Taking Stock of the “First Generation” of Financial Sector Legal Reform

Joseph J. Norton
Abstract

The World Bank Group has promoted “access instruments” in the financial sector (e.g., microfinance and small- and medium-enterprise projects) for many years. More recently, it has conducted major studies on financial system access and implemented projects involving rural financing, cooperative financial institutions, the down-scaling of commercial banking institutions, and home financing for the poor. Germaine to this paper, the Bank Group has been closely involved through its structural adjustment and technical assistance programs (and more recently its Financial Sector Assessment program) with financial sector legal reform initiatives respecting developing, emerging and transitioning economies.

This paper contends that the “first generation” of financial sector legal reform (particularly that related to policies and infrastructure) is really of relatively recent vintage. Historically, such reform has not been a core function of the World Bank or other international financial institutions (IFIs). The reform process has been mainly crisis-oriented and reactive by necessity, driven largely by the systemic objectives of industrialized countries to prevent financial crises and related contagion, foster global financial stability, and, more recently, maintain financial sector integrity.

The “first generation” of reform did not benefit from a conducive reform environment nor, until the recent past, from a developing approach to incorporating such developmental factors as access and equality into the reform processes. This paper suggests that the World Bank Group should step back and take stock of what the preceding stage of financial sector reform has and has not achieved in order to discern appropriate lessons for the next generation of reform. The Bank’s fundamental mandate as a development bank, its current primary mission of poverty alleviation, and its evolving institutional profile as a “knowledge-based bank” should provide the overarching context for this new generation of reform.
Taking Stock of the “First Generation” of Financial Sector Legal Reform

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## Acronyms

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<tbody>
<tr>
<td>AML</td>
<td>anti-money laundering</td>
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<tr>
<td>BSCS</td>
<td>Basel Committee on Banking Supervision, or Basel Committee</td>
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<td>BIS</td>
<td>Bank for International Settlement</td>
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<td>CAS</td>
<td>Country Assessment Strategy (World Bank)</td>
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<td>CEE</td>
<td>Central and Eastern Europe</td>
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<tr>
<td>CGAP</td>
<td>Consultative Group for Assisting the Poor</td>
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<td>CTF</td>
<td>counter-terrorism financing</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EU</td>
<td>European Union</td>
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<td>EWS</td>
<td>early warning system</td>
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<td>FATF</td>
<td>Financial Action Task Force</td>
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<td>FSA</td>
<td>Financial Sector Assessment (World Bank)</td>
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<td>FSAP</td>
<td>Financial Sector Assessment Program (joint program of the World Bank and IMF)</td>
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<td>FSLC</td>
<td>Financial Sector Liaison Committee (joint committee of the World Bank and IMF)</td>
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<td>FSF</td>
<td>Financial Stability Forum</td>
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<td>FTAA</td>
<td>Free Trade Area of the Americas</td>
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<td>G7</td>
<td>Group of Seven</td>
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<td>G8</td>
<td>Group of Eight</td>
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<td>G10</td>
<td>Group of Ten</td>
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<td>G20</td>
<td>Group of Twenty</td>
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<tr>
<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<tr>
<td>IADI</td>
<td>International Association of Deposit Insurers</td>
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<td>IAIS</td>
<td>International Association of Insurance Supervisors</td>
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<td>IASC</td>
<td>International Accounting Standards Committee</td>
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<td>IFAC</td>
<td>International Federation of Accountants</td>
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<td>IFA</td>
<td>International Financial Arrangement</td>
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<td>IFC</td>
<td>International Finance Corporation (World Bank)</td>
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<tr>
<td>IFI</td>
<td>international financial institution</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<td>JF</td>
<td>Joint Forum on Financial Conglomerates</td>
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<td>LVP</td>
<td>Legal Vice Presidency of the World Bank</td>
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<tr>
<td>MERCOSUR</td>
<td>Southern Cone Common Market</td>
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<td>MoU</td>
<td>Memorandum of Understanding</td>
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<tr>
<td>NIFA</td>
<td>New International Financial Architecture (G8)</td>
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<td>OECD</td>
<td>Organization of Economic Cooperation and Development</td>
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<td>OGC</td>
<td>Office of the General Counsel of the IMF</td>
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<td>RFI</td>
<td>Regional Financial Institution</td>
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<td>ROSC</td>
<td>Reports on Observance on Standards and Codes, IMF</td>
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<td>WB</td>
<td>World Bank</td>
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<td>WTO</td>
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Financial Sector Legal Reform

Joseph J. Norton

Introduction

In anticipation of the World Development Report 2006: Equity and Development,1 the World Bank’s Legal Vice Presidency (LVP) perceptively held an extended high-level forerunner conference in December 2005 on “Law, Equity and Development.” The primary purpose of this event was to explore the ways in which the LVP and the Bank should best approach matters of legal and justice reform, including how to move the LVP forward to the next generation of financial sector legal reform.2 It is in this latter context of a next generation of financial sector legal policy and infrastructure reforms that this paper was written. With an estimated three billion of the world’s population “excluded” (in terms of practical effect, not necessarily by intent) from the financial sectors of their respective countries—leaving them without any financial “lifeline” or any effective means to access the financial sector, and without the prospects of wealth creation over time—the importance of getting this next generation of financial sector reform “right” cannot be overstressed.3

1. This World Bank Development Report, a late 2005 copublication of the Bank and Oxford University Press and the work of Bank staff, considers equity in terms of “two basic principles:” equal opportunity and avoidance of deprivation of income. The report “highlights that legal and regulatory frameworks and equitable justice systems can do much to level the playing field in the political, economic and socio-cultural domains, but they can also reinforce existing inequalities.” For definitional purposes, the notion of “equity” can have a broad range of meanings for a variety of different observers. For example, in the financial sector, “equity” might be used as analogous to “ownership,” which would entail: (i) a “bundle” of expectations of the legitimate (not just current) “beneficiaries” of a country’s financial system; and (ii) meaningful access, participation, receipt of benefits, good governance, accountability, disclosure and other owner protections, etc.

2. This conference was held December 1–2, 2005, at the IFC in Washington, DC. In his keynote remarks, Ambassador Roberto Dañino, then head of the Bank’s LVP, expressed his personal view that the LVP and its legal experts should serve “the knowledge side of the Bank” as it reshapes its mission(s) as a global development institution committed to poverty alleviation. He further postulated that a fundamental set of questions for development policy “turns on identifying strategies for building more equitable and accountable legal frameworks and systems.” He emphasized the interconnection between legal and judicial reform and the bettering of the human condition and the optimum development of human capital. Ambassador Dañino conceived of the December 2005 forum as enhancing “the dialogue between lawyers, academics and other development practitioners, thus building common understanding about ways of improving the quality and effectiveness” of the legal and justice reform work of the LVP and the Bank. See www.siteresources.worldbank.org/INTTOPLEGFOR/Resources/LegalForum2005.doc (accessed March 16, 2006). The author notes that in October 2006, a new Bank General Counsel was appointed: Ms. Ana Palacio, former Foreign Minister of Spain and a distinguished Professor at the College of Europe, University of Parma. Although Ms. Palacio is in the very early stages of setting her own mark on the LVP, historically she has shown a strong affinity with the empowerment of the poor to help reduce poverty.

It is the general view of this author\(^4\) that the Bank, its LVP, and others in the economic development arena should undertake the “next generation” of financial sector legal policy and infrastructure\(^5\) reform systematically and thoughtfully within or alongside a complementary framework of meaningful and relevant economic and social development policy objectives, including that of making the financial base broader and more inclusionary.\(^6\) Such reform should be tied to the Bank’s fundamental mandate as a development bank and its primary mission of poverty alleviation (as reaffirmed by the United Nations’ Millennium Goals of 2000\(^5\)) and should be effected (to the extent reasonably practicable) in an integrated, sequenced and coherent manner.\(^8\)

Now that the Bank has begun actively to focus on the interconnected issues of equity and access in financial sector legal reform,\(^9\) the LVP itself should spearhead the legal dimensions of this “next-generation” process (although obviously the formulation of the next generation will certainly be a part of ongoing internal and external dialogues, experimentations, reevaluations and revisions).\(^10\) In formulating this reform, the Bank and its LVP should

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4. Over the coming year, the author contemplates preparing a second paper that will take up the suggestion of Hernando de Soto and others that lessons can be learned from the examples of how developed countries such as the USA have worked to include lower-middle income sectors of society into the financial sector a meaningful way. Also see note 137].

5. That is, the legal framework comprising appropriate laws, regulations and related institutions and instruments.

6. As will be pointed out throughout this paper, modern “financial sector development” is not necessarily consistent with or supportive of what should be a developing country’s broader “economic development” planning and policies. See T. Thorsten, A. Demirgüc-Kunt and M. Soledad Martinez Peria, \textit{Reach Out: Access and Use of Banking Services Across Countries}, Development Research Group, Finance Team, Policy Research Paper, no. 3754 (World Bank: Washington, DC, 2005).


8. In setting forth this proposition, the author recognizes that the World Bank Group and other international financial institutions (IFIs) have been involved in ad-hoc financial access-related projects over a period of several decades. For example, microfinance-related projects can be traced back to the 1950s. Clearly in recent years, the Bank Group and its “affiliated” Consultative Group for Assisting the Poor (CGAP) have been most active and innovative in promoting microfinance techniques and/or structures and projects. See the extensive CGAP website on microfinance at cgap.org/portal/site/cgap (accessed September 24, 2006). In addition, the IFC and EBRD have, for example, been involved in SME development projects (see IFC, \textit{SME Access to Financing}, which discusses at length the IFC’s support of microfinance institutions, such as leasing companies, banks and equity funds, http://www.ifc.org/ifcext/sme.nsf/Content/AccessToFinance (accessed September 24, 2006). These ad-hoc project-type initiatives are indeed most important for the next generation of financial sector legal reforms, but this paper focuses primarily on financial sector policy and infrastructure.

9. See, for example, the materials from the World Bank (Financial Sector) Global Conference, “Access to Finance: Building Inclusive Financial Systems,” May 30–31, 2006, Washington, DC, http://web.worldbank.org/WEBSITE/EXTERNAL/WB1/WBIPROGRAMS/FSLP/0,,contentMDK:20611560~pagePK:64156158~piPK:64152884~theSitePK:461005,00.html (accessed September 24, 2006). These materials explore such topics as measuring financial access and its impact on growth and poverty, infrastructure and outreach, institutions and contracts, and formal financial institutions. The author is aware, as discussed later in this paper, of recent LVP efforts to incorporate “access and equity” issues into Bank FSAPs and technical assistance programs. However, it should be kept in mind that “access and equity” in and of themselves do not fully and adequately address the overall developmental goals and objectives of the financial system of a particular country or the corresponding necessary legal and institutional infrastructure and implementing instruments.

10. As referenced in notes 8, 9 and 92 of this paper, the Bank (through a series of major country studies), related groups such as CGAP (through its extensive work in microfinance), and the Bank’s LVP (through
accordingly step back and take stock of what the preceding financial sector legal reform has and has not achieved. Appropriate lessons should be discerned for going forward so that the legal component can become supportively linked with the economic and social components of an overall reformulated reform process in the financial sector.

