Financial Regulation in a Global Market: Moving Beyond the State

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Introduction

- It is fitting that a British institution renown for its expertise in international and comparative law (BIICL) chooses as the theme for its annual conference the subject which I will broadly discuss in my presentation: financial regulation in a global market: moving beyond the State. This is one of the key questions of our times. It is also a complex issue. How can we design a legal and regulatory framework that effectively deals with the dichotomy between global markets and national law?
- My thanks to Professor Robert McCorquodale for inviting me to open this distinguished conference and to Professor Jeffrey Jowell, Director of the Institute's Bingham Centre of the Rule of Law for his involvement in a key area of the Institute.

Outline

- The impact of globalization upon finance
  - Sovereignty and governance
- The impact of regionalization and globalization upon financial law
  - Overlapping jurisdictions
- The financial crisis 2007-2009: causes and regulatory responses
  - Redrawing the boundaries between the state and the market.

The impact of globalization upon finance

- Not so long ago, most banks were fairly uncomplicated institutions operating nationally, under the umbrella of the central bank, taking deposits and granting loans [the 3-5-3 rule: take deposits at 3%, loan them out at 5% and go home/play golf at 3pm].
- Globalization has changed the traditional understanding of financial markets and has led to the emergence of multinational banks, financial groups and new instruments and markets operating across jurisdictions
- Financial globalization has been fostered by
  - financial innovation, the technological revolution,
  - the integration and liberalization of markets,
  - the mobility of people and capital and other factors.
  - The global financial market is not a huge global homogenous market. It is more like a spider's web or a radial web with multiple interconnections and linkages, in which local markets permeate each other and in which a few players dominate the scene. The size or importance of some of these players (the term SIFIs is now in vogue) is a source of concern globally and nationally. The dangers of SIFIs remind me of the image of the baobabs in The Little Prince:

The Little Prince
Antoine du Saint Exupéry
'The baobabs'

There were some terrible seeds on the planet that was the home of the little prince, and these were the seeds of the baobab. (...) A baobab is something you will never be able to get rid of if you attend to it too late. It spreads over the entire planet. (...) And if the planet is too small and the baobabs are too many, they split it into pieces. (...) After explaining how he cleaned the seeds of the baobabs everyday he added: 'Sometimes, there is no harm in putting off a piece of work until another day. But when it is a matter of baobabs, that always means a catastrophe. (...) [T]he danger of the baobabs is so little understood, and such considerable risks would be run by anyone who might get lost on an asteroid, that for once I am breaking through my reserve. (...) I say plainly, 'watch out for the baobabs'.
'The Little Prince' by Antoine du Saint-Exupéry

SIFIs

Systemically important financial institutions or SIFIs are institutions that are so important for the functioning of the financial system that their problems (in particular, their failure) can trigger systemic risk.

SIFIs – according to the FSB Recommendations of October 2010– are financial institutions 'whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity'. Though as individual institutions SIFIs may be subject to micro supervision (SIFIs can be part of the shadow banking system and thus subject to lesser regulation or no regulation), their systemic significance requires effective macro prudential supervision.

In the US, thee Dodd Frank Act 2010 deals with the definition, supervision and resolution of SIFIs, which are referred as 'non-bank financial companies' with systemic significance. Under Section 113 (a)(1) of the Act, the Financial Stability Oversight Council (FOSC) may determine that a SIFI ('non-bank financial company') should be subject to the supervision of the Federal Reserve System 'if material financial distress … or the nature, scope, size, scale, concentration, interconnectedness or mix of activities … could pose a threat to financial stability of the United States.'

