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Financial Services in the Transatlantic Trade and Investment Partnership

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1. INTRODUCTION

In July 2013, the United States and the European Union launched negotiations on a Transatlantic Trade and Investment Partnership (TTIP). The talks aim to craft a comprehensive accord matching or exceeding the reforms achieved in their previous trade pacts.[1] Since both sides have included financial services in prior free trade agreements (FTAs), they implicitly recognized that the TTIP accord would also cover this sector. But what will be included in the financial services chapter is still subject to debate.

While US and European officials broadly agree that market access problems traditionally covered in FTAs would be the subject of TTIP obligations, they have sharply divergent views regarding how to deal with differences in evolving regulatory policies in each market. Particular concerns arise about how the TTIP could impact the still unsettled European financial reforms and the introduction of new US rules pursuant to the Dodd-Frank legislation of 2010 or other potential US regulatory initiatives.[2]

Both sides agree on the need to reduce *unnecessary* transaction costs for financial institutions but differ over what constitutes *necessary* regulation. Officials seem at odds over some basic questions: Should the TTIP encourage regulatory convergence, i.e., the evolution of common standards and regulatory policies with regard to capital requirements for banks and designated nonbank institutions, restrictions on proprietary trading, and resolution procedures for firms facing insolvency? Or should the TTIP simply follow the basic precedents of previous FTAs and focus primarily on ensuring nondiscrimination between foreign and domestic firms?

Related to these issues, each side seems to have sharply different views on how to define the scope of prudential actions and to what extent such measures, which are by their nature national in design and execution, should be subject to review under the TTIP's dispute settlement procedures. The outcome could have far-reaching implications because of the integral role of prudential policies in the conduct of monetary policy and the supervision of financial institutions. In essence, the US position favors handling financial services as in prior trade negotiations. US Trade Representative Michael Froman has voiced support for including market access issues in the TTIP. But he has declared "that nothing we do in a trade agreement should undermine the ability of regulators on both sides to regulate in the public interest."[3] He has suggested further that "financial

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1. Officials agreed that everything would be subject to negotiation, though France immediately tarnished this golden vow by insisting on exceptions for the audiovisual sector. For analysis of the overall initiative, see Schott and Cimino (2013).

2. The full name of the legislation is The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. A web version is at www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

3. To be clear, Ambassador Froman "emphasized that the Administration sup-

regulatory cooperation" should be negotiated within "existing and appropriate global forums, such as the G-20 and international standard setting bodies, in parallel alongside the TTIP negotiations." His wording suggests that the United States opposes making such discussions a part of the TTIP itself.

In contrast, the European Council mandate sets broader goals for financial services in the TTIP, calling for a "common framework" that is "binding on all regulators and other competent authorities."[4] The EU position goes well beyond what has been done in previous trade pacts by seeking new transatlantic principles and rules for national regulators. EU negotiators reportedly are weighing proposals for new requirements to share data among regulators, improve coordination of the implementation of international financial agreements (such as Basel III on capital requirements), and restrict the extraterritorial application of financial regulations, among others.[5]

We believe that the TTIP can complement the extensive efforts already in train in financial forums by making regulatory policies more transparent and by creating opportunities for trade and investment in financial services in both markets.

Because the stability, structure, and political relations of financial institutions in the United States and Europe are different, and because the United States has made significant strides in setting up new rules that would reduce the dangers of future financial crises, we argue that the scope and speed of regulatory responses to address the lingering problems from the financial crises of the past decade must be tailored to each country's or group of countries' needs. Both sides of the Atlantic have embarked on regulatory reform but with distinct priorities and tempos (see sections 3 and 4 of this Policy Brief). Both aim to complete the next stage of their respective reforms as well as undertake additional measures that might be needed on a faster timetable than the TTIP negotiations (which will likely extend well beyond the targeted completion date of December 2014). TTIP talks should not be used as an excuse to delay or dilute these regulatory proceedings.

The best way to improve regulation and strengthen the global financial system is to let US- and EU-level regulators determine their own prudential guidelines consistent with existing international financial compacts. Each side should stay informed of the other's regulatory reform developments, building on what is already being done in a number of financial forums. These forums include the Basel Committee for Banking Supervision, the Financial Markets Regulatory Dialogue (US-EU), the International Organization of Securities Commissions, the International Association of Insurance Supervisors, the Financial Stability Board, and the G-20.

This is not to say that the TTIP has no role to play. The TTIP permanent committee on financial services could serve as a clearing house for information on new regulatory proceedings in prospect or in process; this would help bring greater transparency and help ensure that regulators benefit from the views of all market participants.

The TTIP should also reaffirm that national regulators have broad discretion to impose prudential measures and that investor-state dispute procedures involving prudential matters should be very narrowly drawn, following the well-defined precedents set out in the Korea-US FTA. For greater clarity, it would be useful if the TTIP also included a statement recognizing that prudential measures consistent with international financial compacts are permitted under the TTIP—that is, they cannot be the subject of claims under the pact's investment obligations as a regulatory taking or indirect expropriation of an investor's assets and thus would not be eligible for investor-state dispute procedures.[6] Instead, only state-to-state complaints should be allowed with regard to this dimension of financial services.

In principle, international cooperation can be helpful for global financial stability. We believe that the TTIP can complement the extensive efforts already in train in financial forums by making regulatory policies more transparent and by creating opportunities for trade and investment in financial services in both markets. At the same time, however, we recognize the contrasting challenges facing US and European regulators and caution against creating international frameworks that could constrain the ability of financial officials and regulators to safeguard their own financial systems.

