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Resolution on Trade Rules and Financial Regulation

Introduction

During the past six years, the European Union and the United States have faced our most substantial economic crisis since the Great Depression. Failing banks, mountainous debt, little consumer savings, falling home values, unprecedented repossessions and foreclosures, high under and unemployment rates and stagnant to falling wages continue to persist, despite the technical 'end' of the recession in 2009. Compounding these problems, public budget austerity programs, following the publicly funded rescue of private financial institutions, have resulted in the further deterioration of our education, health and social security systems.

This terrible economic crisis was triggered by our failure to effectively regulate multinational financial institutions, particularly those which the Bank for International Settlements (BIS) has designated as Systemically Important Banks (SIBs). 'Light touch' regulation enabled the proliferation of financial markets and instruments that were 'dark' to regulators and to the public. The trading losses of SIBs and other large financial institutions resulted in a cascade of defaults, due to regulatory exemptions for favored SIBs from the responsibility to hold adequate capital reserves to cover losses. Retail depositors and pensioners discovered too late that their governments had allowed the SIBs to gamble with their money. While governments rescued the banks, the banks did not reimburse their customers, with whose money they had gambled.[1]

In response to the economic devastation created by the reckless conduct of these financial institutions, US and EU policymakers, finally recognizing that consumer protection must be a central component of regulation, have begun to develop and implement new policies that better limit and control financial industry practices. In the US, a completely new agency, the Consumer Financial Protection Bureau (CFPB) was specifically created for this purpose. Further, while much work still needs to be done, new laws and regulations have been created that have begun to strengthen capital requirements for financial service corporations; define responsible behaviour for financial institutions; attempt to make transactions more transparent and understandable for consumers and investors; and allow for the slow and efficient wind down of failed financial institutions. In the EU, several directives have been adopted or are about to be finalized that: protect consumer deposits up to €100,000 in the event of bank failure; better protect borrowers from irresponsible mortgage lending practices; and better inform and protect retail investors, including limiting conflicts of interest leading to miss-selling practices. Further, a regulation is currently being negotiated that caps interchange fees in the card sector in order to improve competition in the EU payment services area, and cut costs for consumers. Finally, as part of its

[1] "Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act," General Accountability Office, January 16, 2013. http://www.gao.gov/assets/660/651322.pdf

mandate, which includes consumer protection, the European Supervisory Authorities have been given the power to issue warnings and/or ban financial products.

With the financial crisis still having a large impact on both US and EU economies, and with our nations still seeking to further develop policies and regulations that better control financial institution behaviour and better protect consumers and investors, we were interested to discover that the focus of the recently announced negotiations for a proposed Transatlantic Trade and Investment Partnership agreement (TTIP) would be on "*regulatory issues and non-tariff trade barriers.*" While we can imagine that the focus of this negotiation might provide a forum where our nations can exchange ideas about best financial regulatory practices, and then use the agreement to set important minimum standards, we fear that the TTIP process will instead devolve into an effort to deregulate the financial services industry, harmonize rules to the lowest common denominator and preempt local efforts to create stronger rules and regulations. Simply, if the TTIP ultimately addresses financial service regulation, it must focus on creating a floor of acceptable rules, without limiting a nation's ability to more strictly control this vital sector. The TTIP must not be used to undo and/or stop the necessary financial regulations that are currently being developed and implemented on both sides of the Atlantic.

In June 2011, TACD made its position clear on the potential deregulatory danger of Trade Agreements in its "Resolution on G-20 Consumer Financial Protection".[2] Under the recommendation "International Trade Agreements should not Undermine Financial Regulation," the resolution noted: "Financial Transaction Taxes (FTT), capital controls, bans on risky financial services and size limits on banks are some of the policies at risk as provisions of the WTO General Agreement on Trade in Services (GATS) prohibits whole categories of regulation in committed services sectors. Unless WTO limits on non-discriminatory financial regulations are removed and/or a meaningful safeguard for prudential measures is inserted, U.S. and EU governments should lead the G20 in halting further demands for more WTO financial services liberalization in the Doha Round."

Since the 2011 resolution, not only has further financial services liberalization in the Doha Round been stalled, but many WTO members have affirmed the need to maintain policy space for financial regulatory measures to avoid future crises. However, with the launch this year of the TTIP negotiations, as well as a parallel track of multilateral negotiations in Geneva, called the Trade in Services Agreement (TISA), TACD's concerns relating to trade agreement rules' threats to robust financial regulation continue to be both relevant and more urgent than ever.