SIFIs and TBTF

- Before 2008 the term too big to fail (TBTF) was mostly associated with size and with banks. TBTF institutions were typically too-big-to-fail banks. However, Bear Stearns in 2008 brought a new dimension to this doctrine: some institutions were too interconnected to fail; AIG confirmed this dimension. (And the problems in Iceland in 2008 showed that some institutions were too big to save). The fiscal problems..The TBTF doctrine has moved from banks to securities firms and insurance companies. Systemic risk is as likely to arise from securities and derivatives markets as it is from banking markets.
- Today's SIFIs are an extension of the TBTF doctrine. Some institutions are considered to be too important to fail and/or too complex to manage, and if they are too complex to manage, they are obviously to too complex to control/supervise
- A major challenge lying ahead is the boundary problem or perimeter issue. Once a definition of SIFI or global SIFI is established, a clear boundary is drawn and with it an incentive for financial institutions to position themselves on one side or another of the boundary, whichever seems more advantageous. The definition of a SIFI is also dynamic: what is systemic today is not necessarily what will be systemic in future. And the fact that most systemically significant financial institutions have a cross border dimension, calls for a cross-border solution, supra-nationally and/or internationally, in particular with regard to their recovery or resolution.

Sovereignty

- In order to understand financial regulation in a global market we must reflect upon the notion of sovereignty:
- Sovereignty is the supreme power within a territory, the territory of the nation state. Thus, sovereignty has a territorial dimension, and the government is the political institution in which sovereignty is embodied. Sovereignty forms part of the fundamental principles of international law and is a key organizing concept of international relations. But it is a principle rooted in history. The modern understanding of the attributes of sovereignty was developed in the Renaissance. Indeed, politics operated without this organizing principle in the Middle Ages.

Sovereignty and governance

- When it comes to modern financial markets, sovereignty is an inadequate principle to deal with financial conglomerates, complex groups and, generally, with cross border institutions and markets. It is not a good principle to deal with crisis management either, nor with the home/host country divide. Like a tsunami that does not respect territorial borders, the effects of a financial crisis spread beyond geographic frontiers. You cannot fight it only with national measures.
- In some parts of our modern life we need to move beyond national sovereignty. This has happened already in some regional areas, such as the European Union, where countries have been ready to make sacrifices in terms of national sovereignty for the sake of European unity. And it happens whenever countries sign international treaties.
- Power is diffused. It is exercised by a variety of actors including international organisations, multinational corporations, non-governmental organizations, and the civil society too. The political and economic stage is now crowded with new actors who operate across borders as well as within them. And in this stage, financial institutions have become important holders of power and agents of governance given their key role in the allocation of capital.

The impact of regionalization and globalization upon financial law

- The quest for international law in money and finance is a logical response to the increasing globalization of financial markets. It is also a response to the need to prevent and contain contagious systemic risk, a risk that does not respect geographic boundaries.
- The crisis showed that national financial markets cannot be looked in isolation. A fragmented global regulatory and accounting regime gives rise to regulatory arbitrage ('forum shopping'), loopholes and shadow institutions and markets; it also increases transaction costs and can lead to financial protectionism. Incompatible or conflicting rules from country to country increase the regulatory costs and can create new risks. Regulatory competition can also lead to a race to the bottom.
- Globalization has magnified the impact and geographic outreach of systemic risk. **And the globalization and liberalization of financial markets have proceeded at a much faster pace than the development of an appropriate international legal and institutional framework.**

Overlapping jurisdictions

- The financial crisis exposed the limitations of relying upon a loose network of soft-law standard setters and an inadequate system of resolution of financial crises.
- Financial markets need to rely on different levels of governance. An analogy with football (soccer) can be instructive in this regard. There are domestic leagues, ruled by national football associations, there is in Europe a Champions League governed by UEFA, and finally – though this is a competition among countries not clubs – there is FIFA and the World Cup. Some institutions play locally, while others compete in the European or global stage.
- We need to identify the functions (or sub-functions) that require a supra-national or international structure and the functions that are best left at the national level. When it comes to financial markets, there are three key functions that are necessary to achieve the elusive goal of financial stability and these are: regulation (or rule-making), supervision (risk control, monitoring and compliance) and crisis management (lender of last resort, deposit insurance, resolution, insolvency).
- The major obstacle is enforcement. The other major challenge is the fiscal issue.

