International Services Agreement:
Ensuring that Trade-in-Financial-Services Agreements Address Emerging Safety-and-Soundness Risk

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I am pleased to provide this testimony to the United States Trade Representative (USTR) in connection with this hearing on the International Services Agreement (ISA). I am managing partner of Federal Financial Analytics, Inc, a firm that provides an array of advisory and strategic-planning services to global financial-services firms and their regulators. The testimony presented today and the appended papers (see below) reflect only my views and those of my firm.

It is, I believe, vital that USTR take as an immediate priority action item consideration of the pending rewrite of prudential rules for cross-border financial services firms, employing its expertise as an arbiter in trade disputes to craft a fair, free and prudent framework that transparently enhances cross-border banking, securities, insurance and other financial-services activities. Recent developments in the U.S. and other nations discussed below are dividing the U.S. prudential framework from that being crafted in other nations in the wake of the 2008 financial crisis, doing so in ways some argue create protectionist barriers in the U.S. that warrant retaliation against U.S.-domiciled firms on their shores. The increasing acrimony in these disputes comes in tandem, and to some degree as a result of, the continued inability of global agencies to craft binding prudential rules (e.g., the Basel III capital standards).[1] The combination of host-country actions characterized a protectionist combined with the lack of clear cross-border prudential standards has the potential to spark a trade war in financial services. This may seem extreme, but the damaging consequences of even skirmishes in this arena make it imperative that USTR work with other U.S. and global agencies to incorporate prudential standards into revisions to the broader trade-in-financial-services regime contemplated through the ISA.

The major cause of this potential conflict is the fact that, to date, trade-in-financial-services standards are largely predicated on "national treatment." As stipulated in the International Banking Act of 1978,[2] the U.S. is committed to providing access to foreign banks on terms and conditions comparable to those on which U.S. banking organizations must conduct themselves with regards to matters such as access to specific markets, products offered and the regulatory standards applicable to the institution and its activities. In 1991, these standards were tightened by the FDIC Improvement Act[3] to permit the Federal Reserve Board (FRB) to deny access to the U.S. or impose additional conditions should it determine that the foreign banking organization was not comprehensively regulated on a consolidated world-wide basis by its home-country regulator.

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[1] Bank for International Settlements, Basel Committee, *Basel III: a global regulatory framework for more resilient banks and banking systems* (Dec. 2010), *available at* http://www.bis.org/publ/bcbs189.pdf.

[2] International Banking Act, Pub. L. No. 95-369 (1978).

[3] Federal Deposit Insurance Corporation Improvement Act, Pub. L. No. 102-242 (1991).

To date, the FRB has deferred to most home-country regulators, and this structure has also been applied to U.S. practice in securities and, subject to certain restrictions in the states, insurance and other non-bank financial activities. However, the global financial crisis was in part the consequence of lax host-country standards (including within the U.S.) that led to systemic risk in the home countries of foreign financial-services firms. Cases often cited include the contagion created through asset securitization resulting from lax U.S. mortgage-origination standards, insufficient capitalization and/or liquidity resources for foreign banks in the European Union (EU) that pose risk within the EU (especially within the Eurozone) and in host countries like the U.S., and the lack of clear cross-border orderly-resolution protocols that (as in the Lehman Brothers case) permitted rapid transmittal of systemic risk across national borders.

Reflecting these crises, an array of repair work is under way in national regulatory bodies and global agencies. However, in the almost five years since the systemic crisis threatened another Great Depression, few if any of these cross-border rules have been implemented in key markets. At its most recent summit, finance ministers of the Group of Twenty (G-20), along with central bankers from these nations, included in their communiqué[4] a commitment to "full, timely and consistent" implementation of global capital, resolution and over-the-counter (OTC) derivatives rules. However, even as they did so, the communiqué noted areas in which the rules are close to collapse, committing the G-20 to consider action to avert this without offering specifics as to how to do so.

