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Not All Financial Regulation Is Global

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“All politics is local,” as the saying goes, but all economics is global, and regulation is one area where these two realities meet and conflict.¹ This has been particularly true for financial regulation in the wake of the unprecedented financial crisis.

The newly prominent Group of Twenty (G-20) heralded financial regulation as a top priority. But almost two years on, many, especially in Europe, feel that the results have not matched the initial ambition. This warrants a reconsideration of the global financial regulatory agenda. All things being equal, consistent regulatory choices across the globe are

preferable, but achieving consistency involves difficult political and economic tradeoffs.

THE RISE OF GLOBAL FINANCIAL REGULATION

“Financial regulation” usually is a cluster of interrelated policies designed to ensure the proper functioning and integrity of the financial system, including public regulation and supervision of bank capital, leverage, liquidity, and risk management; control of moral hazard and financial industry incentives; customer protection; and regulation of capital markets. Capital flow controls, prevention of money laundering, and taxation of financial activities can overlap with this agenda but are not part of it in a strict sense.

Until the 1970s, financial regulation developed almost exclusively as a national endeavor. In 1974, the international ripple effects of the bankruptcy of Germany’s Herstatt Bank led to the formation by the G-10 central bank governors² of the Basel Committee on Banking Supervision (BCBS) hosted by the Bank for International Settlements (BIS, established 1931). In the 1980s, as the savings and loan crisis led to tighter capital regulation in the United States, American banks successfully argued that equivalent regulation should be imposed on banks in other jurisdictions, especially Japan. Thus in 1988 the BCBS produced the first Basel Capital Accord. Risk weighting under this agreement was subsequently found too crude to be effective, and in 2004 the BCBS produced a new accord known as Basel II.

Separately, a global financial reporting and auditing framework emerged, at first as a private-sector initiative by the international accounting profession through the International Accounting Standards Committee (IASC) in 1973 and the International Federation of Accountants (IFAC) in 1977. The IASC was made independent from professional bodies in 2001 and renamed the International Accounting Standards Board (IASB). Many countries have agreed to adopt the IASB’s International Financial Reporting Standards (IFRS) following

1. Credit is due to Michael Gadbow for this use of the late US politician Tip O’Neill’s proverbial saying on politics.

2. The G-10, established in 1962, is composed of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States, as well as Switzerland, which formally joined in 1983.

Table 1 Major crises and international financial regulatory initiatives

Crisis	Initiative/institution	Period
First World War/German reparations	Bank for International Settlements	1931
Great Depression/Second World War/postwar reconstruction	International Monetary Fund, World Bank, Organization for Economic Cooperation and Development	1945–48
Herstatt Bank failure	Basel Committee on Banking Supervision	1974
Latin-American crisis/savings and loan crisis	Basel Capital Accord	1988
Transition in former communist countries	European Bank for Reconstruction and Development	1991
Asian financial crisis	Financial Stability Forum, Financial Sector Assessment Program, G-20	1999
Enron/various accounting scandals	International Forum of Independent Audit Regulators	2006
Global financial crisis	G-20 Summits, Financial Stability Board	2008–09

the pioneering decision of the European Union in 2000–02.³ Securities regulators coordinate at the global level through the International Organization of Securities Commissions (IOSCO), created in 1983 from a preexisting pan-American regional association formed in 1974. Insurance oversight is discussed within the International Association of Insurance Supervisors (IAIS), established in 1994. Public-sector audit supervisors, set up in the United States and elsewhere after accounting scandals including the Enron collapse in the early 2000s, established in 2006 the International Forum of Independent Audit Regulators (IFIAR).