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ports the inclusion of financial market access issues in TTIP"; see www.ustr.gov/about-us/press-office/press-releases/2013/july/readout-amf-barnier.

4. These quotes are from the European Council's negotiating instructions; see www.s2bnetwork.org/fileadmin/dateien/downloads/EU-TTIP-Mandate-from-bfmtv-June17-2013.pdf. "With regard to financial services, negotiations should also aim at common frameworks for prudential cooperation" (paragraph 25) and "The Agreement shall be binding on all regulators and other competent authorities of both Parties" (paragraph 27).

5. See "EU Refines Demands For Financial Services 'Framework' In TTIP Talks," *Inside US Trade*, September 13, 2013, 7.

6. Canada is reportedly making the same request in its FTA negotiations with Europe.

2. TREATMENT OF FINANCIAL SERVICES IN TRADE AGREEMENTS: A HISTORY

Until the 1980s, services in general and financial services in particular were not the focus of postwar international trade negotiations. Since then, these issues have been included in numerous FTAs and the General Agreement on Trade in Services (GATS) under the auspices of the World Trade Organization (WTO). The United States has led these efforts through negotiation of the Canada-US Free Trade Agreement (CUSFTA), the North American Free Trade Agreement (NAFTA), and most recently the Korea-US (KORUS) Free Trade Agreement.

FTA provisions on financial services have focused on extending traditional WTO-style obligations regarding national and most favored nation (MFN) treatment, removing restrictions on foreign firms operating in the domestic market, while maintaining broad flexibility for prudential measures to enhance the safety and soundness of the financial system. Agreements also include annexes on nonconforming measures that will not be covered by the new obligations.

Twenty-five years ago, the CUSFTA covered financial services but without a great deal of detail. The terms allowed mutual access to each other's markets, subject to "normal regulatory and prudential considerations" (Article 1702, paragraph 4).[7] The CUSFTA established a consultative mechanism administered by the finance ministries to oversee these objectives. The entire chapter was not subject to the general CUSFTA dispute settlement procedures.[8]

NAFTA, which came into force on January 1, 1994, liberalized ownership and market share restrictions imposed on foreign banks, brokerage firms, and insurance companies. It also included standard national treatment and MFN obligations "with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments in financial institutions in its territory" (Article 1405).[9]

Unlike the CUSFTA, NAFTA contained detailed provisions on prudential measures. Article 1406:2 states: "A Party may recognize prudential measures of another Party or of a non-Party in the application of measures covered by this Chapter." There is no requirement to do so, however. Article 1410:1 also allows prudential measures by each country to strengthen the safety, integrity, and stability of financial firms and the broader financial system.

Following in the spirit of CUSFTA and NAFTA, the WTO's Financial Services Agreement, concluded in December 1997, also included broad exceptions for prudential financial regulation (Dobson and Jacquet 1998, chapter 4). The GATS annex on financial services covers insurance, banking, and other forms of intermediation (Article 5 of the annex) and specifically states in Article 2(a):[10]

> 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.

Harmonization of regulations is a possibility but not a requirement. Countries are given latitude and may decide for themselves how to view the prudential measures of another country operating within their borders. In other words, just because country A says that its banks and other parts of its financial system are safe and well-run does not mean that country B is prohibited from applying its prudential regulations to any foreign entity operating on its territory.

The most recent iteration of trade provisions is contained in the KORUS FTA signed on June 30, 2007, though not implemented until March 15, 2012.[11] Like its predecessors, the KORUS FTA contains articles on national and MFN treatment, liberalization of measures that limit the number of financial institutions and the total value of their transactions or assets, and the provision of new financial services, among others. These articles are more extensive than NAFTA obligations. Chapter 13 deals with financial services and continues the tradition of a broad prudential exemption (Article 13.10). For greater clarity, US and Korean officials added a footnote to underscore the nature of the exemption, saying: "It is understood that the term 'prudential reasons' includes the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions or cross-border financial service suppliers."[12]

7. See these materials at www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/us-eu.aspx?lang=eng.

8. The main objective was to "free US-owned banks and other financial institutions operating in Canada from most of the current restrictions on market share, asset growth, and capital expansion imposed against foreign firms." In turn, the pact "guarantees the right of Canadian banks to retain the multi-state branches grandfathered under the International Banking Act of 1978." See Schott and Smith (1988, 144–145).

9. The full agreement is at www.ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-nafta. For a summary of the key NAFTA provisions on financial services, see Hufbauer and Schott (1993, 61–65 and 128–29).

10. See www.wto.org/english/tratop_e/serv_e/10-anfin_e.htm.

11. For more on KORUS, see www.ustr.gov/trade-agreements/free-trade-agreements/korus-fta.

12. In theory, prudential measures can be challenged as inappropriate. In prac-

Both sides recognized the importance of flexibility in imposing prudential measures, a position that undoubtedly has been reinforced as a result of the financial crisis that erupted in the long interval between signature and entry into force of the KORUS FTA. We caution against moving away from those precedents and opening decisions on prudential measures to dispute resolution, including investor-state dispute procedures. Such a move would create too great a risk of tactical litigation aimed at constraining or slowing new regulation, which could be dangerous at a time of continuing vulnerability in financial markets.

To that end, the TTIP could add a clarification to provisions taken from prior FTAs that measures taken for prudential reasons—i.e., to safeguard the financial system—would not be brought before dispute panels and not considered to result in expropriation of a firm's assets. For example, some investors might construe a country increasing capital requirements or otherwise tightening regulation as contrary to their interests, even if it were done in a manner consistent with international financial agreements. It is essential that any such investors not be allowed to bring any kind of case under TTIP; this would greatly slow down the already slow regulatory process.

