# The Hard U.S. Rubber and the Global-Regulatory Road:

## How to Prevent Protectionism in Cross-Border Financial Services

**Karen Shaw Petrou**

**Managing Partner**

**Federal Financial Analytics, Inc.**

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Over the weekend, finance ministers and central bankers from the Group of Twenty said yet again that they support "full, timely and consistent" implementation of an array of rules articulated by G-20 heads of state since the crisis began in 2008. This sentence could have been – indeed, maybe it was – airlifted into this communiqué from all the others in which it's been placed in the five years since the crisis. But, in almost the next sentence of this communiqué, the same group of senior officials from across the globe now mentioned without comment a Basel Committee report last month that makes clear that implementation of a key global standard – capital rules – is anything but "consistent." It's not just the capital rules that are falling apart. The two other top-priority global standards – resolution without bail-out and OTC-derivatives standards – are also in disarray, as are many other standards – e.g., liquidity – long seen as essential post-crisis repairs.

Most of us swear to cross at the light and look both ways forever and ever after a bit of jaywalking brings us uncomfortably close to eternity in the form of a careening taxicab. Heads of state are no different – the near-death financial crisis led them to swear quite sincerely that they would all put lines at the crosswalks and hold hands when next stepping off the pavement. Five years later, though, and it looks to me like some of them are starting to cross the streets like New Yorkers – wherever they want at whatever speed they can muster before the cabs fly across the intersection. Fearing repeated carnage, other regulators are trying to set up barricades so that, if a financial institution dares to cross the street to its side of the intersection, the firm is strictly channeled through a toll-gate that sets unique rules of the road. Case in point: the Federal Reserve's pending proposal for how foreign banking organizations are to comport themselves while setting foot in the United States.

The Federal Reserve defends this proposal on grounds that it is needed protection, not protectionism. This, though, is a complex, subjective distinction. As a result, regulators may think themselves safety crossing guards, but others see immutable barriers to entry that warrant retaliation. From this, a trade war in financial services will all too quickly ensue.

I see signs of this trade war brewing already – see, for example, not just the Fed's proposal, but also the new EU financial-transaction tax. Like any other war, this won't be good for any but the vainglorious. It's damaging to the prospects for free and fair trade in banking, securities, insurance and other financial services essential for economic growth. Regulators will counter that free and fair – the old hallmarks of trade-in-financial-services accords – doesn't necessarily mean safe and sound, thus rationalizing their protections.

The solution is to add prudential standards to the others by which we judge free and fair trade in financial services. Without these, we'll retreat behind barricades. These might create a few fortress financial systems, but the piracy waging around them will all too soon overwhelm the defenders. Some of these pirates will make more than a pretty penny, but regulated financial-services firms will go up in the same smoke circling the regulators. Thus, free, fair and – critically important – prudential trade in financial services is a vital priority not just for policy-makers, but also for the industry.

How to establish free, fair, and safe financial-services standards that take full account of the wide differences in home-and host-country financial systems? That's my topic today. I'll outline why the high ideals of cross-border standards are now a pipedream. Then, I'll argue for building a cross-border regime for financial services based on hard lessons from trade in manufactured goods. Finally, I'll make a few concrete recommendations on what financial institutions in the U.S. can do now to prevent a downward spiral into financial protectionism here, laying out an agenda for the U.S. in forthcoming trade-in-services negotiations. To ensure lots of time for Q&A, I'll summarize these recommendations, which are laid out in detail in a paper my firm released yesterday[1] to buttress testimony prepared for the U.S. Trade Representative as these negotiations get under way.

**Which Rules are Where**

First, is the global framework as frayed as I suggest? On close examination, all of the hoped-for rules the G-20 put on the agenda after the 2008 crisis – not just big-bank capital – are in disarray. Some of this is due to what the press likes to call the power of giant financial services firms, but lots more of it results from unalterable statutory and structural differences in key banking markets. A 2012 paper released by my firm goes into all of these differences in detail,[2] but let me just highlight two of critical importance in the U.S.:

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[1] 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*

[2] 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.

- We have community and regional banks, not to mention a state-regulatory framework for banks, securities firms and insurance companies. Pretty much every other financial system consists almost entirely of behemoth firms regulated at the national level or, if in the "shadows," not at all. The diversity of U.S. finance, not to mention the power of community-focused institutions and state regulators – makes top-down federal standards hard to demand – see, for example, the bust-up here over Basel III.
- The U.S. has a long-established resolution framework for insured depositories and, in a more limited way, broker-dealer and certain insurance customers. You say, sure, but what of the rest of the financial system? It's important to recognize that even basic protection for retail customers is a work in progress in most other major banking centers. Almost all of them have long relied on too big to fail which in recent years morphed into too big to save because many banks dwarf their home-country GDP. This is creating all sorts of discontinuities as global regulators seek to establish cross-border resolution rules. But, in the U.S., we are working hard to build out Dodd-Frank's orderly-liquidation authority, adding bankruptcy resolution for holding companies to FDIC receiverships for banks as trustworthy ways out of too big to fail for shareholders and unsecured creditors.