Beyond these sector-specific initiatives, the emerging-market crises of the late 1990s proved that vulnerable financial firms could cause international macroeconomic instability. In response, finance ministers and central bankers from developed and developing countries gathered in different groupings, successively the G-22 (1998), G-33 (early 1999), and eventually the G-20 (late 1999). Simultaneously, developed countries established the Financial Stability Forum (FSF) to enhance their coordination and foster global standards. Also in 1999, the International Monetary Fund (IMF) was tasked with assessing national regulatory and supervisory frameworks through the Financial Sector Assessment Program (FSAP).⁴

The current crisis further enhanced the status of financial regulation from a technical issue dealt with by specialized bodies to a matter of relevance for political leaders. While the G-7/G-8, meeting since the 1970s, had tended to focus on international macroeconomic and trade issues, G-20 summits of heads of state and government since 2008 have looked extensively at financial regulation, which was the focus of no fewer than 39 out of the 47 action points in the first G-20

summit declaration (November 2008). In April 2009, G-20 leaders extended the FSF to major emerging economies and renamed it the Financial Stability Board (FSB). The membership of the BCBS and other Basel-based committees was also extended to all G-20 countries. See table 1 for an overview of how international financial regulatory initiatives have often followed major crises.

Because financial regulation only recently became a major international economic policy issue, the corresponding conceptual and analytical foundation is less solid than for, say, trade and international macroeconomics, which have been topics of intense economic research and negotiation for decades. The substantial body of literature on financial markets and intermediaries has long been tenuously linked to mainstream economics. The impact of many regulatory issues on specific market participants has also made this policy area prone to various forms of private-sector capture. Consequently, while it has gained great prominence, financial regulation remains a comparatively immature component of international economic policy.

THE NEW CONTEXT: MULTIPOLARITY AND REREGULATION

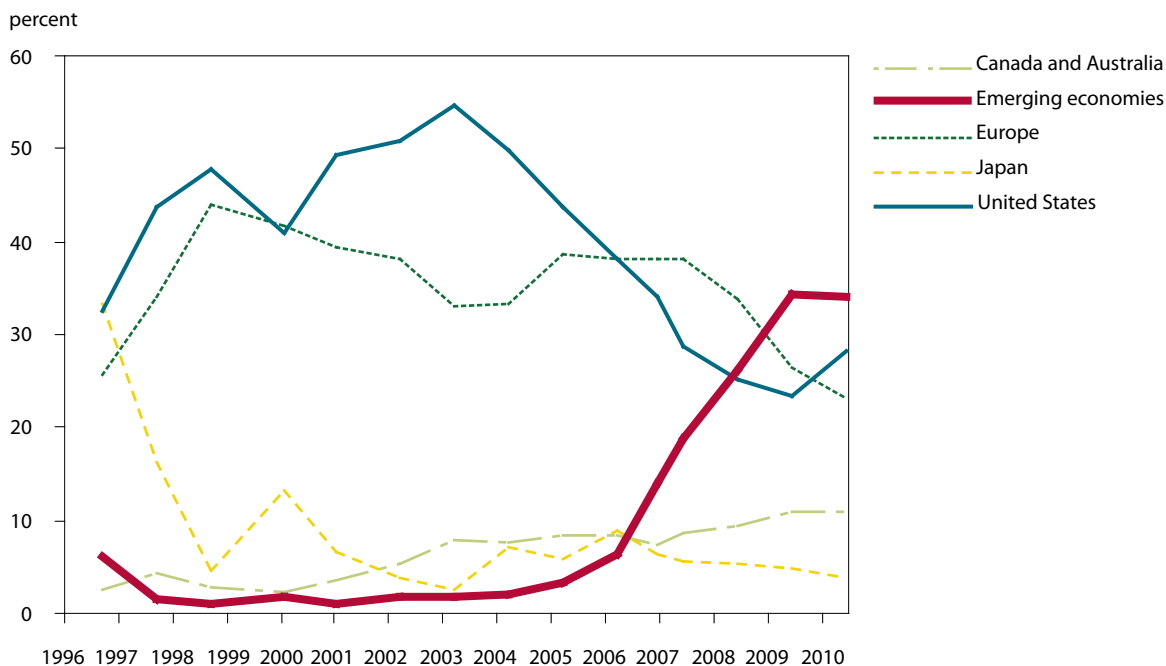
Two major shifts, financial multipolarity and reregulation, will shape policy outcomes. The first predates the crisis but was arguably reinforced by it, while the second is a direct consequence of it.

