An Evaluation of the Role of the WTO in Promoting Global Financial Stability

by

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Abstract

Global financial stability is arguably the most important goal in the regulation of international finance. The fulfillment of that goal pushes domestic regulators in two directions. One is towards strong domestic regulation arising from a desire to fix the problems within and isolate from the problems without. The other focuses on international cooperation, wherein regulators recognize the impossibility of fully isolating the domestic economy from external shocks and thus embrace a coordinated approach to combat the types of risk the global economy now faces.

As a forum for international cooperation, the WTO is particularly powerful in its ability to ensure compliance, which also necessarily means a corresponding limit on domestic autonomy. This paper considers how the WTO's power affects global financial stability, and the extent to which it may be used to navigate the imperatives of strong domestic legislation along with international cooperation.
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## Acknowledgments

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Introduction

“Reform of the international system must have, as its goal, the improved functioning of the world’s economic system in support of the global good.”

As the global economy recovers from the 2008 financial crisis, governments around the world seek to identify the root causes of the crisis and learn what may be done to avoid the next catastrophe. While there are many causes, the under-regulation of financial institutions is frequently cited as a key factor of how the crisis began. Furthermore, under-regulation on a global scale helps explain how financial institutions’ global operations and connections facilitated quick transmission of crises across national borders. Banking crises have been a feature of financial crises for at least the last two centuries, but the global element of the most recent banking crisis has presented significant new challenges for regulators.

Throughout the efforts for reform, there is a palpable tension between domestic protectionism and global cooperation. On the one hand, domestic regulators look inwardly to try to fix what went wrong in their own financial systems and protect their depositors, investors and citizens generally from harm caused by financial crises. On the other hand, there is an increasing awareness of global contagion in the financial sector and the inability of any one government to unilaterally protect its citizens from global systemic risk. While not immediately in opposition to each other, these two goals are in tension when developing rules on how the global financial system will operate. Should global financial regulation favour domestic autonomy permitting governments to protect their own citizens at the expense of foreign interests and regulatory harmonization? Or should it favour international cooperation, binding individual governments to standards that best respond to the realities of global systemic risk? Furthermore, if the latter view is taken as preferable, is it practically possible to hold countries to a system of rules governing global finance in an effective manner?

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2 Carmen M. Reinhart and Kenneth S. Rogoff, This Time is Different (Princeton: Princeton University Press, 2009) at 141.
Historically, global cooperation in finance has arisen from a desire to realize increased economic efficiencies. In the aftermath of the 2008 financial crisis, global cooperation is now widely acknowledged to be required not only to capitalize on increased efficiencies, but also, and potentially more importantly, to combat systemic risk on a global level. This additional requirement for global cooperation calls into question whether the forums traditionally used for such cooperation are appropriate. The Financial Stability Board, College of Supervisors, International Organization of Security Commissions (IOSCO), and the Basel Capital Accords are the most prominent examples of international cooperation in financial regulation. While these institutions existed prior to the financial crisis, their relevance and central role in future policymaking have dramatically increased.

As the focus and forums for international financial regulation have shifted, institutional legacies remain from trade agreements motivated by increasing economic efficiency in financial markets. This paper will focus on the World Trade Organization (WTO)’s financial services commitments contained in the General Agreement on Trade in Services (GATS). While these commitments were made out of a goal to realize increased economic efficiencies in international finance, they now both have the potential to help as well as to hinder overall international financial stability.

Mark Carney, former Governor of the Bank of Canada and current Governor of the Bank of England, has warned against the risk of protectionist measures and emphasized the need to increase integration as opposed to retreating from open markets-

> Although the development of global standards for financial stability is important, full and consistent implementation is absolutely essential to preserving the advantages of an open and globally integrated financial system. Market participants and authorities need to have confidence in the strength of financial institutions and markets in other countries. Moreover, to realize fully the benefits of openness and competition, there must be a level playing field. Recent post-crisis experience demonstrates that when mutual confidence is lost, the retreat from an open and integrated system can occur rapidly. A return to a nationally segmented global financial system would reduce both financial capacity and systemic resilience, with major consequences for output and employment growth.⁴

Mr. Carney’s comments are consistent with the common understanding that retreat from open markets is both undesirable and likely impossible. The purpose of this paper is not to dispute these claims, but instead to examine the way that market access has been achieved, and to

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question whether there is a better way to provide market access without jeopardizing international financial stability.

Individual countries have decided to open their financial services markets to foreign competition for a variety of different reasons, emanating from internal and external sources. A critical juncture in history for this process was the negotiation of the General Agreement on Trade in Services (GATS) during the Uruguay Round of the World Trade Organization (WTO) which ended in December 1993, and the corresponding financial services commitments, ultimately agreed upon in December 1997. Chapter 1 discusses these commitments and the advantages anticipated to accrue both globally and domestically from their adoption.

Chapter 2 applies the benefit of hindsight to identify the issues associated with a global financial system without an equivalent global financial regulator. In Chapter 3, I review the spectrum of approaches that have been advocated to address the under-regulation of the global financial system. While non-exhaustive, this section identifies a spectrum between hard and soft law mechanisms, as well as domestically focused solutions, and summarizes the advantages and disadvantages of each. Finally, Chapter 4 evaluates how the GATS and WTO may continue to interact with global financial stability in light of the unique challenges associated with international financial regulation identified in Chapters 2 and 3.

I argue that at the time of the negotiation of the GATS, there was an underestimation of the need for global supervision, with a corresponding overconfidence in nations’ ability to collaborate and provide any supervision that may be required. The 2008 Global Financial Crisis has since exposed the magnitude of the need for global supervision as well as significant challenges inherent in the goal of global cooperation.

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Chapter 1
Market Access as Conceived Under the WTO

As domestic banking markets have increasingly become open to foreign competition, it is possible to observe several internal and external sources leading to this shift. The Uruguay Round of the WTO from 1986 to 1994 was one such source, and the subsequent Annex on Financial Services in 1997 was a decisive moment in the framework for increasing market access in financial services.

There were and continues to be several sound economic reasons for why opening a domestic market to financial services would benefit that domestic economy. This section will highlight those reasons and detail how the negotiations operated, what risks were acknowledged and what benefits were anticipated.

1 The WTO and the GATS on Financial Services Negotiations

The WTO was the realization of the International Trade Organization, which was conceived under the Bretton Woods conference for establishing global governance post World War II. The WTO was designed to reduce barriers to trade internationally, and is premised on the theory of increasing comparative advantage. Based on Ricardian economic theory, the WTO facilitates mutual concessions through which countries multilaterally decrease trade barriers and thus allow each to maintain or develop comparative advantages and economies of scale in select industries. The WTO “deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.”

The premise of comparative advantage is that through natural geographic features, specialized skill sets and/or economies of scale, one geographic region can develop an advantage in a given industry as compared to other countries. It can then export the product or service it specializes in, and import other products and services from other countries with different comparative advantages. While not Pareto efficient (in which everyone would automatically be better off),

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international trade theory does claim to be Kaldor-Hicks efficient (overall utility is increased such that the winners can compensate the losers and make everyone better off). \(^8\)

The General Agreement on Tariffs and Trade (GATT), which entered into force in 1948, \(^9\) has generally been seen as effective in achieving its goal of reducing trade barriers, and thus increasing economic efficiency. It has a strong dispute resolution system with enforceable sanctions and a positive compliance record. The Uruguay Round negotiations focused *inter alia* on trade in services, which in many ways is more complex than trade in goods; there are more complications in technical and professional standards, personnel transfers, as well as more difficulties in defining reciprocity. Nonetheless it was strongly believed that the economic gains in globalizing the provision of services would outweigh these challenges.

The General Agreement on Trade in Services (GATS) came into force in 1995. However, the multilateral negotiations were unable to achieve completion of negotiations on two main areas at that time - telecommunications and financial services. The increased technical specifications and domestic importance of both of these industries made member countries reluctant to commit to the necessary internal measures to open market access in these sensitive areas. Negotiations on financial services were originally concluded in 1995, but the United States took a broad exemption for itself, awaiting more extensive commitments by other members. Negotiations were finally concluded in 1997, and 102 WTO members made specific commitments on financial services that in 1999 were incorporated and bound in the Fifth Protocol of the GATS. The various statements on financial services by the member countries were contained in two Annexes on financial services, an Undertaking on Commitments in Financial Services and a Decision on Financial Services. \(^10\) The commitments collectively from each of these sources will be referred to as GATS financial services commitments throughout this paper.

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\(^8\) *Trebilcock (Critiques), supra* note 6 at 226.


\(^10\) *Trebilcock, Howse & Eliason, supra* note 5 at 500-503.
2 Benefits of International Trade in Financial Services

In 1997, the WTO produced a study to “clarify the potential benefits and challenges which arise in the context of financial services trade liberalization.”\textsuperscript{11} The study was produced preceding the expiry of an interim financial services agreement in December of 1997, and argued that the main benefits of trade liberalization in financial services would arise from increased competition and better financial intermediation.\textsuperscript{12} Increased competition is expected from more firms entering the market, leading to more bargaining power for consumers, ideally leading to better service and lower prices.

Better financial intermediation finds its rationale in the theory of comparative advantage. Countries that have expertise in the provision of financial services, or in a particular type of financial services, can further develop and capitalize on that expertise by providing it around the world. Other countries therefore can benefit from that expertise while developing their own comparative advantages in other areas. Operating unilaterally, states frequently impose large tariff barriers and limit entry of foreign competitors so as to protect domestic firms. However, when all states act in this protectionist manner, then each domestic economy is operating in substantial isolation and therefore unable to realize comparative advantages internationally. Working together states may increase global efficiency and global welfare by multilaterally opening their borders. Firms are thus able to compete globally and develop further specialization. Furthermore, firms are able to gain increased economies of scale and scope and thus offer consumers lower prices.

For the United States in particular, trade liberalization in services was an increasing priority in the 1990s as its comparative advantage in trade in goods declined,\textsuperscript{13} although it should also be noted that developing countries also possessed a largely unacknowledged comparative advantage in services, which would later prove to be substantial.\textsuperscript{14} Yokoi-Arai has described the process as “horse trading” financial services liberalization for other WTO commitments that the developing

\textsuperscript{12} Ibid.
\textsuperscript{13} Ibid.
\textsuperscript{14} Trebilcock, Howse & Eliason, supra note 5 at 478.
countries wanted.\textsuperscript{15} And Marchetti has observed a similar trend outside of the WTO framework in Preferential Trade Agreements to include financial liberalization for developing countries.\textsuperscript{16} Therefore, developing countries may have received concessions from their trading partners that were on net beneficial to them even if the particular concessions in financial services were not seen, in and of themselves, as beneficial.

