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Ms. Saloni Agarwal

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REGULATION OF INTERNATIONAL BANKING

Ms. Saloni Agarwal

Assistant Professor, Lucknow Public College of Professional Studies.

Ms. Rashmi Sachan

Assistant Professor, Lucknow Public College of Professional Studies.

ABSTRACT

Generally, the goals of banking regulation are promoting bank stability, protecting the public against instability, and promoting the efficiency and integrity of financial services. The Institute of International Finance, the Bank for International Settlements, the Cooke Committee, other supervisory groups, and the Contact Group are addressing the need for better preventative measures that will enable banks to absorb external shocks. Yet, sufficient progress on these issues has not been made. Aside from the Contact Group, which is limited to EEC countries, no organization has sufficient authority to enforce compliance with agreed upon principles. Consolidated supervision is far from achieving universal, effective implementation.

INTRODUCTION

In the past two decades banking has become internationalized to such an extent that national supervision over domestic banks no longer provides an adequate framework for regulating bank operations. Recent circumstances, including several European and American bank failures and the dramatic and unrestrained increase in private lending to developing countries,' have highlighted the gaps in supervising international banking. International cooperation among bank supervisors, which began to develop only a decade ago, has not yet filled these gaps. Thus, the search for better international banking supervision continues as part of the broader quest for internationalfinancial reform.

Various institutions address different aspects of international banking regulation. Although no institution directly regulates international banking, certain institutions influence that regulation significantly. Those institutions are the Institute for International Finance, the Bank for International Settlements, the Cooke Committee and other supervisory groups, and the Contact Group of the European Economic Community. In addition, institutions that do not directly supervise banks, such as the International Monetary Fund ("IMF"), the World Bank, the Paris Club, and private bank advisory committees, engage in activities affecting international lending practices.

i. Institutions Influencing International Lending

- The International Monetary Fund
- The World Bank
- The Paris Club
- Bank Advisory Committees
- The Baker Plan

ii. Influencing Bank Regulation

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- Institute of International Finance
- The Bank for International Settlements
- The Cooke Committee
- Other Groups of Banking Supervisors
- The Advisory Banking Committee and the Contract Group ofthe European economic community

i. Institutions Influencing International Lending

a. The International Monetary Fund

The Institute of International Finance is an organization of private commercial banks created to improve the process of sovereign risk lending. The idea for the Institute was conceived at a meeting sponsored by the National Planning Association held at Ditchley Park, England, in May, 1982. Later that year, representatives of thirty-one major banks from eight countries met in New York to decide upon operating procedures. The Institute of International Finance, Inc., was incorporated in Washington, D.C., as a non-profit institution in January 1983. As of 1984, 189 commercial banks from thirty-nine countries were members. This represents more than eighty percent of total international banking exposure to the developing world.

Participants at the first Ditchley meeting recognized the private banking community's need for up-to-date financial and economic information on debtor countries and identified four basic deficiencies in the flow of information.

First, debtor nations provide information to official institutions, such as the Bank for International Settlements (the "BIS") and the IMF, on a confidential sovereign-to-sovereign basis. Although private commercial banks cannot readily gain access to this information, they are still expected to participate actively in restructuring schemes developed by the official multilateral institutions.

Second, the data available to the banking community is not as current as it should be. For example, information from official sources is frequently out of date by six months or more. According to the "information gap" hypothesis on the 1982 debt crisis, because individual banks did not know how rapidly their competitors were expanding lending (especially short-term lending), by the time the true magnitude of increased debt was known the situation was out of control.

Third, because smaller, regional banks perceive the larger, money- center banks as having far more sophisticated information about the financial condition of borrowing countries, they have been far less willing to continue lending to debtor countries since the advent of the debt crisis.

Fourth, information reported by borrowing countries varies considerably in quality. The Institute, therefore, could obtain information, sufficiently current for banks to make independent credit judgments, which would be available to smaller and non- money-center banks. This information would be drawn from official reports already prepared by the BIS, the IMF, and the World Bank and from member banks which have collected information from debtor countries.