3. ARGUMENTS FOR CONVERGENCE IN FINANCIAL REGULATION

According to European negotiators, if the United States "goes it alone" on financial regulation, this would adversely affect the ability of European banks and other financial firms to compete in the US market. They also take the view that US regulation, which is currently implementing the provisions of Dodd-Frank, could damage their economies and hurt global financial stability. According to press reports, EU Commissioner Michel Barnier has said US prudential regulations "discriminate" against foreign institutions, implying there is not "a level playing field."[13] Concern about such discrimination reportedly also has affected the EU-Canada FTA talks.[14]

According to the official EU negotiating mandate for the TTIP, "financial services" is on the list of sectors for which the goal is "regulatory harmonisation, equivalence, or mutual recognition, where appropriate."[15] Based on the negotiators' statements, three factors are driving Europe's motivation.

First, European authorities fear that the United States will require global financial companies operating within the United States to comply with US rules, irrespective of rules in their home country.[16] For example, Barclays and Deutsche Bank operate subsidiaries in the United States with what some analysts consider relatively little capital because their global parents were thought to be well-capitalized.[17] Under the newly proposed rules from the Federal Reserve, these subsidiaries would no longer be able to escape such capital requirements.[18] In principle, subsidiaries will have to comply with US capital rules, without any of the past exemptions.[19]

Second, Europeans have raised concerns about the effect of US rules on large complex foreign financial firms, particularly arising from the designation of systemically important financial institutions, and the requirement under Title I of Dodd-Frank that firms provide "living wills" showing how they could go bankrupt without disrupting the broader financial system.[20] At least potentially, US authorities could determine that the US and perhaps global operations of insolvent or troubled foreign

tice, this has never happened. If there were a complaint and a panel determined that there had been a violation, then the penalty could only be assessed in terms of suspension of benefits in the financial services sector of the complaining country (see Article 13.18:4 in KORUS).

13. See "Barnier Says TTIP Deal 'Won't Work' If It Leaves Out Financial Regulations," *Inside US Trade*, July 19, 2013.

14. See "EU, Canada's differences over financial services holding up free trade pact: documents," *Financial Post*, May 29, 2013, http://business.financialpost.com/2013/05/29/eu-canadas-differences-over-financial-services-holding-up-free-trade-pact-documents.

15. See footnote 4.

16. Speaking at the Brookings Institution in Washington on July 16, 2013, Barnier said, "Draft US rules on Foreign Banking Organizations should be revised. They do not recognize non-US prudential rules. And they discriminate against non-US banks. And we need to prove that we trust each other by ensuring equivalence or 'substituted compliance.'" See "Time for a New Transatlantic Partnership," http://europa.eu/rapid/press-release_SPEECH-13-643_en.htm.

17. The UK regulator recently instructed Barclays to increase its capital. Deutsche Bank has also announced plans to raise new equity financing, but FDIC Vice Chairman Thomas Hoenig recently described the firm as "horribly undercapitalized" on a global basis (Reuters, June 14, 2013, www.reuters.com/article/2013/06/14/us-financial-regulation-deutsche-idUSBRE95D0X620130614). See table 1 in speech by Thomas Hoenig, "Basel III: A Well-Intended Illusion," Basel, April 9, 2013, www.fdic.gov/news/news/speeches/spapr0913.html.

18. The precise legal situation is complex; the law firm Davis Polk's memo on the topic is 19 pages long: "Dodd-Frank Enhanced Prudential Standards for Foreign Banking Organizations," December 17, 2012, www.davispolk.com/sites/default/files/files/Publication/c891fe48-d955-4c0f-af87-bf845002fa4b/Presentation/PublicationAttachment/7cacd6fa-f6e6-4c4b-8a2c-38b13fd7eabf/121712_Prudential.pdf.

19. Taunus, a Deutsche Bank subsidiary, was reorganized in early 2012 so that it is no longer a bank holding company—and therefore not subject to the same capital requirements with which US banks must comply. See David Enrich and Laura Stevens, "Deutsche Avoids Dodd-Frank Rule," *Wall Street Journal*, March 22, 2012, http://online.wsj.com/article/SB10001424052702303812904577295614224666918.html.

20. Among the banks that have submitted living wills to date are the following EU-based institutions: Barclays, BNP Paribas, Deutsche Bank, HSBC, and Royal Bank of Scotland (RBS). Credit Suisse and UBS, which also have large operations in EU countries, have also filed plans. Under Dodd-Frank, all banks with more than $50 billion in assets (in the United States) are required to submit such documents. Details of the rules and links to the public portion of these plans are at www.federalreserve.gov/bankinforeg/resolution-plans.htm.

banks are in need of restructuring, new management, or bankruptcy proceedings.

Third is the concern over the negative impact on other countries, in Europe and elsewhere, of other US rules. For example, in 2012 Barnier cited the Volcker Rule—which would limit proprietary trading—as a regulation that could limit the amount of trading in and therefore the liquidity of European government debt. The fear is that the rule could increase spreads for some sovereign issues of countries with financial troubles.[21] Barnier further urged that euro area sovereign debt receive the

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same exemption from the Volcker Rule as does US government debt. His reasoning was that euro area debt was just as low risk (or zero risk) as US obligations. In light of the turmoil in Greece and other countries that have required massive bailouts and austerity programs, this argument is no longer plausible.[22]

Some US financial firms have echoed European concerns. For example, some US firms want to water down the capital requirements to the minimum levels mandated by the 2010–11 standards of the Basel Committee on Banking Supervision, known as Basel III, which is also the goal of leading European voices. The logic of the US private sector arguments is the opposite of the EU position, however. For example, the Business Roundtable suggests that allowing the United States to set its own rules on bank equity—and making them tougher than in Europe (i.e., requiring more equity in big banks)—puts American finance and industry at a competitive disadvantage in Europe.[23]

The implication of the European negotiators and their implicit US allies is that the United States should align itself more closely to European banking practices on capital and regulation more generally.[24] Presumably, according to this position, if Europe is not willing to raise capital requirements, then the United States should not act unilaterally to protect its own system.