Related to the general theory of comparative advantage, but particular to finance, is the opportunity to match credit and capital anywhere in the world. The concept is that “capital movements would increase investment, growth, and prosperity by enabling global savings to flow to their most productive uses.”\textsuperscript{17} When the world economy is performing well, this opportunity can present significant advantages for individuals and business communities in the developing world. However, once economic growth slows down, international banks may restrict credit access in these regions and thus can become dangerous for those same consumers and businesses that were being helped (due to uncertainty and unexpected lack of access to credit).\textsuperscript{18}

The WTO report also recognized the improvement of the “inter-temporal allocation of resources” as a benefit to liberalization.\textsuperscript{19} Drawing on the economic concept of income smoothing, countries that have a credit shortage at a given point in time may utilize other countries’ credit surplus. While the report does acknowledge the risks of too much access to credit, and particularly consumer credit,\textsuperscript{20} this area is one of the best examples where the benefit of hindsight is indisputable. The subprime financial crisis can largely be traced to excessive international investment into a lax regulatory lending regime in the United States.

While the theory of improving the inter-temporal allocation of resources generally refers to increasing access to credit in the developing world, Justin Yifu Lin points out that the opposite

\textsuperscript{16} Juan A. Marchetti, “Financial services liberalization in the WTO and PTAs” in Juan A. Marchetti & Martin Roy, eds, Opening Markets for Trade in Services Countries and Sectors in Bilateral and WTO Negotiations (Cambridge University Press, 2009) 300-339 at 300.
\textsuperscript{17} Dani Rodrik, The Globalization Paradox (New York: W.W. Norton & Company, 2011) at 91.
\textsuperscript{19} Kono, supra note 11 at 21.
\textsuperscript{20} Ibid.
appears to have been the case preceding the 2008 financial crisis. Loose U.S. monetary policy, combined with financial deregulation and new and complex financial products, created artificially high domestic consumption. This unsustainable consumption was ultimately financed by export-oriented policies in other countries and particularly Chinese investment.21

Another benefit of opening international borders for financial services arises from the global nature of today’s commerce; when banks operate globally, international businesses can in turn benefit from a corresponding global provision of the services they require. Anticipating these benefits, the business community may put pressure on regulators to liberalize their regulatory regimes to allow for the entry of international banks.

Finally, the WTO report argued that liberalization would prevent governments from using credit and interest ceilings as monetary policy instruments. The report suggested that such measures could have distortionary effects on the economy as the government filters lending into particular industries or financing of government deficits.22

3 GATS Financial Services Negotiations and Concessions

At the time of the negotiations, the above benefits were predominantly countered by reluctance to place limits on domestic autonomy. Marchetti argues that the desire to preserve policy-making space for banking stability and prudential oversight was strong enough that it appears to also have outweighed the goal of liberalization.23 While today, global cooperation is increasingly seen as necessary to enhance banking stability, at the time of the GATS negotiations, signing an international agreement would appear to have been perceived as more of a liability than an asset in pursuit of the goal of stability.

Given countries’ reluctance to make substantial commitments that would limit their domestic autonomy, strong liberalization advocates see the financial services market access commitments as less than ideal. Compared to the rest of the WTO agreements, the GATS financial services commitments contain weaker language and not very substantial commitments. Yokoi-Arai

22 Kono, *supra* note 11 at 20.
23 Marchetti, *supra* note 16 at 300-339.
describes the limited nature of the provisions; they are inclusive rather than exclusive, meaning that countries make specific commitments in areas they want to commit to as opposed to listing exceptions to areas they do not want to commit to. Each country lists in its own annex the liberalization commitments it is making. These weaker commitments are indicative of the importance of financial services regulation, and countries’ lack of willingness to ‘tie their hands’ in an area important to domestic economies.

The main provision that has been both hailed for promoting domestic autonomy, and criticized for its vagueness and therefore uncertainty is the so-called ‘prudential carve-out’. Section 2 of the Annex on Financial Services [the Annex] states-

2. Domestic Regulation
(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.
(b) Nothing in the Agreement shall be construed to require a Member to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

While the exception has not been invoked in any decided WTO cases, Argentina recently included the prudential exception as a potential defence to allegations from Panama that Argentina’s Income/profit tax law contained regulation inconsistent with its GATS and GATT commitments. In a 3rd party submission, the United States highlighted the broad discretion the exception allows for domestic regulators, including individual financial institutions, cross-border financial institutions and overall systemic stability.

24 Yokoi-Arai, supra note 15 at 624.
The European Union also provided a 3rd party submission in the Argentina-Panama case, in which it appears to advocate a more systematic reading of the prudential exception. While not taking a position on the facts, the E.U. proposes a 2-step analysis for the appropriate application of the exception. First, it must be determined whether the action was taken for prudential reasons with consideration of the indicative (but not exclusive) list of examples and the objectives of ensuring integrity and stability of the financial system. Second, it is necessary to determine whether such a measure is being used to circumvent other GATS commitments and obligations. The EU compares this requirement to the chapeau of the general exception clauses in the GATS and GATT, 28 emphasizing that the chapeau operates to prevent abuse or misuse of the exception and that the member invoking the exception bears the onus to demonstrate such. The EU concludes its analysis asserting, “it must be assessed whether the measure at issue, as it is applied in practice… is genuinely pursuing the prudential objective.” 29

Even if a more limited and systematic approach is taken, such as that proposed by the EU, there is still reason to believe the prudential exception casts a wide net. Marchetti and Yokoi-Arai both observe that, compared to other exceptions in the WTO framework, the exception for prudential regulation has a uniquely broad scope. There is no requirement for least restrictive means, 30 nor is it required that the provision be ‘necessary’. 31 This means that a regulator theoretically has considerable flexibility with which to pursue a given prudential objective, with minimal oversight from the WTO or its dispute settlement body.

While the Annex provides examples for what might count as ‘prudential’, no explicit definition is given. Some countries have stated a preference for the intentionally vague definition of prudential so that it could encompass a full range of policy options. The United States specifically emphasized that the broad understanding of the word was relied upon when establishing its own (and others’) commitments under the GATS. 32 The alternative to the vague definition would conceivably be a reliance on stricter definitions and international standards,

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28 Article XX of the GATT and Article XIV of the GATS.
30 Marchetti, supra note 16 at 292.
31 Yokoi-Arai, supra note 15 at 640.
32 US WTO submission, supra note 27 at 7.
something particularly opposed by members who were not part of international standard setting processes (such as Basel).\footnote{Yokoi-Arai, supra note 15 at 639.}

However, the negative side of a broad and unspecific definition is the possibility that a lack of clarity may give rise to a chilling effect in consideration of policy options. In other words, given the uncertainty, domestic governments may avoid certain regulatory measures for fear that a WTO panel would employ a more restrictive interpretation. For example, Yokoi-Arai explains a potential distinction between systemic regulation and prudential regulation. Systemic regulation is said to focus on the safety and soundness of the financial system as a whole, while prudential supervision focuses on the supervision of individual financial institutions, and particularly in correcting information asymmetries between consumers and the financial institutions.\footnote{Ibid at 631.} If such an interpretation was applied, this would prevent countries from implementing a variety of policy measures classified as systemic instead of prudential, but nonetheless necessary for the stability of the financial system.

Another key component of the negotiations were the geopolitical factors between the developing and developed world. The United States in particular was the main holdout in negotiations between the signing of the GATS and the subsequent financial services commitments agreed to in 1997. Having substantially liberalized its own banking system earlier, the United States demanded similar concessions internationally. For a time, it suggested that it would pursue bilateral trade agreements outside the multilateral forum to ensure appropriate reciprocal commitments.\footnote{Trebilcock, Howse & Eliason, supra note 5 at 501.} Agreement was eventually reached under the GATS, but the welfare effects both in the developing world and globally were not all that had been promised. Increased market access to services necessarily required changes in the domestic regulatory structure. As observed by Trebilcock, et al,

Since the Reagan Administration was firmly persuaded that the domestic changes required to meet its market access demands (e.g. privatization and deregulation) would also be of considerable benefit to the countries adopting these changes, it did not see any profound conflict of domestic and global interests in trade in services.\footnote{Ibid at 479.}
The US viewpoint was clearly not universally accepted, as demonstrated by the six-year resistance to the liberalization changes that occurred between the end of the Uruguay Round and the signing of the Annex on financial services. According to Sorsa, the negotiations and subsequent GATS financial services commitments could better be defined as “mercantilist bargaining, rather than economics”.\textsuperscript{37} Mercantilist bargaining has been recognized to pose a danger when a developing country’s banking sector is unsound to begin with, since foreign competition can “lead to costly systemic failures or hamper macroeconomic management”.\textsuperscript{38} In other words, if market access to the banking sector was not a good idea in and of itself for the domestic economy, but was instead traded for something else that was desirable, it could end up doing more harm than good both domestically and internationally.

4 International Financial Supervision at the time of the GATS Negotiations

At the very least, international trade in services generally requires either harmonization or home country regulation.\textsuperscript{39} Harmonization means that all countries agree to the same minimum standards, while home country regulation means that the host country will trust the regulators in the home country to supervise its banks’ international operations adequately. In the financial services sector, the financial crisis revealed significant gaps with both of these strategies, which will be discussed, in greater detail in Chapter 2. Furthermore, the importance of this minimum goal does not appear to have been fully comprehended at the time of negotiations. Countries were inwardly focused in their priorities, desiring to maintain domestic policy space to respond to problems but with little attention to the need for cooperation to combat the increased risks inherent in the new international framework.