By **financial multipolarity** we mean that the geography of global finance is rapidly evolving from a mainly North Atlantic focus toward a much broader canvas. Notwithstanding the 1980s bubble in Japan, the joint dominance of the United States and Europe in financial matters has long looked resilient, in spite of the rapid catch-up growth of emerging-market economies. But the center of gravity of global finance is now

3. The United States is the main outlier. Japan has not made IFRS mandatory but allows companies to use them instead of national standards.

4. This program is jointly operated with the World Bank when applied to developing countries.

Figure 1 Distribution of global 100 largest listed banks, 1996–2010



Note: Distribution of aggregated market capitalization by country of headquarters.

Source: FT Global 500 rankings; authors' calculations.

moving eastward. Among the world's 100 largest listed banks by market capitalization, the share of emerging markets has surged from almost none to over a third, more than either the United States or Europe (figure 1). Part of this surge is explained by the extraordinary rise in value of major Chinese banks since their initial public offerings in 2005–06. Even though their international activity remains limited at the moment, these new entrants represent a major change in the global landscape.

A similar picture emerges when one looks at global financial centers rather than firms. Table 2 shows Asian centers to be hot on the heels of London and New York in the global pecking order.⁵ To chase high savings and sovereign wealth, asset management teams, which a decade ago would have chosen London or New York as their obvious location, increasingly base themselves in Dubai, Hong Kong, or Singapore.

Over the next decade, the combination of deleveraging in the West and continued financial development in emerging economies will certainly reinforce the trend toward multipolarity, with a resulting power shift in the global financial policy debate, even though emerging countries have been discreet on

these issues so far. An additional factor is that the crisis has dented what previously appeared to be Western intellectual leadership in financial matters. Overall, it appears fair to conclude that while the trend toward financial multipolarity well predated the crisis, it was significantly accelerated by the crisis, the most obvious illustration being the sudden shift of power from the G-7/G-8 to the G-20.

Financial reregulation refers to the heightened concern of policymakers in developed economies about financial stability and corresponding disillusionment with the economic benefits of unfettered finance, leading them to constrain the financial industry in new ways. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act of July 2010 in the United States introduces significant changes in many areas and is contrary to most suggestions from the financial industry.⁶ The European Union has similarly initiated new financial legislation. In emerging economies, finance is typically more tightly regulated and in many cases largely or almost totally state-owned.⁷ Several such countries may further liberalize their financial systems to boost credit devel-

5. Unfortunately, both rankings were introduced too recently to be used to analyze mid-term trends.

6. See, for example, Graham Bowley and Eric Dash, "Wall St. Faces Specter of Lost Trading Units," *New York Times*, August 6, 2010.

7. Patrick Foulis, "They Might Be Giants," Special Report on Banking in Emerging Markets, *Economist*, May 15, 2010.

Table 2 Global financial centers

International Financial Centers Development (IFCD) Index		Global Financial Centers Index	
New York	88.4	London	775
London	87.7	New York	775
Tokyo	85.6	Hong Kong	739
Hong Kong	81.0	Singapore	733
Paris	72.8	Tokyo	692
Singapore	70.1	Chicago	678
Frankfurt	64.4	Zurich	677
Shanghai	63.8	Geneva	671
Washington	61.1	Shenzhen	670
Sydney	59.5	Sydney	670

Sources: Xinhua–Dow Jones IFCD Index, July 2010; Z/Yen and City of London, *7th Global Financial Centers Report*, March 2010.

opment and growth, as Raghuram Rajan (2009) recommends in the case of India. But this is unlikely to hamper the drive toward reregulation in richer economies with a high level of financial development.

Reregulation should not be seen as a sudden, across-the-board paradigm change, but rather as a long-term trend reversal. While much financial business remained highly regulated, there was a general trend toward liberalization and reliance on market discipline during the two decades that preceded the crisis. The new trend does not mean that all financial activities will be regulated in the years ahead, but it is nevertheless making its impact felt, is attracting solid cross-partisan political consensus in most major developed economies, and will probably not go away any time soon.