To improve the process of international lending, the Institute has undertaken three main tasks:

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- to improve the timeliness and quality of information available onsovereign borrowers;
- to facilitate communication among the major participants in theinternational lending; and
- to encourage an exchange of views within the financial community on the future of international lending.

b. The World Bank

As a development and project finance institution, the World Bank is not a regulatory institution; yet many of its activities complement those of the IMF and affect international lending operations of banks. Relevant activities include the World Bank's structural adjustment loans, Special Action Programs, and cofinancing. The World Bank's Articles of Agreement require it to lend only for specific projects except under special circumstances. In recent years the serious balance of payments problems of developing countries, which threaten their continued development, have presented the necessary "special circumstances" and motivated the Bank to go beyond its original mandate by making "structural adjustment" loans ("SALs").

According to the World Bank the main objective of "structural adjustment" lending is to facilitate the restructuring of a developing country's economy so as to put its current-account deficit on a sustainable basis within three to five years. The loan support programs . . . are intended to anticipate and avert economic crises through economic reforms and changes in investment priorities‖.

SALs also serve as catalysts for inflows of other external capital that would help ease balance of payments problems. SALs require borrower to meet World Bank conditionality criteria. Because such loans often require debtors to secure an IMF standby credit arrangement, the borrower must meet IMF conditionality criteria as well.

The World Bank has further responded to the liquidity problems experienced by developing countries associated with the debt crisis by establishing a Special Action Program ("SAP"). The SAP authorizes expanded lending for high priority operations supporting structural adjustment policy changes, production for export, greater use of existing capacity, and the maintenance of vital infrastructure.

"Cofinancing" is another means by which the World Bank has sought to increase the flow of private funds to member developing countries. Cofinancing links a World Bank presence with additional external investment finance from official lenders, export credit institutions, and private sources. The World Bank's objectives are not only to increase available funds but also to lengthen loan maturity periods and minimize borrowing costs. Cofinancing provides lenders with certain guarantees of World Bank financing and assurances that projects are well-conceived and supervised. The World Bank's participation in cofinancing with commercial banks may take several forms. The World Bank may participate directly in securing later maturity periods for private bank loans, may instead guarantee those later maturities, or may participate if interest rates rise above a certain level.'

Thus, World Bank participation makes financing available on terms comfortable for banks and debtor countries. Like the IMF, the World Bank influences private lending directly and indirectly: directly by its participation in debt rescheduling negotiations; and indirectly by its own lending and analyses of economies, policies, and project proposals of developing countries. While national bank regulation may typically focuson such prudential measures as capital-asset ratios, World Bank and IMF approval of countries' economic plans provides a different sort of prudential control on international bank lending.

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c. The Paris Club

The "Paris Club" is the "institution" through which credits extended by governments or by private lenders possessing a creditor- government guarantee are rescheduled. Despite its name, the Paris Club has no members and no written operating rules. It does have a chairman, a French Ministry of Finance official, who-convenes meetings upon formal request by a debtor country. All rescheduling are done on a case by case basis, but "institutional memory" allows due regard to precedent.

The Paris Club originated in 1956 when a group of creditor governments met in Paris to negotiate a debt relief arrangement with Argentina. 20Creditor countries wanted to establish common terms for debtrestructuring applications rather than negotiate a series of bilateral arrangements with debtor countries. Since that time the Paris Club has conducted more than sixty-five rescheduling and has become an integral part of efforts to manage the global debt crisis.

d. Bank Advisory Committees

Commercial bank creditors have developed a restructuring process similar to that of the Paris Club. Previously, such creditors negotiated lengthy and complex restructuring agreements. Currently, banks reach a precatory agreement on the treatment of different debt categories. Separate restructuring agreements between the debtor country and the creditor banks are then negotiated to complement the broad agreement on principles.

