed in isolation from that of the whole bank of which it is part should be a matter of concern to the parent authority. For subsidiaries, the primary responsibility for supervising.

liquidity should rest with the host authority, though parent authorities should take account of any standby facilities or other commitments granted by parent banks to these establishments. Similarly, primary responsibility for supervising the liquidity of joint ventures should rest with the authorities in the country of incorporation.

- Foreign exchange operations - The supervision of a bank's foreign exchange operations and positions should be the joint responsibility of the parent and host authorities.

8. The Concordat recommends that in cases where supervision by a host authority is judged to be inadequate, the parent authority should either extend its own supervision to cover the foreign establishment or it should discourage the continued operation of the foreign establishment. Conversely, if a host authority considers that the supervision exercised over the parent bank by the parent supervisory authority is inadequate, the Concordat recommends that the host authority should discourage the operation of local entities of such banks in its own territory or should set specific conditions on the business to be conducted.

9. A large number of countries outside the G-10 have indicated that they agree with the basic principles underlying the Concordat. It has been endorsed by the Offshore Group of Banking supervisors and has received the broad approval of the Commission of Latin American and Caribbean Supervisors.

10. In 1984 the Basle Supervisors' Committee and the Offshore Supervisors' Group jointly commissioned a study on those aspects of the Concordat requiring flows of cross-border information between host and parent supervisors. The resulting recommendations, which were approved by the two Committees in 1986, dealt with authorization procedures, the information needs of parent and host authorities, issues raised by national bank secrecy laws, and the role of external auditors. The recommendations were intended to reinforce existing systems of reporting from foreign establishments to the parent bank and to provide host and parent authorities with a framework to assist the development of effective consultation and cooperation.

(ii) Capital Adequacy

11. The Basle agreement on international convergence of capital measurement and capital standards ("Basle capital framework") was completed in July 1988 following a work programme in the Basle Supervisors' Committee which dated back to the early 1980s. The framework's two main objectives are, firstly, to strengthen the soundness and stability of the international banking system, and secondly, by introducing a high degree of consistency in the treatment of banks from different countries, to reduce existing sources of competitive inequality among international banks. To meet these goals the Basle capital framework establishes a common system for measuring the size of a bank's capital and sets minimum standards for its adequacy in relation to the bank's credit exposure.

12. In defining bank capital the framework makes an important distinction between "core capital", comprising shareholders' equity and disclosed reserves, which must account for at least half a bank's total recognized capital, and "supplementary capital", comprising other types of reserves and various debt instruments. Core capital is given special emphasis because it is generally recognized as the highest-quality capital, having a known, and relatively stable, nominal size and being able to absorb losses while a bank continues as a going concern. A bank's credit exposure is assessed under the framework by weighting and then summing various broad categories of asset and off-balance-sheet exposure. The weights, which are for the most part specified in the agreement, are chosen roughly according to the perceived credit risk of the exposure categories. Finally, a bank's capital adequacy is measured by the ratio of its recognized capital to its aggregate risk-weighted credit exposure. The framework lays down a transitional timetable of minimum levels for this ratio to be applied on a consolidated basis, culminating in an 8 per cent by the end of 1992. Under the agreement national authorities are free to adopt arrangements that set higher levels.

13. The terms of the capital framework apply only to internationally active banks from the member countries of the Basle Supervisors' Committee. However, parallel decisions by various national supervisors will mean in practice that the basic principles are applied in a wide range of countries outside the Group of Ten. Moreover, the United States and the member countries of the European Community intend to apply the basic principles of the framework to all banks, whether or not they are internationally active.

14. Looking ahead, there are three areas in which the Basle Supervisors' Committee is examining the case for refining the capital framework:

- At present the framework gives national supervisors some limited discretion in the way they implement it (notably with respect to some of the risk weightings). The impact of these discrepancies is expected to be negligible; however, the Committee intends to monitor and review the application of the framework in the period ahead with a view to achieving even greater consistency where this is shown to be necessary.

- The current framework is mainly directed towards assessing capital in relation to credit risk (i.e. the risk of counterparty failure), but other risks, notably interest rate risk and the investment risk on securities, need to be taken into account by supervisors in assessing capital adequacy. Thus the Committee is currently studying the feasibility of extending the framework to cover these types of risk.

- The Committee also intends to look further into the classification of provisions to see whether it may be possible to draw a tighter distinction between general provisions that are freely available to meet unknown future losses and are therefore eligible as capital, and other types of provisions which reflect a decline in asset values that is already perceived to have taken place. In addition, recognizing the close relationship between capital and provisions, the Committee will continue to monitor provisioning policies by banks in member countries and will seek to promote further convergence in this field.

(iii) Money laundering

15. In January 1989 The Basle Supervisors' Committee issued a general statement of ethical principles designed to be followed by bank managements and intended to prevent the criminal use of the banking system for the purpose of money laundering. The principles would ensure that all persons conducting business with banks were properly identified; that transactions that did not appear to be legitimate were discouraged; and that cooperation with law enforcement agencies was achieved.

D. Other groupings of bank supervisors

16. To broaden the base of understanding and to enable a wider group of authorities to contribute to the work being pursued in Basle, member countries of the Basle Supervisors' Committee have hosted a series of international conferences for banking supervisors. The first ICBS was held in London in 1979, while the fifth took place in Tokyo in October 1988 with delegates from nearly 100 countries, regions and international organizations present.

17. The work of the Basle Supervisors' Committee is parallelled to varying degrees by that of other groupings of bank supervisors. These are:

- The EC Banking Advisory Committee - The main purpose of this committee, established in 1979 under the terms of the First Banking Directive (1977), is to advise the European Commission on moves to harmonize the regulatory framework of the EC banking system. Its membership is drawn from ministries, central banks, banking commissions, and the European Commission.

- The Contact Group of EC Supervisory Authorities - A group bringing together members from each of the banking supervisory authorities within the European Community. Its principal activities include: the exchange of information on individual problem cases; discussion of developments in national supervisory regimes; comparative studies of the supervisory systems in member states; and technical studies relating to the harmonization of banking supervision and the development of a common banking market in the EC undertaken on behalf of the EC Banking Advisory Committee.

- The Offshore Group of Bank Supervisors - This group, formed in 1980, comprises some sixteen offshore centres. Its aim is to further international cooperation on the supervision of offshore banks, both between members themselves and between members and other supervisory authorities.

- The Commission of Banking Supervisory and Regulatory Bodies of Latin America and the Caribbean - A grouping with over thirty members.

- The SEANZA Forum of Banking Supervisors - This informal group, drawing members from some sixteen countries in the Indian sub-continent, South East Asia and the Pacific Basin was established in 1984, with the aim of exchanging basic information on banking supervisory practices in the area and cooperating with other regional supervisory groupings.

- The GCC Committee of Banking Supervisors - This Committee was established by the Committee of Governors of the central monetary authorities of the Gulf Co-operation Council. It has six member countries and first met in 1983. Its responsibilities are to study and co-ordinate national banking laws and supervision procedures; to study common problems relating to banking supervision; and to liaise with other supervisory bodies.