The principle of home country supervision is articulated in the 1983 Basel Committee report, \textit{Principles for the Supervision of Banks’ Foreign Establishments}. The Basel committee “provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision

\textsuperscript{38} Ibid at 5.
\textsuperscript{39} Trebilcock, Howse & Eliason, supra note 5 at 476.
worldwide.”40 The two basic principles espoused by the Concordat are (1) “no foreign banking establishment should escape supervision” and (2) “supervision should be adequate”.41 To accomplish these objectives, the Basel Committee differentiates between branch and subsidiary supervision. Branches are the responsibility of the home country regulator because they have no separate legal status from the foreign parent bank; subsidiaries on the other hand are legally independent and therefore the responsibility of the host country.42 Additionally, the Concordat imposes an obligation upon both authorities in the host country and the home country to inform each other of serious problems.43

The Basel Committee is probably better known for its role in standards development of capital reserve ratios. These standards have the benefit of wide adoption, however, they have also been criticized for catering to the lowest common denominator, as well as being prone to capture by the regulated.44 Additionally, systemic issues have been revealed in the standards’ reliance on private rating agencies which have been exposed to have a strong conflict of interest, as well as a procyclical impulse wherein rating agencies rate assets higher when banks are lending heavily and lower when they are retrenching.45

Other international efforts to increase cooperation include the International Organization of Securities Commissions (IOSCO), established in 1983,46 and an international association of insurance regulators, established in 1994.47 Anand, Trebilcock and Rosenstock describe the international institutions at this time as following an institutional segmentation model.48 Each of these international organizations was responsible for harmonization of standards as well as limiting risk within its own sphere of responsibility. However, as Anand, Trebilcock and

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40 Basel Committee on Banking Supervision, online: Bank for International Settlements <http://www.bis.org/bcbs/>.
42 Ibid at 1-2.
43 Ibid at 2-3.
44 Barry Eichengreen, “International financial regulation after the crisis” (Fall 2010) Daedalus 107 at 110.
45 Ibid at 111.
46 IOSCO Historical Background, online: The International Organization of Securities Commissions <http://www.iosco.org/about/index.cfm?section=background>.
47 International Association of Insurance Supervisors, online: <http://www.iaisweb.org/>.
Rosenstock further point out, after the 2008 financial crisis, international coordination has had to respond to the fact that systemic risk is not limited to one country or one industry.\textsuperscript{49}

Therefore, at the time of the GATS negotiations on financial services, the international financial system was certainly not devoid of regulation and cooperation. However the need for a strong international regulatory system was overshadowed by the allure of potential benefits from a more open international financial system. The next Chapter will examine the problems with increasing market access without corresponding international regulation.

\textsuperscript{49}Ibid at 33-34.
Chapter 2
International Markets Without an International Regulator

Despite the cooperation and supervision that prevailed preceding the 2008 financial crisis, the aftermath has revealed significant gaps and problems with the global order of financial integration and its lack of global supervision. As Pan argues, the former “international financial architecture proved incapable of preventing or managing the causes and effects of the recent financial crisis.”\(^\text{50}\) This chapter examines how the international financial market systematically differs from a domestic financial market, namely in its lack of central supervisory authority.

While there are many problems with each individual national regulatory system, there are certain practices that have been adopted nationally in most developed and developing economies that have been found to respond to pressing underlying vulnerabilities in the financial system. However, many successful prudential and oversight strategies practiced domestically have no international equivalent. Alexander, Dhumale and Eatwell argue that the major problems with the international financial architecture are not merely concerns with domestic regulatory systems as some have suggested, but instead “require major institutional and legal reforms at the international level”.\(^\text{51}\) The international financial system faces many of the same issues that domestic regulators have been concerned about for decades, yet lacks the full arsenal of tools to deal with these issues.

As financial markets have become increasingly globalized, Pan notes a shift in the types of issues that have defined international financial regulation over the last century. He argues that

[a]s the international financial markets have become private markets, the most pressing international finance questions facing the international community have shifted from how to facilitate state-based financing and maintain a stable foreign exchange regime to how to regulate cross-border transactions by private firms and persons and ensure the safety and soundness of the financial institutions and intermediaries that operate the financial markets.\(^\text{52}\)

\(^{52}\) Pan, supra note 50 at 250.
During the Bretton Woods conference, monetary issues were at the forefront of international financial concerns; however, since the liberalization of market access, microeconomic regulatory issues are becoming increasingly pressing. The modern types of issues more resemble the interwar period of private sector failures, yet now are additionally defined by their international scope.53

The first two sections of this chapter take an historical view to assess the risks created as a result of open market access both under the GATS and independent liberalization movements. The following two sections focus on the economics associated with open market access without a corresponding international regulator.

1 Immediate Regulatory Fallout of Increased Market Access

With the benefit of hindsight, the repeal of the Glass-Steagall Act in the United States is often been cited as a major catalyst for the financial crisis that has ensued over the last several years. While most countries around the world already had allowed commercial and investment banks to merge, this proved to be a particularly dangerous addition to the American system. Pressures both domestically and internationally led to the eventual repeal of Glass-Steagall in 1999. American banks had long been pushing for relaxation of the rules surrounding mergers between commercial and investment banks, pressure that was compounded by the signing of the North American Free Trade Agreement (NAFTA) in 1994. NAFTA prompted concerns for American banks regarding unfair competition from Canadian and Mexican banks.54 As the GATS financial services commitments were being negotiated, these fears were further exacerbated. The internal pressures, from within the United States, were combined with pressure from foreign banks and governments to relax American domestic rules so that foreign banks could operate with increased ease.55

53 Alexander, Dhumale & Eatwell, supra note 51 at 4
Brummer describes the relationship between domestic regulation and foreign investment,

More permissive institutional rules were also introduced, especially in the United States, which allowed greater affiliation between commercial banks and securities firms, and in the process generated greater incentives for traditional depositary institutions to seek higher yielding returns to overseas ventures. Meanwhile, rules on currency convertibility were eased, facilitating the ability of foreign investors to repatriate capital and thus reduce the risk of investment. And thousands of investment treaties were entered into between countries in which governments, hungry for foreign capital, promised to compensate firms should their investments be seized or expropriated.\(^{56}\)

In the developing world, the regulatory changes can be more directly traced to international pressure. Historically, international financial regulation has been predominantly influenced by the most powerful economies, either explicitly through extra-territorial legislation or implicitly through their market power.\(^{57}\)

Rodrik explains the attitude in developing countries prior to external liberalization pressures from the IMF and GATS negotiations,

Traditionally, domestic residents in these [developing] countries had legally not been permitted to take their money out of the country to invest in foreign stock markets or purchase financial assets abroad. Similarly, domestic banks or firms had faced strict limits on their ability to borrow from abroad. Governments typically imposed intricate regulations—taxes, licensing requirements, outright prohibitions—that made moving money in and out of the country a nightmare. Most countries did welcome multinational enterprises and long-term foreign investors, but short-term lending and borrowing or portfolio flows (so-called “hot money”) were viewed differently, as a source of financial instability rather than economic growth.\(^{58}\)

Domestic governments had a more nuanced approached to financial services liberalization, viewing opportunities only in conjunction with the costs to financial stability. Since the liberalization of the 1980s and 1990s, there have been several studies examining the link between liberalization and financial crises. Weber and Arner summarize some of this research and find the results to be quite varied.\(^{59}\) For example, a study by the Bank of International Settlements points out the negative impact financial liberalization in developing countries can have, if not

\(^{56}\) *Brummer (Soft Law and the Global Financial System), supra* note 3 at 10.


\(^{58}\) *Rodrik, supra* note 17 at 91.

accompanied by appropriate restructuring. While maintaining that financial liberalization will ultimately benefit the domestic economy, the study emphasizes the transitional difficulties that can exist: bank credit managers may not have the expertise with which to evaluate the new forms of credit available following the rapid credit expansion from financial liberalization; the entry of new competitors may pressure banks to engage in riskier activities; and the availability of offshore markets can help banks to evade domestic regulation.  

It has been argued that the consequences of the financial crisis were most acutely felt by the poor in the developing world. In 2009, the United Nations commissioned a report to assess the impact of potential reforms in the international financial system on developing countries. The report, entitled Reforming the International Monetary and Financial Systems in the Wake of the Global Crisis identifies a number of reasons for why developing countries experience consequences of financial crises differently than developed countries: developing countries are less able to cope with financial crises because of a lack of resources to begin with; they lack automatic stabilizers such as unemployment insurance; and they have limited ability to borrow which is further limited during a credit crunch. As foreign banks repatriate their capital following a crisis, developing countries remain bound to their free trade agreement commitments (bilateral and WTO) while no longer enjoying many of the benefits. The agreements “enshrine the policies of market fundamentalism … and further limit their ability to regulate financial institutions and instruments, manage capital flows, or protect themselves from the effects of financial market protectionism.”  

The entry of foreign firms may well advance economic progress in a developing country through increased capital and infrastructure investment, but liberalization must be carefully implemented. Different countries experience different needs at different times, and while harmonization is economically efficient it cannot be the end goal. With this reality in mind, Trachtman advocates a “right to regulate” for developing countries to allow a mechanism to account for the diversity

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61 Stiglitz, supra note 1 at 12.
62 Ibid at 16-17.
of various situations. This type of approach helpfully allows for increased market access, but with necessary conditions in place to ensure stability remains a primary goal.

Clearly, the theory of maximizing utility by trading concessions is less compelling when there are significant externalities at work. Consider a bilateral trade agreement where a developing country makes significant financial services liberalization commitments in exchange for agriculture commitments from its developed world-trading partner. Both countries may stand to gain, particularly in the short run from each of those commitments. However, if the developing country’s financial infrastructure is insufficiently robust to handle the liberalization, it could negatively impact both trading partners. Furthermore, the foreign bank that entered the unstable domestic market may also suffer and have spillover effects to its operations in other countries.

2 Limiting Domestic Policy Space

As has been discussed, maintaining domestic policy space was a major priority in the negotiations of the GATS financial services commitments. No formal dispute settlement decisions have been made on a complaint with respect to financial services thus far. Therefore there is no direct evidence that a national regulator has been prevented from implementing regulatory measures seen as appropriate. Yet there are still concerns. The 2009 UN Commission Report on international financial system reforms addressed a “concern that existing agreements under the WTO’s Financial Services Agreement might, were they enforced, impede countries from revisiting their regulatory structure in ways that would promote growth, equity and stability…” Even if not enforced, there is the possibility of a chilling effect arising out of unclear provisions.

One example of a measure that may be interpreted as inconsistent with various international commitments on financial services is the set of bailout packages adopted by many developed countries following the 2008 financial crisis. Both Rodrik and Trachtman note that in Europe in particular, these bailout measures may be interpreted as an illegal subsidy under EU rules. De Meester explains the possibility that a bailout could be found contrary to the GATS financial services commitments, although only under very particular circumstances and may still be saved

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63 Trachtman, supra note 55 at 189.
64 Stiglitz, supra note 1 at 104.
65 Rodrik, supra note 17 at 218, and Trachtman, supra note 55 at 198.
by the prudential carve-out. He further emphasizes that countries would be unlikely to pursue a complaint against a bailout measure; for fear that their own financial services regulation would come under scrutiny.

Practically speaking, international trade commitments did not seem to fall into the realm of decision-making criteria when states decided to bail out major banks. These were huge political decisions with major consequences for both the financial and the real economy, as well as significant expenses on the public balance sheet. The considerations were more focused on whether a given country could afford the bailout than whether they were permitted to do so according to their international commitments. Furthermore, it has been argued that the bailouts may even have a positive impact on stability by preventing the elimination of important institutions and thus helping to preserve a competitive environment.