Overlapping jurisdictions

- Monetary and financial law are nowadays characterised by the existence of overlapping jurisdictions, by a multi-layered structure that combines a national dimension, a regional dimension and an international dimension.
- This is particularly clear in the European Union, where national developments in monetary and financial law overlap with developments at the EU level and with international developments and obligations imposed by membership of international organizations.
- Juxtaposition of areas of jurisdiction. National supervision versus supranational monetary policy, national supervision and international markets …
- Challenge: Cross-border resolution of crisis. Financial markets have grown international in the last few decades, though regulation remains for the most part nationally based, constrained by the domain of domestic jurisdictions.
- **Home and host country issues**

Monetary 'architecture' (monetary stability)

- National level
  - Main actor: Central bank
- European level
  - Main actor: ECB
- International level
  - Main actor: IMF

Financial architecture (financial stability)

- Nat'l fin'l architecture (several actors which vary from country to country)
  - Regulation and supervision
  - Financial stability
  - Crisis management
- EU fin'l architecture (See Chart)
  - Regulation
  - Supervision
  - Financial stability
  - Crisis
- Int'l fin'l architecture

International financial architecture (continued)

- **Regulation** (multiple actors) FSF (FSB) and others
  - Soft law & hard law
  - Private law and public law
- **Supervision**
  - IMF surveillance, FSAP and ROSCs*; others (FATF)
- **Financial stability**
  - "The objective of 'international financial stability' often appears as elusive as the pursuit of the 'holy grail'."
- **Crisis management**
  - Private and public
  - National and international

*ROSCs- Reports on Observance of Standards and Codes – **A** note on standards
FSAP- Financial Sector Assessment Program

September 2008

Causes of the crisis

In a paper with G.Wood we divide explanations for the crisis into ten, not mutually exclusive, groups:

- **(1) Macro-economic imbalances;**
- **(2) Lax monetary policy;**
- **(3) Regulatory and supervisory failures;**
- **(4) Too big to fail doctrine and distorted incentives**
- **(5) Excesses of securitisation;**
- **(6) Unregulated firms, lightly regulated firms and the shadow banking system;**
- **(7) Corporate governance failures;**
- **(8) Risk management failures, bad lending, excessive leverage, complexity;**
- **(9) The usual suspects - greed, euphoria and others;**
- **(10) Faulty economic theories.**

- The first four groups put the blame on the authorities - governments, regulators, central bankers. The second five blame mainly the markets - financial products, managers, risk, greed, leverage. The last group (faulty theories) blames economists.

Causes of the crisis 2007-2009

- The too big to fail doctrine and distorted incentives. The belief that some institutions were too big to fail produced - and continues to produce - huge incentives to moral hazard.
- Excesses of securitisation. These were the 'causa proxima' of the crisis. The securitisation market grew, encouraged by accounting and capital rules, financial innovation, government housing policies to encourage home ownership amongst the poor (sub-prime), mortgage policies in the USA and in the UK and inadequate ratings (reliance on those ratings both for regulatory purposes and as a substitute for due diligence by the financial institutions themselves).
- Faulty economic theories. In the decades that preceded the 2008 crash, some economists relied with almost unquestioned and universal faith on the efficient market theory, and viewed markets as self-correcting mechanisms with rational expectations. Black hole with few formal international rules in finance. ***Finance is still mostly regulated at the national level.***

Crises will always be with us. Kindleberger/Minsky boom and bust.

Here's the song in *Mary Poppins*, that extols the virtues of what banks do with people's savings:

If you invest your tuppence
Wisely in the bank
Safe and sound
Soon that tuppence,
Safely invested in the bank,
Will compound
And you'll achieve that sense of conquest
As your affluence expands
In the hands of the directors
Who invest as propriety demands
You see, Michael, you'll be part of
Railways through Africa
Dams across the Nile
Fleets of ocean greyhounds
Majestic, self-amortizing canals
Plantations of ripening tea
All from tuppence, prudently
Fruitfully, frugally invested
In the, to be specific,
In the Dawes, Tomes, Mousely, Grubbs
Fidelity Fiduciary Bank!