Bank advisory or coordinating committees normally provide the framework for reaching such restructuring agreements. These committees are often referred to as the London Club. Such a committee acts as advisor and liaison for all bank creditors. The committee provides a forum fordiscussing coverage and restructuring terms and, as necessary, maintainingshort-term bank exposure and providing new financing. The banks having the largest exposure to debtor countries usually chair the advisory groups.

The IMF participates in negotiating meetings of the bank advisorycommittees on request. Private Banks frequently insist, either as acondition precedent to executing a restructuring agreement or as a precondition to initiating debt renegotiations, that an IMF adjustment program be in place. A World Bank structural adjustment loan program may similarly be required. A Paris Club agreement may also precede bank renegotiations to allow comparable treatment or to assure IMF participation.

e. The Baker Plan

During the 1985 annual meeting of the World Bank and IMF, U.S. Treasury Secretary James A. Baker III unveiled a new U.S. - sponsored initiative aimed at fostering growth in developing countries and curtailing the international debt crisis. A broad emphasis on economic growth as a condition for the payment of developing country debt lies at the heart of theBaker initiative. Baker's "Program for Sustained Growth" calls upon commercial banks to lend an additional 20 billion dollars over three yearsto support economic growth in fifteen developing countries.

In addition, the program encourages international financial institutions, including the World Bank, to increase lending by 9 billion dollars to support structural policy improvements and to supplement continued balance of payments lending by the IMF. In return for increased capital flows, the fifteen developing countries are urged to implement sound fiscal and monetary policies, strengthen their private sectors, facilitate foreign investment, liberalize trade, and pursue market-oriented approaches to currencies, interest rates, and prices.

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II. Influencing Bank Regulation

a. Institute of International Finance

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To improve the process of international lending, the Institute has undertaken three main tasks: to improve the timeliness and quality of information available on sovereign borrowers; to facilitate communication among the major participants in the international lending; and to encourage an exchange of views within the financial community on the future of international lending.

b. The Bank for International Settlements

The Bank for International Settlements, located in Basel, Switzerland, is an organization of central banks. It was established in 1930 to promote cooperation among central banks, to provide additional facilities for financial operations, and to act as trustee for post-Worlds War I reparations agreements. The Bank for International Settlements (BIS) has twenty-nine members. The United States is a member through a group of private U.S. banks, although it

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is the only country (entitled to do so) whose central bank has chosen not to be represented on the Board of Directors. The central banks of Australia, Canada, Japan, and South Africa are theonly other non-European members.

While all of the Eastern European central banks, except for the SovietUnion, East Germany, and Albania, are members, no developing country central banks are included among the membership.

The BIS is both a forum where central bankers meet to discuss issues of common concern and an international financial institution. Since 1963 the BIS has hosted monthly meetings ten times annually of central bank representatives from the Group of Ten countries for discussions of nationaland international economic issues. Specialists in foreign exchange, the Eurocurrency markets, and bank supervision meet regularly under BIS auspices as well.

In addition, the BIS serve as the secretariat for periodic meetings of the Governors of Central Banks of the European community and is part of the secretariat for the Group of Ten ministers and governors. The BIS hasmobilized financing at various times. In the 1960s and 1970s BIS discussions facilitated balance of payments financing for several European countries. More recently, medium-term credit lines to the IMF have been arranged through a number of central banks. In 1982 and 1983, the BIS helped arrange bridge financing for several countries that were then facing debt-service problems.

These arrangements led to short-term multilateral credits while new medium- and long-term lending commitments were finalized. Not only did the BIS organize central bank participation in these financial arrangements, but it also committed its own institutional resources. The BIS is not an international lender of last resort facility. In fact, no such facility now exists.

