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International financial regulation after the crisis

What was once almost quaintly referred to in the United States as the Subprime Crisis eventually came to be known, in America and abroad, as the Great Global Credit Crisis of 2008 – 2009. The change in terminology is itself indicative of the international spread of the crisis. It reflects how, in the end, no country was immune to the global reach of financial instability.

Now that the worst effects are past, officials have begun drawing lessons and formulating policy responses. The United States has focused on strengthening mortgage underwriting standards, moving transactions in derivative financial instruments onto organized exchanges, and curbing proprietary trading by depository institutions insured by the Federal Deposit Insurance Corporation (FDIC). The United Kingdom has emphasized the perverse incentives created by bonus-based compensation of financial executives and sought to reform executive pay. France and Germany have singled out the risks created by lightly regulated hedge funds and private equity firms. Officials in other countries have prioritized still other issues. On what should take precedence there is little agreement.

Herein lies the problem: to be effective, regulation of financial markets and institutions must be coordinated across countries. Most big banks operate in more than one country, affording them the opportunity to relocate their operations and employees. When the United Kingdom moved to tax bankers' bonuses, the bankers in question threatened to move to Geneva. When the European Union began to contemplate strict regulation of hedge funds, fund managers proposed moving their operations to New York. When the EU then mooted the possibility of prohibiting residents from investing in hedge funds and private equity firms regardless of where they were located, the U.S. Treasury complained that such measures unfairly discriminated against the U.S. financial services industry and violated international treaties like the General Agreement on Trade in Services.

Not only is disagreement among national regulators over priorities and strategies a source of potential conflict, but it threatens to vitiate their efforts to make the world a safer financial place. In a financially integrated world, many regulatory restrictions are impossible to effectively enforce purely at the national level. Whatever the regulatory response – taxing bank size, bank bonuses, or specific bank activities – limiting evasion requires a significant degree of international cooperation.

The above examples are specific instances of the general phenomenon known as *regulatory arbitrage*. When restrictive regulation raises the cost of doing business (as it is designed to do when business activities have social costs), businessmen have an incentive to relocate to more permissive jurisdictions, frustrating regulators' efforts and raising the costs to society of the business activity in question. In the United States, regulatory arbitrage may mean shifting an activity between affiliated firms that are subject to different regulations and overseen by different regulators – from a bank to an affiliated insurance company or a structured investment vehicle (SIV), for example. Regulatory arbitrage can also mean shifting high-risk activities from a country with more stringent regulation to another where regulation is more permissive. To limit this behavior, international cooperation in establishing a common regulatory standard is the obvious way forward.

While the case for cooperation is straightforward in principle, the mobility of finance creates a temptation for regulators to undercut one another in practice. Competition for business may create a race to the bottom. Competing jurisdictions, seeking to attract footloose financial firms, have an incentive to offer more permissive regulation or lax enforcement. More than one country has launched "Big Bang" reforms, liberalizing burdensome regulation and, sometimes, weakening enforcement in an effort to enhance its attractions to internationally mobile financial firms. To address this problem, competing countries might enter into an international agreement that requires consenting parties not to undercut one another's regulatory efforts.[1]

A further argument for international cooperation is that individual countries, making decisions in isolation, lack adequate incentive to engage in rigorous supervision and regulation of domestic financial firms and markets. While doing so is costly, the benefits accrue not just to the individual country but also to its neighbors. The virulence of financial "contagion" – the speed and extent to which instability can spread, infecting the financial systems of other countries – such as that which was evident in the aftermaths of the Bear Stearns, American International Group, and Lehman Brothers crises in March and September 2008, illustrates the point. In these episodes, inadequate supervision and regulation in the United States spawned a crisis that engulfed the entire world. As Thomas Mayer, chief economist of Deutsche Bank, put it, "In this day and age, a bank run spreads around the world, not around the block."[2]

The implications for regulation are direct. If a government invests in regulation, some of the benefits may accrue to other countries, giving the initiating country inadequate incentive to invest. The problem is not unlike that of residents of a fire zone. It is in the self-interest of each resident to clear the underbrush around his home in order to enhance his own safety. But the individual homeowner may not consider the additional benefits, from a social point of view, of his brush-clearing exercise; he may not see that doing so also enhances the safety of his neighbors. In the urban context, municipal regulation requires everyone to clear additional brush. In the context of global finance, the solution rests on international standards and coordination of financial regulation.

Finally, cooperation could create a viable alternative to the uncontrolled bankruptcy of troubled financial institutions on the one hand and emergency rescues on the other. Emergency rescues are criticized on both equity and efficiency grounds. To the extent that a rescue is financed by taxpayer money, present or future, it is rightly seen as unfair. Moreover, because banks know they will receive assistance in the event that the bets they make go bad, they have an incentive to place bigger and riskier bets. Regular recourse to rescues creates moral hazard, which has social costs.