TACD Recommendations

1. Better financial regulation, not deregulation in TTIP or TISA.

The TTIP negotiation process crisis creates an opportunity for the EU and US to exchange ideas about best financial regulatory practices, and then use this agreement to set important minimum standards, without limiting local efforts to create stronger rules and regulations. Unfortunately, US and European financial services firms have made clear their interest in using the TTIP to roll back financial reforms enacted in the wake of the global financial crisis. EU negotiators have explicitly called for new disciplines

[2] TACD Resolution on G20 Action on Consumer Financial Protection http://tacd.org/index.php?option=com_docman&task=cat_view&gid=60&Itemid=40

on financial regulation to be included in TTIP[3]. EU Commissioner for Internal Markets Michel Barnier has called for elements of the Volcker Rule, a cornerstone of the US Dodd-Frank regulatory framework, as well as US state-level regulation of insurance, and the US Federal Reserve's rule on capital requirements for foreign banks to be rolled back in the context of the TTIP negotiations. In the WTO context, the EU has supported new requirements that countries must prove that domestic regulations are "necessary" – which in the context implies that they must be the least trade restrictive measure possible – as well as other explicit tests limiting domestic regulation. In the wake of the financial crisis, it is reckless to limit our governments' ability to regulate the financial services industry. Instead the TTIP negotiators need to use this process to create necessary minimum standards of financial service regulation.

2. Fix the so-called "market access" rules for financial services in past trade agreements to ensure sufficient policy space for robust financial regulation.

While US officials have to date signaled concerns about the EU proposal for *new* disciplines on domestic regulation of financial services, US officials support the use of outdated "Market Access" rules that would impose significant constraints on many forms of financial regulation. These old "Market Access" rules were established in the early 1990s, when financial deregulation took off, in the context of the GATS. These rules forbid countries to maintain or establish certain types of financial regulation with respect to any financial service sector that a country commits to 'liberalize' under the agreement, even when the regulations apply equally to domestic and foreign firms. Both the US and EU indicate that these same Market Access rules will likely serve as the basis of the TTIP and TISA talks with respect to financial services. Yet, under these rules, countries would be forbidden to ban risky financial services or products, such as certain derivatives. And other commonly used policies would be subject to challenge as violating these rules, including those that limit the size of financial firms so that they do not become 'too big to fail', and 'firewall' rules such as in Glass-Steagall that limit the types of financial services any one firm may offer to limit the spread of risk across sectors. **Because the TTIP and TISA both aim to further liberalize financial services in the US and EU, it is critical that these 1990s-era rules be updated to reflect the post-crisis consensus toward financial re-regulation.**

3. Eliminate the ban on countries' use of capital controls and other macroprudential measures that manage capital flows.

Both the old-style Market Access Rules and a separate provision included in GATS and various Free Trade Agreements (FTAs) require free flows of capital. These "Transfers" rules apply to inflows and outflows relating to both capital and current accounts. These rules would conflict with proposed financial transaction taxes (e.g. the "Robin Hood tax") to stem Wall Street speculation and forbid the use of capital controls, a policy tool now endorsed by the International Monetary Fund (IMF) for curbing destabilizing flows of speculative capital.[4] **Given the global shift towards the importance of managing capital flows to ensure financial stability, these outdated terms must not be included in the TTIP or TISA.**

4. No investor-state enforcement.

US and EU officials have announced that the TTIP is slated to include the controversial investor-state enforcement system. The notion of elevating an individual private firm to equal state with a sovereign government to privately enforce the terms of a public treaty by suing governments for cash damages in

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[3] "U.S. Wants Financial Services Off Table in EU Trade Talks", Wall Street Journal, 15 July 2013 http://online.wsj.com/article/SB10001424127887323394504578607841246434144.html