This author recognizes the significant work that the LVP and other areas of the Bank and the IMF have expended on “deepening” financial sector legal reform in developing countries since the mid-1990s, often in an environment where they were reacting to immediate financial crises. Yet to date, the financial sector legal reform efforts of those international financial institutions (IFIs) that are part of the so-called “New International Financial Architecture” (NIFA) mandated by the G7/G8 (which include the Bank Group and the IMF) have not yet formally and systematically considered, within the context of an overall legal infrastructure and policy approach and/or framework, how financial sector reform efforts should fit into and support the economic and social development needs of a particular developing country. Their systemic concerns to date have primarily been: (i) financial crises and related contagion prevention, (ii) global financial stability, and (now) (iii) financial sector integrity in the context of anti-money laundering (AML) and combating

the FSAP initiative with the IMF and its efforts on law and justice reform) have already begun to set the stage for the next generation of financial sector legal reform. However, this author suggests that still greater and broader efforts are needed to assess the first generation of reforms, provide a coherent policy and structural basis for the second generation of reforms, and institute a coordination process within the Bank and the LVP for building, assessing, revising and refining (as needed) this next generation of reforms.

11. For example, they have focused on the importance of property and contract rights and remedies, secured transactions, corporate governance, and corporate and bank insolvency—all with limited staff and resources. Without being an apologists for the LVP, before one critiques the law reform efforts of the past decade or so, one needs to be aware of the then existing environment and practical realities of the World Bank. Historically, law and justice reform work was not a core function of the Bank and started as incipient, collateral activities of the LVP. One must also note that financial crises and their contagion were rampant during this period, requiring immediate “firefighting” just to try to develop a range of laws on central banks, commercial banking, etc., for a large number of Bank/IMF client countries. In a sense, the financial sector legal reform was developed “on the job.” The Bank perceived relatively early the related importance of judicial reform; however, this was again an incipient, collateral activity attended to with limited personnel and resources. In the late 1990s, the Bank responded to the G8 mandate of internal accountability, closer IFI cooperation efforts, and assessment mechanisms available to IFI client countries. In addition, the G8 became increasingly concerned about corruption and good governance, financial fraud, financial-related criminality and terrorist financing in the 1990s, particularly after “9-11.” Moreover, other lawyers within the Bank were endeavoring to assist in developing international standards for creditors’ rights and corporate insolvencies, as well as international principles for bank insolvencies. As becomes readily apparent, the involvement of the LVP and other Bank lawyers became significantly expanded over this time, with little time to step back and take a broader look at the true developmental implications of such reforms, better coordinate their effects and plan for the next generation of reform. Cooperative legal efforts between the LVP and the Office of the General Counsel (OGC) of the IMF are also of relatively recent origin; the development of such inter-institutional cooperation, in and of itself, inherently brings both start-up and ongoing institutional “cultural” tensions and adjustments.


terrorism financing (CTF). Given this context, their vantage point has quite understandably been that of industrialized countries with a global perspective.

Section I of this paper will consider how the first generation of financial sector legal reform developed largely through the policy orientation of the G7/G8, beginning with the practical mandates given to the IFIs in the mid-1990s. Section II will discuss how these mandates gave rise to a series of international financial standards and codes that came to form the heart of the first generation of reform efforts. While such standards and codes have evolved beyond formal commercial bank, central bank and capital market laws to address related subjects, such as corporate and bank insolvency, secured transactions, payments systems, accounting standards and corporate governance (and the implementation thereof), they never addressed, in terms of setting overall policy, developmental issues such as access and equity. Section III will discuss how, at the turn of this millennium, greater emphasis began to be placed on oversight, coordination, evaluation and assessment. The conclusion will then attempt to draw together some relevant observations and “lessons learned.”

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14. This author is in no way arguing that the G7/G8 efforts and IFI implementation, dissemination and assessment over the past decade have not been without merit. He is suggesting that these efforts and directions are not sufficient, inasmuch as they deal with an incomplete picture of a developing country’s longer-term economic and social developmental requirements, which can be facilitated through financial sector legal development. See J.J. Norton, Financial Sector Law Reform in Emerging Economies (London: BHCL, 2000).

15. In a real sense, the compressed, quickly changing and unpredictable events over the past decade plus have kept the LVP and the Bank, until very recently, in a largely reactive mode, which in turn impeded them from focusing more clearly on their broader, longer-term and evolving historical development mandate. More generally, it needs to be kept in mind that throughout this past decade, the Bank as a whole has been in an evolving stage of significant transformation. See, for example, the recent presentation of Dr. T. Genta-Fons, Lead Counsel in the LVP, “The Evolution of the Role of the World Bank as a Development Institution: From Bretton Woods to the Millennium Development Goals,” March 8, 2006, Southern Methodist University, Dallas, Texas. Bank economists themselves, moreover, who comprise the vast majority of Bank and IMF professional staff, are only recently coming to grips with the relationships between financial sector development and economic growth and actual poverty reduction. See, for example, Patrick Honohan, Financial Development, Growth and Poverty: How Close Are the Links? World Bank Policy Research Paper, no. 3203 (Washington, DC: World Bank, 2004), available at http://econ.worldbank.org/files/32898_wps3203.pdf (accessed June 30, 2006).
I. The Search for Global Financial Stability and Financial Sector Integrity

The G7/G8\textsuperscript{16} invention of the notion of a “New International Financial Architecture” (NIFA) a decade back\textsuperscript{17} logically presumed the prior existence of an “international financial architecture,” inasmuch as it projected the institution of a new “architecture.”\textsuperscript{18} In the same way, the invocation of the “next generation” of financial sector reform by the LVP and the Bank presumes the pre-existence of some “first generation” of reform. Yet, as with the NIFA, which is in fact a misnomer of sorts and, in some sense, a public relations ploy to dress up an ongoing quandary,\textsuperscript{19} the term “next generation” might also lend itself more to “hype” than substance. Yet, regardless of whether a true “architecture” or “first generation” existed, there has come to exist a working base from which a new architecture and a next generation can be developed.

This being said, the NIFA, as it has unfolded over the past decade, has endeavoured to coordinate and direct a wide grouping of different, though related, international bodies that have their own mandates, jurisdictions and powers. These bodies included: (i) multilateral agencies (IMF, WB, BIS, OECD),\textsuperscript{20} (ii) policy formulation groups (G7/G8, G10, G20),\textsuperscript{21} and (iii) international regulatory arrangements (IFAs) and standard setting authorities (Basel Committee, IAIS, IOSCO, IASC, JF, FSF).\textsuperscript{22} In addition, NIFA has in various and

\textsuperscript{16} The G7 was inaugurated in 1975 by the then heads of the French and German governments as a more meaningful forum for summits of heads of state of the major industrialized countries. Known as the G7 from 1976 until 1998, when Russia was fully admitted and it became the G8, the summit meets annually to consider major global macroeconomic and political issues. At the first meeting, held in Rambouillet, France in November 1975, only six countries were present: Britain, France, Germany, Italy, Japan and the United States (it was thus the G6 for one year). Canada joined in 1976, and the European Community, in 1977. In 1989, the G7 invited 15 leaders of developing countries to join them at their annual meeting. They met with the G7 leaders on the eve of the 1989 Paris Summit.

The agenda of these annual meetings has broadened considerably, particularly since the 1990s, and ancillary ministerial meetings (most notably, of finance ministers) have become routine. See the remainder of Part I of this paper above for a further discussion of G8 summits. See also the major G8 website, maintained by the University of Toronto: www.g8.utoronto.ca (accessed July 21, 2006). The website notes: “The summit also gives direction to the international community by setting priorities, defining new issues and providing guidance to established international organizations. At times it arrives at decisions that address pressing problems or [in the] international order more generally.”

\textsuperscript{17} Beginning in the mid-1990s, the G7 (now G8) began to focus on what it referred to as the “international financial architecture.” The first use of the specific term “new international financial architecture” is often attributed to Mr. Michael Camdessus, former Managing Director of the IMF, who began regularly to use this term in 1998 (see, for example, Michel Camdessus, “Toward a New Financial Architecture for a Globalized World,” address at the Royal Institute of International Affairs, London, May 8, 1998).


\textsuperscript{19} Ibid., 180–182.


increasing ways brought the private financial industry into the equation.\textsuperscript{23} NIFA might accordingly be viewed as an evolving policy construct—moving towards a new governance structure that reflects a public-private partnership among governments, financial sector authorities, intergovernmental financial institutions and private international financial institutions in the search for a stable but viable global financial environment.\textsuperscript{24} However, as discussed further in this and subsequent sections of this paper, the main focus of this public-private partnership is, for the most part, global financial stability and deepening financial markets, not financial inclusion or meeting the economic and social development needs of the majority of the population of developing countries.

\textit{The Backdrop}

Financial sector legal reform as a mandate for domestic and international financial authorities is clearly of recent vintage. This type of reform is largely the reactive by-product of a number of factors: financial crises and the quest for global financial stability,\textsuperscript{25} the collapse of the Soviet empire, the new “transitioning economies, the enlargement of the European Union and the ongoing onslaught of economic globalization—all of which are interconnected in various ways. It is true that there are anecdotal examples of financial law-related reforms in the 1960s and 1970s, but these were largely one-off, isolated reforms designed to facilitate specific development projects.\textsuperscript{26}

In fact, when one reviews the annual intergovernmental \textit{Communiqués} of the G7/G8 from 1975 through the mid-1990s, one notes the conspicuous absence of the issue of financial sector infrastructure (including its legal dimensions). Macroeconomic issues of global significance were then the rule of the day. Monetary stability, not financial stability, was the focus, along with other macro issues such as growth, inflation, employment, fiscal responsibility and multilateral trade and investment liberalization. Energy issues came to the

\textsuperscript{23} Virtually all the international bodies listed here directly or indirectly involve the financial industry in their deliberations, revisions and implementation of international financial sector standards, whether by way of seeking input, more direct and ongoing cooperative involvement and/or good-faith implementation of the standards. Further, in certain areas (for example, capital adequacy), the private financial sector came to provide viable operational models.


\textsuperscript{25} See the discussion in sections I and II of this paper.

\textsuperscript{26} When I taught “Legal Aspects of International Financial Law” and “Emerging Markets: Investment and Finance” at the University of London, one of my co-teachers was a senior international finance partner at a major law firm for the financial services industry. He would periodically entertain the graduate students with the occasional anecdote about how his firm had to draft a business and/or financial law on short notice to effect a project in one of the “oil kingdoms” ruled by an absolute ruler, or alternatively, that in South Central Asia, his firm had to have the “parliament” under the control of a military ruler pass, over a weekend, a needed piece of financial legislation in order to deliver a required legal opinion on a project. Another, more IFI-related example of this type took place in the early years of the EBRD, which views itself as more an IFC-type, commercially-oriented development institution. In the 1990s, any institutional or legal reform in its mandate countries had to be specifically project-focused. Only by mid-decade did the EBRD set up a legal reform component within its General Counsel’s Office and this division tended to look more at generic issues of legal reform, such as model secured transaction law. See, for example, J.J. Norton and M. Andenas, eds., \textit{Secured Transactions and Emerging Economies} (The Hague: Kluwer, 1997).
foreground when energy crises developed and in the mid-1980s, environmental issues became a regular agenda item.