Anyone who has seen the film or the musical remembers that these 'tuppence' trigger the bank run...

Regulatory responses to the crisis

- The first group looks at the substance of regulation, at the 'what to regulate', with new rules (or proposed rules) for capital, liquidity etc. Basel III is an example of this type of responses. The answer may combine more regulation with more transparency and with litigation.
- The second group looks at the structure of supervision, at the 'how' and the 'who', and the intensity of supervision. E.g., Dodd-Frank Act, new structure in the UK, EU. All nationl 'architectures', whether one authority, twin-peak, or many regulators, failed to prevent the crisis (Garicano and Lastra, 2010). A distinction is now made between macro-prudential supervision and micro-prudential supervision.
- The third group concern the behaviour of the banking industry and bank management, through better risk management, better corporate governance, or simply the responsibility that comes with the banking job: the need to internalize the costs of protection.
- A fourth group of focuses on the fiscal side, the problem of 'extracting rents' (rather than merely profit taking) in a banking and financial market largely subsidized by governments' rescue packages, monetary & fiscal policies. TBTF. Acute moral hazard problems persist.
- Fifth are the bank structural reforms . Debate of 'utility banking' vs 'casino banking'. Amon Kotlikoff has proposed the 'mutualisation' of the financial industry, John Kay has advocated narrow banking; Volcker rule; break the banks etc.)

The multiplicity of objectives and the allocation of these objectives

- Consumer protection
- Conduct of business
- Financial stability
  - Prevention
  - Crisis management
- Competition
- Social considerations
- Others (avoid undue concentration of financial resources, prevent the use of the financial system for financial crime/ML, educate the public/increase awareness)

Types of regulation

- Prescriptive rules vs general principles
- Entry provisions, competitive rules, mandatory rules (capital and lending), disclosure requirements
- Preventive – protective

- *Ex ante* measures to strengthen the financial system should comprise a mix of better regulation and supervision, responsible risk management and improved corporate governance.
- *Ex post* mechanisms should continue to include the lender of last resort role of the central bank, a well designed deposit insurance scheme, as well as early intervention, contingency planning and credible resolution procedures (including insolvency proceedings) both for banks and for non-banks, thus tackling the too-big-to-fail problem and the multiple variants of this doctrine during the crisis (too interconnected to fail, too many to fail, too complex to fail, too big to save, etc.). The problem with guarantees; types of guarantees (explicit, implicit); moral hazard

Summary of Regulatory responses

- **What to regulate**
  - **Bank Capital Regulation: Basel I, Basel II, Basel III (liquidity)**
  - **Cross border resolution**
  - **Other issues (compensation, shadow banking etc)**
- **Who regulates and How to regulate and intensity of supervision**
  - **Structural/architectural issues**
  - **Micro and macro prudential supervision**
  - **Structural reforms**
- **Bankers' behaviour, corporate governance, risk management**
- **Fiscal side and compensation**

Macro prudential supervision (view of the forest)

Basel I, Basel II & Basel III

- Basel I is simple
- Basel I is short
- Basel I broad acceptability
- Basel I adopted one-size-fits-all approach to risk
- Basel I is a formula

- Basel II complex
- Basel II extensive
- Basel II raised scepticism
- Basel II risk sensitive
- Basel II combined formulas, models and incentives
- Never adopted US