3 Global Banks & Externalities

The absence of a central authority for regulatory purposes is one characteristic that distinguishes the international economy from the domestic economy. When banks operate internationally, the risks and opportunities often exist in different countries. Therefore no one regulatory authority is able to effectively consider all the incentives at work. Global financial stability has been characterized as a global public good, which has seen insufficient investment by any national government. Or in other words, “externalities lead competing regulators to choose suboptimally low standards”. If a bank operates internationally, the cost of its failure is felt internationally. However, when the bank is profitable the benefits are primarily experienced by the home country. Therefore, there is incentive for a domestic government to under-regulate since it does not experience all the risk. By attracting banks to a lax regulatory regime the domestic government can enjoy the extra tax revenue and economic activity of the bank, without the full

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67 Ibid at 28.
69 Trachtman, supra note 55 at 170.
risk of the results of poor regulation. Eichengreen notes that big banks themselves can additionally move employees and operations between countries, a fact which further requires regulatory coordination amongst those countries to prevent regulatory arbitrage.\footnote{Eichengreen, supra note 44 at 107-108.}

The failure of the Icelandic bank, Landsbanki, provides an excellent example of the risk of a country under-investing in financial stability. Iceland had developed an attractive regulatory system where banks were able to make substantial profits with risky investments. Due to the European passport system, the banks were able to operate across Europe, and the high interest rates on deposit accounts were particularly attractive to British and German depositors.

Operating in the European Economic Area (EEA), an EU Directive required Iceland as the home country to provide deposit insurance for up to 20,000 Euros, but did not require minimum premiums from which to fund this deposit insurance.\footnote{Harry Huizinga, “The EU Deposit Insurance Directive: Does One Size Fit All?” in Asli Demirgüç-Kunt, Edward Kane & Luc Laeven, eds, Deposit Insurance Around The World (Cambridge: The MIT Press, 2008) 253 at 256.} When the Icelandic banks began to experience trouble, it became clear that there was insufficient deposit insurance to cover the liabilities, which sparked fears of a bank run. In response, the British government guaranteed all British deposits as well as taking over Icelandic bank assets in England to pay for the guarantee.

Iceland’s experience demonstrates that unregulated global finance can induce individual countries to under-regulate their own financial systems to gain the benefits of the banks’ activities during good times, while not experiencing the full harm during bad times.

The U.K.’s response is also indicative of another disadvantage to regulatory divergence- what Claessens has termed “financial nationalism”. Claessens is critical of the various domestic interventions that characterized the 2008 financial crisis, mostly coming from developed countries. He notes that surrounding countries were forced to adopt similar measures as their neighbours practiced or risk capital flight; strategies commonly described as ‘beggar thy neighbour’ policies.\footnote{Claessens, supra note 68 at 267.} Such policies included ring fencing of assets as practiced by the U.K. with respect to Icelandic banks; incentives or restrictions encouraging local lending; and guaranteeing deposits which forced other countries to also guarantee deposits lest they suffer capital outflows...
and currency depreciation as investors leave.\textsuperscript{74} These nationalistic policies may benefit domestic citizens, but the cumulative effect of the policies can ultimately be welfare reducing globally.

Once an international bank has failed, there will inevitably be conflicting claims of creditors between different jurisdictions. A prominent example is the failure of Lehman Brothers in 2008, where conflicting claims between creditors in the United Kingdom and the United States “created serious difficulties for courts and regulators seeking to limit the systemic consequences of the institution’s failure in 2008.”\textsuperscript{75} International conflicting creditor claims is a significant issue in international law, but the scale and contagious effects in the case of banks makes the issue all the more deserving of international regulatory attention.

The pursuit of global financial stability is further complicated by the fact that banking regulation is not just about saving banks, but is about accurately assessing the impact of the bank’s failure on the real economy. Banking oversight is therefore not simply an analysis of risk and reward to the bank, or even its depositors and creditors, but risk to the national and global real economies. ‘Too big to fail’ institutions are a product of this reality, and it is widely regarded that international cooperation is necessary to deal with international bank insolvency.\textsuperscript{76}

Relatedly, concerns surrounding regulatory competition may demand increased economic cooperation. Weber argues that a minimum level of basic prudential standards is essential to guarantee a level playing field and avoid a regulatory ‘race to the bottom’,\textsuperscript{77} and developed countries in particular have been noted to view lower standards in the developing world as precipitating a ‘race to the bottom’.\textsuperscript{78} Additionally, when dealing with retail customers, the information asymmetries between banks and their consumers are such that regulatory competition is likely to work against the interests of stability and more towards a ‘race to the bottom’. Regulatory competition is dangerous if the people protected by the regulations “lack the ability to identify and evaluate inadequate regulation.”\textsuperscript{79}

\textsuperscript{74} Ibid at 271.
\textsuperscript{75} Eichengreen, supra note 44 at 109.
\textsuperscript{76} Weber, supra note 57 at 161-164.
\textsuperscript{77} Ibid at 163.
\textsuperscript{79} Trachtman, supra note 55 at 186.
There can be serious distorting effect of uncoordinated system. Bailouts in one country, not accompanied by bailouts in another country, can result in ‘beggar thy neighbour’ policies.\footnote{Claessens, supra note 68 at 267-268.} Coordination is required because tightly integrated global supply, must “help (re-)level the playing field, avoid major distortions and thereby restore competitive conditions.”\footnote{Ibid at 263.}

Example: Bank Runs and Deposit Insurance

One example of a response that had gained wide acceptance of its domestic usefulness, but of which no international equivalent has emerged is the use of deposit insurance. By the nature of turning short-term deposits into long-term investments, banks are susceptible to bank runs. Banks lend out more money than they have, subject to applicable capital reserve ratios in the given jurisdiction. Ordinarily, this is not a problem because only a fraction of the deposits currently being held will be called for at any given time. However, when confidence in the bank is lost, more than that fraction of depositors will want to take out their deposits. If confidence is severely lost, then all depositors may wish to take out their deposits and the bank will become illiquid. To compound matters, the bank may try to realize its own productive assets, but must do so at fire-sale prices, thereby creating a situation of insolvency from realizing less than the anticipated value of those assets.

This is known as a situation of multiple equilibria. One equilibrium is for the capital reserve ratio to be sufficient to maintain daily operations of the bank. Another equilibrium is when, with or without fault on the part of the bank, there is reason to doubt the bank’s ability to remain liquid and depositors en masse demand their deposits, thus creating a self-fulfilling prophecy. Given that this can occur for factors completely unrelated to the bank (such as rumours, outside speculation or external circumstances) this latter equilibrium is particularly deserving of regulatory attention.\footnote{Reinhart & Rogoff, supra note 89 at 144-145.}

The Diamond-Dybvig model, developed in 1983 explains the undesirable consequences of multiple equilibria and how deposit insurance can be an effective solution to maintain depositor
confidence.\textsuperscript{83} A strong deposit insurance system can prevent the spiral of depositors simultaneously withdrawing their deposits (which leads to insolvency) by providing them with confidence that their deposits will be paid regardless of the health of the bank itself.

As with most insurance systems, the solution can in itself create a different problem in the form of moral hazard. By reducing depositors’ incentives to investigate the riskiness of the bank, it thus reduces the bank’s incentive to avoid risky, high-reward investments. However, regulators generally do not expect average retail depositors to investigate the health of an individual bank, and therefore opt for alternative forms of oversight to mitigate the moral hazard problems associated with deposit insurance.

Goodhart and Lastra situate the international issues surrounding deposit insurance in the wider context of the problems with establishing boundaries between regulated and unregulated institutions. While deposit insurance systems functions to provide security and stability with certain financial institutions, those institutions operating outside a given system can enjoy wider profit margins and offer better services in different ways,\textsuperscript{84} as is evident in the recent growth of the “shadow banking” sector in many countries. Since consumers do not, and are often not expected to, understand the difference, this can create market biases in favour of riskier institutions.

This negative externality internationally is indicative of the types of domestic policies that do not have an international equivalent. Rodrik summarizes the issue, “a bank may face a run for no good reason other than public fear that it will face a run. Modern economies have invented powerful tools against this pathology… except in international finance”.\textsuperscript{85}

There is no international deposit insurance, and domestic governments will make different choices on how they want to organize and fund their deposit insurance systems. Funding a deposit insurance system can be expensive, whether accomplished by bank premiums, government funding or some combination thereof, giving rise to temptations to underfund the

\textsuperscript{85} Rodrik,\textit{ supra} note 17 at 94.
system. As long as the banks are operating domestically, that temptation is mitigated by fear of bank runs and domestic financial crises. However, as banks operate internationally, the risk of underfunding increases since the negative consequences of an underfunded system would be spread out across other countries, while the immediate benefit of low premiums could be an attractive regulatory feature at home.

As countries liberalize their banking systems and allow foreign banks to operate domestically, there are limited minimum standards that all financial institutions adhere to. As Tietje and Lehmann point out, there has always been a conflict in financial regulation between market freedom and strengthening regulation and supervision, but the imperative for international cooperation is somewhat new. As national governments prioritize an open domestic financial services market that gives consumers a wider range of banking choices and opportunities, they struggle with protecting consumers from the risky activities of those internationally active banks. The other side of the coin is that national governments are similarly accountable for supervising their own internationally active financial institutions in a responsible manner. These considerations all militate toward increased regulatory cooperation and harmonization.

4 International Contagion

While the above problems associated with under-regulated financial markets could conceivably be eliminated, or at least strongly mitigated, by stricter rules regarding market access, the problem of international contagion is not limited to where a bank has its operations. Bank failures have impacts on the real economy that can quickly spread across borders regardless of whether those borders are “open” to free trade in services. Furthermore, “the 2007-10 financial crisis showed the limited capacity of existing efforts … (such as the Basel Committee and its capital adequacy standards) to prevent highly destabilizing spillovers.” The international financial architecture was unprepared to deal with the magnitude of cross-border contagion.

87 Trebilcock, Howse & Eliason, supra note 5 at 477.
Reinhart and Rogoff describe banking crises as “an amplification mechanism and not necessarily as an exogenous causal mechanism”.\textsuperscript{88} Numerous studies have indicated that as capital flows across borders increase, so too do the risk of banking crises.\textsuperscript{89} While not determinative from a policy perspective, this correlation is significant for the analysis of appropriate timing and methods for liberalizing rules on foreign capital and bank operations, as well as necessary mitigating measures to address the additional risk. Not only does the risk of banking crises increase with liberalization of domestic banking laws, but the impact of those banking crises can be felt more broadly and more acutely. Instead of being isolated to one country, the impact of a failed domestically operating bank can quickly spread to other countries through the operation of cross-border contagion.

