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Free trade in financial services and global regulatory standards: friends not rivals

It is a great pleasure to be in Berlin and a very important time to be considering global regulation. It is also a sobering thought that this year marks the tenth anniversary of the start of the global financial crisis. Such a phrase is quite often used to convey a sense that time passes quickly, or appears to do so, when we are enjoying ourselves. That's not the context for its use in relation to the financial crisis. Rather, I think, it is the opposite in meaning; that ten years on we are still dealing with the consequences and legacy of the crisis, and we are still therefore tested on whether the set of public policies being deployed are fit for the purpose.

I am going to use my time to consider those policy responses and whether they have served the purpose and remain appropriate; the overall context in terms of one or two of the big questions in economics that we face today; and then suggest a future role for global regulation which would set a somewhat different course to the one to which we have grown accustomed. I should say that this is my own thinking and not the policy of the UK Financial Conduct Authority or the Bank of England's Financial Policy Committee of which I am a member.

Policy responses to the financial crisis

Let me start with the policy response to the crisis. Here I am talking about a combination of monetary policy, macroprudential policy and microprudential and financial conduct regulation.

I will use the UK as the case study. Monetary policy was used aggressively as a response to the economic impact of the crisis. How should we think about the effects of that action? My background, a long time ago, is in economic history.

So, I am by nature more inclined to assess the experience of the past rather than resort quickly to forecasting. Economic historians have developed over many years an approach called the counterfactual This is not difficult to describe at a high level, namely would experience have been different had some element of the past been different. The counterfactual on monetary policy is not difficult in my view: absent the aggressive policy response there would have been something much nearer to the great depression of the 1930s, featuring mass unemployment, widespread company failures and home repossessions.

The other areas of policy that I mentioned, macro-prudential and micro-prudential and financial conduct regulation have all seen a major strengthening of approach in order to tackle the causes and consequences of the crisis. Macro-prudential is a new development focused on the stability of the financial system as a whole and filling an essential missing part of the policy landscape. It is also worth making a quick point about financial conduct regulation, the job of the FCA in the UK. I quite often say that in the last ten years we have experienced two financial crises, and the UK is not alone in this respect. The first was the prudential crisis which began almost a decade ago. The second, and somewhat more recent, has been a crisis in the conduct of finance, both in wholesale and retail markets.

The recovery from the crisis in terms of economic activity in the UK has been weak, and again this is not a uniquely British story. The past decade has seen a very slow rate of growth of real earnings.

Whether that rate of growth is slower than we should have seen given the scale of the crisis is a matter that historians will consider for a long time I suspect, just as they have debated at length whether growth in the mid-nineteenth century British economy was slower than it could or should have been.

Why mention the mid-nineteenth century here, you may well ask? Because it was the previous period in which the British economy was highly open under free trade policies which also saw extensive global mobility of capital and labour.

The recovery from the financial crisis has been slow, but policy has acted to avert a much worse situation. In so doing, it has led to a much greater focus on the distribution of income and wealth. This is not going to be the focus of my comments today, but it is an important backdrop to the policy issues that I will discuss. History shows that income and wealth distribution matter for the evolution of economic policy and that in this respect globalisation can plant the seeds of its own destruction. This was arguably the story of the late nineteenth and early twentieth centuries, and at least in part the cause of the subsequent retreat from free trade in goods and services, the free movement of capital, and likewise the free movement of people. This set of issues therefore matters a lot.

But, before I move on, let me add two important points which are also lessons of history. First, we should not over-simplify, because the impact of activities like trade on income distribution varies enormously depending on the structure of economies. Secondly, criticism of monetary policy should be tempered not only by recognising what would have happened without it, but also that the beneficial effects have created the scope for other policies to be used in calmer conditions than would otherwise have been so. The mistake here is to think that it is the only show in town.

Some big questions in economics

The first section of my remarks has pointed to one big question, namely can the openness of economies – in terms of trade in goods and services and factor mobility (capital and people) - have an effect on income and wealth distribution? The answer from history is a strong yes.

The second big question that comes from history and is highly relevant today is to ask whether free trade is a substitute for the mobility of capital and labour or a complement to such mobility? In other words, do they have to operate together, or can they be alternatives? This is a critical question, and one that has been around for a century (it is most often associated with the economic historian Eli Heckscher and the trade theorist Bertil Ohlin). Their model states that trade and factor mobility are substitutes. But is has been challenged for a long time. Again, the experience of the late nineteenth century open economy is useful here. The evidence there rejects the idea that trade and factor mobility are substitutes, and in the words of one comprehensive study, the evidence "is a little more comfortable with the thesis that they were complements"[1].