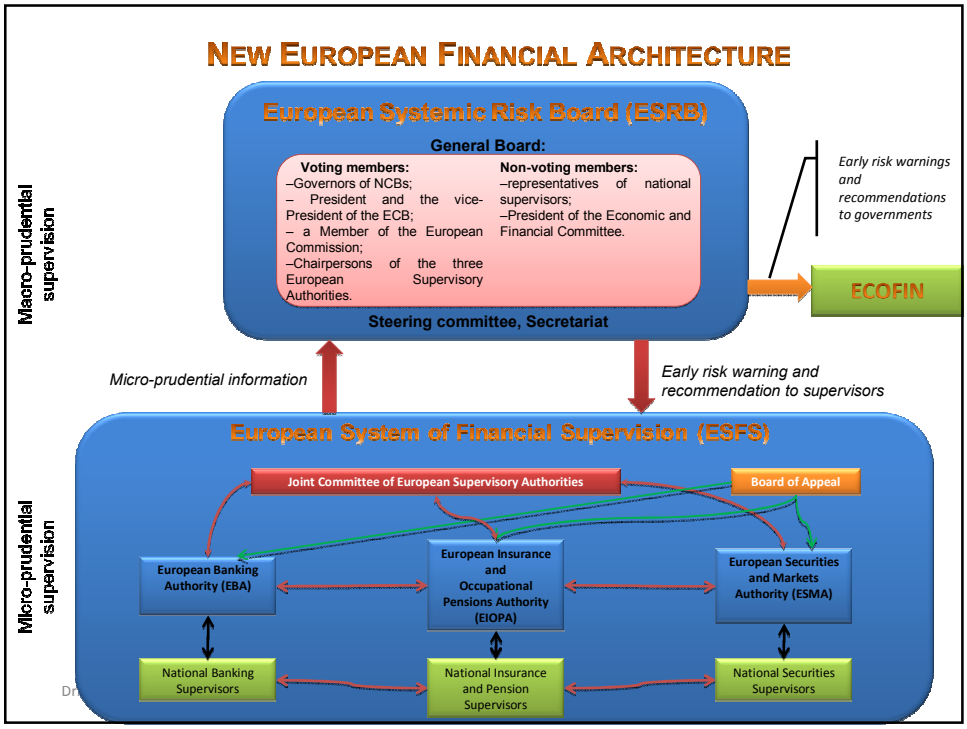
- Basel III combines capital & liquidity
- More economic capital – tier 1
- Long transitional period (Basel IV?)
- Provisioning
- Net stable funding ration and Liquidity coverage ratio

Cross Border Resolution

- The dichotomy between international markets and national law and regulation is acute when it comes to cross border resolution and crisis management. **Institutions (like Lehman Brothers) may claim to be global when they are alive; they become national when they are dead.**
- In any financial crisis, it is necessary to have a clear and predictable legal framework in place to govern how a financial institution would be reorganized or liquidated in an orderly fashion so as not to undermine financial stability. We do not have such a framework yet with regard to cross-border banks, neither at the European level nor at the international level.
- In the aftermath of Lehman Brothers, no one wishes another chaotic resolution. The alternative, a 'bail-out' package, is equally unpalatable. A viable solution between chaos and bail-out is an orderly resolution.
- By analogy with the WTO's dispute settlement, which is a central pillar of the multilateral trading system, in the field of international finance we need to devise appropriate mechanisms for the settlement of financial disputes.
- The crisis has shown that the pursuit of the private interest is at times greatly misaligned with the pursuit of the common good and that, <u>with cross border banks and financial institutions, national solutions alone or uncoordinated national solutions are not enough to combat systemic risk.</u>

EU Responses to the financial crisis

- Supervisory overhaul – from Lamfalussy to De Larosière
- Regulatory measures (capital req. directive, rating agencies regulation, alternative investment funds)
- Monetary policy measures .
  - Standard - interest rate reductions &
  - non standard - purchases of government bonds – Securities markets programme
- Liquidity Assistance (ECB) - expanded list of assets accepted as eligible collateral for refinancing operations. Enhanced credit support measures
- **State aid measures (**approval of national measures) and incipient framework for crisis management.
- Rescue packages, despite no bail out clause and no economic/fiscal union
  - **European Financial Stabilization Mechanism (122 TFEU, 100.2 ECT) - £60Bn**
  - **European Financial Stability Facility (national law) - £440Bn**
  - **European Stability Mechanism:**
- The European Council of 28-29 October 2010 agreed "on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole" and invited "the President of the European Council to undertake consultations with the members of the European Council on a limited treaty change required to that effect, not modifying article 125 TFEU ("no bail-out clause")." The European Council mentions among the general features of a future new mechanism three important elements: "the role of the private sector, the role of the IMF and the very strong conditionality under which such programmes should operate". Following the simplified procedure of Article 48 par 6, the revision will add a third paragraph on Article 136, of the chapter of the TFEU, which includes "Provisions specific to Member States whose currency is the euro". It will read as follows: "**3.** ***The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.***"