LIMITS AND PRIORITIES OF INTERNATIONAL COLLECTIVE ACTION

The consequences of financial multipolarity and reregulation may be more profound and wide-ranging than has been often acknowledged. They make global financial regulatory harmonization a more distant prospect than was the case before the crisis. It is easier to harmonize when one country or one bloc dominates than when many diverging voices need to concur for a decision to be made. It is also easier to harmonize rules in an era of deregulation, by reaching agreement on a low common denominator, than when expectations are raised as to what the rules should achieve and these expectations may differ from one jurisdiction to another.

In today's multipolar financial world, levels of financial development vary hugely. As a consequence, not only do preferences differ but also governments' interest in financial

regulation, and technical capacity to discuss it, are unequal. In certain cases, authoritarianism or a fierce commitment to sovereignty may limit the scope of global agreement. By the same token, multipolarity means that the range of financial regulatory issues on which developed countries can negotiate an agreement and then impose it on the rest of the world is dwindling rapidly. These limitations are likely to become increasingly visible in the next few years. In the current context, harmonization efforts may lead only to weak global standards, necessarily complemented by tougher rules in countries with higher regulatory expectations. This is far from condemning global discussions to irrelevance but means that expectations on their results must remain measured.

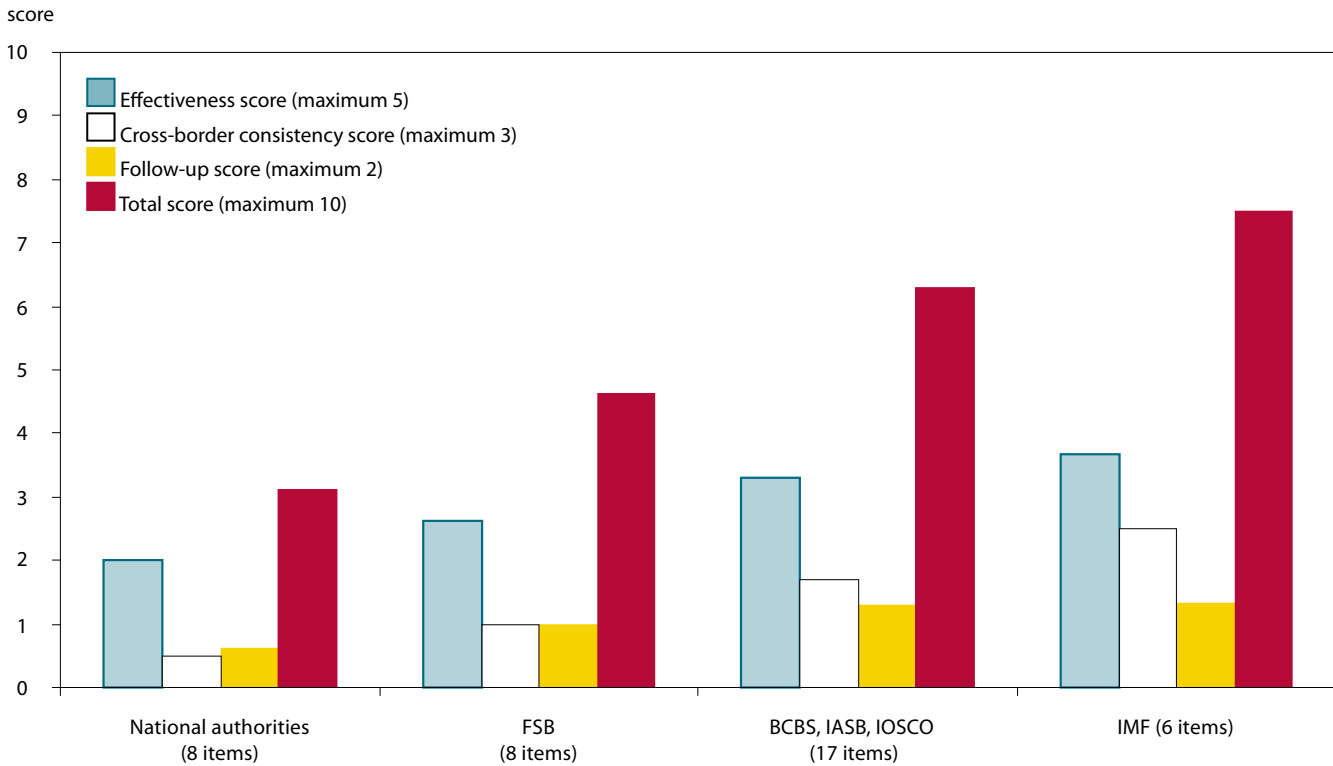
The shift to reregulation also transforms the position of several actors, especially the European Union. In the previous phase, EU institutions were instinctively internationalist, as global initiatives could be effective drivers of intra-EU harmonization. The adoption of IFRS in 2000–02 is a quintessential case. It enabled unification of accounting standards throughout