Accounting standards is another area that some argue is ready for greater convergence on both sides of the Atlantic. There are some major differences between US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), and harmonizing some of them could make doing business more efficient without harming the safety of banks and the system. But both sides already use a process for converting the accounting standards on reporting of derivatives and other matters. It is already possible, for example, to convert US GAAP accounts at least roughly into their IFRS equivalent values.[25] Accounting is a complex topic, involving both market and regulatory considerations—and already covered in the relevant forums. Embedding this in TTIP negotiations would only prolong the talks without producing a more decisive outcome—the relevant parties have already been discussing it for a long time.

We certainly agree that the TTIP could help make financial regulation more transparent, for example, by having its financial services committee serve as a clearing house for updates and information. However, a broader role for TTIP in harmonizing financial regulation is not an appealing idea—and not one that sits well with current US official thinking.

4. THE US POSITION ON FINANCIAL REGULATION

Background

Under Dodd-Frank, the US government has broadened the scope of prudential regulation, marking a change from the discussion of financial services during NAFTA and the Uruguay Round negotiations in the 1990s or even the initial signing of the KORUS FTA in June 2007.

21. Barnier's letter is at www.sec.gov/comments/s7-41-11/s74111-479.pdf. His concerns were very close to those expressed by representatives of European banks. See, for example, the comment letters submitted by the European Banking Federation by itself (www.sec.gov/comments/s7-41-11/s74111-192.pdf) and with the Institute of International Bankers (www.sec.gov/comments/s7-41-11/s74111-279.pdf).

22. Subsequent to Barnier's letter, dated February 8, 2012, Greek sovereign debt was restructured with "private sector involvement"—meaning that banks and other holders of this debt experienced a writedown in the value of their asset. The precise nature of risk surrounding sovereign debt in the European Union more broadly remains unclear and subject to some debate, but from a US regulatory perspective the risk characteristics seem quite different from debt issued by the US federal government.

23. Other financial sector representatives have also argued to "include financial services in the benefits of the planned regulatory cooperation provisions of the agreement." See www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2013-5.16-Transatlantic-Trade-Investment-Partnership.pdf.

24. The letter is at http://businessroundtable.org/news-center/letter-to-house-committees-on-financial-services-and-us-eu-trade-talks. For a more extensive analysis, see Simon Johnson, "Multinational corporations support for big banks is not persuasive," *New York Times*' Economix blog, http://economix.blogs.nytimes.com/2013/06/06/multinational-corporations-support-for-big-banks-is-not-persuasive.

25. See, for example, the work by Hoenig cited above, which does exactly this conversion.

For example, the Basel III agreement set minimum requirements for equity capital using standardized measures.[26] It also allowed countries to raise requirements for firms considered to be of systemic importance. The United States is on its way to strengthening capital requirements for systemically important financial institutions, having adopted a leverage ratio above the Basel III minimum (see below for more detail).

The United States is also putting in place a suite of complementary regulatory reforms, as mandated by Dodd-Frank. After a slow start, the implementation process is picking up speed. The complex coordination required across regulatory agencies has also become more productive.[27] Congressional intent and current regulatory interpretation are that these requirements must apply to all financial institutions operating in the United States.

By contrast, discussions on continental Europe are at a much earlier stage. Some parts of the European banking system are undergoing structural change, with steps to separate commercial from investment banking in the United Kingdom (as recommended by the Independent Commission on Banking, known as the Vickers Commission, in 2012).[28] On the other hand, implementation of the major recommendations on structural change in banking by the Report of the European Commission's High-Level Expert Group on Bank Structural Reform in 2012, known as the Liikanen Report, is in some doubt.[29]

Cross-border issues thus remain a matter of disagreement given the current state of reforms in Europe and the United States. But relevant regulators are directly taking up these issues and have made notable progress in the past 12 months. For example, the Federal Deposit Insurance Corporation (FDIC) and the Bank of England have agreed to cooperate on handling the potential failure of a global megabank.[30] These UK-US talks seek to reduce or, ideally, eliminate the incentive for foreign regulators to seize or freeze the local assets of troubled US financial firms if one of its British subsidiaries goes under.

The Commodities Futures Trading Commission (CFTC), which regulates commodities derivatives among other things, has reached an agreement with the European Commission on how to regulate swap transactions across borders.[31] The CFTC has also issued guidance on cross-border swaps.[32]

The Obama administration is under some pressure from pro-reform lawmakers in Congress to not let trade and services negotiations dilute the hard-won reforms enacted after the crisis. On July 22, 2013, Senator Carl Levin—chairman of the Permanent Subcommittee on Investigations, which has conducted a number of high-profile investigations into recent financial sector issues—wrote to Treasury Secretary Jacob Lew, cautioning against allowing the TTIP negotiations to slow down implementation of Dodd-Frank reforms. Senator Levin noted that "the United States already participates in a plethora of forums dedicated to international coordination of financial regulations," adding that "calls to restrict or undermine the prudential exception should be rejected."[33]

Perhaps the most useful role for the TTIP in this regard would be to acknowledge that rules made by all US regulators fall under the heading of prudential—and therefore effectively cannot be challenged through investor-state actions. This would remove a major concern about the TTIP, which is that it could further slow the process of making the financial system safer.