The G7/G8 considered the third world debt crisis adequately handled by the debtor countries, IFIs and private commercial lenders under an “international strategy” that effectively used an ad-hoc, case-by-case approach. Statements on anti-terrorism began to appear in the early 1980s and anti-money laundering in the early 1990s. Later in the nineties, anti-corruption concerns took center stage, although primarily in a macroeconomic context. Increased liquidity of the international financial system and greater transparency of financial markets, their participants and IFIs themselves also become major concerns. It was really not until the Birmingham (1998), Cologne (1999) and Okinawa (2000) Summits that the NIFA began to be fleshed out.27

The Evolution of International Standards and Practices for Banking Institutions

As will be discussed more fully in Part II, one tool for achieving NIFA objectives has been the development, implementation and dissemination of “international standards,” “best practices” or “principles” with respect to a number of financial-related areas.28 Particularly germane for this paper are the various banking standards, principles and guidance papers formulated by the Basel Committee on Banking Supervision (Basel Committee, or BCBS) over the past quarter century.29 The Basel Committee is briefly touched upon in this subsection to make the point that long before the NIFA gave consideration to the banking systems of developing countries, a G10 subcommittee was well on its way to formulating international banking standards for industrialized countries, a framework that was transported substantially to the developing-country arena in the latter half of the 1990s.30

Quite clearly, the development of international banking standards by the Basel Committee long antedates the emergence of the NIFA. In fact, the ministers of finance and central bank governors of the Group of 1031 became interested in the possible development of

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29. See the website of the Basel Committee, www.bis.org/bcbs (accessed October 12, 2007). The original name of this Committee was “Basle Committee, the Committee on Banking Regulations and Supervisory Practices.” The name was later changed to the “Basel Committee on Banking Supervision.” For purposes of convenience and to avoid confusion, the current name will be used for all purposes in this paper.
31. The G10 Group came about in 1974 as a consequence of the General Agreement to Borrow (GAB) in 1962, which was established pursuant to a decision of the Executive Board of the International Monetary Fund (IMF). The Group was informally established with the support of the IMF, OECD, the Bank for International Settlement (BIS) and the finance ministers of Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom and United States. Its primary purpose was intergovernmental consulting regarding the implementation of calls on lines of credit extended to the IMF under the GAB. The scope of consultation was broadened over the years. Subsequently, Switzerland became an active member of the Group, rendering the "G10" designation a misnomer. The G10 Group operates through respective finance ministers at the highest level, but also through various ad-hoc
international bank supervisory standards in 1974 due to the interrelated insolvency of two small international banks, the German Bankhaus Herstatt and the American Franklin National Bank. These banks had failed due to excessive exchange rate risks and lack of coordinated supervision by the relevant regulatory authorities. As a result, the Group of 10 established what is now the Basel Committee in 1975. Although this incident did not make the central bank governors concerned about a specific systemic crisis, it dawned on them that in the new 1970s era of global floating exchange rates, international risks for banking institutions had increased and there was no agreed mechanism for coordinating cross-border supervision of such institutions.

In addition, the Governor of the Bank of England became concerned that the “capital adequacy” of banking institutions was turning into an issue of international import. Traditionally, bank regulators/ supervisors were primarily concerned with institutional liquidity. The first tasks of the Basel Committee were thus to consider cross-border supervision and capital adequacy. The objects of this focus were international banks of the industrialized countries that comprised the membership of the Basel Committee. The driving forces behind the Committee were the Bank of England, the U.S. Federal Reserve Board of Governors and the then European Community’s “Contact Group.”

During the 1980s, the Basel Committee did produce a revised framework, or “Concordat,” that attempted to allocate international bank supervisory authority among a bank’s host country and home regulator/ supervisor. (A rather sketchy version of the framework had been quietly put together in 1975). This framework was revised on several further occasions during the remainder of the 1980s and in the 1990s, largely as a reaction to specific bank failures that exposed the framework as inadequate. Also during the mid-1990s, it became apparent that “international banking institution” was an incomplete notion when referring to the supervision of large industrialized banks, as they tended to operate more and more within the structure of banking and/or financial conglomerates. Thus, a supervisory framework for dealing with these conglomerates was also developed. This in turn led to a consideration of the issue of the lead regulator with respect to such conglomerates.
The most significant efforts of the Committee to date have been on risk-based capital adequacy standards. After extended, and at times contentious, internal deliberations, a risk-based “Capital Adequacy Accord” was promulgated by the Committee in 1988. While a non-binding, non-official document, the Accord soon became the international benchmark for bank capital adequacy within the developed world (through a complex, informal and uncoordinated transmission matrix) and later, the developing world. Prior to the Accord, the capital approach taken by most bank regulators and/or supervisors was a basic initial capitalization requirement, followed by an ongoing requirement of some form of fixed capital-based ratio (e.g., capital to assets). At the time, the 1988 Accord was thought to be a complex approach. Today, it is considered a basic, rudimentary framework compared to what the Committee has currently proposed in the form of the Basel II Accord.

In a sense, the 1988 Capital Accord opened a “Pandora’s box” of future formulations of international banking standards. Once a risk-based approach became the guiding measure, it became logical for the Basel Committee to delve into a range of other risks, such as those related to exchange rates, interest rates and other market-based and operational risks. These investigations all resulted in other detailed Committee pronouncements. Moreover, beginning in the late 1980s and continuing through today, the Committee became concerned with money laundering and, more recently, related counter-terrorism regulatory standards.

In the later part of the 1990s, it began to address issues of the institutional governance of banking institutions more formally.

Thus, by the time the NIFA came to the forefront of banking and/or financial system policy concerns, a broad foundation for international banking supervisory standards was in place—all based on the concerns of the central bank governors and banking institution regulators and supervisors of the G10 industrialized countries. It is true that in the late 1970s, a biennial International Conference of Bank Supervisors was initiated by the Basel Committee for the purposes of informing bank supervisors and regulators from non-G10 countries, including the developing world, of the Committee’s work, with a view toward globally promoting its efforts.

In addition, beginning in the early 1980s and increasingly in the early 1990s, regional, sub-regional and special groups of national bank supervisors and regulators were created informally to consider how Basel Committee–based pronouncements could be translated into the purview of particular groups. These groups were not part of the Basel Committee

43. See Norton, “Capital Adequacy.”
46. See, for example, Basel Committee, “Enhancing Corporate Governance for Banking Organizations,” Basel, Switzerland, February 2006 revision.
47. See Walker, International Banking Regulation, chapter 1, section 6.10.3.
itself, but were often technically supported by it. However, the importance of these groups was not so much that they provided upward feedback to influence the standards formulations of the Basel Committee, but allowed for a top-down transmission of the Committee's industrialized-country determinations.48

**G7/G8 Communiqués, 1975–1994**

Admittedly, from 1975 onwards, the G7 made annual intergovernmental policy statements concerning linkages with the developing world, particularly with respect to assisting the poorest countries and more particularly, Africa. For example, discussion of a new international development strategy was put forward in 1980 at the Venice Summit of the G7 and discussions of specific debt relief for the poorest countries came to the forefront in the late 1980s.49 In reality, however, nothing of real ongoing substance was put forth by the G7 until the 1999 Cologne Summit,50 and it was not until the 2005 Gleneagles Summit that debt relief for the poorest countries, with a focus on Africa, appeared to gain substantive momentum (by being linked directly to the United Nations Millennium Goals agenda).51 Yet the most recent July 2006 St. Petersberg Summit seems to have foundered on such highly contentious issues as the Doha Trade Round stalemate, North Korea, Iran, and the political situation in Israel, Palestine, and Lebanon.52

The first near-direct reference of the G7 to financial sector legal reform found by this author was a one-sentence passage in the 1992 Munich Summit Communiqué, which referenced the need for a “dependable legal framework for private investors” in the newly “transitioning” Central and Eastern European countries. But it was not until the unexpected 1994 non-sovereign debt financial crisis in Mexico that became apparent that the summits needed to consider issues of financial infrastructure on more than an ad-hoc basis.54 At the 1994 Naples Summit, the G7 Heads of State made financial sector reform a major agenda item for the 1995 Halifax Summit.55

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48. Ibid., section 6.10.4.
50. For information on the 1999 Cologne Summit, see [www.g7.utoronto.ca/summit/1999koln/index.htm](http://www.g7.utoronto.ca/summit/1999koln/index.htm) (accessed October 12, 2006).
54. In the early 1990s, Mexico was considered to have largely recovered from the 1980s debt crisis and had made major reforms to upgrade its economy and become integrated into the international economy (for example, it was admitted to the WTO). In fact, with the successful signing of the NAFTA Treaty in 1994, everything looked rosy for the Mexican economy. But even before NAFTA came into effect in 1995, an economic and financial crisis set in that required a prompt major intervention by IFIs and the U.S. Treasury. See Norton, “The Mexican Experience with Financial Sector Reform,” in *Financial Sector Law Reform*.
55. See section 1, paragraph 3 of the 1994 Naples Summit: “To carry out this responsibility, we have agreed that, in Halifax next year, we will focus on two questions: (1) how we can assure that the global economy of the 21st century will provide sustainable development with good prosperity and well-being of the peoples of our nations and the world? (2) what framework of institutions will be required to meet these challenges in the 21st century? How can we adapt existing institutions and build new institutions to ensure
The Turning Point: The Halifax and Lyon Summits

The 1995 Halifax Summit did address the issue of financial system crises in light of the 1994 and subsequent 1995 Mexican financial crises. However, the primary attention of the G7 heads of state was on “the growth and integration of global capital markets [which] have created both enormous opportunities and new risks.” Their emphasis was on the prevention of crisis, with the preferred course of action still being largely macroeconomic in nature, with each country pursuing sound fiscal and monetary policies. It was also agreed that there was a need for “an improved early warning system [EWS] so that we can act more quickly to prevent or handle financial shocks.” Such a system was viewed as including “improved and effective surveillance of national economic policies and financial market developments and fuller disclosure of this information to market participants.” The IMF was given this mandate, along with the task of establishing a new emergency financing mechanism for greater international liquidity.

Down the line of priorities, but of great significance for financial sector reform, the Halifax Communiqué refers to “[c]loser international cooperation in the regulation and supervision of international institutions and markets to safeguard the financial system and prevent an erosion of prudential standards.” To this end, the G7 encouraged a “deepening of cooperation among regulators and supervisory agencies” in order to help ensure “an effective and integrated approach, on a global basis” so as to foster the “safeguards, standards, transparencies and systems necessary to monitor and to contain risks.” Yet, at the same time, they encouraged the dubious further liberalization of capital market restrictions.

In addition, the G7 finance ministers were directed to prepare a study for the 1996 Lyon Summit based on the work of international organizations responsible for banking and securities regulations (i.e., the Basel Committee and IOSCO). The Halifax Summit also noted that “international financial fraud is a growing problem.” These recommendations were largely taken from a relatively abbreviated background document entitled “Review of the International Financial Institutions.”

the future prosperity and security of our people?” (www.g7.utoronto.ca/summit/1994naples/communique/introduction.html; accessed October 12, 2006).

57. Ibid.
58. Ibid.
59. Ibid.
60. Ibid.
61. Ibid.
62. Ibid.
63. Ibid., section 6.
64. Ibid., section 5.
65. Ibid., section 6.
66. To access this document, see www.g7.utoronto.ca/summit/1995halifax/financial/index.html (accessed October 12, 2006).
While G7 financial sector reform objectives were not developmental in nature or intent, as they did not address the role financial sectors might play in reducing poverty, their impact could in certain ways be viewed as impacting the developing world (i.e., a safe, sound and stable playing field is a prerequisite for developing any financial sector and its development is important for sustained economic growth). However, the implementation of these objectives was assigned to a group of disparate IFIs and international financial arrangements (IFAs), primarily the IMF and World Bank, which were directed to engage in increased cooperation.

While this mandate appeared to imply both policy and implementation efficiencies, the reality is that, at the time, there were really no appropriate institutions, instruments or a relevant knowledge and/or technical assistance base appropriate to the circumstances. In effect, both the Fund and the Bank were thrust into embracing new mandates and, although they were fundamentally different institutions with their own respective “cultures” and original mandates, they were directed to undertake cooperative efforts in the new mandated area of financial sector reform.

The relevant resources that existed in this area in the mid-1990s were located within or through IFIs and/or IFAs. However, using these resources often pushed an IFI into new mandate territory. For example, the IMF was created as an international monetary institution to deal with short-term macroeconomic issues of its members and ensure a stable international exchange rate system. The Bank was set up as a development institution for post-World War II reconstruction and economic development. Now, these different but related Bretton Woods institutions were being asked to participate in entirely new tasks and to do so jointly. Against this backdrop, it is amazing that many constructive, cooperative accomplishments have been made in the economic and financial legal reform area over the past decade. Certainly this work has been achieved largely in an often unknown, uncertain environment of great institutional stress and strain, and hence, an inevitable degree of less-than-optimal institutional coherence, efficiency and effectiveness.