[4] International Monetary Fund.THE LIBERALIZATION AND MANAGEMENT OF CAPITAL FLOWS: AN INSTITUTIONAL VIEW, November 2012, Available at: http://www.imf.org/external/np/pp/eng/2012/111412.pdf

extra-judicial tribunals comprised of private sector attorneys acting as 'judges' is extremely concerning. However, it is entirely inappropriate and unacceptable in the context of an agreement between the US and EU which both have well-functioning domestic court systems. Investor-state enforcement of financial sector provisions poses the untenable risk of the very firms that domestic financial regulations are seeking to govern being empowered to skirt domestic laws and courts, and demand taxpayer compensation for being required to follow the same rules that apply to any firm operating in a jurisdiction. According to the BIS, 15 of the largest 16 dealer brokers of Over the Counter Derivatives are either European or US-headquartered, each of them having hundreds of US and European subsidiaries and affiliates.[5] Given the transatlantic operational structure of these banks, under the TTIP financial regulation would be under a permanent siege of investor state lawsuits or threat of lawsuits.

5. No standstill on new regulation.

The US and EU were among 33 WTO countries that agreed to meet the terms of a WTO "Understanding on Commitments in Financial Services" that includes a standstill on new regulation. Neither the TISA nor the TTIP, which would involve additional US and EU sectors being committed, must include such a freeze on new regulation. Certainly after the global financial crisis, countries cannot agree to lock in the level of deregulation they agreed to in the 1990s. Similarly, these pacts must not include any obligation to guarantee foreign firms the right "to offer in [their] territory any new financial service," which is a term in the WTO Understanding on Commitments in Financial Services. Such a rule would mean that, while a country could ban its domestic firms from offering certain new risky financial service "products", it could not equally prohibit foreign firms operating within the country from doing so.

Background

Existing rules governing trade in financial services in the WTO and the standard model of many FTAs were established in the 1990s, when extreme financial deregulation first became in vogue. Taken as a whole, these "trade" rules can impose expansive limits on robust regulation of the financial service sector. Some of the main concerns are:

- **Certain forms of regulation banned outright:** *When countries agree to liberalize a sector under Market Access rules, they also are bound not to maintain or establish certain forms of regulation, even if such regulation applies to domestic and foreign firms equally.*

- **No bans on risky financial services or "products" in committed sectors:** *A WTO tribunal has already ruled that a regulatory ban, even if it applies to domestic and foreign firms, constitutes a forbidden "zero quota" that violates service sector Market Access obligations. This restriction conflicts with proposals to limit various risky investment instruments, such as certain derivatives including naked default swaps.*

[5] "Macro-economic costs and benefits of OTC derivatives regulatory reform", Table 3, Bank for International Settlements, August 2013, 2. http://www.bis.org/publ/othp20.pdf Dafna Avraham, Patricia Selvaggi and James Vickery, "A Structural View of Bank Holding Companies," *Federal Reserve Bank of New York Economic Policy Review,* July 2012, Table 1: Number and Distribution of Selected Top Fifty Bank Holding Companies, at 71. http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf

- **No limits on capital flows such as financial transactions taxes (FTT) and capital controls:** *GATS Article XI and a footnote to GATS Article XVI forbid limits on capital inflows and outflows with respect to financial sectors that countries have committed to liberalize under GATS. GATS Article XII contains a narrow exception for temporary use of such measures if the IMF approves after a country has had a serious balance of payments crisis. US FTAs contain boilerplate language requiring that: "Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory." The FTAs specify that such transfers include: a) contributions to capital, including the initial contribution; (b) profits, dividends, capital gains, and proceeds from the sale of all or any part of the covered investment or from the partial or complete liquidation of the covered investment; (c) interest, royalty payments, management fees, and technical assistance and other fees; (d) payments made under a contract, including a loan agreement. The FTAs include similar provisions specifically relating to cross border financial services and services in general: "Each Party shall permit all transfers and payments relating to the cross-border supply of services to be made freely and without delay into and out of its territory." US FTAs do not even include this extremely limited GATS exception to the obligation that countries allow free 'transfers' of inflows and outflows relating to both capital and current accounts. Such measures undermine the policies now being praised by the IMF that set long-term limits on inflows to avoid speculative bubbles which lead to crises. Global consensus has shifted towards support of careful macro-prudential management of capital flows. A 2010 EC staff paper noted a potential conflict between a Financial Transactions Tax (FTT) and the EU's commitments in the GATS: "As the EU has taken specific commitments relating to financial transactions, including lending, deposits, securities and derivatives trading and these commitments relate to transactions with third countries, a currency transactions tax could constitute a breach of the EU's GATS obligations."*