But the alternative – allowing a big bank to declare bankruptcy – is not tenable if doing so threatens the stability of the financial system. The troubled institution will have borrowed from other financial institutions. It will have other contracts outstanding, many of which will be frozen when bankruptcy is filed and an automatic stay is imposed. A stay may therefore cause liquidity problems – and worse – for the bank's counterparties, forcing them to call in their own loans in order to raise funds. Asset prices may collapse in a fire sale, and the liquidity crisis may cascade through the financial system. Lack of attention to third-party effects in Chapter 7 and Chapter 11 bankruptcy proceedings coupled with the slow pace of court proceedings render these problems especially pervasive and this approach to resolution particularly problematic in the case of financial firms.[3]

In the United States, the FDIC can step in, seize, and ring-fence the operations of a bank to which it extends deposit-insurance coverage. It can pay off a bank's obligations to its counterparties. But the FDIC lacks this authority with regard to the big, complex bank holding companies that pose the most serious threat to systemic stability. Insurance companies and other large nonbank intermediaries are also beyond its jurisdiction.

The Dodd-Frank financial reform bill adopted in Summer 2010 gives federal regulators new authority to seize and break up large troubled financial firms. What it fails to recognize, unfortunately, is that most large financial companies – the presumed targets of these procedures – operate internationally. A case in point is Lehman Brothers, which had consequential operations in the United Kingdom as well as in the United States. The conflicting claims of creditors in the two jurisdictions, together with differences in resolution regimes, created serious difficulties for courts and regulators seeking to limit the systemic consequences of the institution's failure in 2008.

Establishing an orderly resolution regime as an alternative to bailouts is desirable. But meaningful progress will require, at a minimum, that provisions adopted at the national level be coordinated internationally. And if cooperation proves inadequate, regulators will have to contemplate creating a supranational resolution authority.

Not everyone is convinced, however, by the case for international regulatory coordination. Regulatory oversight, to be effective, must be tailored to local needs. National financial structures and systems differ, requiring differences in the structure and application of regulation. In some countries, financial systems are predominantly bank-based. In others, the United States and the United Kingdom being prominent examples, the securitization of financial claims is more extensive. In these countries, the growth of securities markets has led to "disintermediation" – the displacement of bank borrowing and lending to securities markets. Financial systems must be regulated differently according to whether they are dominated by banks or securities markets. Further differences include whether the state owns a stake in the country's leading financial institutions; whether Internet banking is prevalent; and whether the country is predominantly Islamic, as Islamic banking prohibits the payment of interest, requiring lending to be structured in other ways. All these are reasons why one-size-fits-all regulation, which is what tends to come out of international agreements, is undesirable.

An additional danger is that international coordination may lead to lowest-common-denominator regulation. Agreements on matters such as minimally adequate capital ratios for internationally active banks, to be effective, must be accepted by all countries with consequential banking systems. As a result, agreements tend to be by consensus. For all concerned countries to agree, any provision that one country finds objectionable must be removed from the agreement or, at the least, watered down. The result is a weak and ineffectual agreement. As a case in point, critics of international agreements point to the Basel Accord for Capital Adequacy for Internationally Active Banks. The Basel Accord is designed to ensure that banks have buffers to cope with adverse circumstances, but it has not prevented bank capital from falling to near zero and bank solvency from being threatened in each of our recent financial crises.

Part of the problem may be that international agreements negotiated in far-distant places like Basel are prone to be captured by the regulated. Banks with a preference for relatively permissive regulation have the resources and expertise to influence the Basel Committee on Banking Supervision. This is not so for the man or woman in the street concerned that regulation should be sufficiently stringent to protect his or her interest. This is another reason that international agreements may lead to weak and ineffectual rules.

Finally, some argue that regulatory diversity is desirable for the same reasons that biodiversity is desirable. Efforts at international coordination, whereby governments converge on a single set of standards, may in fact leave the global financial system more exposed. The standards in question may turn out to be poorly designed and inappropriately targeted. If they are designed to contain one set of risks and a different set materializes, the fact that all jurisdictions have adapted their regulatory policies in the same way may only contribute to financial instability. From this standpoint, given the possibility of diverse shocks to global financial markets, the presence of diverse regulation may enhance the stability of the financial ecosystem.

There is something to these arguments – which is precisely why there is a debate about the efficacy of internationally coordinated reform. Yet, even conceding these points, the case for cooperation is overwhelming. For one, the implications of differences in financial structure should not be overstated. Despite variance across national systems, over time there has been a strong tendency toward convergence. Furthermore, countries with bank-based financial systems and those with market-based systems can adopt the same approach to regulation of their banks and securities markets; the consequential difference would be to which set of regulations they devote the bulk of their enforcement effort.