History may not be conclusive, but it does point to why this is such a difficult and important question. As a policymaker in financial regulation my interest in this issue lies in the relationship between international capital mobility and economic growth under free trade conditions. The theory tells us that international capital mobility breaks the link between domestic savings and domestic investment, making investment demand a more important determinant of economic growth than domestic savings supply.

[1] Kevin O'Rourke and Jeffrey Williamson: Globalization and History (MIT Press, 1999), Page 268

History indicates that capital mobility complements and supports trade. Moreover, the evidence suggests that global capital markets were better integrated between 1870 and 1924 than throughout much of the twentieth century that followed.[2]

What does this mean for today's situation? A lot I would say. If we return to the argument that international capital mobility breaks the link between domestic savings and domestic investment, then we have the case underlined for European Capital Markets Union. In my view this is big prize for Europe as a whole. The lesson of history is that global capital flows are growth enhancing. European Capital Markets Union should be an important part of promoting global flows of capital and stronger growth in Europe and elsewhere.

Let me briefly summarise the argument so far. We have not abandoned the commitment to free trade and open economies in the response to the financial crisis. History tells us to expect impacts on income and wealth distribution. We are learning I think that the response to these effects should be to use all our policy tools, and that these actions will be more effective if we have preserved macro-economic stability. International capital mobility supports economic growth under conditions of stability and is more likely to complement free trade in goods and services than act as a substitute.

[2] O'Rourke and Williamson Pages 207-223

The course of financial regulation

A stable macroeconomic environment enhances the capacity to use, and the effectiveness of, other policies, which can in turn take the load off macroeconomic policies and over-dependence on those policies of a sort that has proved to be unstable at a number of points in history. British history suggests a tendency towards over-confidence that a stable macroeconomic environment diminishes the need to use other policies to a degree that has turned out to be a problem in its own right. One area of complementary policy is regulation of the financial sector.

Regulation – both prudential and conduct - is in some circles regarded as an obstruction to growth and the competitiveness of finance. I don't believe this to be the case if it is effective in its public interest objectives. The regulatory response to the crisis over the last ten years has been directed towards creating conditions which support stability in finance, enable competition in the supply of financial services and ensure conditions where users – consumers – can reasonably expect conditions of fairness. These are essential basic conditions not nice-to-haves.

But, do we have a regulatory system that does all it can to support free trade and capital mobility, bearing in mind the lessons of history that these are important conditions for economic growth? Not sufficiently is my view. Why? Because while we have done a great deal to develop global regulatory standards in the aftermath of the crisis, we have taken very few steps towards using those stronger standards as the basis to govern market access for financial firms. Our approaches remain national, or in Europe regional.

We face evidence of pressure to, if anything, go in the other direction in terms of further limiting market access. This would be a big mistake in my view.

The G20, of which Germany is the President this year, has led the way in post-crisis regulatory standards, supported by the work of the Financial Stability Board. Alongside the umbrella of the G20-FSB sit a number of global standard-setting bodies in the areas of financial services. The scope and membership of the standard setters varies depending on local markets among other things, but they include regulatory authorities of G20 jurisdictions, and sometimes many others, who work together with the aim of both developing and implementing regulatory standards and principles. The standards themselves are not legally binding in the way that a treaty is under international law. Rather, they provide a broad, common framework across specific global markets. The important standard setters include the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). Taken together, these three bodies set standards for much of the internationally traded financial services. All of them work closely with the FSB.

The post-crisis response has combined the more bottom-up work of the three standard setters with the top-down commitments emanating from the G20 Heads of State. The FSB could be thought of as the melting pot in the middle, the place where it comes together under the objective of global financial stability.

In the European Union, quite a few of the regulatory initiatives following the financial crisis have been informed by global standards and follow the broad direction of travel set by global bodies. In general terms, this "broad direction of travel" is seen in other countries. But in the EU the legislation that provides the specific legal underpinning for integrated EU financial services markets has become much more granular, technical and detailed in its provisions.

I want to pose the question, would it be possible to take a different approach and to base market access on common recognition of higher level global standards which are transparent and subject to regular review? Wouldn't this be the best thing we could do to support the global economy. You won't be surprised to know that I think the answers here are yes.

A primary aim of global standards is to promote regulatory outcomes that are consistent across jurisdictions, thereby avoiding so-called 'regulatory arbitrage' – the risk that firms might seek to locate their business in a jurisdiction where the regulatory regime is perceived to be less onerous. In doing so, they seek to ensure minimum standards to enhance financial stability and provide for a framework for cooperation among supervisors. By helping to promote international consistency and hence reducing the risks of regulatory arbitrage, global standards can support trade in financial services between jurisdictions.