- **Additional Limits on Common Financial Regulatory Measures:** *Policies that limit the array of financial services any one firm is permitted to offer are exposed to challenge as a violation of Market Access rules. This regulatory limit could conflict with attempts to 'firewall' different financial services, which is a policy tool used to limit the spread of risk across sectors. Before it deregulated, the US, for instance, used such policies to insulate consumer saving accounts by forbidding entities that operated such businesses from also providing risky securities or derivatives offerings. As well, Market Access rules, for instance those contained in GATS Article XVI(2), prohibit government policies that limit the size or total number of financial service suppliers in covered sectors. There is a debate about to what this limitation applies, as the language of the provision is ambiguous and untested. Some countries assumed the limit applies to the size of specific firms, and scheduled exceptions in their GATS commitments. The US Trade Representative argues that this limitation applies to an entire sector, not to specific firms, and did not preserve this policy space. What is clear is that this ban applies absolutely. It is not a requirement that domestic and foreign firms be treated the same. These rules also ban limits on the value of service transactions and number of service operations. This GATS obligation could make it difficult to solve the 'too big to fail' problem, whereby a single bank's failure could endanger the entire financial system.*

- **Treating foreign and domestic firms alike is not sufficient:** *The GATS Market Access limits on domestic regulation apply in absolute terms. In other words, even if a policy applies to domestic and foreign firms alike, if it goes beyond what trade pact rules permit, it is forbidden. And, forms of regulation not banned outright by these rules must not inadvertently "modify the conditions of competition in favor of [domestic] services or service suppliers", even if they apply identically* *to foreign and domestic firms.*

- **Other non-discriminatory domestic regulations also subject to review:** *GATS subjects policies of general application that may affect service sector firms to review, with WTO tribunals empowered to determine if they are "reasonable", whether they "could not reasonably have been expected" and whether licensing and qualification requirements and technical standards limit foreign firms' access.*

- **Standstill on new regulation:** *The WTO dictate to deregulate – and the limits on reregulation – are even more extreme for the 33 countries, including the US and the original EU states, that agreed to additionally adopt the 1997 WTO Understanding on Commitments in Financial Services. In addition to the constraints noted above, the Understanding obligates its adopters to put a freeze on new regulations in covered financial service sectors. This so-called "standstill" provision is contained in the Understanding's Article (A), and reads: "Any conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures." The effect of this provision is to lock adopters into the level of deregulation they agreed to in the 1990s. How this provision will be interpreted, as countries begin to regulate after the financial crisis, is a matter of considerable debate and concern. The Understanding's Article B(7) obliges its adopters to ensure that the commercial presence guaranteed under Article B(5-6) is accompanied by the right "to offer in [their] territory any new financial service". In other words, while a country could ban its domestic firms from offering certain new risky financial service "products", it could not equally prohibit foreign firms operating within the country from doing so.*

- **The only exception to these rules is viewed by many to be useless:** *WTO and FTAs contain a "prudential exception" that can be invoked as a defense if a financial policy is challenged. However, the provision contains a clause that many deem 'self-cancelling'. That is to say, the effectiveness of the provision is at best contested in that its acceptable use is explicitly limited to circumstances where invoking the exception does not contradict a country's "trade" pact commitments. But a country would not use the exception unless it felt that a financial policy did just that.*

A Potentially Dangerous Expansion through TISA and the TTIP

In the context of the WTO, countries are only bound to these rules to the extent that they committed specific services sectors to the agreement. While the US and EU took extensive commitments in financial services sectors, the Doha Round of multilateral negotiations aimed at further deepening 'liberalization' of financial services and other sectors. The Doha Round has been deadlocked, and some consider it altogether derailed; however, the US and EU have joined a small bloc of WTO countries[6] calling themselves "The Really Good Friends of Services" (RGF) in trying to revive the financial deregulation agenda from the Doha Round by pushing for plurilateral negotiations of the TISA. Official negotiations began in 2013, and while little information has been made available to the public, the stated intent is to further liberalize trade and investment in services among participants, and expand "regulatory disciplines" on all services sectors, including financial services. If the problems of the GATS with respect

[6] The countries currently involved in the TISA negotiations include: Australia, Canada, Chile, Colombia, Costa Rica, Hong Kong, Iceland, Israel, Japan, Mexico, New Zealand, Norway, Panama, Pakistan, Peru, South Korea, Switzerland, Taiwan, Turkey, the United States, and the 28 member states of the European Union.

to policy space for financial regulation are not addressed, a TISA could pose further dangers to financial re-regulatory efforts on both sides of the Atlantic.