The shadow banking industry is one of the biggest challenges currently facing international regulators. It is little understood, difficult to regulate, and has massive impacts on the real economy. At its core, shadow banking is the provision of credit by non-mainstream institutions. Broader definitions of shadow banking would include any bank-like activity, not regulated as a bank.\textsuperscript{90} The defining feature of the shadow banking industry generally is speculative betting on real assets and liabilities. The motivation was that it was possible to increase access to credit by securitizing loans and theoretically spreading risk across multiple different types of assets, thus requiring little capital to protect against potential losses.\textsuperscript{91} The decreased risk proved to be a myth however, as the valuation of the loans plummeted in times of crisis and were much more connected to one another than originally anticipated.

Given its unregulated nature, shadow banking is particularly dangerous internationally. Businesses looking for credit are tempted to look outside the traditional credit market, particularly when regulated banks are tightening their own credit services.\textsuperscript{92} Theoretically, caveat emptor might apply to this type of speculative investment. However, as the 2008 financial crisis

\textsuperscript{88} Reinhart and Rogoff, supra note 2 at 172.
\textsuperscript{89} Ibid.
\textsuperscript{92} Ibid.
revealed, banks’ own involvement in these speculative practices can additionally make them insolvent, thus confronting governments with a difficult decision. Governments must choose between letting a bank fail (and thus letting the country experience the economic consequences), and bailing the bank out at significant taxpayer cost as well as increasing moral hazard for banking activity.93

The financial services industry is heavily interconnected, and under-supervision and under-regulation in one area can have disastrous effects throughout the real economy. These difficult policy issues enforce the need for international cooperation: both to consider how to deal with the shadow banking industry; and to learn how to best protect domestic consumers and companies from the lure of apparently cheap credit.

Chapter 3
Approaches to Global Financial Stability

A variety of solutions have been proposed to respond to the challenges identified with the regulation of international financial services. At one end of the spectrum, many scholars have proposed something equivalent to a supranational regulator, either under the auspices of an existing international organization or an entirely new organization, to supervise global financial activity. This and proposals like it are classified under the “hard law” category of global integration. At the other end of the spectrum some suggest that further regulatory integration would only harm domestic economies, and increasing national sovereignty in this area is the best alternative. In the middle, many would insist that soft law solutions (optional standard setting with minimal enforcement) are not only the most feasible, but also promise to be the most effective at managing the prevalent risks in the global financial system. Each of the approaches has various advantages and disadvantages, and varying degrees of applicability depending on what area of financial regulation is under consideration.

1 Nationalistic Focus

Rodrik is a proponent for preserving domestic policy space, in spite of increasing international pressures towards globalization. He emphasizes the need for “trial and error” in financial regulation, arguing that no one currently knows the best way to regulate global finance and it may even be unknowable, and therefore it could be catastrophic to standardize globally any regulatory system of which the ill-effects are impossible to predict. Furthermore, there are benefits that come from trying new policies because best practices may develop from trial and error. Tietje and Lehman present a picture that the current regulatory system is really a patchwork of responses to all the crises that have occurred throughout banking history. The current framework is therefore less of an intentional set of regulations that effectively work together, but instead a fragmented, often over-compensating, series of responses to a history of financial crises. Systems need to be able to grow to respond to new crises and try new ideas so that they can effectively develop into robust regulatory frameworks.

94 Rodrik, supra note 17.
95 Tietje and Lehmann, supra note 86 at 134.
Regulatory innovation is also essential in the financial services sector because of the speed and complexity of financial innovation. Consider for example the prevalent securitization of assets and loans in the lead-up to the 2008 financial crisis. Regulators and rating agencies did not fully understand the implications of these and many other complicated products. As the industry innovates at a fast pace, it is necessary for regulators equally to have the capacity to innovate their risk management techniques. If all countries are committed to a static set of standards based on previous and outdated financial products, they are unable to be responsive to new risks.

Regulatory competition was discussed in Chapter 2 as leading to a dangerous ‘race to the bottom’ as countries compete for the most favourable conditions preferred by the financial institutions (low taxes, minimal supervision, lax prudential standards, etc.). However, there is also an element of regulatory competition, particularly when combined with regulatory innovation, that can be positive. Consider for example American corporate law, where each state sets its own standards. Instead of a ‘race to the bottom’, American corporate law has been characterized by what is known as the ‘Delaware phenomenon’. While the corporate directors choose where to incorporate the company, the favourable conditions they are looking for are not exclusively about low costs for the corporations. They must additionally be cognizant of the expectations of their shareholders and customers, and therefore will choose a balanced regulatory structure that is not only good for them, but also good for their stakeholders. In this way, as states design their regulatory structures they have appropriate incentives to consider all stakeholders involved and therefore avoid a ‘race to the bottom’.

Similarly, if banks supply a service, the quality of that service is to some extent a product of its regulatory environment. Therefore regulators have a market incentive to create the best regulatory environment for both banks and their customers. Similarly, Goodhart and Lastra emphasize that there are certain natural restrictions on any ‘race to the bottom’ because firms will always desire a minimum degree of legal certainty and contract reliability. Furthermore, they suggest that the lowest common denominator is not necessarily a bad thing if it involves an element of regulatory cooperation. Their prescription is that “a global banking and financial

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96 Brummer (Soft Law and the Global Financial System), supra note 3 at 11.
97 Tietje and Lehmann, supra note 86 at 138.
system requires some binding international rules and an international system for the resolution of conflict and crises.”

As Trachtman has identified, the key consideration for which direction regulatory competition will work in, is whether the stakeholders are sufficiently attentive to the regulations under which a bank is operating, thus making the bank and then its regulators attuned to the stakeholders’ interests. If aligned properly, these natural incentives can be an effective mechanism for healthy trial and error in local financial regulation.

In addition to not knowing what the best way forward may be, there are also reasons to be concerned that the implementation of any standardized regulations will have different impacts in different countries. Pistor is critical of the assumption that legal harmonization will result in an improvement in legal institutions, and emphasizes the need to be aware of the existing institutions which may or may not be receptive of new international standards. She offers two main reasons against standardization, particularly as it applies to developing economies. First, she emphasizes the interdependence of legal rules and argues that if the legal infrastructure is not hospitable to begin with, implementing standardized rules can do more harm than good. Second, she describes law as a cognitive institution, which must be understood and embraced by society including those who are required to abide by it. She argues that an “external supply of best practices… sterilizes the process of lawmaking from political and socioeconomic development.”

Similarly, Yokoi-Arai highlights the very different structures of regulatory environments between countries, and emphasizes that any high level adjustments would be felt differently in different countries. The literature suggests that even if a rule were perfectly designed in a theoretical sense, incorporating it into domestic legal frameworks can be problematic and lead to mixed results between different countries. As standards are developed, it must be asked whether the new standards will be compatible with existing laws, and whether they may create inconsistencies with the legal system generally. Pistor advocates a more organic approach

98 Goodhart and Lastra, supra note 84 at 180-181.
99 Trachtman, supra note 55 at 186.
101 Ibid.
102 Yokoi-Arai, supra note 15 at 622.
wherein laws are adopted through regulatory competition; she is additionally clear to emphasize that such a practice will not necessarily make better laws, but that the process of regulatory competition will in itself make the adoption of those laws smoother in the domestic environment.\textsuperscript{103}

Another line of reasoning that would favour domestic sovereignty is the skepticism over whether it is even possible to achieve effective international coordination. If broad financial services regulatory integration is an unachievable goal, then it might be best for countries to focus on their domestic structures and in no way cede sovereignty to a formal or informal global institution that is unlikely to deliver on what it promises.

A final reason for preferring nationalistic policies to global integration is a philosophical democracy argument. The question of whether states should be bound to international agreements, enforceable upon them by foreign corporations and foreign governments, is a live debate. Many suggest that such limits on domestic accountability are undemocratic and privilege corporate interests over those of local citizens. Whenever a government signs an international trade agreement, it does so presumably because it believe it to be best for the country overall. However, subsequent governments may disagree because of differing politics or changing information. If those subsequent governments (or even the same government) are unable to adjust their policies in response to citizens, this can be become a major political issue on lack of democratic responsiveness.

The democracy argument is often made in regards to proposed environmental and labour standards, which may be found to be contrary to an international trade agreement. Citizens will often have strong and evolving opinions regarding necessary environmental measures to prevent pollution, climate change, etc. and similarly developed stances on national and international appropriate labour standards. In response to these concerns, trade agreements may contain a clause to allow for reasonable domestic measures to be taken in these areas, so long as they are not disguised protectionism.

While at first glance, the democracy argument seems somewhat less convincing in the area of financial services than other areas of international trade, the activities of banks are an

\textsuperscript{103} Pistor, supra note 100 at 107.
increasingly common subject matter for popular debate. From bankers’ salaries to expensive bailout packages, many people are forming strong opinions on how regulators ought to interact with banks. The policy responses ought to be at least somewhat informed by the public demands; however, governments’ ability to be responsive in this way may be constrained by international trade commitments.

Trachtman argues that international law should generally be subsidiary to domestic law, but further acknowledges that international regulatory cooperation is indeed necessary in certain situations. “International regulation is needed when states do not bear all the risks of their regulatory actions, where states acting individually would otherwise under-invest in a global public good or where states may regulate more efficiently by working together.”104 Each of these situations can be observed in the context of financial services regulation; therefore, while there are many compelling arguments for why states ought to be concerned about giving up sovereignty on financial services, the realities of both international contagion and the current entrenchment of market liberalization militate towards pursuing international cooperation. Both policy-makers and private industry participants generally acknowledge that a purely national approach to policy making will be insufficient.105 As argued by Kevin Lynch, vice chairman of BMO Financial Group, “[f]ailure to reboot international policy cooperation will hamper the goal of governments to revive economic activity and employment, and will foster frictions between advanced and emerging economies.”106 Similarly, as Mark Carney has identified, a movement away from policy coordination would reverse the benefits that have been experienced from the opening of financial markets.107

With these realities in mind, there are still lessons to be taken from the discourse on retaining domestic sovereignty. First, as standards are developed, there must be awareness that uniform implementation may not be possible or desirable, and countries’ unique circumstances must influence the evolution of these standards. This is particularly true for developing countries, especially when these countries have not been extensively involved in the standards development

104 Trachtman, supra note 55 at 183.
105 Weber, supra note 57 at 161.
107 Carney, supra note 4 at 4.
process. Where there is risk of disparate impact and indeterminate prospects for implementation, soft law mechanisms (as will be discussed below) are more appropriate.

Second, any international system must be sufficiently flexible to respond to innovations within the financial industry. This does not preclude international cooperation by other mechanisms, but does suggest that binding standards are inappropriate if they cannot respond to ongoing innovation from the institutions they are regulating.

Finally, it is important to recognize that the distinction between international cooperation and domestic sovereignty is not an “all or nothing” situation. Countries can and do make hard law commitments in certain areas, while maintaining domestic policy space in others.