The BIS functions of providing a forum and arranging financings are complemented by its third role of compiling information. For example, since 1981 the BIS has collected consolidated data-as a result of Cooke Committee efforts-on asset and liability maturities so that the maturitymismatching problem can be better understood and addressed.

c. The Cooke Committee

In 1974 the Bank for International Settlements, seeking to address new issues in international banking supervision, created a standing committeeof bank supervisors from the Group of Ten countries plus Luxembourg and Switzerland. This Committee on Bank Regulations and Supervisory Practices is referred to as the Basel Committee or by the name of its chairman, currently Peter Cooke of the Bank of England. The basic role of supervision is to ensure that banks have adequate procedures to manage risk and possess sufficient information on which to base lending decisions. The Cooke Committee was designed to augment national supervision techniques.

In the words of Chairman Cooke ― **The purpose of the Committee is toprovide a regular forum for closer international cooperation on banking supervisory matters and to work towards improving the cohesion of arrangements for supervising the activities of banks operating in international markets".** It has set out to do this in three ways:

1. to improve the general coverage and effectiveness of supervisory techniques for international banking business,
2. to address particular prudential problems affecting banks operating internationally and

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3. to exchange information on national supervisory arrangements with the object of improving the quality of banking supervision worldwide

The Cooke Committee, along with other supervisory groups, addresses a continuing agenda of international banking problems. Current issues include techniques of international cooperation, improvements in the exchange of information, standards of capital adequacy, professional assessment of risk, and the practical problems of dealing with failing or failed banks.

d. Other Groups of Banking Supervisors

The Cooke Committee realized that to establish universal and adequate banking supervision it needed to spread the principles and practices of supervisory cooperation beyond its own membership. The Committee, therefore, circulated committee documents among the supervisory groupings, particularly among developing financial centers. As a result, several new groups are now in operation, including the Offshore Supervisors' Group; the Commission of Latin American and Caribbean Banking Supervisory and Inspection Organizations; and other similar groupings in the Middle East, Southeast Asia and Western Pacific regions; Scandinavian’s countries; and Central American Republics.

Additionally, several international conferences of supervisory authorities have promoted cooperative action with nonmembers. Supervisors at the first conference, held in London in 1979, generally accepted the Concordat principles. The Offshore Supervisors' Group itself has accepted the Concordat principles, a significant step since offshore banking centers are the weak link in adequate banking supervision.

e. The Advisory Banking Committee and the Contract Group of the European Economic Community

In 1977 the EEC Council of Ministers adopted the First Banking Coordination Directive. It established minimum authorization criteria for credit institutions, uniform calculation of prudential ratios for solvency and liquidity (initially for observation purposes only), and the Advisory Banking Committee to assist with further coordination efforts. More recently, the 1983 Consolidation Directive prescribed supervision of banks on a consolidated basis. It directed member states to eliminate all legal obstacles, including national banking laws and regulations, to the exchange of the information necessary for consolidated supervision. To support consolidated supervision, The Advisory Banking Committee introduced a new series of observation ratios covering solvency, liquidity and profitability.

The Advisory Banking Committee is a high-level policy-making committee, backed by a secretariat from the EEC Commission, which in turn makes recommendations to the EEC council. It consists of not more than three representatives from each member state and the EEC Commission, and usually meets twice a year in Brussels. The committee works alongside the EEC Commission to formulate general policy guidelines for supervisory coordination within the European Economic Community.

BANKING REGULATIONS

Bank regulation seeks to promote the “safe and sound” operation of banks, and in tandem preserve the stability of the financial system. The latter has a macro-prudential focus that is the subject of the next section. We focus first on the safety and soundness of individual financial institutions. In Chapter 12, we explained how deposit insurance creates a risk-inducing moral hazard. Thus, restrictive regulations are deployed to mitigate these endogenous risks that arise due to the government safety net. Government safety net includes

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the explicit deposit insurance scheme (see the discussion of the FDIC in the United States and deposit insurance arrangements in the previous section) but also consists of implicit government guarantees to financial institutions that are deemed too big (or important) to fail.