In any event, G7/G8 “marching orders” were being put in place for the IFIs with an increasing emphasis on institutional cooperation. At the Lyon Summit in 1996, the G7 heads of state and finance ministers were still concerned primarily with macroeconomic financial system issues: more effective macroeconomic surveillance, greater international system liquidity, closer cooperation on exchange markets and increased strengthening of early warning systems for financial crisis prevention. However, they also gave considerable

67. The term “IFA” (international financial arrangements) is used in this paper to refer to the various, more informal bodies in the international financial sector area that are not true “international organizations,” such as the Basel Committee.
attention to “better prudential safeguards in international financial markets.” As noted by the finance ministers: “[c]omprehensive and effective financial regulation, market-reinforced prudential supervision and enhanced international cooperation among regulators are among the keystones for maintaining stability of the international financial and monetary system.”

In response to an initiative of the G7 Lyon Summit in June 1996, representatives of the G10 countries and emerging-market and transition economies jointly sought to develop a strategy to foster financial stability. This strategy was based on analysis of previous financial crises and the elucidation of basic standards and principles to guide individual nations in developing stronger financial systems. The subsequent study concluded that a financial system that is “robust” is less susceptible to the risk of crisis in the wake of real economic disturbances and more resilient in the face of crises that do occur.

The G7 also directed a number of international organizations to develop agreed mandatory international prudential standards to encourage and improve confidence in and the viability of domestic financial systems. The aim of such standards was to promote sound financial institutions, minimize systemic risk and encourage savings and investment activity through increased confidence in financial markets, both domestically and internationally. It must be noted at the outset, however, that these international principles and standards were to be just that: minimum internationally agreed-upon guidelines that leave signatory countries wide latitude in their implementation.

The G7 finance ministers were impressed with the previous work of the Basel Committee and the International Organization of Securities Commissions (IOSCO) on developing “international standards for prudential supervision” of banks, securities firms and markets, as well as of payments and settlements systems. The ministers particularly approved the joint Basel Committee/IOSCO work on market risk and capital adequacy, derivatives and futures exchanges—all sophisticated areas of concern for industrialized countries. They also recognized cooperation among bank, securities and insurance supervisors through a body called the Joint Forum on Financial Conglomerates (JF) and recommended better vehicles for increased institutional cooperation. In hindsight, one can see in this original thread the subsequent increased importance and spread of international standards and codes and the later formation of the international standards coordinator, the Financial Stability Forum (FSF).

At Lyon, the G8 finance ministers did encourage greater outreach of the Basel Committee and IOSCO to emerging markets. In fact, the organizational structure of IOSCO had already internalized a parallel Emerging Market Committee. At the same time, the Basel Committee

72. Ibid.
75. Established in 1996 by the Basel Committee, IOSCO and the International Association of Insurance Supervisors.
(as mentioned above) had begun to develop a network of separate regional and sub-regional “mini-Basel Committees.” As noted by the finance ministers,

Because emerging markets are growing in significance, these Committees should be encouraged to strengthen their outreach to and cooperation with emerging market supervisors in order to promote high prudential standards. The International Financial Institutions should give more attention to promoting effective regulatory and supervisory structures in emerging markets.77

Although more attention was directed toward the emerging economies, in terms of their adopting international prudential standards, no attention was given to how financial sector development could help reduce poverty and economic inequality in these countries. Neither was any policy consideration given to which standards, and in which form, would be best for emerging economies, just as no real concern was expressed for the financial systems of lesser-developed economies.

**Fleshing Out the New International Financial Architecture (NIFA)**

At the 1997 Denver Summit, the G7 heads of state and finance ministers again put financial stability center stage, issuing a final report on the subject.78 Greater cooperation among supervisors of internationally active supervisors and among the IFIs was further encouraged. Interestingly, corruption and anti-terrorism also became main subjects of consideration. The summit even focused on the role of small- and medium-sized enterprises (SMEs), a subject that, if pursued in later summits (it was not), might have become linked to developing-country issues of access and equality. Yet, while greater emphasis was placed on emerging markets, the summit really concentrated on the wider transmission of the new (1977) “Core Principles” of the Basel Committee to banking supervision authorities in these countries.79

The G7 finance minister reports in Cologne (June 1999) and Okinawa (June 2000) specifically followed up on the following NIFA components in some detail:

- strengthening macroeconomic policy for emerging economies
- strengthening and reforming IFIs
- accurate and timely information flows and transparency
- strong financial regulation in industrial countries
- strong financial systems in emerging markets
- exchange rate policies
- sound accounting standards
- legal infrastructure
- corporate governance
- anticorruption and money laundering
- technological innovation and adaptation
- risk management

77. Ibid.
Integral to all these components was a significant “law-based dimension” that involved global principle and standard setting, including:

- banking regulation
- capital markets regulation
- insurance supervision
- corporate governance
- financial conglomerates
- payment, settlement and custody mechanisms
- pension funds and collective investment schemes
- accounting and auditing standards

Other matters related to NIFA that were addressed, but not adequately so (in the view of this author) by the finance ministers included exchange rate stability, short-term capital flows, regional responses to financial crises, reform of IFIs, offshore centers and highly leveraged institutions (“HLIs”). Additional relevant matters that were also not sufficiently addressed included major moral hazard issues (e.g., deposit insurance), the interaction of international prudential standards with the WTO/GATS financial services liberalization process, social safety-net component issues and the consolidated supervision of global banks, banking and financial organizations and financial conglomerates.

Although the G8 heads of state and finance ministers did consider developing countries at their annual meetings at Birmingham, Cologne and Okinawa, they were examined mainly within the context of debt alleviation for the poorest countries and how to integrate the developing world into the “global environment.” The underlying assumption appeared to be that sustained global growth, increased trade and investment liberalization would bring increased economic growth to developing countries, just as a strengthened international financial system would foster global growth.\(^{80}\) The G7 singled out treatment of emerging economies in financial sector reforms, but when one reads through the materials, the summit’s bottom line appeared to be that these economies needed to adopt and implement existing and unfolding international standards and best practices, with IFIs playing a major role (directly and/or indirectly) in their transmission and implementation, as well as through related technical assistance processes.

From 2000 to the present, the G8 appears to have been absorbed by a proliferating range of international political and security crises. As for financial sector reform, the use of Financial Sector Assessment Programs (FSAPs) and greater IFI cooperation has been encouraged and concerns have increased regarding financial crimes, corruption and fighting terrorism financing.\(^{81}\) As mention above, debt relief for the poorest developing countries gained further and more detailed traction at the 2005 Gleneagles Summit.\(^{82}\)


\(^{82}\) See www.g7.utoronto.ca/summit/2005gleneagles/index.html (accessed October 12, 2006).
II. Financial Sector Reform and International Standard Setting

As discussed above, since the mid-1990s, a primary instrument for achieving the G8 agenda of handling financial crisis and related contagion prevention, as well as fostering global financial stability, has been the development and coordination of international financial standards and their global transmission within the developed and developing worlds. The “transmitters” have ranged from international organizations such as the OECD (corporate governance), to unofficial arrangements of a limited number of bank supervisors and/or regulators, such as the Basel Committee (banking and financial conglomerates) to a much broader array of domestic governmental bodies and private capital market authorities and organizations, such as IOSCO (securities markets). The World Bank’s role in this process has largely been that of a “transmitter” of these standards through its conditionalties/structural adjustment lending and technical assistance, although its role now includes that of an “assessor” through the FSAP program.83 The Bank can, moreover, be viewed as an actual standard setter in connection with its corporate and bank insolvency initiatives.84

As is emphasized throughout this paper, it needs to be kept in mind that historically, the formulation of international financial standards has been driven by the highly industrialized countries,85 whose concerns have been primarily been:

- financial crisis avoidance and resolution
- financial stability
- financial services liberalization
- regional and global cooperation

More recently, financial sector reform has also been driven by industrialized countries’ concern over financial sector integrity, a notion that has come to embrace the following:

- anti-money laundering (resulting from drug dealing and other criminal activities)
- combating terrorism financing (post-September 11)
- anti-corruption
- corporate governance of financial institutions
- transparency and accountability
- greater availability of information (enhanced disclosure)86

85. For example, the formation of the BCBS-Basel Committee came about in the mid-1970s as a result of the concerns of central bank governors of the G10 countries about possible exchange-rate risks, as exemplified in the non-systemic “Herstatt crisis.” The Committee gave global significance to capital adequacy concerns in the 1980s with respect to the industrialized countries. This was the beginning of the Committee’s role in developing a range of “international standards” in the bank supervisory/regulatory area. See Norton, “Capital Adequacy.”
While one can reasonably and in good faith rationalize, as does the Bank and other IFIs, that these focal points are directly related to the economic development processes of developing countries, the truth is that these concerns have been engendered directly by industrialized countries. In most instances, the interconnection between their concerns and substantive development goals, such as poverty reduction, is indirect and in some instances, quite tenuous at best. Taking this into account, the role of the Bank in financial sector reform over the past decade has been mandated largely by the G7/G8 global policy determinations and “directives.”

The remainder of Part II discusses how international standard setting has evolved in the financial sector since the 1970s. This process began incidentally in the mid-seventies, evolved over the 1980s and early 1990s, and has since become linked to the G7/G8 process (and IFI/IFA cooperation and technical assistance). The pre-1997 international standard setting of the Basel Committee on banking institutions was considered in the preceding subsection.

**Background**

As mentioned above, over the past two plus decades the international financial community has been in the process of devising a consensus on international standards and codes of conduct to achieve financial stability and develop robust financial systems. This consensus takes the form of pronouncements by such bodies as the Basel Committee, the International Accounting Standards Committee/Board (IASC/IASB), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum on Financial Conglomerates (JF), and the Financial Stability Forum (FSF).

However, even the diligent application of these standards and codes do not necessarily achieve optimal outcomes when reforming the financial systems of developing economies. For example, former World Bank Chief Economist Joseph Stiglitz, who is a critic of the “Washington consensus,” has emphasized the need to contemplate various political, social

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87. For example, having “Basel-compliant” banking systems is a good goal for all countries—developed and developing alike—but for a developing country, compliance does not get to the core issue of how the banking and financial system should best be structured to serve optimum country-specific economic and social development needs. One can also readily see that whereas corruption is a key issue for donor countries and IFIs, it is also a core concern for effective development. When one gets to the area of anti-money laundering and counter-terrorism financing, these objectives are clearly of key concern to the USA and other highly industrialized countries in the so-called “global war on terrorism,” but it is quite dubious that the amount of effort that development banks now devote to this area produces any real development benefits that could justify this effort or its cost.
89. The “Washington consensus” refers to the policy of the International Monetary Fund and the U.S. Treasury that promotes, among other neoclassical economic objectives, market economies, capital account liberalization and effective external market access.
and cultural facets of development as well. This paper similarly argues that financial sector reform needs to be part of broader objectives for the sound economic development of a particular developing country.

In the first place, internationally accepted banking supervisory standards for developing economies should be effective. At a minimum, the legal infrastructure needs to be “enforceable.” But many of the problems that led to or exacerbated the Thai financial crisis in 1997 were problems of infrastructure and culture. Application of international best practices by itself was therefore inadequate. As well as substantially improving legal and judicial frameworks, societal cognizance of and adherence to rules and their enforcement, normative actions must also be encouraged. Yet such actions involve a long-term educational process that must penetrate an entire society to enhance fairness, greater transparency and economic opportunities for a larger proportion of the domestic society.