Latest Official Position

Treasury Secretary Lew best describes the current US view on financial regulation, after the opening of TTIP discussions.[34] In a forceful statement on July 17, 2013, which followed a public prod from President Obama, who said the reform implementation process was lagging, Lew said the administration would not back down from the Dodd-Frank reforms and that substantial reforms would be implemented by the end of 2013. Amid widespread concern that the reforms still

26. For details on the agreement, see www.bis.org/bcbs/basel3.htm.

27. On the slow progress of reform implementation to date, see Donna Borak, "Regulators Still in Dodd-Frank Quagmire Three Years Later," *American Banker*, July 19, 2013, www.americanbanker.com/issues/178_139/regulators-still-in-dodd-frank-quagmire-three-years-later-1060744-1.html.

28. The current state of UK financial sector reform is at www.gov.uk/government/policies/creating-stronger-and-safer-banks.

29. The European Commission summarizes the current state of affairs at http://ec.europa.eu/internal_market/bank/structural-reform/index_en.htm.

30. Federal Deposit Insurance Corporation and Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions*, www.fdic.gov/about/srac/2012/gsifi.pdf.

31. See US Commodity Futures Trading Commission, "The European Commission and the CFTC Reach a Common Path Forward on Derivatives," press release, July 11, 2013, www.cftc.gov/PressRoom/PressReleases/pr6640-13.

32. For an evaluation of the guidance see this comment letter by Better Markets, a proreform group, at www.bettermarkets.com/rulemaking/better-markets-comment-letter-further-guidance-cross-border-application-swaps-provisions-#.Ufu7Bm3OBI0.

33. Letter dated July 22, 2013, from Senator Carl Levin to Jacob Lew, Secretary of the Treasury, "Re: Financial Services Regulation and the Transatlantic Trade and Investment Partnership (TTIP)," web version available at www.levin.senate.gov/newsroom/press/release/levin-correspondence-with-federal-agencies-2010-to-present (which shows all letters by date) (accessed on July 30, 2013).

34. See remarks of Secretary Lew at the 2013 Delivering Alpha Conference hosted by CNBC and Institutional Investor, July 17, 2013, www.treasury.gov/press-center/press-releases/Pages/jl2016.aspx.

left several institutions that were too big to fail, as was the case in 2008–09, Secretary Lew noted that further financial reform may be in order "if we get to the end of this year and we cannot, with an honest, straight face, say that we have ended Too Big to Fail, we are going to have to look at other options."[35] In any case, he said "we will not let the pursuit of international consistency force us to lower our standards."

Recent statements and proposed rules from the Federal Reserve and the FDIC are in line with this thinking. In particular, we highlight

- the recent proposed increase in leverage ratio (from the 3 percent minimum under Basel III to 6 percent for insured banks and 5 percent for bank holding companies);
- a likely rule on the total amount of equity and long-term debt that bank holding companies should issue; this is part of implementing the single point of entry approach to orderly liquidation, developed with the FDIC;
- new rules for money market funds, which are still under development;[36] and
- the Volcker Rule, limiting proprietary trading by big banks, which Secretary Lew has committed to have in place this year.[37]

Unfortunately, none of these rule changes has an obvious European counterpart. The reform priorities in the European Union seem to center more on limiting executive bonuses, an approach that has not gained traction in the United States.

In contrast to Secretary Lew's sense of urgency on completing this phase of financial reform, TTIP negotiations are scheduled to conclude by the end of 2014. Realistically, the talks likely will take several more years before the deal is done.

If the TTIP ultimately yields a US-EU compromise that requires some harmonization of financial regulations, US implementing legislation for the TTIP probably would almost certainly spur another cycle of regulatory proceedings to reverse or modify the changes introduced in 2013–14.[38] This could be a long and messy process. Potentially 22 individual board members or commissioners at the Federal Reserve (7), FDIC (5), Securities and Exchange Commission (SEC) (5), and CFTC (5) would need to be brought on board with any financial reform regulations.[39] If the TTIP required changes in regulation, they would need to be proposed, commented on, and—based on recent practice—likely reenacted. The typical schedule is such that final rules might not be implemented until 2018 or even 2020.

Continuing Debate on Capital Requirements

Capital requirements is a central issue in any discussion of potential international cooperation on financial regulation. "Capital requirements" are the rules establishing buffers of loss-absorbing equity financing. If banks are required to fund themselves with more equity capital, this lowers the risk that the institution (and the financial system writ large) would be overwhelmed by another financial meltdown.[40]

Before Basel III was adopted in 2010–11, banks were regulated by the previous regime known as Basel II, which had even looser curbs on equity funding and allowable debt relative to their balance sheets. Thus if the United States had more fully adopted Basel II before 2007, and abandoned its cap on leverage (i.e., the overall limit on debt relative to assets, not adjusted by any risk-weighted calculation), its large financial institutions would have taken on more debt in the boom—resulting in financial sector problems over the past half-decade

35. As quoted in Michael R. Crittenden, "Challenges in Bid to Revamp Banks," *Wall Street Journal*, July 18, 2013, C1, http://online.wsj.com/article/SB10001424127887324263404578611491045065504.html.