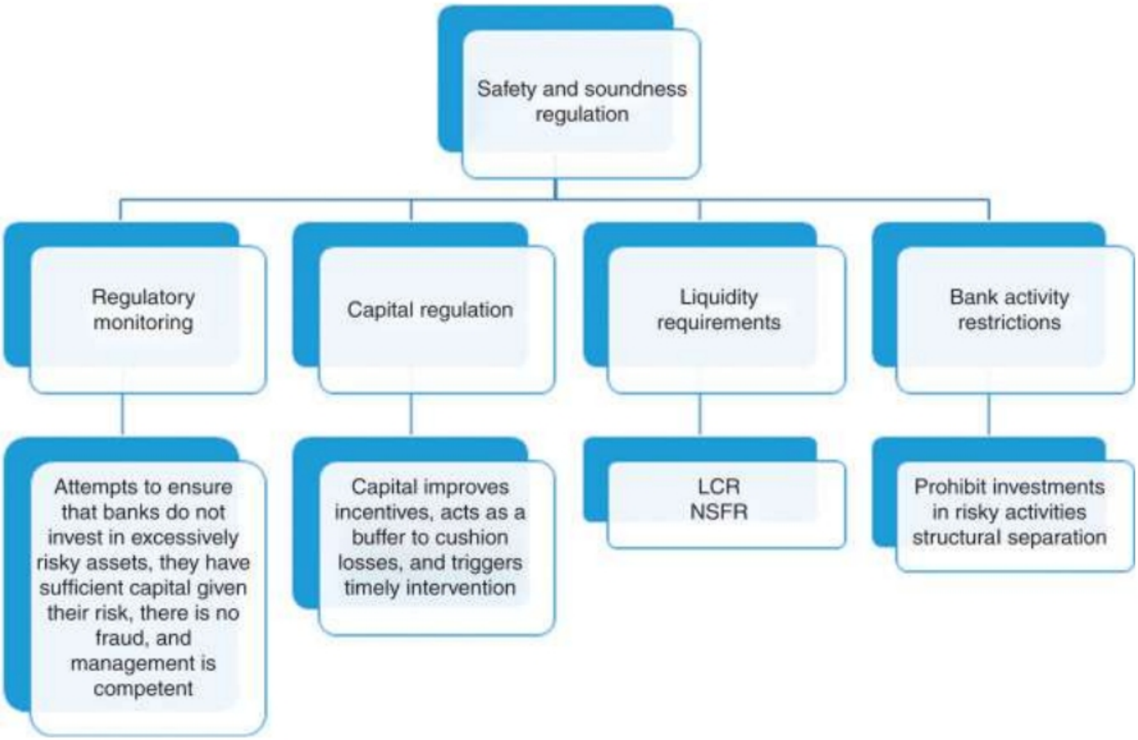

Figure summarizes the types of safety regulation. Redundancy in these regulations recognizes the difficulty of achieving safety objectives, especially when the regulated institutions can circumvent these regulations.

Key Regulatory Frameworks and Standards in International Banking

Regulatory Framework/Standard	**Description**	**Key Regulatory Body/Organization**	**Impact on International Banks**
Basel I, II, and III	A set of international banking regulations that set capital requirements for banks, focusing on the risk-based capital ratios.	Basel Committee on Banking Supervision (BCBS)	Ensures that international banks maintain sufficient capital to withstand financial stress, improves global financial stability.
Dodd-Frank Act (USA)	A U.S. federal law aimed at reducing risks in the financial system, following the 2008 financial crisis.	U.S. Government, Federal Reserve	Strengthens oversight and regulation of financial institutions, limits risk-taking behavior, and enhances transparency.
International Financial Reporting	A set of accounting standards that	International Accounting	Enhances comparability and