But even in this scenario, if one considers the domestic banking and financial systems of a developing country such as Thailand, one quickly sees that these systems really serve the upper elites of the society and the government, not a significant portion of the population and their developmental needs.

The World Bank recently conducted significant studies on the issue of “exclusion” in Brazil, Colombia, and Mexico, which reinforce this observation. These findings lead to issues of access and equity, which are now being considered by the Bank and other IFIs in designing their respective financial sector reform efforts. Yet, even in these organizations, financial reform efforts do not fully consider the actual requirements of economic and social development of disenfranchised populations with respect to the financial sector. Although one can argue that incorporating such considerations into financial sector reform does not really constitute “public goods,” the fact of the matter is that standards and code setting

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91. Financial crises erupted in the markets of Asia in 1997 and engendered a broad “contagion” effect. Thailand was the first country to be affected. Abandoning its pegged exchange rate for the baht on July 2, 1997, it experienced a dramatic “free fall” of its currency value. After Thailand agreed on a “stand-by arrangement” with the IMF in October 1997, reform of the Thai financial sector took place with the guidance of the international community. See Tull Traisorat, Thailand: Financial Sector Reform and East Asian Crises (London: Kluwer 2000).


93. These most helpful reports make numerous specific recommendations and observations, but largely do not address broader governmental infrastructure policies and institutional reforms that should be made.
impact the establishment of policy priorities and the allocation of resources in the financial sector.

In all events, “financial stability” itself, that is, the stability of national and international financial markets, has clearly become viewed today as a “public good” by most responsible governments and intergovernmental IFIs. Part of the search for stability involves creating a safe, sound and effective banking regulatory framework. Without financial stability at the domestic, regional and global levels, it is impossible to develop a sound domestic system—whatever the domestic policy underpinnings might be. In addition, financial instability has various “negative externalities,” the most prominent of which is a redistributive effect wherein the poor are more severely affected than the rich. Other externalities include national and international contagion, as well as the regulatory “race to the bottom.” Also inherent in most financially unstable situations is significant informational asymmetry.

To strengthen the financial system against these and other vulnerabilities, the G10 (and more recently, the G7/G8) countries have fostered standards and principles that are considered “best practices.” These best practices are promulgated through international forums such as the BCSC, IOSCO, IAIS, IASC and now, the FSF. In large measure, these practices are derived from the experiences of developed countries (e.g., the USA and EU countries). To a lesser degree, they are derived from observations regarding the difficulties of economic transition (e.g., the Central and East European, or CEE, nations) and of major emerging economies over the past decade. The 1997 Basel Committee “Core Principles” themselves emanate from Committee endeavors that date back to the 1970s. The Principles were to some extent supported by the “Washington consensus,” as transmitted in part by the application of “conditionality” to IMF/World Bank borrower loans and the provision of technical assistance to country clients.

Recent international cooperation efforts to develop standards and principles are becoming more “country user-friendly,” with the participation and input of emerging economies actively sought. As mentioned above, in response to the Lyon Summit of June 1996, the G10 nations and emerging economies convened to seek a framework to foster financial stability. It was also noted that the new Financial Stability Forum (FSF) involves non-G10 representatives, including Hong Kong, Singapore, Australia and the Netherlands. While FSF membership did not formally specify particular developing countries or emerging-market nations, a range of other countries (including certain developing countries) are invited to attend various working groups of the Forum as observers. Further, as seen above, the

95. There are various reasons why banks are given special consideration. One of the main arguments is the supposed contagion effect of a bank failure. Banks are susceptible to contagion mainly for three reasons: (1) a low capital-to-assets ratio (high leverage with little capital to cover losses); (2) a low cash-to-assets ratio (fractional reserve banking, which requires the sale of earning assets to meet deposit obligations); and (3) a high-demand debt and short-term debt-to-total debt ratio (a maturity mismatch of assets and liabilities, which is the cause of a bank run). See G.G. Kaufman, “Bank Failures, Systemic Risk, and Bank Regulation,” Cato Journal 16, no. 1 (1996): 16-31.
96. See Arner, Financial Stability, part II.
97. See the subsection “G7/G8 Communiqués, 1975–1994” in section I of this paper.
98. Transmission has occurred in other ways as well, such as through EU accession programs, country group “peer pressure” and unilateral country decisions.
statements of the G7 finance ministers at the 1998 Birmingham and Cologne Summits were particularly germane in setting the stage for the current, more inclusionary efforts of the World Bank and other IFIs.99

Regarding banking institutions, the Basel Committee continues to formulate appropriate supervisory principles by looking at advanced capital adequacy rules that also cover operational and market risks.100 As alluded to above, other international bodies, such as IOSCO, IAIS, and IASC, are also working towards international standard setting, often working together jointly and with the Basel Committee.101 While international standards for the financial system are still in the process of development and refinement, those produced by these respective forums are accepted as de facto “best practices” by both developed and developing countries.102 When reforming their financial system, for one reason or another, most economies today try to emulate these standards. In assessing the financial systems of developing countries, IFIs use these standards as their reference point.103

As mentioned above, the G7/8 views robustness as an essential characteristic of a stable financial system. To promote this quality, the G10 Working Group has identified three crucial actions that should be taken by each country, according to their specific situations:

- creation of an institutional setting and the financial infrastructure for a sound credit culture and an effectively functioning market;
- promotion of functional markets so that owners, directors, investors and other actual and potential stakeholders exercise adequate discipline over financial institutions; and
- creation of regulatory and supervisory arrangements that complement and support the operation of market discipline.104

These actions would entail improving the infrastructure of the financial system, namely, the legal and judicial framework, accounting and disclosure standards and the market structure. When viewed in this way, financial legal sector reform becomes a deep, complex and long-term matrix of reform efforts that presents truly awesome challenges for and makes significant demands upon IFI resources and personnel at a time when they are being

101. See the subsection “Fleshing Out the New International Financial Architecture (NIFA)” in section I of this paper. See also Arner, *Financial Stability*, chapter 4.
102. The consensus often includes that of private parties because groups such as the BCSB-Basel Committee have a consultation period prior to the agreement of principles.
pressed to react to ongoing, immediate financial crises. Yet this deep reform process is not directed toward broadening the financial system to be more inclusionary (i.e., greater access) or otherwise serve true developmental objectives.

The Supporting Legal and Judicial Framework

As IFIs came to learn and incrementally appreciate during the 1990s, the legal framework of a country supports its financial system by establishing clear rights, responsibilities and liabilities of parties in a transaction; maintaining appropriate incentives and adequate information to facilitate market forces; and providing the means to enforce legal obligations and claims effectively. For the legal system to achieve these objectives, key legislation needs to be put into place. At a minimum, this legislation should include modern contract, corporate, bankruptcy, private property and commercial laws, as well as modern banking and investment securities laws (and most probably, a basic asset securitization law). These latter legal provisions specifically govern financial activities and need to be “rule-based” and transparent, while preserving the required degree of flexibility to adapt to innovations and changing market conditions.

Financial legislation and/or regulation should also promulgate disclosure of information to enable market forces to discipline the activities of financial institutions and other market players. Clarity of entry and exit standards for financial institutions reduces uncertainty within financial markets. In addition, a well-defined exit policy is especially imperative, since such a policy applies at times when the market is likely to act rashly and cause self-fulfilling bank runs.

In addition, administrative and judicial procedures need to be sufficiently clear and backed up by quality enforcement. The problem for many emerging economies is the lack of any effective enforcement. Ensuring that enforcement is carried out means extending appropriate incentives to market participants to act normatively. Two specific priorities are seen as improving the enforcement of financial contracts:

- effective means for taking possession of collateral; and
- revision and updating of legal codes to reflect new market realities.

Lack of legal remedies in the case of non-compliance can paralyze well-functioning markets and discourage foreigners from investing in emerging markets. The uncertainty surrounding the outcome of legal procedures and processes also inhibits the robustness of financial

105. See, for example, an early discussion of these problems in J. Norton and M. Andenas, Emerging Financial Markets.

markets. Other key components of modern international financial best practices and/or standards might well include the following:

- transparency, accountability and disclosure
- market structure
- corporate governance
- stakeholder oversight
- stakeholder protection
- international surveillance, oversight, data assembly and dissemination
- sound regulation and supervision
- market discipline
- sound accounting standards and practices

All these reform components serve to strengthen and deepen the stability of a pre-existing financial sector, which in reality is only representative of the top of the economic and social pyramid. They are not designed to broaden the financial base of the sector.

The Basel “Core Principles” and Related Methodology

The “Core Principles for Effective Banking Supervision” of the Basel Committee provide the global standard for banking supervision. These principles were endorsed by the Committee in September 1997, were recently revised in 2006, and are now accepted as the benchmark for assessing the effectiveness of supervision. The principles cover the criteria that a financial institution must meet to conduct banking and also provide ongoing supervision guidelines. In addition, they include capital adequacy requirements to ensure that a bank operates safely and soundly.

According to the Core Principles, the foundation of effective banking supervision is the delineation of clear responsibilities and objectives for each agency involved, institutional independence and ensured adequate resources. These prerequisites should be supported by a legal regime that provides adequate and specific statutory powers for supervision, licensing and addressing concerns of safety and soundness. Arrangements for agencies to share information must also be established by statute, regulation and/or Memoranda of Understandings (MoUs) in order to avoid redundancy and ensure timely response. The importance of these Core Principles for both developed and developing economies has been emphasized repeatedly by the G8 and its finance ministers.


109. See www.bis.org/publ/bcbs129.htm (accessed October 19, 2006).

110. See the subsection “Fleshing Out the New International Financial Architecture (NIFA)” in section I of this paper.
The criteria for authorization of banking institutions should also be clearly defined, including an assessment of at least a bank’s ownership structure, directors, senior management, operating plan, internal controls, projected financial condition (including capital base) and if the parent organization is a foreign bank, the authorization awarded to the parent by its home-country supervisor. The “fit and proper” requirement of directors and senior management is pivotal, since it will determine the integrity of a bank’s operations.

Capital adequacy should be subject to ongoing review and supervision. Capital levels should reflect the risk exposure of particular bank assets and the relevant financial system. For example, if macroeconomic performance is weak or financial markets are underdeveloped in a given country, banks in that country should hold additional capital beyond the Basel normative standards. On a “micro level,” a bank’s internal control mechanisms should be commensurate with the nature and scale of business activities that it conducts. These mechanisms would include risk management and enforcement measures to remedy deficiencies.

To foster greater transparency, information requirements should oblige each bank to maintain adequate records consistent with accounting principles and practices, as well as to publish acceptable financial statements on a regular basis. Supervision should be conducted both on site and off site. This type of supervision requires a significant governmental commitment to creating, supporting and sustaining an adequate supervisory examination system that that is “risk-focused.” Collection and analysis of prudential reports by the relevant supervisors and/or regulators should be carried out on both a solo and consolidated basis. Regulators should, moreover, have contact with bank management on a regular basis. The independence of the supervisory agency is also crucial. The supervisor should have formal power to implement prompt corrective measures when prudential requirements are not met, regulatory violations occur or the depositor base of an institution is materially threatened in any way.

Following the publication of the Core Principles in September 1997, the focus of the international banking supervisory community turned to how best to introduce and implement the principles swiftly in each relevant country. International organizations such as the IMF and the World Bank are due to play an active role in this implementation process. For instance, the IMF is expected to encourage implementation through “conditionality” and ongoing surveillance, Article IV consultations and FSAP assessments. The World Bank will promote adoption to its client countries through its version of “conditionality,” as well as through technical assistance programs and FSAP assessments.