Financial integration is a global public good whose benefits may be at risk in an era of financial multipolarity and reregulation.

the European Union, where previous EU-only efforts to achieve that aim via directives had failed. But now, such dynamics are becoming unlikely as more EU-specific political objectives are fed into the regulations. This is illustrated not only by growing tensions between the European Union and the IASB (which themselves dampen the prospects of IFRS adoption in the United States) but also by other cases such as the Alternative Investment Fund Managers directive proposals. Reregulation is making the European Union more unilateralist and thus more akin to the United States as a power that instinctively thinks domestically before thinking internationally. It could even be argued that the European Union is at risk of falling behind the United States in international awareness, as Washington has appeared more mindful of international constraints in recent times—for example, the Dodd-Frank Act of 2010 gives rise to fewer problems of extraterritorial application than the Sarbanes-Oxley Act of 2002 had.

The combination of financial multipolarity and reregulation also reduces the relative effectiveness and increases the complexity of soft coordination, which in turn gives more salience to formal, often legally grounded processes. The high level of voluntary cooperation among central banks throughout the crisis provides a counterexample, but the unique specifi-

Figure 2 Scoring of implementation of financial regulation action items in the November 2008 G-20 declaration, by main decision-making institution



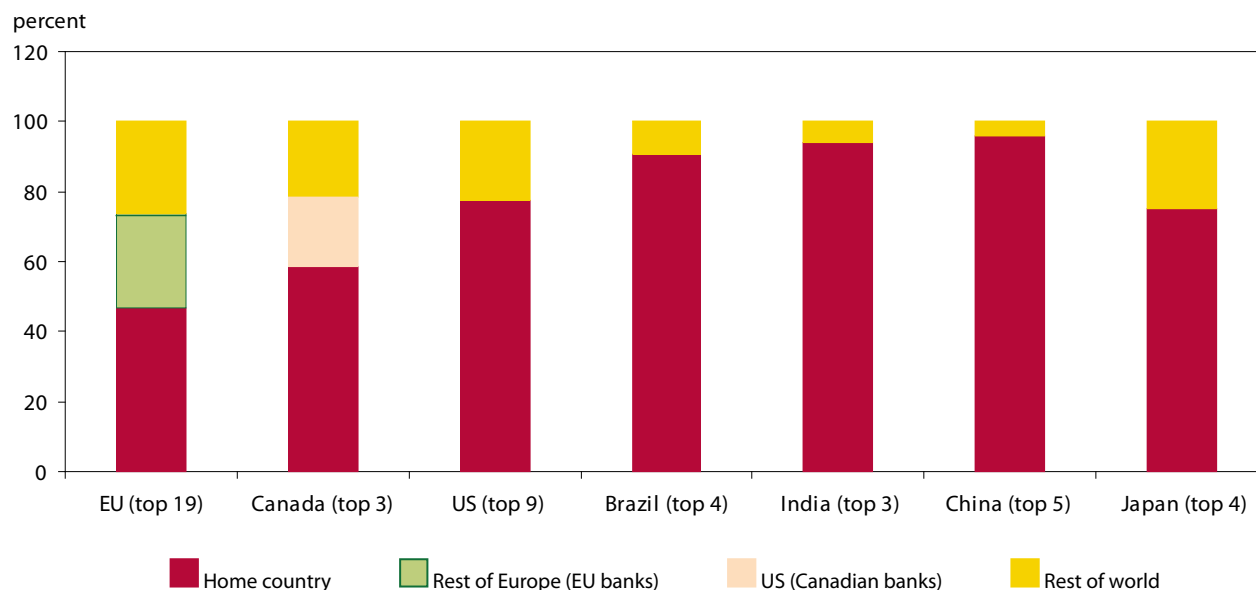
FSB = Financial Stability Board
 BCBS = Basel Committee on Banking Supervision
 IASB = International Accounting Standards Board
 IOSCO = International Organization of Securities Commissions
 IMF = International Monetary Fund
 Source: The data and methodology are detailed in Rottier and Véron (2010).