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Regulatory Framework/Standard	Description	Key Regulatory Body/Organization	Impact on International Banks
Standards (IFRS)	companies, including international banks, must follow when preparing financial statements.	Standards Board (IASB)	transparency of financial reporting across borders.
Anti-Money Laundering (AML) Regulations	Laws aimed at preventing money laundering and financing of terrorism, requiring banks to implement robust customer due diligence processes.	Financial Action Task Force (FATF)	Protects banks from being used for illicit financial activities, ensures compliance with international law.
Solvency II Directive (EU)	A set of regulatory requirements for insurance firms in the European Union, focusing on risk management and capital adequacy.	European Insurance and Occupational Pensions Authority (EIOPA)	Strengthens financial stability in the European insurance sector, indirectly impacting banks with insurance-related activities.
MiFID II (EU)	A legislative framework that regulates financial markets and trading activities across the EU.	European Securities and Markets Authority (ESMA)	Enhances transparency, investor protection, and market integrity in European financial markets.
Volcker Rule	Part of the Dodd-Frank Act, it restricts banks from making certain kinds of speculative investments and proprietary trading.	U.S. Government, Federal Reserve	Limits the risk-taking by banks and reduces exposure to high-risk financial activities, affecting global operations.
Capital Requirements (Basel III)	Strengthens the global banking system by enforcing stricter capital reserves and liquidity requirements.	Basel Committee on Banking Supervision (BCBS)	Ensures banks are better capitalized and liquid during times of economic stress, enhancing global financial system stability.
Global Systemically Important Banks (G-SIBs) Framework	A set of guidelines for identifying and regulating the largest banks whose failure could destabilize the	Financial Stability Board (FSB)	Focuses on banks that are deemed "too big to fail" and places higher regulatory

Regulatory Framework/Standard	Description	Key Regulatory Body/Organization	Impact on International Banks
	global financial system.		requirements on them to mitigate systemic risk.
European Banking Authority (EBA) Regulations	Supervisory guidelines for banks operating in the European Union, focusing on prudential regulations.	European Banking Authority (EBA)	Enhances stability and consumer protection in European banks, sets regulatory standards for risk management, and capital adequacy.

Key Highlights:

1. **Basel Accords** (I, II, III) are central in regulating capital adequacy across banks globally, ensuring they have enough resources to cover potential losses.
2. **Dodd-Frank Act** and **Volcker Rule** primarily target reducing risks associated with speculation and improving overall financial stability in the U.S., which impacts international banks operating there.
3. **AML Regulations** and the **FATF** ensure banks operate in a way that prevents financial crime, including money laundering and terrorism financing.
4. **IFRS** provides a standardized method for financial reporting, which is crucial for multinational banks to maintain transparency and comparability in international operations.

CONCLUSION

The regulation of international banking is a crucial and multifaceted subject that plays a significant role in maintaining the stability, integrity, and efficiency of the global financial system. As the global economy has become increasingly interconnected, the role of international banking has expanded, facilitating cross-border trade, investment, and the movement of capital. However, with these increased activities, risks such as financial crises, systemic collapses, and money laundering have emerged, making robust regulatory frameworks necessary to safeguard the interests of consumers, businesses, and national economies alike.

At the heart of international banking regulation lies the need for banks to maintain adequate levels of capital and liquidity, manage risks, and comply with legal and ethical standards. This is vital not only for individual financial institutions but for the global financial system as a whole, where the failure of one institution can have far-reaching consequences. This regulation is achieved through a combination of national laws, regional directives, and international agreements. These frameworks aim to prevent excessive risk-taking, promote transparency, and ensure financial institutions operate in ways that support economic growth and stability.

Among the most prominent international regulatory frameworks are the Basel Accords (Basel I, II, and III), which set the standards for capital adequacy, liquidity, and risk management. The Basel Committee on Banking Supervision (BCBS) has worked to enhance the resilience of the banking sector by introducing stringent requirements on capital buffers,

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leverage ratios, and liquidity coverage ratios. Basel III, for example, strengthens the capital requirements, aiming to ensure that banks are more resilient in times of financial stress, which was a significant issue during the 2008 financial crisis. The regulations under Basel III are designed not only to protect banks from insolvency but to safeguard the entire financial system from the kind of systemic risk that could result in a global financial crisis.