To further promulgate the implementation of the Basel Core Principles and subsequent assessments of individual countries’ compliance, the Basel Committee developed an assessment methodology to provide consistent compliance appraisal: the Core Principles Methodology, which was recently revised in 2006. This assessment methodology can be used for self-assessment by bank supervisors, “peer reviews” by regional groups and for

reviews by private third parties and the IMF and World Bank. In all cases, however, the Committee suggests that an assessment be made by suitably qualified outside parties, with at least two individuals who have different perspectives. One effective characteristic of this methodology is that it does not require the cooperation of all relevant authorities.

The Basel compliance methodology emphasizes that the preconditions for effective banking supervision\textsuperscript{113} be in place to make an assessment valuable. The existence of a suitable credit culture is also especially vital.\textsuperscript{114} Thus, an assessor should review the backdrop of whether these preconditions are satisfied or not. In most emerging and transitional countries, it is likely that these preconditions will not be fully developed. Fulfillment of the essential criteria for each Core Principle is crucial for full compliance. Further, the criteria must be met without significant deviation. However, they can be met through different means than those delineated in the Principles. The assessment methodology, moreover, delineates the substance required under each Principle in some detail. By providing both the basic concepts and relevant interpretations, the methodology should enable assessors to take into account not only the strict application of the Principles, but also the comprehensive adoption of the mechanisms that underlie them.

\textit{Standards and Codes in General}

The following chart prepared by the FSF depicts the current 12 core international financial standards and codes:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Principle} & \textbf{Standard/Code} & \textbf{Description} \\
\hline
1. &sound and sustainable macroeconomic policies; &
\hline
2. &a well-developed public infrastructure; &
\hline
3. &effective market discipline; &
\hline
4. &procedures for the efficient resolution of bank problems; &
\hline
5. &mechanisms for providing an appropriate level of systemic protection (or public safety net). &
\hline
\end{tabular}
\end{table}

\textsuperscript{113}These preconditions comprise: (1) sound and sustainable macroeconomic policies; (2) a well-developed public infrastructure; (3) effective market discipline; (4) procedures for the efficient resolution of bank problems; and (5) mechanisms for providing an appropriate level of systemic protection (or public safety net).

\textsuperscript{114}Basel Committee on Banking Supervision, “Core Principles Methodology,” 6.
## Table 1. 12 Key Standards for Sound Financial Systems

<table>
<thead>
<tr>
<th>Area</th>
<th>Standard</th>
<th>Issuing Body</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomic policy and data transparency</td>
<td>Code of Good Practices on Transparency in Monetary and Financial Policies</td>
<td>IMF</td>
</tr>
<tr>
<td>Monetary and financial policy transparency</td>
<td>Code of Good Practices on Fiscal Transparency</td>
<td>IMF</td>
</tr>
<tr>
<td>Fiscal policy transparency</td>
<td>Code of Good Practices on Fiscal Transparency</td>
<td>IMF</td>
</tr>
<tr>
<td>Data dissemination</td>
<td>Special Data Dissemination Standard/ General Date Dissemination System¹</td>
<td>IMF</td>
</tr>
<tr>
<td>Institutional and market infrastructure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insolvency</td>
<td>Principles of Corporate Governance</td>
<td>OECD</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>International Accounting Standards³</td>
<td>IASB⁴</td>
</tr>
<tr>
<td>Accounting</td>
<td>International Standards on Auditing (ISA)</td>
<td>IFAC⁴</td>
</tr>
<tr>
<td>Auditing</td>
<td>Core Principles for Systemically Important Payment Systems</td>
<td>CPSS</td>
</tr>
<tr>
<td>Payment and settlement</td>
<td>Recommendations for Securities Settlement Systems</td>
<td>CPSS/IOSCO</td>
</tr>
<tr>
<td>Market integrity</td>
<td>The Forty Recommendations of the Financial Action Task Force/</td>
<td>FATF</td>
</tr>
<tr>
<td></td>
<td>9 Special Recommendations Against Terrorist Financing</td>
<td></td>
</tr>
<tr>
<td>Financial regulation and supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking supervision</td>
<td>Core Principles for Effective Banking Supervision</td>
<td>BCBS</td>
</tr>
<tr>
<td>Securities regulation</td>
<td>Objectives and Principles of Securities Regulation</td>
<td>IOSCO</td>
</tr>
<tr>
<td>Insurance supervision</td>
<td>Insurance Core Principles</td>
<td>IAIS</td>
</tr>
</tbody>
</table>

Notes:

1. Economies with access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.
2. The World Bank is coordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.
3. Relevant IAS are currently being reviewed by the IAIS and IOSCO.
4. The International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.


Though technically not yet part of the more officially considered international standards, one might also add to this chart the guidance recently established by the International Association of Deposit Insurers on deposit insurance schemes⁴¹⁵ and the principles and

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sound practices, respectively, of the World Bank on corporate insolvency and creditors rights, as well as on bank insolvency.

These standards and codes have evolved and continue to be refined and revised on the basis of global and industrialized-country experiences and expectations. In this sense, they represent the model components of a country’s “modern” financial system. (The FSF has compiled key standards and codes into a working “Compendium.”) They may be utilized for multiple purposes. For example, the standards may be employed unilaterally by a country to reform its domestic financial system, comprise a part of IMF and Bank “conditionality” programs or used by an IFI in a requested technical assistance package, used by the IMF in ROSC macroeconomic surveillance efforts, or by the World Bank more flexibly in assessing domestic country financial sector infrastructures for development purposes.

For whatever purpose they are used, however, on-the-ground reform work over the past decade plus has shown repeatedly that the application of standards and codes is a top-down model. Each country’s situation is sui generis and these standards and codes have not been designed as instruments for development and access.

III. Financial Sector Assessments: The Possible “Launching Pad” for the Next Generation of Reform

The financial sector reform picture that begins to unfold in Sections I and II is driven by the G7/G8, its finance ministers and their formulation of the so-called NIFA. The NIFA is largely concerned with financial crisis prevention and financial stability, primarily by means of enhanced surveillance, transparency, information sharing and early warning systems (EWSs). One key to this approach is a sound legal infrastructure for the financial sector, which centers on evolving international financial-related standards and codes and increased IFI involvement on a cooperative basis. In 1998 and 1999, the Birmingham and Cologne Summits of the G7/G8 further fleshed out the components of the NIFA, including internal and external oversight, coordination and evaluation and assessment.

119. See Norton, Emerging Markets.
As referenced above in Section I, in order to foster robust and stable international financial markets—especially after the 1990s crises in Mexico, Asia, and Russia—the Financial Stability Forum (FSF) was set up in February 1999 by G8 finance ministers and central bank governors. Political concern for financial stability had been rising and consequently became an agenda item of G7/G8 after 1995.

In response to a growing need for an international coordinating body for financial stability and a recommendation by the British Chancellor of the Exchequer Gordon Brown, President of the Bundesbank Hans Tietmeyer was commissioned to report on ways to strengthen the international financial system. Tietmeyer’s recommendations included the following key points:

- The need to integrate the contributions of each international financial institution, which are currently fragmented.
- The development of a control system by concerted effort to identify incipient vulnerabilities with systemic implications; the building up and implementation of standards and codes of conduct; and the improvement of cross-sectoral financial supervision.
- The mitigation of systemic risk by assessing domestic weaknesses in light of global conditions, pooling information for this purpose, and increasing the coordination of domestic and international regulatory groups. Assessment of the need for regulation of non-regulated entities.121

In response to these recommendations, the G7 stated that better processes were needed to monitor and promote the stability of the international financial system. These processes depend on a greater sharing of information and the establishment of a proper policy-coordinating vehicle.122

The FSF was established as a new forum where an array of relevant, independent bodies could meet and exchange views on systemic issues. Participants include G8 members and representatives of international financial institutions, although representation of other states is envisaged.123 The mandate of the FSF is to strengthen the surveillance and supervision of

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123. As explained in the previous section of this paper, the Forum began with the participation of representatives from Hong Kong, Australia and Netherlands, in addition to the members of the G8 and the major IFIs. Other countries are involved in the working groups.
the international financial system. The body comprises a main forum and three working groups.124

Through the analyses and reports of its working groups, the FSF considers specific policy initiatives that can be undertaken by its members and other institutions and countries around the world. The importance and political significance of the FSF will depend on the value of its recommendations and their relevance in times of systemic crisis. If the international financial community does not rely on the vehicle provided by the FSF when a contingency is required, the objective of the Forum will be defeated. Hence, the real contribution of the FSF will depend on its transformation into a body that recommends policies and offers a set of procedures to address financial instabilities and otherwise provides ongoing, meaningful oversight and coordination of the international standard-setting arena.

**Financial Sector Assessment Program**

Another output of the Birmingham and Cologne G7/G8 Summits were mandates given to the IFIs to evaluate the internal effectiveness of their legal reform programs and projects and, more broadly, develop mechanisms to assess the condition of the financial sector as a whole and make recommendations on reform. The policy assumption is that the identification of financial system strengths and vulnerabilities will help promote financial stability and reduce the potential for crisis. These mandates have led to the enhancement of IMF surveillance mechanisms, the establishment of independent internal assessment offices, and the creation of a joint IMF-Bank Financial Sector Assessment Program (FSAP).

The latter program began with a joint pilot program in 1999. Based on the initial success of the pilot program, the joint FSAP program was refined and formalized on an ongoing basis. This initiative is being coordinated through an IMF-World Bank Financial Sector Liaison Committee (FSLC).125 As originally conceived, the FSAP was

> . . . widely recognised by participating countries and by the international community as an important instrument for diagnosis of potential vulnerabilities and analysis of development priorities in the financial sectors of member countries. . . . One objective of the FSAP is to help countries map a transition to a more diversified and competitive financial sector without creating vulnerabilities. A well-functioning financial services sector is essential for sustained economic development and poverty reduction. The existence of a wide and diversified set of sound, well-managed institutions and markets also reduces the likelihood and magnitude of a financial crisis. [emphasis added] 126

From its inauguration, the FSAP initiative has been articulated in terms of bifurcated objectives in order to accommodate the differing institutional missions of the IMF and the Bank. These objectives are: (i) financial crisis prevention and financial stability, and (ii) economic development and poverty reduction. This author suggests that these objectives are neither necessarily coextensive nor fully compatible. Further, in terms of the Bank’s

124. The working groups study highly leveraged institutions, capital flows, and offshore financial centers, respectively. For more information on the Forum, see its website at www.fsforum.org/home/home.html (accessed October 19, 2006).
126. Ibid., 4.
mandate, these objectives gloss over what a “well-functioning financial services sector” should mean in terms of economic development and poverty reduction. Finally, the causal linkage between the “modern” financial-sector model envisioned by FSAP criteria and instruments and actual “poverty reduction” has never been empirically substantiated. This being said, the Bank’s stated FSAP objective may possibly provide the context within which the best use of the FSAP process as a catalytic and supportive vehicle for the next generation of financial sector reform can be determined.

Functionally, an FSAP is requested voluntarily by a country and is normally effected by several joint IMF-Bank team missions. Upon completion, the team prepares an aide-memoire presenting their findings. This non-published, confidential document is used by the IMF to prepare a Financial Sector Stability Assessment (FSSA) for presentation to its Executive Board and is often also used as part of the Fund’s surveillance role under its biennial “Article IV consultations.” World Bank staff use the aide-memoire to put together a Financial Sector Assessment (FSA) for its Executive Board.

The FSAP itself entails three main components: (i) systematic analysis of financial soundness indicators (FSIs) and stress tests; (ii) assessments of standards and codes; and (iii) an assessment of the broader financial stability framework, including systemic liquidity arrangements, governance and transparency, financial safety nets and insolvency regimes. FSAP work has come to support the IMF’s role in the area of standards and codes, as well as the Bank’s development efforts (particularly regarding technical assistance), including its Country Assistance Strategies (CAS).