As a result, global prudential standards are, at best, in disarray. This is creating a strong incentive for nations, including the U.S. to rewrite prudential standards that may well transgress prior national-treatment criteria because of increasing fears that major financial markets do not adhere to the necessary prudential standards required to find that their firms are indeed comprehensively regulated on a consolidated world-wide basis. If not quickly addressed, this collapse of global standards into nation-by-nation financial standards will, I believe, promote a "banking-by-border" framework with profound systemic risk. Finance is simply too instantaneous and mobile to be walled off behind nominal regulatory barriers. Failing to create a global trade-in-financial-services framework that reflects the hard lessons of the global crisis will repeat the incentives that created lowest-common-denominator standards before the 2008 debacle.

The major points I would like to emphasize are that a new framework for trade-in-services applicable to financial services must:

- apply across the range of financial services, not just banking, securities, insurance and other regulated sectors. Failure to incorporate other activities dubbed "shadow

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[4] G-20, *Communiqué of Finance Ministers and Central Bank Governors, Moscow* (Feb. 16, 2013), *available at* http://www.g20.org/load/781209773.

banking" by the Financial Stability Board (FSB)[5] will promote migration of regulated activities in a nation party to the ISA to less-regulated, "haven" states. This will create both competitive and prudential risks;

- reflect the recent, hard experience of the financial crisis. To do so, it must go beyond a focus principally on "national treatment" to identify the key terms and conditions that differentiate appropriate host-country prudential regulation (the equivalent of safe-goods standards for customs) from protectionist impediments to efficient and fair cross-border finance; and

- define the boundaries between prudential and protection in trade-in-financial-services by reference to edicts issued by the FSB and its member regulatory agencies, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors.

These points are discussed in more detail below. They are extensively analyzed in two papers released by Federal Financial Analytics that are submitted herein as appendices[6] to this statement:

- an analysis of the statutory and structural factors in the U.S., European Union (EU), Japan, China and emerging nations that make it impossible to express any binding cross-border regulations along lines now hoped for by all of the global organizations referenced above. This paper, prepared in August of 2012, outlines a new trade-based protocol to harmonize cross-border financial standards in a transparent fashion to promote safety and soundness as quickly as possible; and

- a February, 2013 paper prepared to support this testimony based on the USTR's request for views germane to the ISA. This paper includes an update of the status of key global financial regulations, noting the continued collapse of many negations in this area. It then provides specific recommendations for USTR, in conjunction with other U.S. governmental bodies for quick action in this vital area (see also below).

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[5] FSB, *A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities*, (Nov. 18, 2012), *available at* http://www.financialstabilityboard.org/publications/r_121118a.pdf.

[6] Federal Financial Analytics, Basel's Burst Bubble: How Basel Has Broken Apart and What Should Now Be Done to Fix Bank Regulation (Aug. 27, 2012), available at: http://www.fedfin.com/images/stories/client_reports/Basel%27s%20Burst%20Bubble.pdf and Federal Financial Analytics, Banking by Border: Preventing Prudence from Turning into Protection in the New Financial Regulatory and Trade Framework (Feb. 19, 2013), available at: http://www.fedfin.com/images/stories/client_reports/Petrou_Banking_by_Border.pdf.

Please note that these analyses and the principles noted above are, I believe, germane not only to the ISA, but also to other ongoing efforts by the USTR to harmonize cross-border trade-in services. They should, for example, be reflected in the newly-announced negotiations with the EU.[7] Prospects for a trade-war in financial services are particularly acute between the U.S. and EU in the wake of two developments:

- a proposal from the Federal Reserve Board to impose an array of new conditions on the activities in the U.S. of "foreign banking organizations."[8] Although this proposal has become a lightning rod for protectionist accusations against the U.S. and threats of retaliation by other nations, it is not the only contentious U.S. proposal to spark strong international objections to recent U.S. decisions;[9] and

- the newly-announced plan by eleven nations in the EU to impose a "financial-transaction tax."[10] Although nominally just a home-country tax, the proposed approach covers extraterritorial transactions and thus may effectively tax activities outside of taxing nations or force financial-services firms to abandon all activities in such regimes, much in the way a tariff barrier bars entry into protectionist trade-in-goods regimes.