The global standards we have today were not put in place to facilitate market access. Therefore they are not currently regarded as providing an alternative either to the financial services passport within the EU Single Market or to third country access provisions as provided in certain EU directives such as MIFID II.

But they are designed to ensure the objective of global financial stability is enhanced and they are set up to work across a broad range of legal and regulatory regimes. They are high level in nature, but I see that as an advantage since they should capture the essence of broad equivalence on which market access should depend.

What should be the scope of global standards, and thus the basis of market access? They should clearly cover internationally active firms and activities. This concept of internationally active firms is at the heart of the Basel Committee definition of the scope of application of its Accords, and this has been the case since the origin of the Basel approach in the 1980s, and has its roots in the Basel Concordat of 1975.

In my view, global standards should – as they mainly do – apply to those areas over which it makes sense to oversee using international standards and leave to national or regional jurisdiction those standards that should be specific to local markets. I would require global standards for core prudential requirements (for banks that would be capital, liquidity and large exposures), for the resolution of failed firms where that needs a special regime beyond standard insolvency law, and for market practices where those present a sufficient threat to financial stability. These could be the broad global standards of equivalence. I would then require the home authorities of the country in which the firm is based to be transparent about the standards they set for governance, remuneration and other areas that affect critical incentives and thus the culture within firms. These should be subject to peer review, as they are now by the IMF. Finally, I would leave much of the regulation of financial conduct to be done at the national or regional level in the countries in which firms operate.

In other words, all firms operating in a country would be subject to the conduct rules of their "host", and this should apply whether they have a presence in the host country of sell services across borders.

Finally, I would not subject smaller firms that choose not to trade across borders to the global standards. They should be subject to national standards, and these could within sensible limits be set to support competition in ways that do not always happen today.

In terms of how more effective global regulatory standards might be beneficial, it may be helpful to provide an example. Currently, where a firm seeks to enter an overseas market to undertake regulated financial services activity, it will likely be required to attain authorisation from the relevant regulatory authority in that market. The information that the firm is obliged to give to the regulator as part of its application varies from jurisdiction to jurisdiction. One important piece of evidence that the regulator may consider is whether, and to what extent, the firm's domestic authorities adhere rigorously to global financial regulatory standards. This may help facilitate the firm's authorisation application. Under the UK's authorisation regime, for example, where a firm from outside the EU is making an application, the Financial Services and Markets Act (FSMA) allows the FCA and/or PRA to have regard to the supervision of that firm's home country regulator in forming their opinion. But, while being subject to a jurisdiction which adheres to global standards can be a factor influencing authorisation, it is currently not considered to be a sufficient condition.

If the body of global standards were to be judged sufficient, it could provide a broader basis on which market access decisions could be made. This would of course need to be supported by consideration of how such standards would be created, implemented and then overseen. Market access on this basis would help to reduce barriers to entry and promote more competitive markets. A system of mutual recognition could thereby be established. Bilateral mutual recognition between securities regulators has some precedents but is far from commonplace. For example, the United States Securities and Exchange Commission (SEC) and the Australian Securities and Investments Commission (ASIC) signed a mutual recognition agreement in 2008 which provides a framework for US and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions, without – under certain circumstances – the need for separate regulation in each country.[3] To be clear, however, such a scenario could only be realised where regulators had sufficient assurance in the effectiveness of each other's regimes.

Conclusion

Post-crisis global regulatory standards are not weak. They represent progress towards simplification in terms of reducing the number of national standards. But they are still not well rooted, and there is more to be done on their development. I hope that another step will come this year with agreement on finalising Basel III. A much broader commitment to open up market access using global standards would be a decisive step in the right direction at a time when the openness of the world economy is more under threat.

[3] For more information please see http://asic.gov.au/about-asic/media-centre/find-a-media-release/2008-releases/08-193-sec-australian-authorities-sign-mutual-recognition-agreement/

And the last time in history that an open world economy came under major threat, a century or more ago, the response turned out to be a disaster. That's a lesson from economic history.

Let me finish on the use of global standards by also noting that their use in market access does not require jurisdiction to be given to the courts or regulators of one country over those of another in the home market of the latter.

We are at a very important point in terms of how we can best deploy public policies to support economic growth. Free trade and open markets remain in my view the best approach to secure stronger growth. But with free trade comes a number of critical questions on the best supporting policies. My view is that open financial markets are the best way to support trade in goods and services. We could take a big step in that direction by using global regulatory standards as the basis for market access around the world. Thank you.