The FSAP is separate from but substantively linked to IMF Reports on Observance of Standards and Codes (the ROSC initiative). According to the Bank, there are three reasons for its participation in the ROSC initiative:

- The structural and institutional underpinnings of a market economy are an important complement to sound macroeconomic policies for both successful integration with the world economy and for sound development.
- Implementation of standards can assist countries establish these foundations, in turn contributing to domestic and international financial stability.
- Partnership with the IMF provides the basis for a comprehensive approach and broad-based effort to implement standards.

However, the FSAP—at least for the Bank, which selectively utilizes particular codes and standards in consultation with host countries—may deal with standards not formally considered by ROSC (e.g., creditors’ rights, corporate insolvency, deposit insurance and bank insolvency), as well as with cross-sectoral issues. In recent years, the Bank has been attempting to integrate the FSAP, FSA and ROSC processes into its evolving development

128. The aide-memoires have not been published. Prior to March 2003, FSAP teams prepared more lengthy FSAP reports.
agenda. Notably, this integration effort has sparked an effort to address the developmental context of financial legal infrastructure overall, including issues of access.

For the Bank, the FSAP process has limitations in addressing the developmental context and content of the next generation of financial sector legal reform. The complex technical process is a joint institutional effort and has divergent overall objectives. However, it is also a flexible data gathering process that most probably can be better and more broadly utilized by the World Bank and its LVP to evaluate, revise, and prioritize financial sector reform policy objectives and related technical assistance. Certainly, this process is well worth the serious consideration of the Bank and the LVP.

The Wildcard: Financial Sector and Services Liberalization

International agreements on the liberalization of trade in financial services (GATS, NAFTA, FTAA, MERCOSUR) focus on opening domestic boundaries to allow the provision of financial services at both cross-border and local levels. The financial sector reform needed at the domestic level to implement commitments undertaken internationally mainly emphasizes competitiveness and greater concern for financial stability as a consequence of opening the capital account. In terms of self-fulfilling crises, financial liberalization makes attacks possible and exposes underlying financial system vulnerabilities to the vagaries of international capital markets. This tension between market liberalization and systemic stability, safety and soundness, needs to be better understood and appreciated by all.130

Both developed and developing countries should consider carefully ex ante the implications of financial crises, as well as the efforts of the WTO and, more directly, the General Agreement on Trade in Services (GATS) and its component negotiations on financial services.131 In the present extensive debate on the role of the architecture of the international financial system in both preventing and responding to financial crises, as well as preserving financial stability, the interplay of the IMF, World Bank Group, and the WTO/GATS has not been addressed.

Defining the nexus between trade liberalization and “safety and soundness” concerns for financial markets and institutions is a major cooperative challenge for trade and financial services officials and financial authorities at the multilateral, regional and domestic levels.132 Moreover, the issue of sequencing in financial services liberalization is critical. It seems to this author that the primary emphasis needs to be placed on the maturing of internal financial markets (which includes broadening access to the financial system) before wholesale external liberalization takes place. In addition, liberalization itself should be shaped in a manner to encourage economic development and the broadening of the domestic financial markets.

131. The latter negotiations concluded December 12, 1997.
Conclusion

Since the Bank and other IFIs began to take on financial sector law reform as a mainstream institutional function (as mandated by the G7/G8), their reform efforts have moved well beyond the formulation of a limited range of individual financial laws to focus on the broader supporting legal infrastructure. This process has, moreover, gone from rule making to implementation and assessment. However, no one was prophetic enough at the start of the process to propose a comprehensive “first-generation” reform package. Yet the largely ad-hoc evolution of the reforms has in fact produced a relatively extensive legal reform program for the financial sector, albeit an admittedly incomplete and not entirely coherent one. In moving forward with the next generation of reforms, what lessons can be learned and what observations might be made for the future?

Lessons Learned

The following lessons, among others, have been learned from financial sector reform efforts in developing countries over the past decade or so:

**G7/G8-driven.** The reform efforts have been largely driven by the G7/G8 and its concern with preventing financial crises and preserving financial stability and financial sector integrity (i.e., anti-money laundering, or AML, and combating terrorism financing, or CTF). As a result, the World Bank and other IFIs, which were already engaged in legal reform efforts in the CEE transition countries, were effectively pushed into a new “line of business.”

In fairness, the Bank and IFIs have never had the opportunity to institutionally evaluate how best to integrate such reform activities with their respective overriding missions and objectives. In the case of the Bank, that mission is meaningful and sustainable economic and social development and the reduction of poverty. Much, then, has been a reactive post-rationalization process on the part of the Bank and other IFIs. In addition, given the limited resources of the Bank, when the G7/G8 directs it to pursue areas such as financial crisis prevention, financial stability and, more recently, AML/CTF, these directions will obviously crowd out, or at least crowd, the Bank’s ability to focus more fully and directly on objectives of access, equality and poverty reduction.

**Reform/growth/poverty reduction.** It has become reasonably clear that a safe, sound and stable playing field is a prerequisite for developing any financial sector. Likewise, it has become clear that financial sector stability is important for sustained economic growth. However, although initial studies have been undertaken, the experts have not yet causally linked in any conclusive, comprehensive and meaningful way the Bank’s current financial reform efforts with its overriding mission of equitable economic development and poverty reduction. As the Bank further develops these studies, the LVP should take on this task.

**Law as a means.** Legal reform is only one societal means for achieving and legitimizing appropriate policy objectives. In the area of financial sector reform, therefore, the approach to reform should be interdisciplinary, where law is the thread that weaves together

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economic, political and social objectives into a transparent and fair implementation process.\textsuperscript{134}

**A law-based approach.** Financial sector reform invariably entails a broad, rule-oriented framework to which unfettered discretion, non-transparency and cronyism must give way. But such a framework should not only be a matter of substantive scope, it should also be deep in implementation and enforcement. A comprehensive and coordinated framework will accordingly need to interconnect the legislative, administrative, supervisory, examination, enforcement and judicial administration processes of a country. Moreover, if reform is to address issues of access and equality in the financial sector and the domestic economy as a whole, a special policy orientation, resource prioritization, legal instruments and legal institutions and processes may well be required. Such specialized components would go beyond the traditional ones conceived by the industrialized countries and IFIs and IFAs.\textsuperscript{135}

**Financial sector infrastructure.** Financial law reform in developing countries is not about the adoption of individual financial laws, but the creation of a viable and coherent financial legal infrastructure suitable for the development of well-functioning financial markets and a sound business environment. In addition to good central and commercial banking laws, securities and securities market laws, a wide range of interconnected and supporting laws are needed. These include modern laws in the areas of contracts, property, property security rights, commercial and finance law, insolvency, corporations (including partnerships and joint ventures), corporate governance, foreign investment, licensing, intellectual property and taxation.

Any legal infrastructure will, however, only be as strong as a country’s constitutional, administrative and judicial law infrastructures. Moreover, a host government and the IFI or regional financial institution (RFI) that assists it should consider viable financial-sector infrastructure in a broader developmental context, not just from a traditional financial stability viewpoint. For example, consideration should be given to which types of institutions, laws and instruments should be put in place to make the financial system more inclusionary and equitable.

Lessons can be learned from the study of other developing countries\textsuperscript{136} and, perhaps, from developed countries such as the United States. Specifically, the experience of the United States in rebuilding its banking and financial systems after the Great Depression of the late 1920s and the 1930s, as well as its current attempts to address the increasing number of its


\textsuperscript{135} While developing countries share many policies regarding financial system “safety and soundness,” this congruence begs the issue as to what should be the policy and resource priorities of financial sector development in a developing country (for example, where the majority of the population are the rural poor or, if in urban areas, are living in slums outside the “real” economy).

\textsuperscript{136} For example, in this author’s own experience, important and differing lessons can be learned from the financial sector development of countries such as China, South Africa and Mexico. The author notes most favorably the increasing range of country studies (albeit non-legal in nature) being prepared by the World Bank. It will be important for the LVP to evaluate these studies in drawing up a base for future financial sector reform efforts.
“unbanked” residents, may prove useful to other countries. Such comparative studies cannot, however, be left as separate studies, but need to analyzed in a coordinated manner.

**Moral hazard reduction.** A viable legal infrastructure with effective implementation and enforcement that underpins a banking system should significantly reduce moral hazard concerns. While reducing this risk is clearly a microeconomic objective, excessive concern over moral hazards should not be used as impediments to the creation of an overall, inclusionary financial-sector infrastructure. Creation of such an infrastructure requires special mechanisms for government support and assistance, including possible subsidization for some period of time in order to bring the mass of the currently excluded into the financial system in a manner that is fair and equitable and will create the possibility of wealth generation for all.

**Long-term societal commitment.** Financial sector legal reform entails a long-term societal commitment in which the notion of a process based on the rule of law becomes ingrained—and does not function merely as a facade—within and throughout the fabric of civil, political and economic society in emerging economies in a substantive, accessible and fair manner.

**Limitations on IFI/RFI reform.** There are no quick solutions for effective financial sector reform for a particular developing country. This being said, the international standard-setting process is an important component of such reform, albeit only one part. Further, the role of the IFIs and RFIs in weaving together the strands of sustainable financial and economic development in transitioning and emerging economies needs to be viewed as largely directive, in a general sense, and supportive of a particular country’s national commitment to true market, legal, political, developmental and social reform.

Moreover, given that IFIs are comprised principally of macroeconomists and their legal staff, the staff of these institutions has not been and probably remains not ideally suited for what is essentially a micro-system area of developmental reform. In addition, many of the well-meaning consultants retained by the IFIs to assist them in their work are bureaucrats drawn from the industrialized countries or development experts with no significant financial-sector background in developing countries. Learning within the IFIs has thus been “on-the-job,” with their approaches often shaped by the inherent backgrounds of their respective staffs and consultants.

**Country ownership.** Legal reform of the financial sector ultimately must be country-specific (clearly, one size does not fit all: each country is *sui generis*). In effect, the reform process needs to be owned, developed, administered and enforced effectively and fairly by the host country. Purely top-down legal reform is not viable in the long term—much has to come from the bottom up. Active and fully committed host-country participation is needed from the very beginning. Keeping in mind that each country represents an individual case, nations may need to adopt solutions that correspond to their different levels of development.

137. The 1930s depression in the United States and its experience in rebuilding the national financial sector while addressing significant issues of poverty and unemployment may well be helpful to look at, along with more recent U.S. experience of fighting discrimination, exclusion and predatory practices in the financial sector. Such an analysis would be consistent with the approach suggested by Hernando de Soto and others. See Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).
and their different needs, especially in relation to the financial sector. This means that the initiative for conducting and construing reform in a broader developmental context should rest primarily with the involved country.

**Coordination (external and internal).** Uncoordinated, piecemeal reform may, in the long-term, be counterproductive. It is important that reforms and liberalization are not implemented in an ad-hoc, random fashion, but in line with broader developmental goals. Here the World Bank, sitting at the top of the IFI/RFI institutional pyramid, should be in the best position to provide broad policy perspectives and guidance for other IFIs, RFIs, donor countries and host developing countries. For the Bank to do so, however, will require better coordination and meshing of its own internal agendas, programs and projects in the area of financial sector reform. The Bank is indeed a large, complex, diverse and rather decentralized international bureaucracy. Any improvement of its internal coordination processes would thus have to come at the highest operational levels of the Bank.