ties of central banking do not provide a template for regulatory policy. Figure 2 scores the 39 financial regulation action items in the first G-20 summit declaration. For each item, we have graded effectiveness of implementation, cross-border consistency, and follow-up initiatives so far. The analysis shows that the more the implementation of the action item depends on action by an international body with significant autonomy in administration and resources, the more effective the implementation.

Given the reluctance to delegate formal powers to the supranational level, which is accentuated by differences of financial-industry structures across jurisdictions (such as the dominance of universal banks in the European Union, state-owned banks in developing countries, and differences between common-law and civil-law systems), global financial regulation will be unable to provide a seamlessly integrated, global level playing field in which all financial intermediaries could compete fairly on all markets, independent of their country of origin.

From this perspective, it should not be a surprise if the eventual outcome of the “Basel III” discussion, due in November 2010, is not deemed demanding enough to meet the reregulation requirements of key countries, in spite of the achievement of concluding an extremely complex agreement in a fairly limited timeframe. Ambitious reregulatory targets were promoted by the United States and other countries in terms of capital and leverage ratios, as well as the definition of tier 1 capital. But due to the opposition of Japan and several European countries, the final compromise is likely to fall short of initial aims on these counts, which could result in some countries (possibly including the United States, United Kingdom, and Switzerland) “goldplating” it with additional requirements that would not be internationally harmonized. Conversely, some European countries may find the final compromise too lenient on investment banking activities and may impose extra capital charges on them.

Figure 3 Degree of internationalization of the largest listed banks in selected jurisdictions



Note: Average distribution of total 2009 revenue.

Sources: Corporate reports; authors' calculations. Mauricio Nakahodo's research assistance is gratefully acknowledged.

Separately, measures to tackle the moral hazard inherent in systemically important financial institutions, on which the FSB is to produce a report later this year, and more generally rules that shape the structure of the financial industry, such as the Volcker Rule in the United States, will predominantly belong to the national (or EU) level as the differences of structures of different banking systems multiply the political challenges to global convergence. Meanwhile, insistence on fiscal sovereignty makes it unlikely that strong supranational bank resolution regimes could emerge. Only the European Union may constitute an exception if it eventually adopts a crisis management framework such as that proposed by the IMF in March 2010 (Fonteyne et al. 2010, Strauss-Kahn 2010), and even this remains far from assured at this point.

