

Over the last fifty years progressive liberalization of international trade has given Adam Smith's invisible hand a larger role in guiding economic affairs. Since the establishment of the General Agreement on Tariffs and Trade in 1948, several rounds of trade negotiations have lowered tariffs and reduced other barriers to international trade. These reforms give markets more room to allocate resources to their most efficient uses and encourage nations to specialize according to their strengths. The volume of trade has expanded a hundred-fold, bringing consumers more goods at lower prices. Despite the problems of adjustment, the gains from trade are clear. Globalization is now controversial primarily because of its success.

As market impediments disappear, however, further improvements in the global trading system are becoming increasingly difficult. The extension to services, and particularly financial services, introduced new complexities unanticipated in the theory of international trade. David Ricardo illustrated the theory of comparative advantage with Portuguese wine and English cloth. It is less clear that citizens of Germany and Switzerland would both be better off if German engineers built the bridges of both countries and Swiss banks financed them. The efficiency arguments might be overwhelmed by legitimate concerns that under certain scenarios either the bridges or the banks might collapse. The credibility of the institutions is paramount.

These institutional considerations require refinements to trade theory if it is to suggest policy implications for financial services. Wine and cloth, or steel and bananas, can be misleading analogies for banking and insurance. The essence of financial services is not exchange, but **intermediation**. Financial firms do trade financial instruments, but

their main business is re-packaging those financial instruments to meet the risk and liquidity preferences of their customers. They aggregate financial claims and manage efficient portfolios of assets and liabilities simultaneously. By sustaining those positions in the marketplace, they create liquidity and reduce risk.¹ But because financial intermediaries are both buyers and sellers of financial instruments, the interests affected in financial services negotiations are harder to unravel than the interests of consumers and producers of manufactured goods.

For example, since Germany is a much bigger country, for the Swiss banks to provide efficient financing they must attract a large number of German depositors as well as German borrowers.

The GATS Prudential Carve-out

*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.*

To instill confidence, Swiss banking supervision must be as credible as German banking supervision. But negotiating one standard for both countries is tricky. Suppose that German borrowers perceive the Swiss system as more favorable while depositors prefer the German system, or vice versa. Swiss borrowers and depositors may or may not agree, and the institutions have their own views. No compromise will likely satisfy all the contending interests, and the supervisory system may lose credibility as a result.

To this complex environment, add a suspicion that some aspect of supervision is merely disguised protectionism. The General Agreement on Trade in Services obligates member countries to open their markets to service providers from other countries, except when acting for **prudential** reasons.

¹D. W. Diamond and R. G. Ryan, "Liquidity Risk, Liquidity Creation, and Financial Fragility," *Journal of Political Economy*, 2001, pp. 287-327.

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The limits of this so-called “prudential carve-out” are not defined, although “Panels for disputes on **prudential issues** and other financial matters shall have the necessary expertise relevant to the specific financial service under dispute.” Prudential supervision is beyond the reach of the WTO, but it is only a matter of time until alleged prudential supervision becomes the subject of a trade dispute.

To define prudential supervision, it might help to consider the economist’s standard justifications for market intervention. Economists generally argue that competitive markets allocate resources most efficiently unless there are significant economies of scale, externalities, or information problems. At one time the economies of scale in generating and distributing electricity spawned natural monopolies that could set their own prices unless regulated. Economics literature abounds with studies of public utility regulation, as well as studies of externalities like pollution and other consequences of economic activity not reflected in market prices. Aside from the well-known information problems in insurance, adverse selection and moral hazard, the otherwise scanty literature on insurance regulation offers little insight. Perhaps experience has superseded analysis because the plight of policyholders of insolvent insurers convincingly demonstrated the need for regulation.

Protection of policyholders is the standard justification for insurance regulation, considering the complexity of insurance products, their long-term nature, and search costs in evaluating insurers’ financial condition. But some economists argue that the market should allow consumers to judge products and insurers for themselves.

Even if one agreed with this extreme position, one characteristic of financial firms frustrates the invisible hand: their **fragile capital structure** masks needed information.

Entrepreneurs raise capital to acquire productive assets, such as the farmer’s seed and fertilizer; or the manufacturer’s plant, equipment, and raw materials. The entrepreneur’s capital consists of a combination of debt and equity. Debt imposes strict repayment terms and other conditions on the use of the funds. In fact a sole lender can control the fate of the enterprise. Multiple lenders may syndicate their loans in an attempt to retain that measure of control, but generally the more sources of capital, the less

influence each has on the firm’s operations. The same goes for equity holders, who share the risk of the enterprise. The more stockholders, the less influence each has. By relinquishing control, their claim on the firm’s assets becomes more liquid.

Capital structure is the proportion of debt to equity. Because debt repayment terms are fixed, a successful entrepreneur can generate more profits by borrowing funds to expand the business. The profits belong to the equity holders. Borrowing increases their rate of return on their investment in the business. Americans call this important concept **leverage**; Europeans call it gearing. A firm with a higher degree of leverage or gearing might generate a higher rate of return, but it also bears more risk. Lenders control leverage by increasing their interest charges, or by denying credit, as a firm’s capital structure becomes more risky.

Financial intermediaries do not need to borrow money because their business generates funds. Banks accept deposits, insurers collect premiums. These are their liabilities, but their numerous depositors and policyholders have no influence on operations. Financial intermediaries invest vast amounts of other people’s money.

Like other enterprises, financial firms can increase their rate of return by increasing their degree of leverage. Unlike other enterprises, they do not face a rising cost of capital as a result because the depositors and policyholders who supply funds have no input into the firm’s management decisions. Moreover, policyholders cannot possibly foresee future changes in the insurer’s financial strategy at the time of purchasing the policy. The market provides no countervailing force to the insurer’s temptation to increase the rate of return by increasing leverage. Prudential supervision is the only antidote to excessive risk. Capital requirements, particularly if they reflect the risk profile of the firm, constrain leverage and align the interests of the firm’s owners with its policyholders, who depend on its survival.

Prudential supervision is the antithesis of risky behavior. Protecting policyholders [from what?] states the objective of prudential supervision too broadly. One should say its objective is to assert the interests of policyholders in restraining risk-taking with their money. By adding this restraint, prudential supervision **creates** markets; it does not impede them.