36. Borrowing from US money market funds proved to be a source of vulnerability for European banks in the latest crisis; see Technical Committee of the International Organization of Securities Commissions, *Money Market Fund Systemic Risk Analysis and Reform Options: Consultation Report*, available at www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf. Some European officials have been supportive of attempts to reform US money market funds. See, for example, Paul Tucker, "Shadow banking—thoughts for a possible policy agenda," speech on April 27, 2012, www.bis.org/review/r120427a.pdf?frames=0.

37. In 2012, the US Chamber of Commerce suggested that the Volcker Rule may violate US trade obligations, but this claim has not been substantiated. See Simon Johnson, "Last Ditch Attempt to Derail Volcker Rule," *New York Times*' Economix blog, December 20, 2012, http://economix.blogs.nytimes.com/2012/12/20/last-ditch-attempt-to-derail-volcker-rule. Presumably a similar lobbying and legal strategy could be pursued vis-à-vis any new FTA obligations.

38. Such legislation is likely to be formulated under so-called fast-track procedures, which expired in June 2007 with the lapse of trade promotion authority (TPA). Reauthorization of TPA is a high legislative priority in the current Congress to set US negotiating objectives and to expedite US trade initiatives like the TTIP.

39. Not all positions are filled at all times, but the overlapping nature of terms means that new board members also need to be convinced to join reform efforts that are already in progress. Other executive branch officials also matter for financial reform, including the director of the Consumer Financial Protection Bureau, the head of the Office of the Comptroller of the Currency, and the Treasury secretary. Members of Congress are also sometimes involved in discussing detailed regulations—for example, this has been the case with the Volcker Rule.

40. Anat Admati and Martin Hellwig explain in their 2013 book, *The Bankers' New Clothes*, that more equity reduces the risk of financial distress (http://bankersnewclothes.com). The work of Admati and Hellwig, including with Peter DeMarzo and Paul Pfleiderer, has been influential in shifting the broader debate and some official positions. See this website for their contributions and relevant media coverage: www.gsb.stanford.edu/news/research/admati.etal.html.

that would probably have been worse than the outcomes actually experienced.[41]

Thinking within the Federal Reserve System appears to be shifting towards the position that the Basel III accord on capital sets a floor, not a limit, on what the US authorities must do. Indeed, the latest official proposal is for the Fed and the FDIC to require a tougher restriction on how much banks can borrow, relative to their balance sheets and therefore relative to their loss-absorbing equity, than required under Basel III.[42] In spite of protests by many leaders of financial institutions who say the new rules would limit their ability to lend and generate profits, new studies by Fed economists argue that current capital requirements are not excessive.[43] The unstated implication is that current capital levels in Europe—which are low and not likely to increase quickly—would not be regarded as sufficient in the United States.

Notwithstanding the objections of some in the financial sector, Fed Chairman Ben Bernanke, Secretary Lew, and other leading US officials appear to share the view that higher capital requirements strengthen the US financial system—and help improve the competitiveness of both financial and nonfinancial firms. In light of past experience, it is therefore essential that regulatory authorities in the United States retain the ability to take further official action on these rules.

By contrast, European countries are pursuing a range of looser approaches on bank capital. Some large and influential countries appear to prefer significantly lower levels of bank equity than is the current policy preference in the United States. For example, there are no signs that US steps to raise the leverage requirement (a form of equity capital requirement) beyond Basel III minimum levels will be matched uniformly in Europe.[44]

In fact, European-level officials seem content to settle at or around a 3 percent leverage ratio (i.e., requiring that debt be no more than 97 percent of total assets). There is also a serious proposal to set a cap on this ratio (i.e., limiting how much equity a bank is "allowed" to have relative to its assets) for European banks, supposedly to help maintain a common market in financial services.[45] The European Commission adds that national authorities cannot increase capital requirements "unless a specific add-on is justified following an individual supervisory review or based on systemic risk or macro-prudential concerns."[46]

More broadly in the United States, there remains an active debate regarding exactly the right level for banks in general and for very large financial institutions in particular. For example, Thomas M. Hoenig, vice chairman of the FDIC, has argued that the risk-weighting scheme that underlies Basel II and III is flawed—and should be largely deemphasized in determining bank regulations.[47] And a recent letter to the Fed, FDIC, and the Office of the Comptroller of the Currency (OCC) from Senators Sherrod Brown (D-OH), Susan Collins (R-ME), Bob Corker (R-TN), David Vitter (R-LA), and Elizabeth Warren (D-MA) marks growing bipartisan concern with the Basel emphasis on risk weights (i.e., allowing banks to determine what is and is not relatively risky in their portfolios—and adjusting their capital requirements on that basis).[48]

In a series of influential statements, Richard Fisher, president of the Dallas Fed, has also pushed for making the core financial system safer.[49] Meanwhile, from the academic side, voices such as Anat Admati and Martin Hellwig continue to gain traction for their arguments in favor of raising capital requirements much further than is currently under consideration.

While the final position of policy remains unclear, the direction of US official thinking is clear—and therefore different enough from the current set of policy priorities expressed by leading European trade officials to warrant

41. The details are in Bair (2012, chapter 3). She and her colleagues at the FDIC resisted efforts by the New York Federal Reserve Bank (and others) to fully adopt the European way of calculating and regulating capital requirements.