The Dodd-Frank Act, introduced in the United States after the 2008 financial crisis, represents another milestone in the regulation of international banking. By imposing stricter oversight on financial institutions, it seeks to address the risks posed by large, complex financial entities and limit the potential for future crises. The Volcker Rule under this Act, which restricts banks from engaging in proprietary trading, aims to curb speculative risk-taking, protecting both consumers and the stability of the financial system. It reflects a growing recognition that regulatory frameworks must evolve in response to new financial products and strategies that could potentially destabilize markets. International banks operating in the U.S. are required to comply with this regulation, impacting their operations globally.

The Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) regulations are another critical element in international banking regulation. These standards, set by organizations like the Financial Action Task Force (FATF), aim to prevent the illicit use of the banking system, such as money laundering and terrorist financing. With the increasing globalization of financial services, banks are under increasing pressure to maintain due diligence procedures, monitor suspicious transactions, and report them to the relevant authorities. The AML regulations are crucial in ensuring the integrity of the international banking system, protecting it from exploitation by criminal and terrorist organizations.

The International Financial Reporting Standards (IFRS) provide a uniform set of accounting principles for international banks, ensuring that financial statements are transparent, consistent, and comparable across borders. This standardization is particularly important in a world where banks operate across different countries, each with its own set of national accounting standards. By harmonizing financial reporting, IFRS contributes to greater investor confidence and stability in the international banking system. Moreover, it enhances the ability of regulators to monitor the health of banks operating in various jurisdictions and allows for better decision-making by investors, policymakers, and other stakeholders.

Regulation of international banking also includes regional frameworks like the European Banking Authority (EBA) and MiFID II regulations in the European Union. These regulations aim to standardize banking practices across EU member states, focusing on consumer protection, market transparency, and the stability of the financial system. The EBA's guidelines on capital adequacy and liquidity ensure that EU banks maintain the resilience required to weather financial challenges, while MiFID II regulates securities markets, ensuring fair and transparent trading environments. These frameworks have helped shape the regulatory landscape for banks operating within the EU and beyond, influencing banking operations worldwide.

The Global Systemically Important Banks (G-SIBs) framework is another critical piece in the regulation of international banking. The Financial Stability Board (FSB) introduced this framework to identify and regulate the largest and most interconnected banks that pose risks to global financial stability. G-SIBs are subject to higher regulatory standards, including increased capital buffers and additional supervision, to mitigate the risks they pose to the international financial system. This regulatory approach highlights the need for special attention to banks whose failure could lead to cascading effects across markets and countries.

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Despite the many successes of international banking regulations, there are ongoing challenges. One significant issue is the complexity and cost of compliance, particularly for smaller banks or banks operating in multiple jurisdictions with varying regulatory requirements. There is also the risk of regulatory arbitrage, where financial institutions exploit differences between national regulations to circumvent stricter rules, potentially undermining global stability. Furthermore, while regulation has become more comprehensive, the rapid development of financial technologies, such as digital banking and cryptocurrencies, poses new challenges for regulators. Many of these innovations operate outside traditional banking frameworks, raising questions about how to effectively regulate these new forms of financial activity.

Another ongoing concern is the coordination of regulations across different countries and regions. While international regulatory frameworks like the Basel Accords aim to provide a unified approach to banking regulation, the differences in the financial systems and priorities of countries can complicate the implementation and enforcement of these rules. Global coordination is essential to ensure that regulations are not only effective in addressing risks but also fair and conducive to competition among international banks. In some cases, there may be resistance from countries or banks that feel that international regulations impose undue burdens or interfere with their national interests.

The continued evolution of international banking regulation will require adaptive policies that can address emerging risks while fostering growth and stability in the global economy. As the financial landscape changes, regulators will need to stay ahead of new challenges, such as the rise of fintech, digital currencies, and the increasing complexity of financial markets. Cooperation between national regulators, international bodies, and financial institutions will be key to creating a regulatory framework that supports the long-term stability of the global financial system.

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