The TTIP negotiations pose more extreme dangers in this regard, as the EU has been pushing for even further 'disciplines' on financial regulation. Both the US and EU have indicated their intention to include investor-state dispute settlement, which would empower individual financial firms to challenge financial regulatory policies through extrajudicial tribunals outside our domestic court.

TACD's concerns about the potential deregulatory impacts of the TTIP and TISA are not theoretical. In their public comments to the US Trade Representative's office with respect to the TTIP negotiations, European and US banks have been remarkably candid in naming the specific US and EU financial regulations that they would like to see dismantled via the TTIP.[7] Some examples of the regulatory rollbacks the banks hope for in TTIP, as stated by the banks themselves, include:

- **Exempt banks from regulations**: *The US Securities Industry and Financial Markets Association – a conglomerate of Wall Street firms like AIG, Citigroup, JP Morgan, Bank of America and Goldman Sachs – suggests that via the TTIP, US and EU governments could simply "agree to exempt financial services firms of the other party from certain aspects of its regulatory regime with respect to certain transactions, such as those with sophisticated investors."[8] That is, so long as foreign banks are dealing with "sophisticated" investors, regulators need not bother with regulating the banks.*
- **Weaken the Volcker Rule:** *The Association of German Banks has made clear it has "quite a number of…concerns regarding the on-going implementation of the Dodd-Frank Act (DFA) by relevant US authorities,"[9] referring to the Wall Street reform enacted in the wake of the financial crisis. The banking conglomerate includes Deutsche Bank, a German megabank that received hundreds of billions of dollars from the US Federal Reserve in the aftermath of the crisis in exchange for mortgage-backed securities.[10] The German banking behemoth particularly takes issue with the Volcker Rule, a centerpiece of the Wall Street reform, calling it "much too extraterritorially burdensome for non-US banks." The foreign banks hope US regulators will "take our concerns into account" in the context of TTIP negotiations.*
- **Outsource risk regulation:** *The European Services Forum, a banking conglomerate including Germany's Deutsche Bank, has stated that the TTIP should prevent US regulators from placing tougher regulations on too-big-to-fail foreign banks operating in the US unless foreign government entities do so first: "we think that it should not be possible for a company operating*

[7] USTR request for comments on TTIP ahead of Public Hearing, May 2013 http://www.regulations.gov/#!docketBrowser;rpp=50;po=0;D=USTR-2013-0019

[8] Written Submission on behalf of the Securities Industry and Financial Markets Association to USTR found at: http://www.regulations.gov/#!docketBrowser;rpp=50;po=0;D=USTR-2013-0019

[9] Association of German Banks, "EU and US 7 September 2012 call for input on regulatory issues for possible future trade agreement" Available at: http://ec.europa.eu/enterprise/policies/international/cooperating-governments/usa/jobs-growth/files/consultation/regulation/7-association-of-geman-banks_en.pdf

[10] http://www.huffingtonpost.com/2010/12/01/fed-opens-books-revealing_n_790529.html

globally to be designated as a systemically important financial institution (SIFI) in a foreign jurisdiction but not in its domiciliary jurisdiction."[11]

- **Remove state-level leverage limits**: *Insurance Europe, a collection of Europe's largest insurance firms, has stated its hope that TTIP can be used to "remove" collateral requirements enacted by US states to keep insurance corporations from taking on risky degrees of leverage: "Insurance Europe would like to see equal treatment for financially secure well regulated reinsurers regardless of their place of domicile with statutory collateral requirements removed."*[12]

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[11] European Service Forum Contribution to Public Consultation on EU-US High Level Working Group on Jobs and Growth, April 2012, Available at: http://www.regulations.gov/contentStreamer?objectId=09000064812d81d5&disposition=attachment&contentType=pdf

[12] Insurance Europe's response to EU-US Dialogue Project, October 2012. Available at: http://ec.europa.eu/enterprise/policies/international/cooperating-governments/usa/jobs-growth/files/consultation/regulation/33a-insurance-europe_en.pdf