Reforming International Financial Regulation
- What role for a World Financial Organisation and the WTO/GATS?

Professor Dr. Kern Alexander, Faculty of Law, University of Zürich, and Centre for Financial Analysis and Policy, University of Cambridge

Cambridge Finance

Lessons from the crisis

- Institutions and market structures
  - Power of financial contagion in integrated cross-border financial markets
- Policy analysis
  - Micro-prudential financial regulatory models do not adequately monitor and control systemic risks – role of macro-prudential regulation
- Policy implementation
  - Out-dated regulation can exacerbate externalities
  - Market-based regulatory models do not adequately incentivise banks to monitor and control systemic risks

Crisis impact on developing countries

- Average GDP growth rate of developing countries fell to less than half the pre-crisis rate.
- Particular severity for economies that have relied on capital inflows to expand economic activity & domestic financing
- Financial protectionism b/c of reduced cross-border lending by developed country banks as govt-support programmes set domestic lending targets, also indirectly reducing cross-border trade finance
- Deleveraging leading to 'crowding out' of riskier borrowers, especially small and medium-sized enterprises, especially in developing countries.
- World trade suffered largest decline in 80 years with DCs such as Indonesia, Turkey & Philippines drops of 20% in exports

European Commission 'Augur' project

What global financial regulation will look like in 2025?

- G20/FSB/IMF regime – build on existing international regime – 'muddling through'
- Regional groupings of states – EU, NAFTA, Mercosur, Asian groupings
- A return to the primacy of nation states
- Further consolidation of the existing international regime through the creation of a ***World Financial Organisation***

What role for WTO/GATS?

Market failure and regulation

- FS sector is unique both in terms of its fundamental importance for development and in the types of risks it poses
- Potential for imperfect competition
- Market failures arising from substantial information asymmetries & misaligned incentives
- Large externalities for economy – financial stability?

These characteristics suggest caution when liberalising trade in FS and cross-border capital flows

Inadequate regulatory capital

'The Basel Committee . . . promulgated a set of capital rules that failed to foresee the need that arose in August 2007 for large capital buffers'

Alan Greenspan, FT, 26 March 2009

Global reform agenda

- Global consensus on need for more effective, better coordinated macro- and micro-prudential regulation and supervision
- Oversight of systemic risk has to be globally co-ordinated
- Systemic risk oversight bodies: international, regional, national
  - Global: Financial Stability Board (FSB)
  - EU: European Systemic Risk Board & European Supervisory Authorities
  - UK: Financial Policy Committee of Bank of England
  - USA: Dodd-Frank – Financial Stability Oversight Council
  - France: Financial Regulation and Systemic Risk Council

Building on existing international regime

- The G20 Washington Action Plan and the London & Pittsburgh Summit Statements on strengthening the financial system
- FSF's April 2008 and 2009 Reports
  - A roadmap on financial supervision and regulation
  - A more robust supervisory and regulatory framework based on new rules not only for financial institutions but also other actors, markets and supervisors

  - **Macro prudential to complement micro prudential regulation**

G20 and Financial Stability Board Initiatives

- Global arena:
  - FSB principles for cross-border cooperation on crisis management
  - G-20/FSB protocol to establish colleges for all major cross-border financial institutions
  - Basel Committee enhances regulatory capital standards
  - Basel Committee membership increased to 20 (Australia, Brazil, China, India, Korea, Mexico and Russia)

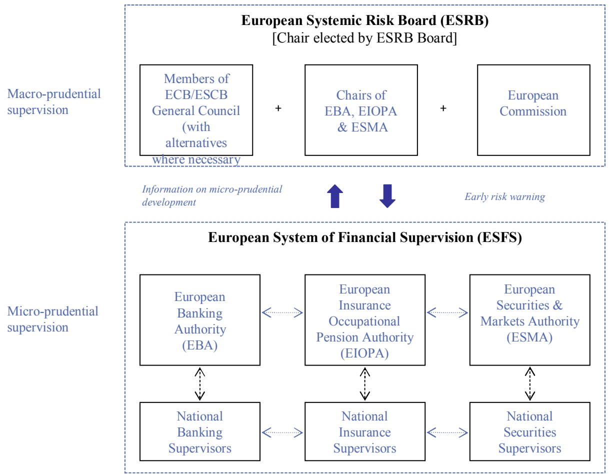
However, political resistance to enhanced regulatory capital

'I don't see why regulators would insist on massive reserves, massive buffers.'