42. For more details, see Simon Johnson, "A Call to Battle on Bank Leverage," *New York Times*' Economix blog, July 11, 2013, http://economix.blogs.nytimes.com/2013/07/11/a-call-to-battle-on-bank-leverage. The proposed definitions in this leverage ratio are close to but not exactly the same as that in Basel III. Still, it is roughly correct that a 6 percent leverage ratio, if adopted for insured banks, would be roughly twice the equity requirement agreed under Basel III—and also twice what the United Kingdom is now requiring and where the euro area might end up (although the euro area might also find ways to keep this dimension of capital requirements lower than 3 percent for a long while.) On the latest UK developments, see Simon Johnson, "British Banks's Comedy of Terrors," Project Syndicate, June 26, 2013, www.project-syndicate.org/commentary/the-british-financial-regulation-fiasco-by-simon-johnson.

43. For example, see a recent study by the Federal Reserve Bank of Boston at www.bos.frb.org/bankinfo/capital-positions/capital-positions-large-financial-institutions.pdf.

44. For a comparison of leverage (i.e., equity relative to total assets) in leading US and European banks, see Frederick Cannon, Brian Kleinhanzl, and Matthew Dineen, "Financial Stocks Weekly: U.S. Bank Leverage: Is Better Than Europe Good Enough?" Keefe, Bruyette and Woods, June 16, 2013 (available via subscription). For alternative calculations, see Hoenig, "Basel III Capital: A Well-Intended Illusion." According to Hoenig's estimates, leverage in the largest US banks (tangible capital or loss-absorbing equity relative to tangible assets) is currently not much higher than in some leading European banks. However, some big European banks have capital significantly below US capital levels.

45. See http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en.

46. Current indications are that the United Kingdom will have a capital add-on justified on this basis.

47. Hoenig, "Basel III Capital: A Well-Intended Illusion."

48. The full text of the letter is at www.corker.senate.gov/public/_cache/files/c1f2556e-e0db-4ad9-bf58-9d5b48d2ada5/Corker-Vitter-Brown-Collins-Warren%20letter%20on%20too%20big%20to%20fail%2004-09-13.pdf.

49. See, for example, Simon Johnson, "The London Whale, Richard Fisher, and Cyprus," *New York Times*' Economix blog, March 21, 2013, http://economix.blogs.nytimes.com/2013/03/21/the-london-whale-richard-fisher-and-cyprus/?_r=0.

concern.[50] Europe has different priorities. It is making progress in dealing with its particular financial weaknesses, caused in part by the absence of an integrated supervisory and resolution system and multiple national, local, and regional authorities to govern banks. Indeed, Europe has achieved remarkable progress in setting up a European banking union with more authority being granted to the European Central Bank and other authorities. But with great progress has come great compromise. Thus, the priorities in the United States and in Europe are not likely to be more synchronized through discussions about financial regulation in the TTIP.

The priorities in the United States and in Europe are not likely to be more synchronized through discussions about financial regulation in the TTIP.

Specific Concerns about the European Economy

The euro area economy remains troubled after its near collapse and the need to bail out banks and governments in three countries since 2010. Its financial sector has persistent and deep problems—in part because equity capital fell to dangerous levels (and has not been sufficiently rebuilt) and in part because the European regulatory and private sector application of "risk weights" has not performed well. Indeed Europe has resisted the sort of "stress tests" that were imposed on banks in 2009 in the United States precisely because of concern that so many banks would fail the test. Bank regulators still consider sovereign debt within the euro area to be low or zero risk, despite all evidence suggesting the opposite over the past five years.

During the financial crisis of 2007–09, the Federal Reserve provided a great deal of dollar funding, largely in the form of swaps with the European Central Bank. Most of this funding was apparently used to support European financial institutions that could not raise sufficient funds in private markets. Additional support to European banks was provided through ensuring that AIG, which failed in 2008 in part because of reckless trading actions of its London subsidiary, paid off fully on credit default swap contracts to major investment banks that were its creditors.[51]

In addition, while the European situation has stabilized in the past 12 months, macroeconomic stability is far from assured. Fiscal and financial policy remains in flux. The resolution regime for failing cross-border banks operating within Europe—including bankruptcy, restructuring, and recapitalizing procedures—remains unfinished. Indeed such a regime does not currently exist. The latest European Commission proposals have met with a mixed response from important countries.[52]

If a major European bank were to encounter difficulties, how would its liabilities in the United States be treated?[53] There is considerable scope for further cooperation on cross-border resolution between regulators and supervisors in the United States and Europe. However, it is hard to see how any of this would fit well into an FTA-type framework.

The failure of leading Icelandic banks in fall 2008 may also serve as a lasting cautionary tale. Iceland did not belong to the European Union, but its banks were allowed—under the so-called passport system allowed by the terms of the European Free Trade Agreement (EFTA)—to establish branches in the United Kingdom and the Netherlands without being subject to effective local regulation. The systemic consequences were disastrous.[54]

50. On the European priorities, see Barnier's recent speech at Brookings, cited in footnote 16. The Europeans definitely have some policy changes in mind and under way, including caps on executive compensation. But their priorities are not the same as those of American officials. See, for example, Michael R. Crittenden and David Enrich, "Regulatory Drift Develops Globally over Financial System," *Wall Street Journal*, http://online.wsj.com/article/SB10001424127887324263404578611961807623432.html. To be fair, other EU countries, such as the United Kingdom and Sweden, seem likely to end up closer to the United States on capital regulation.

51. Several dimensions of official US support directly benefited EU banks. US support for money market mutual funds was also critical to EU banks, which were heavily financed by funds. The Term Securities Lending Facility, which bailed out bank repo trades, was also critical for EU banks because of their repo exposures. For more details, see US Government Accountability Office, "Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance," July 2011, www.gao.gov/products/GAO-11-696.