Regulation and ethics

- We need regulation to ensure appropriate behaviour
- Laissez faire proponents argue that it is unfettered free market that encourages virtue and government regulation that destroys it…
- But lack of regulation (e.g., rating agencies) or inadequate regulation (capital, liquidity…) contributed to the crisis…
- The real problem today is how to reconnect the interests of bankers with the rest of society'
- ***Finance* needs to be re-designed after its misuse. It needs to go back to being an *instrument directed towards improved wealth creation and development*.**

Market discipline and self regulation

"Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief…" Greenspan, October 23, 2008

Redrawing the boundaries

- Until the 1980s: public ordering, state planning and ownership, intervention & pervasive regulation, 'closed' economies, dominance of administrative law. (Salacuse: Development Model I). I
- Following the collapse of communism. Reliance on markets, private ordering, privatization, deregulation, openness. Dominance of commercial law: from plan back to contract. (Development Model II)
- Fatigue with the Washington Consensus, a reassessment of the functions of the State – public and private sector have both an important role to play.
- After the crisis: state support, redistribution and exit strategies. The boundaries between the state and the market have been again redrawn. Regulation is the price to pay for greater protection. Regulation is the price for protection. Rainy days and sunny days. The aim is not to protect institutions, nor shareholders, but the system (access to critical banking functions – payment system - in a crisis is essential) and depositors.

Concluding observations

- Capitalism relies on the lure of wealth (privatisation of gains) and the discipline imposed by the fear of bankruptcy (privatisation of losses). The time is ripe to reassess issues of bank structure, incentives (profit maximisation) and compensation in the light of this 'logic of capitalism'.
  - Link between banking problems and fiscal problems (& sovereign debt crises).
  - The perimeter/boundary problem, TBTF (need to price implicit guarantee and to ensure competition) and cross border dimension remain the major challenges
  - Global problems require global solutions. The limitations of sovereignty as an organising territorial principle that forms the anchor of the nation state are all too clear when it comes to global finance.
- Need for effective disciplinary dialogue. A certain belief in the superiority of mathematics, game theory and modelling over what were perceived as less rigorous disciplines - law, political science, psychology, sociology, history - permeated much research and teaching in economics & finance departments. But confidence and trust – the foundation of enterprise and development – is supported by a legal framework. That framework provides certainty, continuity and predictability of contract and property rights.

The future of financial regulation

- By analogy with the WTO's dispute settlement, which is a central pillar of the multilateral trading system, in the field of international finance we need to devise a system of hard law rules (not simply soft-law standards) and an appropriate mechanisms for the settlement of financial disputes. These functions could be undertaken by a new WFO or by the granting of a new mandate to existing institutions (IMF, FSB).
- In the quest for better financial regulation we need to move beyond the boundaries of the State. And we need international and comparative law to make substantial progress. The creativity of the legal mind – which is nurtured in this Institute - can surely raise to the challenge.

So what are the functions that require an international financial architecture?

- We need better observance of the standards to ensure competitive equality amongst nations
- We need a mechanism to ensure the consistent application of global financial rules
- We need a forum to bring disputes when standards are not observed.
- We need effective sanctions in the case of non-observance
- We need effective macro prudential supervision that pools the data gathered by different national supervisory authorities (e.g., on RRPs, leverage, mortgage markets etc).
- We need legitimacy, accountability and adequate resources

‘We can’t solve problems using the same kind of thinking that we used when we created them’