2 The Need for Global Supervision: Hard Law versus Soft Law

Having established that some international supervision is essential for the management of the global economy and particularly for the banking system, there remain options for how entrenched that system should be. These options can be classified on a range between hard and soft law.

Many elements of domestic law would be characterized as hard law. Criminal law, for example, is clearly enforceable by the state, with understandable and enforceable sanctions for breaking a given law. Internationally, hard law is much more complex because states are sovereign individually and therefore international enforcement of an international agreement is limited. The WTO is likely the strongest example of hard law in international law with clear economic sanctions and a robust dispute resolution system in the event of contravention. Other than the GATS Annex on Financial Services, there is currently no clear hard law mechanism for financial services.

Therefore, most of the international financial services regulation today is described as a soft law approach. National regulators negotiate amongst themselves, and set non-binding standards they wish to adhere to. While the standards are not binding, they can still have significant persuasive power both for the countries involved in the negotiations and for countries outside the negotiations that wish to be active members of the world financial economy. Ferran and Alexander define soft law as “standards, guidelines, interpretations and other statements that are
not directly binding and enforceable in accordance with the formal techniques of international law but nevertheless capable of exerting powerful influence over the behaviour of countries, public entities and private parties.”

Brummer identifies three basic genres of soft law. First, there are best practices that “concern discrete issue areas, like capital adequacy, optimal disclosure rules, and due diligence techniques for preventing money laundering.” This category can additionally include organizations with a broader scope such as Basel and IOSCO that “provide an overview of what qualities are necessary for sound supervisory and prudential oversight.” IOSCO is typical of soft law, with a standard setting mandate (in the area of securities regulation) and numerous members, but lacks enforcement capacity for those standards. The second category focuses on regulatory reports and observations. Third, there are institutions that facilitate information-sharing and enforcement cooperation. This last category operates in recognition of the global nature of financial institutions and the need to cooperate regionally and globally.

Soft law is attractive because the commitment costs are perceived to be significantly lower than hard law commitments with clear sanctions. Countries are therefore more willing to engage in negotiations, as it is politically easier to informally commit to a set of standards than it is to formally commit in the face of hard sanctions if commitments are breached or withdrawn. This also means that countries are better able to tailor their systems to unique domestic or regional needs. Additionally, soft law has the benefit of quicker response times and allows for regulatory innovation to occur as countries try out new mechanisms.

Ferran and Alexander argue that while soft law still has much to offer, it may be reaching its limits. Pan is even more critical of the efficaciousness of soft law, arguing that the necessity to rely on head-of-state negotiations ex post a crisis is a “worst case scenario” and therefore a

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110 Anand, Trebilcock & Rosenstock, supra note 48 at 38.
111 Brummer (Soft Law Dominates) supra note 109 at 99-102.
112 Ferran and Alexander, supra note 108 at 7.
113 Ibid at 4.
rebuke to both soft law and transgovernmental networks’ ability to maintain sufficient international cooperation.\textsuperscript{114} Brummer describes two ways in which soft law may be inadequate in international financial regulation. First, he argues that financial services regulation differs from other areas structurally because of the dominance of administrative agencies in decision-making. Financial services regulation is undertaken by technocratic regulatory authorities in their home countries, and therefore those regulatory authorities also play a large part in international negotiations because of their technical expertise. However, they cannot and should not be able to enter into binding international agreements. Secondly, existing theories “ultimately assume a considerable consonance of interests between regulatory players”, but in reality there are significant distributive considerations in international finance when positive and negative benefits can arise in different countries from the same rule.\textsuperscript{115} This makes international power dynamics very important, since the question of who is making the decisions and setting the standards will clearly have an impact on what decisions are made and for whose benefit.

An additional factor to consider is when soft law quickly and potentially insidiously gains momentum and begins to develop the attributes of hard law. While soft law does not advance hard sanctions, it possesses its own type of enforcement power. For example, compliance with ‘best practices’ can help lower sovereign debt financing costs and garner better financing terms for financial institutions.\textsuperscript{116} This can be beneficial for holding countries accountable to their commitments, but also detrimental as those soft law mechanisms lose the benefits of flexibility and democratic accountability.

Ferran and Alexander describe soft law’s evolution to hard law as an “unavoidable paradox” wherein “the success in terms of practical effectiveness feeds the intensity of concerns about the accountability and legitimacy of relevant actors.”\textsuperscript{117} Brummer similarly argues that soft law may have “binding” characteristics depending on its enforcement mechanisms.\textsuperscript{118} He describes two theories for how soft law facilitates regulatory coordination. One school of thought attributes regulatory coordination to being a “mere by-product of competitive processes”.\textsuperscript{119} On this view,

\textsuperscript{114} Pan, supra note 50 at 244.
\textsuperscript{115} Brummer (Why Soft Law Dominates), supra note 109 at 105.
\textsuperscript{116} Ferran and Alexander, supra note 108 at 6.
\textsuperscript{117} Ibid at 13.
\textsuperscript{118} Brummer (Soft Law and the Global Financial System), supra note 3 at 5.
\textsuperscript{119} Ibid at 17.
coordination is not an active goal of regulators; instead it is considered the end result of regulators catering to the lowest common denominator so as to attract market participants, which naturally ends in a set of minimum standards.\textsuperscript{120} As discussed above however, this ‘race to the bottom’ fear must be tempered with a detailed analysis of how the market participants interact with each other and with regulators (banks would desire lax regulations, but may also need to consider their customer’s desire for stability).

The second theory Brummer identifies views “international financial law as the product of global regulatory cartels, immune in many regards to market preferences, and which if unchecked, could produce new forms of global governmental dominance.”\textsuperscript{121} From this viewpoint soft law lacks the benefit of democratic legitimacy, and if enforceable would also lack its flexibility. Countries may understandably become reluctant to having their policy space limited by international standards that they did not have a role in creating. Soft law’s persuasive power can therefore re-introduce concerns surrounding democratic accountability and regional specificity. However in this case the “sanctions” are endogenous to the system in which the country desires to be a member.

While there is limited actual hard law in international financial regulation, there is no shortage of proposals for hard law institutions to be developed. Eichengreen summarizes the general sentiment expressed by scholars in the field; “it has become clear... that more comprehensive, binding, and coordinated international regulation will be crucial to financial stability worldwide, now and in the future.”\textsuperscript{122}

Anand, Trebilcock and Rosenstock propose a voluntary system whereby countries enter into memoranda of understanding on issues of monitoring and compliance of systemic risk. They additionally emphasize the need to have some enforcement mechanism built in to either compel or incentivize adherence to international standards.\textsuperscript{123} The major considerations for such an enforcement mechanism include whether to utilize an existing institution or create a new one, and finding the appropriate balance between respecting national sovereignty and providing

\textsuperscript{120} \textit{Ibid.}
\textsuperscript{121} \textit{Ibid.}
\textsuperscript{122} Eichengreen, supra note 44 at 114.
\textsuperscript{123} Anand, Trebilcock & Rosenstock, supra note 48 at 37.
enforceable sanctions. They highlight various proposals identified by Pan; Garicano and Lastra; Alexander, Dhumale and Eatwell; and Eichengreen.

Alexander, Dhumale and Eatwell propose a multilateral framework treaty to establish an international organization, ultimately led by a “Global Financial Governance Council” with representatives from member states. Critical of the undemocratic nature of the original Bretton Woods institutions, they would seek to limit sovereignty costs of this new organization—requiring agreement to basic principles of good financial regulation but allowing states to disregard a treaty provision if the state itself felt its economic or financial stability would be undermined (although consultation with other states would be encouraged in that decision).\(^{124}\)

Somewhat contradictory from the self-policing core of the model is the proposed option to delegate surveillance and enforcement of any standards developed by existing international supervisory bodies to other international organizations such as the IMF, WTO or World Bank.\(^{125}\) While the authors maintain that such delegation would leave “ultimate implementation authority with national authorities”,\(^{126}\) these organizations are somewhat notorious for promoting the opposite. The IMF and World Bank are particularly troubling in this regard because their enforcement power is proportional to a country’s economic needs (i.e. whether they have required a loan from the IMF), enshrining a geopolitical divide as to which countries receive hard law and which soft law. Moreover, this divide may have no correlation with actual financial supervision needs. Alexander, Dhumale and Eatwell’s vision for the WTO is similar to its current function of monitoring market access commitments and ensuring prudential measures are not disguised protectionism.\(^{127}\)

Pan argues that one significant problem with soft law is that it has focused predominantly on standardization and left significant gaps in the areas of prudential supervision and systemic risk regulation. He argues that as countries come to recognize this deficiency with the transgovernmental network model, it is time to look for something more powerful, for which he recommends an “international administrative law model for financial regulation”.\(^{128}\) He

\(^{124}\) Alexander, Dhumale & Eatwell, supra note 51 at 162-163.
\(^{125}\) Ibid at 163.
\(^{126}\) Ibid.
\(^{127}\) Ibid.
\(^{128}\) Pan, supra note 50 at 246.
emphasizes an important distinction between the processes of rulemaking and standard setting and the need for supervision, and suggests the creation of a new international prudential regulator whose focus would be on cross-border financial institutions.

Eichengreen presents a slightly different model, advocating the creation of a World Financial Organization (WFO), with hard law sanctions similar to that of the WTO. He suggests that this organization would be responsible for establishing principles for prudential regulation and supervision (similar to the WTO’s establishment of principles for trade policy), but would leave the specific details of implementation of such standards to the individual country. One particularly interesting element of Eichengreen’s proposal is the option to make market access contingent on membership in the WFO, meaning that countries would only be allowed access to each other’s domestic financial markets if they adhere to the principles of prudential regulation and supervision established by the WFO.

Anand, Trebilcock and Rosenstock note the extensive cost of creating a new organization, which could potentially outweigh or even defeat the possible benefits. Garicano and Lastra’s proposal to make the IMF a “global sheriff” is therefore interesting in this vein. They are critical of the overly informal and complex nature of the current patchwork of regulatory efforts, and like Eichengreen, argue that a hierarchical organization similar to the WTO is necessary to fix the current system. With the IMF’s financial expertise, it could be well placed to take on this larger role. However, as discussed above, the IMF’s enforcement power is proportional to a country’s economic need, and therefore using the IMF for such a purpose could serve to re-enforce geopolitical divides.

The coordination and certainty available from the harder law approaches can be very attractive. While advocates of national sovereignty point to the need for regulatory innovation, proponents

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129 Ibid at 264.
130 Ibid at 273.
131 Eichengreen, supra note 44 at 113.
132 Ibid at 113.
133 Anand, Trebilcock & Rosenstock, supra note 48 at 37.
135 Ibid.
of hard law integration emphasize the risk of regulatory competition, which can lead to a ‘race to the bottom’.