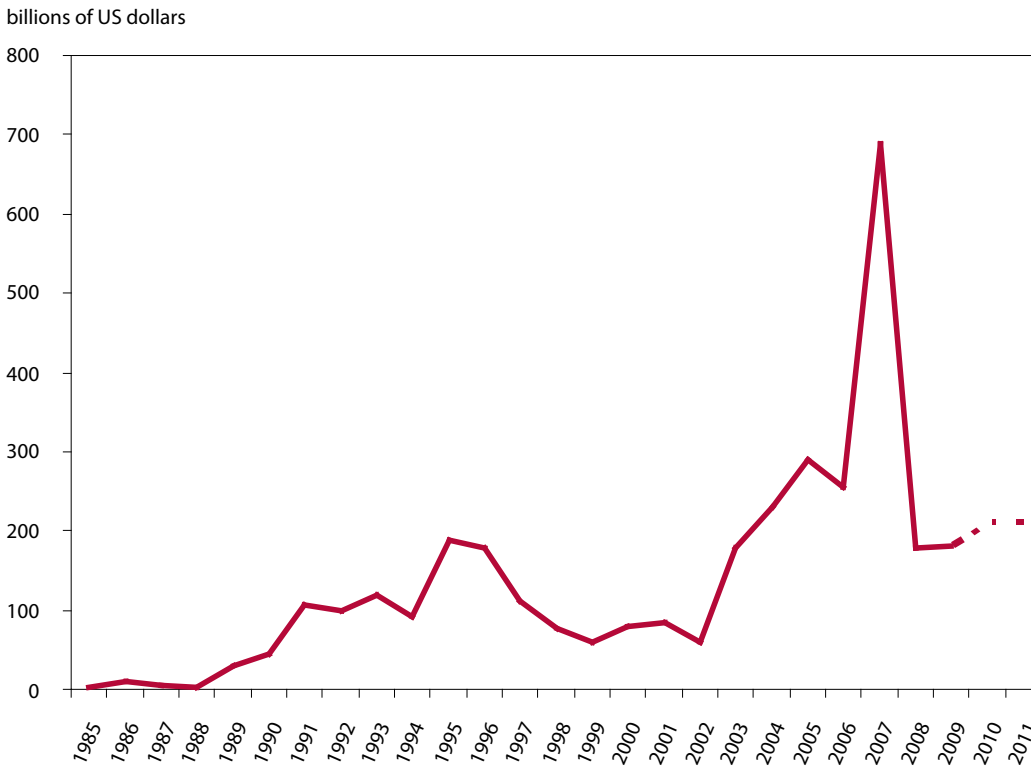
Fortunately, many aspects of financial stability policy can be effectively tackled at the local level, and diversity of approaches can even be beneficial. As figure 3 illustrates, international activity of large banks is typically less than one-quarter of the total. The main exception is the European Union, where a high level of cross-border integration and the commitment to a single market call for a strong supranational supervisory framework, which is currently being discussed. But elsewhere, even multinational groups do not require internationally uniform supervision. The likes of HSBC or Banco Santander illustrate that international synergies can arise from the leverage of technological prowess or consumer

service know-how, even with locally capitalized and funded subsidiaries that are subject to disparate supervisory standards. As for cross-border retail branches, they are a generally disappearing species following the Iceland's experience.

However, some crucial regulatory concerns can be addressed only at the global level. Without adequate global collective action, there is a risk of fragmentation of global capital markets. The economic benefits of global financial integration have been questioned in the case of developing economies (Rodrik and Subramanian 2009), and the Asian crisis in particular led international financial institutions to step back from advocating unlimited openness to foreign capital flows (IMF 2007). But for developed economies, and increasingly for emerging economies as well, there is wide agreement among economists that capital-market integration has a significant positive impact on growth, by broadening the pool of investors that capital-hungry economic actors can tap into, and conversely by broadening the range of investment opportunities for capital providers (see a development of this argument and extensive literature review in Cline 2010).

In other terms, and with due qualification, financial integration is a global public good whose benefits may be at risk in an era of financial multipolarity and reregulation. Reregulation enhances the risk of mutually incompatible policies leading to market fragmentation, and no single power can exert sufficient leadership, benevolent or otherwise, to

Figure 4 Net private financial flows to emerging and developing countries, 1985–2011f



Source: IMF World Economic Outlook database and forecasts, April 2010.

ensure consistency. The crisis itself has stalled the growth of cross-border financial flows to emerging countries, as figure 4 illustrates. Available data such as those collected by McKinsey Global Institute (2010) suggest that the same is true of global capital flows more generally.