Christine Lagarde, French Finance Minister,

15 March 2011, speaking in Paris at the Economist banking conference

Regional groupings - EU financial supervision



Bilateral agreements - FTAs and BITs

- Requires liberalisation of cross-border trade in financial services and liberalising the capital account.
- US FTAs and BITs do not have 'sequencing' mechanisms for capital account liberalisation and provisions for reversal in time of crisis
- Positive list v. negative list approach – inadequate safeguards for DCs/EMEs
- MFN clauses in FTAs/BITs which might implement GATS commitment through the backdoor with prudential regulation carve-out.

The WFO and enhanced international regulation

Perhaps a more holistic regulatory approach is needed:

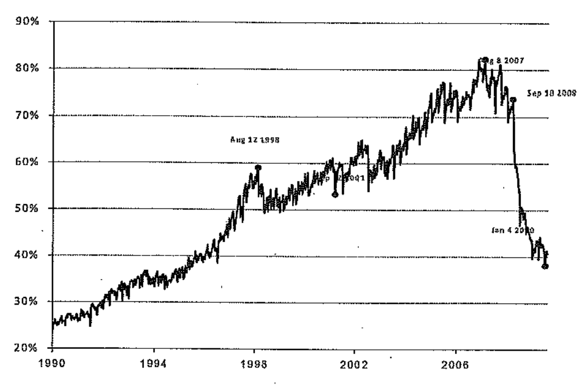
1) most stringent and enhanced capital levels
2) Liquidity requirements (ie., asset requirements),
3) Counter-cyclical capital and/or dynamic provisioning,

But also enhanced macro-prudential tools needed

1) Address credits booms: loan to value ratios (LTVs) and loan to income ratios (strictly enforced)
2) Bank liabilities should consist mainly of retail deposits, followed by equity, with smaller % from securitised finance & repos
3) Leverage caps/ratios – linking asset growth to equity growth (Morris & Shin 2008) (bank capital should be a constraint on balance sheet growth)
4) Financial stability tax on bank's non-core liabilities (IMF 2010 FSC proposal, a balance sheet tax)

Macro-prudential oversight

Figure 3. Repos and Financial CP as Proportion of M2 (Source: US Federal Reserve)[2]



What role for the WTO/GATS

Schedules of commitments (Most-favoured nation and national treatment) – members have made limited commitments

Prudential carve-out (broad scope) protects domestic regulatory measures to depart from these commitments, unless used 'as a means of avoiding the Member's commitments or obligations under the Agreement.' Must have prudential regulatory intent, not protectionist intent.

Article VI imposes disciplines on regulatory measures adopted by members to sectors subject to liberalisation commitments

Inter-temporal aspects of interpreting the GATS/prudential carve-out. What seemed to be a 'prudential reason' in late 1990s may not be a valid 'prudential reason' in 2011.

What role for the WTO/GATS

- The nature of market access and national treatment commitments should be reassessed in light of the crisis
- A robust prudential carve-out
- Article VI disciplines that respect prudential discretion and differential application of regulatory models.

Query the role of transparency in macro-prudential regulation

Conclusion

- Financial crisis demonstrates inadequacy of international regulatory regime
- What model for the future?
- G20/FSB efforts focus on macro-prudential supervision inadequate
- Rise of regional groupings presents challenges
- BITs/FTAs pose more of a threat to developing countries
- Reassessment of WTO/GATS commitments in international financial regulation