52. See Jacob Funk Kirkegaard, "The EU Commission's Latest Proposals for Troubled Banks," RealTime Economics Watch blog, Peterson Institute for International Economics, July 11, 2013, www.piie.com/blogs/realtime/?p=3774.

53. There are related concerns regarding how swaps with affiliates of US banks would be treated—and a host of similar issues. See letter by Senators Jeff Merkley, Carl Levin, Tom Harkin, Elizabeth Warren, Jeanne Shaheen, Barbara Boxer, Richard Blumenthal, and Diane Feinstein to the CFTC and SEC at www.merkley.senate.gov/newsroom/press/release/?id=d452a900-e124-4c05-998f-80dbb58ea72a.

54. Contrary to some expectations, the EFTA Court determined that Iceland was not responsible for paying deposit insurance after the collapse of Landsbanki's Icesave branches. See www.eftasurv.int/internal-market-affairs/articles/nr/1646. The judgment of the court is at www.eftacourt.int/uploads/tx_nvcases/16_11_Judgment_EN.pdf. The Agreement on the European Economic Area (EEA) is at www.efta.int/legal-texts/eea.aspx. Annex 9 covers financial services: www.efta.int/~/media/Documents/legal-texts/eea/the-eea-agreement/Annexes%20to%20the%20Agreement/annex9.pdf.

Understandably, most of the constructive euro area official attention on financial regulation in recent years has been focused on remedying key defects of its currency union, which created one monetary system without creating a unified approach to bank regulation, supervision, and resolution. A Single Supervisory Mechanism is being established and the European Commission has proposed a Single Resolution Mechanism. But implementation is unclear and a long way off while competing factions in Europe squabble over a range of issues.[55]

5. POLICY RECOMMENDATIONS

The TTIP can deepen the already substantial ties that bind the United States and the European Union in the world's largest economic and strategic alliance. That said, the TTIP will only be a part, a relatively small part, of the rich and complex economic relationship between the United States and Europe. Many other economic and financial initiatives—along with channels of cooperation and consultation—will continue to operate in parallel to the implementation of any comprehensive trade accord.

We are concerned about continuing financial and macroeconomic vulnerabilities in Europe and thus conclude, as a practical matter, that the United States must preserve its ability to strengthen rules and raise capital requirements ahead of what leading European countries are willing to do.

With regard to financial services, a large, if not fully integrated, transatlantic network of meetings among central banks, finance ministries, financial regulators, and international financial organizations already exists. These institutions formulate and implement policies and regulatory standards to safeguard the stability and integrity of both national markets and the global financial system.

Deliberations and actions of official agencies and international organizations have an impact on the cost structure and competitiveness of financial services firms and therefore affect their ability to provide financial services via cross-border transactions or subsidiaries established in each market. Some of the factors that influence the ability of firms to successfully operate are covered by standard FTA obligations regarding national and MFN treatment and commitments not to impose restrictions on the number of firms, their management and employment, or their market share. But all of this is subject to prudential considerations that apply to all market participants. Such rules are part and parcel of the "high standard, 21st century" FTAs negotiated by the transatlantic partners with South Korea and others.

For the TTIP, the key issue is not whether to include financial services in the pact. Differences arise, however, with regard to the scope of the new obligations and in particular whether to redefine the scope of the prudential exemptions in the interest of promoting policy harmonization.

From the US perspective, the rule-making process that followed Dodd-Frank has been drawn out and involved a great deal of pressure from the industry. With US regulators on the cusp of making final rules for a range of complex issues, such as the Volcker Rule and leverage ratio, the possibility of further lobbying—both on TTIP content and on subsequent implementation—is unlikely to be appealing to US policymakers. If the TTIP is seen as a channel to slow the process of financial reform in the United States and/or open the door to new litigation designed to blunt new regulatory proceedings (of all kinds), it will substantially weaken the prospective benefits from—and strengthen opposition to—the TTIP on both financial and nonfinancial trade issues. Financial regulation could become a huge unnecessary and unproductive distraction for the TTIP.

The recent progress on cooperative frameworks, including the Basel III agreement on capital requirements, the newly minted agreement on cross-border swaps, and the trust needed to handle potential failure of large cross-border complex financial institutions, is all encouraging. That said, we are concerned about continuing financial and macroeconomic vulnerabilities in Europe and thus conclude, as a practical matter, that the United States must preserve its ability to strengthen rules and raise capital requirements ahead of what leading European countries are willing to do.

Trade pacts cannot require regulatory convergence when the two sides face such fast-changing and differing financial market conditions. However, the TTIP could play three useful roles.

- First, the TTIP permanent committee on financial services should serve as a clearing house for information on new regulatory proceedings in prospect or in process.

55. For a summary of the current situation, see Simon Johnson, "Europe's Slow Financial Reforms," *New York Times*' Economix blog, August 15, 2013, http://economix.blogs.nytimes.com/2013/08/15/europes-slow-financial-reforms/?_r=0. For background, see Véron (2010).

- Second, the TTIP should include a provision that reaffirms that SEC, CFTC, Federal Reserve, FDIC, and OCC rules with respect to all dimensions of derivatives and other activities are prudential. In addition, the principle of independent regulators should also be reaffirmed—recognizing established practice in the United States, which limits the extent to which the executive branch can constrain the activities of regulators (including with trade agreements).
- Third, investor-state dispute procedures involving prudential matters should be very narrowly drawn. We suggest that prudential measures consistent with international financial compacts like Basel III should not be considered a regulatory taking or indirect expropriation of an investor's assets and thus would not be eligible for claims under the investor-state dispute procedures. Instead, only state-to-state complaints should be allowed with regard to this dimension of financial services.

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