Second, the fear that agreement by consensus leads to lowest-common-denominator regulation should not preclude cooperation. Rather, 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.

Finally, if nonfinancial interests are inadequately represented in international negotiations, then the appropriate response is not to abandon those negotiations but to open them up to additional stakeholders.

Historically, the most prominent international institution concerned with regulatory reform has been the Basel Committee on Banking Supervision, which is made up of representatives of central banks and other banking supervisors. The Basel Committee meets on the premises of the Bank for International Settlements in Basel, Switzerland, a minimum of four times a year. When it was founded in 1974, only the United States, Canada, Japan, and seven European countries were represented. Membership has since expanded to twenty-seven countries, including the emerging markets of Latin America and Asia.

While the Basel Committee has traditionally focused on ensuring that banks have enough capital to weather shocks, over time it has also considered a variety of other stability-related issues, including, most recently, liquidity risk. Its signature achievement is the Basel Accord for Capital Adequacy for Internationally Active Banks, as virtually all large banks today are internationally active.

Unfortunately, the Basel Accord, and especially the updated version, Basel II, published in 2004 and adopted by a growing list of countries subsequently, are now understood to be seriously flawed. Basel II allowed banks to hold less capital against assets that received investment-grade ratings from commercial credit rating agencies. Because ratings are revised upward in good times and downward in bad times, this practice was strongly procyclical. It encouraged even more lending when lending was booming and more retrenchment when financial institutions were retrenching. It ignored the conflicts of interest to which the rating agencies were subject. It also allowed banks to use their own internal models – later shown to be problematic – to evaluate the risk of losses and the amount of capital that had to be held against those risks. It bought into the bankers' arguments that they could safely reduce their own funds held in reserve (so-called Tier 1 capital) to little more than 2 percent of bank assets.

Some of these problems issue from the Basel Committee's origins and their influence on its remit. The Committee was created in 1974 in response to problems with a major cross-border *bank* (Germany's Herstatt Bank); the focus of the Basel Committee on Banking Supervision, therefore, is on *banking* supervision. Once upon a time, the perimeters of the banking and financial systems were roughly coincident because banks were the dominant providers of financial services. But with the growth of securities markets and nonbank financial firms, this is no longer the case.

As a result, the Basel Committee set capital adequacy standards for commercial banks; meanwhile, in countries such as the United States, it was not just the large commercial banks (and commercial bank holding companies) that posed potential risks. Once upon a time, investment banks like Lehman Brothers invested only their own partners' capital, but more recently, they began leveraging their operations with borrowed funds. Broker dealers like Bear Stearns that booked and cleared the trades of others increasingly engaged in proprietary trading, using an even higher ratio of borrowed money to own capital than was typical of investment banks. Insurance companies like the American International Group (AIG) were overseen only by state insurance commissioners – to the extent that they were overseen at all. Markets in structured derivative securities were often entirely unregulated. The members of the Basel Committee were aware of these gaps, but awareness does not equate to the capacity to act.

Early recognition of these problems led to the 1999 formation of a second body, the Financial Stability Board (FSB; originally named the Financial Stability Forum). The FSB, which is supported by a small secretariat also housed at the Bank for International Settlements, has a mandate to assess vulnerabilities affecting the entire financial system and to oversee action to address them. It seeks to monitor market activity, highlight regulatory developments, and identify systemic risks. Some two dozen countries are represented. Members include not just central banks and other regulators but also financial standard-setting bodies like the International Association of Insurance Supervisors and the International Organization of Securities Regulators. The FSB has created committees concerned with a range of issues that potentially pose risks to financial stability, including international capital flows, hedge funds, and offshore financial centers. Its deliberations, when agreement is reached, result in a set of recommendations and a published report.

The FSB's mandate to monitor the global financial system as an integrated whole constitutes an important step forward. The Board's limitation is that it is essentially a talk shop: a place to exchange information and pontificate on what is desirable, after which regulators are free to go home and do more or less as they please. Like the Pope, the FSB has no army. It has even less sanctioning power.

Its members are aware of this problem. Indeed, one need only consult the FSB's antiseptically titled January 2010 report, "Framework for Strengthening Adherence to International Financial Standards." This report succeeds in identifying only three mechanisms for ensuring adherence to its standards: leading by example on the part of member jurisdictions, peer review, and a vaguely specified "toolbox of measures" (specific tools presumably being too sensitive for the lid on the box to be lifted). It seems unlikely that the FSB entertains any illusion that these limp instruments will get national regulators to sit up and listen.