Specific recommendations for USTR are, as noted, discussed in detail in the 2013 paper referenced above. They are:

- RECOMMENDATION ONE: USTR should convene a high-level working group of federal and state regulators under the rubric of the Financial Stability Oversight Council (FSOC). FSOC is chaired by Treasury and comprised of key regulators and thus creates a ready-made venue in which to craft the financial stability and regulatory considerations USTR should take into account as the ISA advances.

- RECOMMENDATION TWO: This USTR/FSOC process should be open to public input and launched through an invitation for comment on key questions. These include:
    - ways to advance transparent criteria for trade-in-financial services entry into the U.S. that meet relevant statutory requirements and regulatory-and-supervisory concerns in each key financial-industry sector;

[7] USTR, *U.S., EU Announce Decision to Negotiations on a Transatlantic Trade and Investment Partnership* (Feb. 13, 2013), *available at* http://www.ustr.gov/about-us/press-office/press-releases/2013/february/statement-US-EU-Presidents.

[8] FRB, Proposed Rule, *Enhanced Prudential Standards and Early Remediation Requirements for FBOs and Foreign Nonbank Financial Companies*, 77 Fed. Reg. 76628 (Dec. 28, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf.

[9] See for example, the inter-agency Volcker standards, CFTC's extraterritorial application of U.S. rules, and Dodd-Frank's "push-out" of certain derivatives activities.

[10] Proposal for a Council Directive on implementing enhanced cooperation in the area of financial transaction tax COM [2013] 71 final.

  - terms and conditions the U.S. deems necessary in other nations to ensure fair and prudent trade in financial services; and
  - the degree to which mutual recognition, passporting and other procedures can ensure fair and prudent trade in financial services in the absence of consistent prudential standards.

- RECOMMENDATION THREE: Based on the process outlined above, the USTR, in consultation with other U.S. agencies under the FSOC, should present a proposed framework for trade-in-financial-services that reflects regulatory desires to protect U.S. financial markets in concert with open, fair and non-discriminatory cross-border financial operations. To limit the degree to which financial-services firms are forced to "subsidiarize" – that is, operate through separately-incorporated entities in each country in which they do business – the framework should create standards for branched operations based on transparent criteria.

- RECOMMENDATION FOUR: Based on the work of crisis management groups, national resolution authorities (e.g., the FDIC in the U.S.) should reach formal, public agreement with other nations in which their financial-services firms have significant operations or where major firms active in the host country are based. The ISA should stipulate that financial-services firms operating in an acceptable cross-border resolution regime based on home/host agreement should be granted favored-nation status for purposes of trade in financial services. This term should be defined by USTR and FSOC for U.S. purposes and expressly included in the ISA.

- RECOMMENDATION FIVE: Under specific instructions from the G-20 as needed, the FSB should prioritize its work to focus on prudential standards best suited to ensure free, fair and prudent cross-border trade in financial services. Much of FSB's work to date has highlighted fears about competitive disadvantage and/or regulatory arbitrage resulting from inconsistent application of prudential standards formulated by the Basel Committee and international insurance and securities regulators. Building on this work, FSB should prioritize requirements home countries should implement to ensure ready access by their financial-services firms to host countries, using peer reviews to provide home and host countries with transparent assessments on which to base entry decisions and under which global trade negotiators (e.g., the World Trade Organization) may settle disputes brought under the ISA. The FSB should also as a priority matter set criteria by which nations and the WTO may differentiate nations setting more stringent prudential standards to protect national markets in a manner akin to customs barriers based on risky goods from those set principally to protect host-country markets. It is vital that the FSB work to promote highest-common-denominator global rules, not allow nations to use seemingly-tougher requirements in fact to isolate host-country financial markets.

- RECOMMENDATION SIX: As the FSB shadow-bank regime takes shape, its prudential standards should govern cross-border trade in cited financial activities. USTR should ensure that the ISA is not so sector-specific as to exempt non-banks from appropriate home-country regulation and prevent host-country barriers from discriminating against U.S. firms. Again, the FSB should set the parameters of highest-common denominator financial regulation.