According to Pan “a financial regulator must have the capacity to monitor markets and market participants, the expertise to identify problems and formulate regulatory responses, the authority to promulgate rules and standards and the ability to implement and enforce such rules and standards.” He further measures the existing international institutions against this standard for an effective financial regulator- he finds that the IMF and World Bank would likely possess the technical competence to be effective, but lack the legal competence, whereas the WTO has the opposite problem- possessing the legal competence but lacking the necessary technical expertise.136

In the discussion of hard law versus soft law options, it is additionally important to recognize that different approaches may be appropriate for different areas of regulation. Standard setting, supervision and enforcement may all benefit from different types of law. Alexander, Dhumale and Eatwell describe the decision of which combination of hard and soft law to use for governing particular areas as a “central dilemma in analysing international soft law.”137

Standard setting requires buy-in from a broad base. To be effective, many voices must be heard and unique regional and economic particularities need to be considered. Therefore soft law forums with broad participation are likely the most appropriate for this area of international financial regulation.

Prudential supervision however requires a degree of intentionality and predictability that is not easily achieved via soft law. The huge gaps in international prudential supervision throughout the financial crisis highlights the deficiencies of soft law, and therefore harder sanctions and intentional international oversight are particularly necessary in this area.

136 Pan, supra note 50 at 251-252.
137 Alexander, Dhumale & Eatwell, supra note 51 at 155.
Chapter 4
GATS Financial Services Commitments and Global Economic Stability

It is clear that the WTO places limits on national sovereignty and domestic policy space; the welfare effects of those limits are less clear. In the area of financial services regulation, increased market access has brought with it both improved economic opportunities as well as increased risk to the global financial system. Going forward, further limits to national sovereignty may be necessary to combat that increased risk. Is the WTO an appropriate forum in which to have those limits enforced?

In assessing the WTO’s influence on domestic policy space, an important distinction must be made between positive and negative integration. Most international trade agreements focus on negative integration, which consists of telling a country what it cannot do. Negative integration commitments concentrate on limiting or eliminating certain policy options that would discriminate against other countries and thus have negative trade ramifications internationally.\(^{138}\) This may be contrasted with positive integration in which countries actively agree to alter their domestic laws so as to promote regulatory harmonization. The types of laws that need to be changed are not discriminatory per se, but the divergence of the different laws between countries can create compliance and transactions costs as well as barriers to entry, and therefore their elimination can make for smoother economic interactions.\(^{139}\)

As the WTO facilitates both negative and positive integration in a variety of areas of trade, the question of whether the benefits of international cooperation outweigh the costs to national sovereignty is certainly not unique to financial regulation. For example, should an energy policy with discriminatory effects on international trading partners be permitted on environmental grounds or excluded as a violation of a WTO commitment? Should a domestic government be able to expropriate assets based on a national fiscal emergency or does this reduce incentive for future business ventures not only in that country but also in countries around the world? Should a government be able to ban certain hunting practices they deem unconscionable despite the impacts on its trading partners? The WTO framework has been used in these and many other


\(^{139}\) Ibid at 9.
cases to both make and enforce commitments with regards to trade policies, particularly where they clash with objectives potentially far removed from the original context of the trade commitments.

When the WTO facilitates any form of integration, and thus limits domestic policy space, it is for the purpose of increasing market access. The corollary to this is that any other benefits accruing from integration are ancillary to the goal of increasing market access. So for example, while the WTO may be capable of aspiring to reduce systemic risk in the global economy, that goal would be secondary or tertiary to the primary goal of increasing market access. If the management of systemic risk must be the prime objective of global financial governance, can there be any role for the WTO in furthering this goal?

Brummer has observed that “efforts at reform have typically focused on whether the existing soft law architecture should be replaced with more “hard law” commitments and formal international organizations.” And, indeed some form of hard law is necessary to offset the risks inherent in the international financial architecture. The international financial system requires a degree of cooperation that will necessarily constrain national sovereignty. To effectively combat systemic risk arising from the operation of global banks and contagion from the financial sector generally, countries must be prepared to place limits on their domestic policy space. This chapter analyses how the WTO generally as well as the GATS commitments, as they are currently structured, may impact global financial stability. It also considers potential extensions of the current role of the WTO and the implications thereof.

1 Openness as a Tool to Stability

Mark Carney has argued that a retreat from an open system would reduce systemic resilience. He therefore emphasizes the need to have broad standards implementation alongside market access to ensure the full benefits of openness and competition and protection against systemic risk. Implicit in this argument, however, is the assertion that it is possible to have broad standards implementation and sufficient international coordination to be able to realize all of these benefits. Put another way, if it is possible to have a well-coordinated international financial system, then it should be as open as possible because openness will increase systemic resilience.

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140 Brummer (Soft Law and the Global Financial System), supra note 3 at 5.
141 Carney, supra note 4 at 4.
As has been noted, if this is not possible, then it may not be worth the costs. Markets that have been liberalized without sufficient oversight have been more susceptible to economic shocks. For example, opening market access to Icelandic banks in Europe meant catastrophe for many depositors (until they were bailed out by their respective governments) due to the lack of oversight from the Icelandic authority. Hindsight reveals major deficiencies with liberalization strategies employed around the world, and it is unclear whether regulators will be able to learn from these mistakes going forward.

If a well-coordinated and effective liberalization strategy is used and maintained, then there are reasons to expect the international financial system to be more resilient based on its degree of openness. A closed national system is more susceptible to bank runs and internal shocks than an international system which diversifies risks across countries. Furthermore an open system with clear rules can more effectively supervise and respond to troubled banks, and coordinated bailouts for example can prevent the risk of ‘beggar thy neighbour’ style bailout policies.

2 Standards Implementation in the WTO

The Annex on Financial Services may give rise to an indirect impact on international financial regulation by encouraging the implementation of international standards. While not explicitly mentioned in the Annex, the use of internationally recognized standards has been used in other areas of the WTO as a way of differentiating trade protectionism from legitimate purposes allowed within a WTO exception. In this way, for a WTO panel or Appellate Body to make use of international prudential standards would not be beyond the realm of possibilities, either with a strict interpretation of the current prudential exception or a more specific articulation of “prudential” in a subsequent agreement.

Of particular relevance are the Agreement on Sanitary and Phyto-sanitary Measures (SPS Agreement) and the Technical Barriers to Trade Agreement (TBT agreement), both negotiated during the Uruguay Round.142 Both agreements make reference to international standards. The SPS agreement specifically defines international standards, and there is an automatic presumption that conformity to international standards, guidelines or recommendations is consistent with the SPS agreement. The TBT agreement also makes use of international standards.

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standards, and members are required to rely on international technical standards except where the standards are ineffective or inappropriate for the fulfillment of legitimate objectives.\textsuperscript{143}

The E.U. 3\textsuperscript{rd} party submission in the Chile-Panama dispute, discussed in Chapter 1, particularly emphasized the need to identify and disallow disguised trade protectionist measures from falling under the prudential exception.\textsuperscript{144} Resort to international standards has been an important method to achieve this objective in other areas of international trade. However, given the nuances of international financial regulation discussed in throughout this paper, explicit reliance on international financial regulation standards by the WTO could be problematic. First, the standards may not be appropriate for all countries. Second, entrenching standards in a hard law institution such as the WTO precludes regulatory experimentation, which can be necessary to respond to innovation within the financial industry. Finally, given the uncertain nature of financial regulation hindsight may subsequently reveal severe deficiencies in the standards that were thought to be effective.

In the ordinary application of WTO exceptions, such as those in the SPS and TBT Agreements, once a measure is found to violate a trade commitment, the onus is on the offending country to fit within an exception, often by demonstrating that their actions either conform to an acceptable international standard or are based on scientific evidence. The emphasis here is not to make these standards more widely enforced, but to excuse an otherwise protectionist measure from being found protectionist.

Brummer points out that the GATS on financial services currently “does not so much coordinate specific regulatory actions as define the limits of regulatory authority.” Since it places few limits on national regulators and only serves to exclude prudential considerations from grounds for complaint, it cannot be described as prudential in nature.\textsuperscript{145} The types of coordination necessary for international financial regulation are coordinated mitigation of systemic risk, decreasing externalities, and increasing standards internationally to reduce the risk of contagion. An ex post analysis of whether a given measure was consistent with international standards will either be neutral or harmful with respect to the above objectives, by limiting the scope of available policy options ex ante.

\textsuperscript{143} Ibid at 153-154.
\textsuperscript{144} EU WTO Submission supra, note 29.
\textsuperscript{145} Brummer (Why Soft Law Dominates), supra note 109 at 98.
Financial regulation is less of a science than other areas where international standards are widely used by the WTO. There is always the risk that the popular standards of the day may be “wrong” or at least not ideal, given the difficulty of assessing ex ante whether they will be sufficient for the purposes for which they are intended. This could mean wide implementation of harmful standards\(^ {146}\) plus the loss of regulatory innovation that would otherwise come with domestically developed non-uniform standards.\(^ {147}\) As has been discussed, ideas are constantly evolving and changing regarding what type of regulation is best, with new regulatory responses to innovation within the industry, and fixes to gaps that have been identified in previous regulatory frameworks. Furthermore, standards for international financial regulation are necessarily complex, and involve very high stakes.

It could be said that the WTO as an institution is generally ambivalent to the standards it is enforcing; the only concern is that the standards are either internationally recognized or provide sufficient indication that the impugned measure is not disguised trade protectionism. It would therefore seem imprudent to rely on the WTO in a substantive way for the purpose of combating systemic risk; a hard law institution ought not to be responsible for enforcing these types of standards where financial stability is a secondary or even tertiary goal.

It is additionally important to emphasize an element of path dependency; even if a certain direction is desirable in a theoretical sense, it may not be possible from the infrastructure that exists today. As Anand, Trebilcock and Rosenstock argue, “path dependence is driven by a series of self-reinforcing mechanisms that inhibit the adoption of different institutional arrangements”—thus restricting the scope of realistic changes in standard setting and enforcement.\(^ {148}\)

As global standards are created it is imperative that they be made in consideration of both developed and developing countries. When standards are introduced there ought to sufficient guidance from the international community on how those standards may be applied, as well as international support to set up institutions (monetary, expertise, etc.).\(^ {149}\) Failing these practical considerations, even well-designed standards may fall short if implementation is insufficient.