Then there is the Group of 20 (G20), which, recognizing the emergence of a more multipolar world, has assumed the role of steering committee for the world economy (a role played previously by the Group of 7 and Group of 10 advanced countries). Its twenty members include advanced countries and emerging markets alike, as well as the European Union. At recent meetings, it has also included a twenty-first member, Spain, a large country that was inexplicably excluded when the G20 was formed but whose attendance was insisted upon by the European Commission, and a twenty-second, The Netherlands, a member of previous groupings that insisted on inviting itself. The G20 is a mechanism to ensure that not just regulators but leaders (finance ministers and prime ministers, who presumably give marching orders to the regulators) buy into the process of policy reform. Following its biannual meetings of heads of state and government, it issues communiqués that include commitments on financial reform. At its June 2010 summit in Toronto, for example, leaders committed to phasing in higher capital standards for banks. Similar to the FSB, the G20 forms working groups to investigate financial problems and offer recommendations.

But the G20 has a legitimacy problem: it was formed in response to an earlier crisis in the late 1990s, essentially in ad hoc fashion. (The equally ad hoc participation of Spain and The Netherlands, whether desirable or not, is indicative of this fact.) No one appointed this particular set of countries to make decisions for the world. Nothing ensures that their recommendations will be respectfully received and acted upon by countries represented in their deliberations.

A final institution concerned with financial stability is the International Monetary Fund (IMF). The IMF has a written constitution, the Articles of Agreement, to which its members are bound. It organizes countries into constituencies, each of which is represented by a member of its Executive Board, ensuring that all 180-plus national members have voice; it therefore does not suffer from the same kind of legitimacy deficit as the G20. It publishes a Global Financial Stability Report designed to provide a synthetic assessment of risks to the international system. In conjunction with the FSB, it conducts early-warning exercises designed to anticipate financial problems. Together with the World Bank, its sister organization, it conducts regular financial-sector assessments intended to provide outside reviews of the financial strength and regulatory practices of its members. In the course of this review, it recommends adherence to international best-practice standards. Countries that borrow from the Fund are subject to an enforcement mechanism; the IMF can deny disbursement of the next quarterly installment of its loan to countries it judges to have made inadequate progress in fixing economic and financial problems.

But the IMF possesses no such power over other countries. Illustrative of this limitation is the fact that countries must agree before a potentially embarrassing assessment of their financial sectors can be conducted. Shortly before the Subprime Crisis, the IMF and World Bank reportedly approached the U.S. government to request an assessment and were refused.

Evidently, there is no dearth of studies and no shortage of committees, boards, and organizations concerned with international aspects of regulatory reform. There is, however, a shortage of consequences for countries whose regulatory policies are not adequate. The question is how to address this problem.

One option would be to create a new body, a World Financial Organization (WFO), membership in which would create concrete obligations whose violation would have significant consequences. In the same way that the World Trade Organization (WTO) establishes principles for trade policy (such as nondiscrimination, reciprocity, transparency, binding and enforceable commitments) without prescribing outcomes, the WFO would establish principles for prudential supervision and regulation (capital and liquidity requirements, limits on portfolio concentrations, adequacy of risk measurement systems and internal controls) without attempting to prescribe the structure of regulation in detail.

But once the WFO defined obligations for its members, the latter would be obliged to meet them. Membership could be made mandatory for all countries seeking freedom of access to foreign markets for their investors and domestically chartered financial institutions. The WFO could appoint independent panels of experts to determine whether countries were in compliance with their obligations. In cases of noncompliance, other members would be within their rights to restrict the ability of financial institutions chartered in the offending country to do business in their markets. Not only would this measure protect members from the negative consequences of inadequate regulation abroad, but doing so would provide a real incentive to comply.

Critics will undoubtedly object that governments, not least the U.S. government itself, will never allow an international organization to dictate their national financial policies. However, the WFO would not dictate; the specifics of implementation could be left to the individual country. Furthermore, the equivalent already exists for trade. The United States is among the countries that have signed WTO agreements with specific obligations. The WTO has the power to establish dispute settlement panels and determine whether national law complies with a country's WTO obligations. Violators have the choice of changing that legal provision or facing trade sanctions. If the United States and other countries accept this authority in the case of trade, one might ask, why shouldn't they accept it in the case of finance?

There is no reason why the Basel Committee, the FSB, the IMF, and the others should not continue their useful work studying regulatory problems, encouraging their correction, and promoting the international coordination and harmonization of regulatory initiatives. It has become clear, however, that more comprehensive, binding, and coordinated international regulation will be crucial to financial stability worldwide, now and in the future.

ENDNOTES

1 To be sure, some would assert that restrictions on financial firms and markets are excessive and that regulatory competition is desirable as a countervailing force. But their position is less tenable in the wake of the crisis.

2 Quoted in Mark Landler, "Europe Catches What's Ailing U.S. Financial Sector," *The New York Times*, October 1, 2008.

3 Chapter 7 and Chapter 13 are the provisions of the bankruptcy code under which the operations of an insolvent entity are liquidated and reorganized, respectively.