**Sequencing.** The sequencing of reforms is not a mechanical process, but one that should be customized and fine-tuned on a country-by-country basis. Legal reform should be approached from a made-to-order, *not* a ready-made, perspective. As has been demonstrated, improper sequencing (i.e., liberalization that precedes strengthening of financial reforms) has been a critical underlying factor in many financial crises. This author would also suggest that sequencing will be important as a country tries to broaden its financial system in a meaningful, fair and equitable manner to make it accessible to the multitudes of citizens who are presently excluded from it.138

**Transparency.** Optimum transparency, to the extent that it can be developed, is necessary both so that all players understand the rules of the game and the game can continue successfully. The emerging international consensus on the requirements of financial stability is built on the principle of transparency and for this reason, the financial and legal infrastructure of any emerging market must be transparent. Moreover, transparency acts as a baseline for financial and legal development and resulting financial stability.139

**Evaluation.** Economic and financial legal reform efforts are by nature largely subjective and unscientific. To the extent that it is realistic, these processes need built-in procedures to ensure accountability, monitoring and evaluation. Appropriate and ongoing monitoring and evaluation mechanisms are perhaps the ultimate challenge for IFIs and IFAs. The World Bank and other IFIs and RFIs can make significant contributions to policy formulation and resource allocation in the financial sector reform process. Through data gathering, informational and technical exchanges, as well their overall evaluation capabilities, they can develop a reasonably well-developed picture of the financial sector development needs and capacities of a particular country.140

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139. See, for example, Arner, *Financial Stability.*

Administration and enforcement. The “rule of law” with respect to economic or other societal regulation is of little practical value unless fair and effective administration and enforcement can be attained and sustained. Regulatory authorities accordingly require adequate personnel and technological capabilities in order to ensure effective, fair administration and enforcement. Enforcement must be fair both substantively and procedurally, which requires transparent and judicially reviewable administrative processes. Finally, administrative enforcement cannot be entirely fair and effective without an independent, well-educated and non-corrupt judiciary.

Corruption and criminality. Corruption can undermine the reform process by reducing public confidence. Certainly, it is counterproductive to sound and sustainable economic development. Related to the need to crack down on corruption is the ongoing fight against using financial institutions for illicit purposes, such as money laundering or terrorism financing.141 These problems go to the core of the integrity of financial institutions and their management. They touch institutions and financial systems in both developed and developing countries. However, the jury is still out as to whether the Bank’s current emphasis on this area is justified (whether or not mandated by the G7/G8) on a cost-benefit basis or on an objective prioritization basis (i.e., is it the best use of Bank resources vis-à-vis its poverty reduction and development objectives?).

Supporting companion educational infrastructure. A companion educational infrastructure needs to be forged among legislative, bureaucratic, judicial, practical, academic, business, financial and civil society components of a country in order to ensure a sound educational base for overall financial sector reform in a given country. This educational infrastructure should not simply be focused on policy priority setting and enactment, but also on effective administrative implementation and administrative and judicial enforcement, as well as meaningful monitoring and readjustment mechanisms. Without well-educated and trained public and private participants in the long term, financial reform processes most likely will not succeed or be sustained.

Enhanced IFI cooperation. Continued joint undertakings and cooperation among the IFAs, IFIs, and RFIs (and related donors and donor groups) have had, and should continue to have, a significant positive influence on the international convergence and coordination of international codes and standards, as well as on meaningful information-sharing. However, in terms of actual reform projects, it has not been uncommon in the past that a country can receive uncoordinated technical assistance from multiple IFIs and RFIs on the same project. In all cases, it is important to keep in mind that each IFI or IFA has its own particular institutional mandate and objectives, which in reality may place significant strains on and skew cooperative reform efforts. Also, each IFI is structured and operates differently. For example, the World Bank is highly decentralized, while the IMF is centralized. These

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institutional differences can create both internal and joint external problems in reform cooperation.

**Social dimension.** One of the traditional non-prioritized, and often forgotten, aspects of financial sector reform and related corporate-sector reform is the provision of an adequate social safety net. Only more recently has the inextricable link between financial and economic reform and social issues been identified by IFIs and industrialized countries as a major priority. Recent events in the world economy [e.g., the negative social fallout from the Asian financial crisis] have underlined the important link between economic and social issues; highlighting that good economics also depend on stable relationships between governments and their citizens, that is, on strong social cohesion.

By equipping people for change, an efficient social system builds trust and encourages people to take the risks that are a necessary part of a competitive modern market. This in turn helps mitigate risks and spread the benefits of globalization. Effective social policy in particular can ease the task of structural adjustment during times of crisis, help build support for the needed government policy refocus and ensure that the burden of adjustment does not fall disproportionately on the poorest and most vulnerable groups in a society. Although the Bank and other IFIs have begun to incorporate social components into their adjustment financing and technical assistance programs, creating complementary social systems that both work and are fundable presents one of the greatest, yet most neglected, challenges for the NIFA and IFIs.  

**Technology dimension.** Since the advent of the first generation of financial sector legal reform, it has become apparent that the role of technology in making financial services more readily and broadly available may well become a major development instrument. How technology may be utilized to enhance issues of access will become increasingly important to reformers. With this component of reform, however, will come a new series of legal issues that will need to be addressed.

**Looking to the Future**

The primary point of this paper is that before rushing into a next generation of financial sector legal reforms, the World Bank and its LVP should step back and comprehensively and candidly reflect on where they have been. While there are probably truisms to be discerned from the Bank’s experience to date, they do not answer the fundamental question of how financial sector development in developing countries should be undertaken to bring the overwhelming number of disenfranchised and/or excluded residents of a country into the financial system, as well as to otherwise assist the Bank’s primary mission of poverty alleviation.


144. These truisms include, for example, that (i) what is good for enhancing financial sector infrastructure in terms of implementing developed international standards, codes and best practices, as well as in terms of financial crisis prevention and stability enhancement, will be good for the financial sectors of developing countries, and (ii) financial sector development is connected positively to overall economic growth.
Although the Basel Committee, IOSCO and other involved IFAs and IFIs have attempted to provide generally applicable core prudential standards and principles on various aspects of a sound banking and financial system, these standards and principles have largely emanated from industrialized countries and have not taken into consideration that the existing financial system in most developing countries largely serves only a limited segment of society. Further, as previously discussed, the general assumption of liberalization of financial services is that this liberalization is, by definition, good for development. Again, this assumption is most often shaped by the industrialized countries (e.g., through WTO and GATS).

It is not so much a situation of intended exclusion as unintended failure to consider not only what a financial system of a country currently is or will be in the short term, but what it should be in the longer term to support broader economic and social development purposes. It needs to be kept in mind that the primary focus of international standards has been financial crisis prevention, financial stability and, more recently, financial sector integrity. As the World Bank and its LVP embark on their “equity and access” agenda, the assertion of Claessens and Perotti now seems self-evident to those who have been involved with financial sector reform:

The relationships between inequality and finance seem to become clearer at the beginning of the 21st Century. Important research conducted so far has suggested that to reduce inequality, financial systems need to be broadened, not only deepened. Financial reform will only reduce inequality... if it improves access for more individuals with growth opportunities. Reforms thus need to broaden, not just deepen financial systems.

Certainly, to logically and pragmatically follow through on Sen’s paradigm of “choice (freedom) and development,” choice presupposes meaningful and effective access. This, in turn, presupposes the existence of suitable supporting governmental policies and a financial sector infrastructure, which presumes in turn the presence of appropriate, enabling policies, institutions, legal infrastructure and legal instruments.

The need “to broaden,” however, is not simply about creating greater access to the financial system for the currently disenfranchised population. It is also about broadening the financial system itself so that it is not structurally geared only to elite economic, business and social elements of a developing country’s society, but is systemically structured to provide appropriate institutions, laws and instruments to accommodate poor, low-income and other

145. For example, as observed recently by this author in the Colombian case, domestic financial reforms efforts are aimed at generating macroeconomic development, financial system stability and financial system “modernization.” Current reform emphases include a new unified regulator, financial conglomerate regulation, anti-money laundering/anti-terrorism, Basel II, capital adequacy enhancements, securitization and capital market reform. The current beneficiaries of such reforms, to the extent that the reforms can be effectively implemented (which is not at all clear), will be those people occupying the “elite tip” of the socioeconomic pyramid. While these reforms are important (yet in a number of instances, not a developmental priority), the societal reality is that meaningful access to financial services in Colombia simply does not exist for most of the population, particularly among the middle, working and agricultural classes (with the latter two categories being mostly “poor”).


excluded groups of a country’s population. Without having a financial system that is relevant to a country’s developmental stage and objectives, and designed to bring in and serve the excluded in meaningful ways, a country’s financial system cannot effectively contribute to optimal, meaningful and sustainable economic and social development in the long term. Nor can it provide a broad, stable platform for financial stability and robust financial sector growth.

In sum, the basic questions this paper wishes to raise for possible further research and practical consideration are:

- Should a significant development framework and/or component regarding the role of the financial sector in alleviating poverty be an integral part of any meaningful financial sector reform in a developing country?

- If so, what types of policies, institutions, laws and instruments are needed to “broaden” financial sector reform to meaningfully involve middle, working and agricultural classes within the formal financial sector and otherwise provide at least a “life-line” link to the poor?

- To what extent and in what ways are such matters as administrative rulemaking and practice, together with judicial and educational reforms, necessary complements of the development component of financial sector reform?

- What role should the existing financial sector and financial institutions play in the inclusionary agenda?

- What role(s) might the World Bank and its LVP play in the next generation of financial sector reform?

Inherently, the World Bank and other IFIs and RFIs represent enormous repositories of accumulated knowledge concerning policies, theories, issues and practices in the developing world. They are in a real sense socioeconomic and legal development “knowledge banks.” As such, they should be in the best position to help influence and guide the much-needed connection between financial sector development and meaningful economic development goals with respect to their developing country members.148

Accordingly, the World Bank’s Legal Vice Presidency appears to be particularly well suited to serve as a legal and institutional “knowledge bank” and coordinator (within the Bank and with other IFIs/RFIs, donors and client countries). As a coordinator, the Bank can help oversee the development and implementation of the next generation of financial legal sector reforms for the developing world, reforms that will be more inclusive, equitable and link relevant international standards with a meaningful economic and social development component in a coherent manner.

148. This is often easier said than done for a variety of overriding practical reasons. For example, IFIs, RFIs tend to be complex bureaucracies and there is enormous internal and external competition for their limited human and financial resources. These institutional demands have expanded exponentially over the past several decades, covering not simply traditional macroeconomic development concerns, but also a very broad range of microeconomic matters, macro- and micro-financial sector concerns, human capital development issues (with poverty alleviation paramount) and societal dilemmas, such as gender issues, global human migration and fundamental human rights. Financial sector issues are, then, only one of many pressing demands upon IFI/RFI resources.
The Bank and its LVP might well be the best central forum for identifying and evaluating on a global basis the range of institutional and legal tools that have been used (currently and historically) to broaden a country's financial system. They might also be the best forum for putting together, via technical assistance and assessment programs, comprehensive analyses and critiques of current financial sector reform efforts in developing countries. Finally, they can foster greater access and equity in developing financial sectors through the Bank's various technical assistance and assessment vehicles.

Even more importantly, the Bank and its LVP, together with the IMF, may be in the best position to influence and guide domestic finance and economic ministers to better coordinate domestic policy so that the economic development and financial sector priorities of a country can coalesce and be mutually supportive. Today, there appears to be a major disconnect between the two processes.

As indicated earlier in this paper, it is estimated that at least three billion people are excluded from the financial sectors of their respective countries. The Bank's “soul” is that of a development bank, its current driving mission is poverty alleviation, and its evolving institutional profile is that of a “knowledge-based bank.” Accordingly, the next generation of Bank and LVP financial sector legal reform should be devised with this mandate, mission and institutional profile as the primary reference points.
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