Can top-down rules be mandated by Basel or other global regulators when critical national factors – e.g., market structure and resolution standards – differ so materially? I don't think so and, apparently neither does the Federal Reserve, the European Central Bank, the Bank of England and regulators in critical emerging markets (e.g., China and Brazil). Sitting down together and signing communiqués filled with happy talk is one thing all of them seem able to do, but actually implementing any of these commitments in anything like common form on anywhere like the specified deadlines is just not happening.

**The Fed Fires First**

Empowered as it is by Dodd-Frank, the Fed threw a fireball across the diplomatic deliberations at the G-20 when it late last year proposed a new paradigm for host-country financial regulation that, in short, says "My way or the highway." Eschewing euphemism, the preamble of the FRB's proposal lays out its rationale, citing systemic risks posed here by foreign banking organizations (FBOs) that not only threatened U.S. market stability, the FRB says, but also forced the FRB to fork over billions to FBOs from the discount window because parent banks either wouldn't or couldn't sustain their U.S. operations.

Based on this hard lesson, the FRB is proposing an array of new standards FBOs must meet here even if their U.S. operations do not include banking. Time doesn't permit detailing the specifics of the Board's approach. Suffice it to say that it has become a lightning rod for rhetoric over the degree to which global financial markets can remain integrated or if, as trends already portend, banking and other financial services will head inexorably back to what I call a banking-by-border regime of subsidiaries separately chartered in each country in which they do business. The cost of this is considerable to affected financial institutions, and the prudential result is at best a mixed blessing, since capital will flee to the least regulated markets and tougher ones which can still attract a bank or two will see FBOs operate with "trapped" pools of capital and liquidity that could well make them more fragile, not stronger, under stress.

**Saving Cross-Border Financial Services**

As current events make clear, we face a stark and immediate decision: allow the collapse of global financial regulation to continue, taking the chance that it will spark a trade war – or come up with a revised, refined approach to cross-border financial regulation that, chastened by all the challenges since the crisis, takes a more realistic view of where global regulators meet national barriers.

Throughout this talk, I've emphasized trade in financial services because, after all, that's what happens when banks, securities firms, insurers and others go abroad. Like providers of manufactured or agricultural goods, they seek to sell their wares in new markets. Financial services firms do so more easily because financial services now are largely information transfers that leap borders in single, instantaneous bounds, not products trucked or shipped from place to place. Still, at its heart, cross-border finance is trade.

Given this, let's use the trade framework to govern how financial services cross borders. We have established standards and dispute-resolution protocols to find unfair trading in both trade-in-goods and trade-in-financial services through the World Trade Organization and an array of bilateral treaties. We also know how to spot and sanction dangerous products at customs crossings for manufactured or agricultural goods, but we lack any comparable paradigm for cross-border finance. Trade in financial services standards can deal with fair trade – largely using a "national treatment" standard here – but there is no protocol to determine if a rule like the FRB's one for FBOs is fair or foul – that is, is it an appropriate safety-and-soundness standard or unduly protectionist?

The USTR's negotiations form an ideal – indeed an essential – framework to establish safe rules of the road for financial services. At the start, USTR should work with the FSOC to identify U.S. prudential concerns in each key market sector, doing so in an open transparent process that includes extensive public input. From this, we should develop a U.S. trade-in-financial-services policy that should not only guide the USTR, but also the FRB and other regulators as they craft prudential standards applicable to non-U.S. firms. We already have a global framework – the pronouncements of the Financial Stability Board and all the other agencies begging member nations to do what they promise at the G-20. But, if these rules are not so much pressed as top-down mandates for each national financial regime, but rather established as the criteria by which free, fair and safe are judged in financial services, then an objective framework against which firms and regulators can judge each other is readily at hand.

If we have established international prudential standards, then the FRB and other regulators can decide which firms can come here as branches, which through subsidiaries and which not at all. They can also decide if home-country rules pose risks by comparing them against FSB best-practices criteria and peer-review results. If the degree to which a foreign firm in fact complies with standards that nominally meet global rules is unclear, then additional entry criteria can be imposed – a free and fair way to ensure safety and soundness. Where taxes like the EU's financial-transaction ones seek to strike home-country activities, global regulators at the FSB should sanction these as the equivalent of tariffs and use all of their persuasive powers – the only ones they have – to ensure taxation, like capital and other criteria, is imposed in a free, fair and safe fashion, not deployed for discriminatory or home-country purposes unrelated to financial regulation.

Is this new framework easy to construct? Of course not. But, what will happen if we don't try. I hear the guns of February auguring the onset of a trade war in financial services. Since this is a worst-possible result, let's try hard at quickly crafting a best-practices solution.