\(^{146}\) Rodrik, supra note 17.
\(^{147}\) Trebilcock and Howse, supra note 78.
\(^{148}\) Anand, Trebilcock & Rosenstock, supra note 48 at 40.
\(^{149}\) Pistor, supra note 100 at 118, 126.
Flexibility for unique situations across countries is necessary to allow countries everywhere to tailor regulations according to their needs. However, policies of ‘financial nationalism’ in the developed world will make emerging markets less competitive; for example, in the case of developed countries’ bailout packages by forcing developing countries to likewise guarantee deposits or risk capital outflows.\footnote{Claessens, supra note 68 at 270.} Even an implicit guarantee of support is also a strong advantage to banks operating in advanced industrial countries.\footnote{Stiglitz, supra note 1 at 9-10.} In general, measures should avoid exacerbating global inequalities. Developing countries are less able to pursue counter-cyclical policies both because of lack of resources and because of conditions on international aid.\footnote{Ibid at 13.} If a country is dependent on international aid, it generally has less policy space in which to pursue its own domestic agenda. When this is the case for financial services regulation, it can mean under-regulation within that country with impacts both within and beyond national borders.

Path dependence is also important to recognize from a ‘going forward’ basis, that if standards are instituted in hard law now, their legacies will remain and will be difficult to alter if they are subsequently recognized to be poor standards. Similarly, it important to remember Pistor’s warnings (noted in Chapter 2) regarding the interdependence of legal rules, and the difficulties with imposing standards on a country with different institutional infrastructure that may not be receptive to a new set of standards.\footnote{Pistor, supra note 100 at 98-99.}

Some hard law will be necessary to ensure stability in the global financial system, but any hard limits placed on domestic sovereignty must be for the explicit purpose of combating systemic risk. To place limits for other reasons may only serve to frustrate the goal of stability by limiting the policy options available to domestic regulators. If international coordination is to be achieved via hard law, it ought to be done through an institution designed for that purpose. Without a mandate to consider financial stability as a prime consideration in enfor\cction international standards, the WTO body could risk implementing standards that are harmful to stability. Furthermore, whenever standards are adopted widely it can risk creating a false sense of security if relied upon internationally.\footnote{Rodrik, supra note 17 at 238; Pistor, supra note 100.} 

\footnote{Claessens, supra note 68 at 270.} \footnote{Stiglitz, supra note 1 at 9-10.} \footnote{Ibid at 13.} \footnote{Pistor, supra note 100 at 98-99.} \footnote{Rodrik, supra note 17 at 238; Pistor, supra note 100.}
3 Decision Making Capacity of the WTO

Many proposals for improved global financial regulation call for the creation of an international financial regulator. While the WTO possesses the required hard law sanctioning capacity to fulfill this role, it is generally dismissed as a contender to fully supervise the international financial system for a number of reasons.

One of the main impediments to the WTO’s usefulness as a financial supervision watchdog is the response time.\textsuperscript{155} The WTO operates under a country-based complaints system, through which one country can challenge another country’s practices as contrary to their commitments. The challenge will go to a WTO panel, and then can be appealed to the Appellate Body, a process that may take up to two years. Another important consideration is that the WTO is generally viewed as lacking the necessary technical competence to effectively supervise the international financial system.\textsuperscript{156} While GATS panel experts are required to consist of services experts, there is still reason for concern that disputes would be adjudicated based on free trade principles, not financial stability considerations.

Global banking regulation requires ongoing supervision, and cannot be merely complaints based. Furthermore, while anti-competitive regulations tend to be obvious—i.e. foreign banks are excluded from participating in a domestic market, risky regulatory practices are less obvious and may not be clear until after the damage has been done. Therefore a complaints based reporting system is not likely to be effective from a supervisory perspective.

4 Contingent Market Access

As a potential solution to complex border issues, Goodhart and Lastra suggest that domestic market access ought to be conditional upon the home country instituting certain prudential and supervisory standards.\textsuperscript{157} As opposed to an ex post explanation for a given measure (such as a test for prudential consistency with international standards) this proposal would require ex ante criteria upon which market access would be granted.

\textsuperscript{155} Anand, Trebilcock & Rosenstock, supra note 48 at 38.
\textsuperscript{156} Pan, supra note 50 at 252.
\textsuperscript{157} Goodhart and Lastra, supra note 84 at 181-182.
Contingent market access can be conceptualized under the positive integration framework for trade negotiations. Instead of just removing barriers as with negative integration, it would ideally involve countries negotiating standards that would effectively protect each host banking system from lax banking regulations in home countries as well as the negative externalities currently at work in the international financial system. Positive integration specifically tailored to prudential supervision could be an effective means of mitigating or eliminating the economic externalities and ‘beggar thy neighbour’ temptations that currently plague the international financial system.

The best examples of positive integration are generally observed when there is a central government authority regulating or at least coordinating the necessary harmonization. The European Union is the archetype of positive integration internationally; with the signing of the Treaty of Rome in 1957\(^{158}\) and the Single European Act in 1986,\(^{159}\) European member states have ceded their sovereignty to the central European government in a variety of areas.

The EU experience shows that regional integration can play a role in promoting the adoption of sound principles and practices in economies and in supporting their implementation. The fundamental principle of mutual recognition and a system of a single license ensure that these directives provide a set of minimum norms while at the same time avoiding the creation of obstacles to competition among financial intermediaries.\(^{160}\)

However, close integration has meant additional challenges in the European Union. As discussed previously, the passport system can entail increased and unnecessary risk for the host country when the agreed upon standards are lacking and therefore home country regulations are insufficient. A more extreme example of the challenges involved with positive integration is the sovereign debt crisis in Greece, and to a lesser extent in Ireland and parts of Southern Europe, which left other Eurozone members with little choice but to bail out those countries or risk major devaluation of their shared currency. While adopting a common currency could be viewed as one of the ultimate forms of positive integration, the types of issues experienced in Europe are indicative of the problems with partial regulatory integration but a continued separation of control over major risk factors (i.e. fiscal spending in the case of the sovereign debt crisis).

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\(^{159}\) Single European Act, (1 July 1987).

In the abstract the benefits of contingent market access along with positive integration are clear—countries gain the benefits of access to each other’s financial markets, while each accept a harmonized standard that all others also adhere to. Unfortunately, such a robust system of standards is unlikely to be the product of multilateral negotiations and a lowest common denominator set of standards is the more predictable result. For this reason, Eichengreen insists that “countries most concerned with risks to financial stability should move ahead with coordinated reforms and apply sanctions that discourage their financial institutions from doing business with the countries that lag behind. They should similarly prohibit financial firms chartered in less regulated jurisdictions from entering their markets.”

While a strict set of potentially divergent criteria would likely be at variance with the current GATS commitments, I argue that countries ought to have the autonomy to institute higher prudential standards when allowing market access above and beyond an agreed upon minimum. Minimum standards are an important step to help contain international contagion and prevent ‘beggar thy neighbour’ type policies. However, they cannot be a complete solution and market access should be based not only on minimum standards but additionally on country-specific needs and even regulatory experiments that a country chooses to pursue. While more flexible market access standards lack any mechanism to detect disguised trade protectionism (since each country would decide for itself what prudential standards are necessary for market access), this seems an acceptable price to pay for granting market access in a safer way.

Rodrik similarly argues that international trade law ought not to limit countries’ domestic policy space for financial regulation, but that countries should be able to pursue more or less strict regulations, as they require. However, he further argues that this “commitment to regulatory diversity has a very important corollary: the need for restrictions on global finance.” Rodrik insists that if countries are going to open their financial markets to foreign supervised banks, they must be able to dictate whichever standards they see necessary.

Domestic flexibility to institute appropriate standards ought to be a necessary prerequisite for allowing market access. If those standards are harmonized internationally, this can increase the effectiveness of that market access (via increased efficiencies and economies of scale) and also

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161 Eichengreen, supra note 44 at 110-111.
162 Rodrik, supra note 17 at 264
lessen the risk of a regulatory ‘race to the bottom’. However, harmonization and positive integration cannot be the end goal. Individual countries must retain the final say in what standards they deem necessary, so as to ensure that stability is the paramount goal in financial regulation.
Conclusion

As the global financial system has evolved, the risks inherent in the business of banking have both remained and been exacerbated by the global nature of today’s economy. Additionally, new risks have emerged reflecting jurisdictional externalities, which cause risk to be transferred internationally while the rewards can be realized domestically. With these increased and differing kinds of risks, domestic regulators acting alone are generally considered to be incapable of fully addressing the risks to the global economy.

For a country that wants to focus fully on domestic measures and isolate itself from external shock, the realities of global contagion that impact the real economy make this approach inadequate to fully protect the domestic economy from global shocks. Even if foreign banks were prevented from entering a domestic market, the risk may still enter through other mechanisms (for example, an international bank failures’ impact on the real economy) and thus some international coordination is generally thought to be desirable.

The question then is what form of coordination will best serve the goal of combating systemic risk? Chapter 3 identified the range of options from nationalistic protectionism to soft law to hard law. Soft law measures are generally the preferred mechanism as they aim to implement appropriate standards, but with respect for flexibility, innovation and tailored implementation to domestic circumstances. As soft law succeeds in its goals, it quickly approaches a paradox, however, when its implementation power resembles that of hard law and it loses the flexibility and accountability that defined it to begin with. However, it retains the benefit of easier buy-in, and if the standards are appropriate, it can be effective for combating systemic risk.

The WTO is one of the strongest forms of hard law in the international arena, but has had limited impact on the regulation of financial services. The GATS financial services commitments provided for market access commitments for international banks, but included a wide-ranging exception known as the prudential carve-out. Since there have been no decided cases under the agreement, its impact on domestic policy space would appear to be minimal, but it may also have a chilling effect on a country’s willingness to implement necessary measures that could be interpreted as contrary to the GATS.
Since the purpose of the WTO is to increase economic efficiency by reducing trade barriers, it would seem imprudent to assign it a secondary objective of combating systemic risk in any substantial way. The flexibility and technical expertise that regulation of the financial services industry requires is inconsistent with the slow, strict methods of the WTO. Even using objective standards to clarify the definition of prudential would risk a wider implementation of standards that may not be capable of the task to which they are being put. Countries should maintain a wide latitude to use their own criteria for what they consider to be prudential, and not be limited to what is provided in an international standard, particularly as the standards are still in development.

The opposite approach of conditioning market access upon minimum standards is somewhat more promising. The implementation of the host-home country procedures similar to that of the EU would be one way to help ensure that banks are properly supervised and reduce the impact of jurisdictional externalities, although in doing so, the effectiveness of the standards must be a paramount goal over harmonization of standards. If the WTO continues to be used as a forum for increasing market access, the stability of the international financial system demands that the market access be granted prudently and intentionally. Furthermore, the responsibility for defining that access should remain as much as possible with the domestic regulator.

The future of international financial regulation demands a fine balance between global cooperation and preserving domestic policy space. This balance must have regard for the benefits of regulatory experimentation, context-specific regulation (i.e. being mindful of the differing needs between developed and developing countries), and harmonization of best practices where possible. The exact line to walk is unclear, yet the pursuit of financial stability requires such a balance to be found.
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