A PRACTICAL AGENDA FOR GLOBAL CAPITAL MARKETS

To ensure the sustainability of financial integration, four components are essential. The first is **stronger global public institutions**. The current environment makes this difficult to achieve but at the same time more necessary, as the potential for effective voluntary coordination is eroded. Global public institutions help to provide a comprehensive analytical picture, set authoritative standards, and foster and monitor consistency of regulatory practice. Policymakers should build on existing bodies wherever possible, but where suitable bodies are unavailable, they must also be ready to create new ones. The G-20 can play a major role in empowering such institutions and granting them wide acceptance, but it cannot

claim to represent all countries and is bound to fail if it tries to micromanage individual topics. The overall geography of global public bodies, whose symbolic but also practical impact cannot be overstated, should be rebalanced, perhaps by relocating one of the Bretton Woods institutions in Asia.

Key pillars of a global financial body’s strength include (1) a transparent governance framework that clearly sets out its mission, properly identifies its stakeholders, and makes it accountable to them; (2) adequate and stable financial and human resources, avoiding funding mechanisms that could be leveraged by special interests to compromise the body’s independence; (3) sufficient access to relevant information, for which formal commitments by national or regional authorities may often be indispensable; and (4) practice that is consistent with its proclaimed aims.

As far as existing institutions are concerned, the current discussion on IMF governance reform should be concluded with a better representation of emerging economies, thus mirroring present and future financial multipolarity. The IASB should reform its governance model to make itself more directly accountable to its stakeholders, especially investors

who are the primary users of financial reporting and whose trust in IFRS standard-setting has tended to decrease in recent years. It should also reform its funding structure accordingly, streamline its oversight structures, and add public authorities from leading emerging economies to those that already control it through the Monitoring Board formed in early 2009. The BCBS should make its proceedings more open to outside scrutiny, beyond the central banking and supervisory

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community. The BIS and IMF should be formally guaranteed better access to nonpublic national data. And the status of the FSB, including its relationship (or lack thereof) with the BIS, should be clarified if this unique institution is to find a sustainable role in the global landscape. The FSB should also diversify the chairmanship of its work streams.

Second, **globally consistent financial information** is crucial. In addition to the governance changes suggested above, the IASB should better monitor how IFRS are applied, in liaison with local authorities. It should also insist on universal recognition of voluntary IFRS adoption by those issuers that desire it, instead of trying to have each of its standards made mandatory everywhere, which is an overly ambitious aim in the short term. Such measures are needed to prevent the risk of this unique experiment in global standard-setting being derailed.⁸

Equally important is to ensure better consistency of audits. Currently, audit firms are regulated only at the national level; IFIAR does not even have a permanent secretariat. The US Sarbanes-Oxley Act of 2002 attempted to grant US audit oversight authorities an extraterritorial mandate, but this has not been accepted internationally. A new global body (or dramatic stepping up of IFIAR's status) may be needed in the future to underpin the global integrity of audit processes.

Public information on financial risks should be dramatically enhanced, especially for financial-sector firms. Current

risk disclosure frameworks, whether as part of IFRS or Basel II ("third pillar"), have proved insufficient, and the malfunction of credit rating agencies in assessing structured products has compounded the problem. The publication of "stress test" results in the United States (May 2009) and the European Union (July 2010) was linked to the crisis and may not be made a regular process, but regulators must find a way to bring lasting improvement to financial risk disclosure. Additionally, public supervision of rating agencies, which is spreading at a rapid pace,⁹ should be very strongly coordinated at the global level in order to safeguard the global consistency of rating methodologies.

At an aggregate level, the degree of internationally comparable information currently available to the public on financial systems and markets, including disclosures on government finances and their support to financial firms, is entirely insufficient. It must be increased. Governments and supervisors should make a credible commitment to provide much more detailed, reliable, and frequent information, to be pooled at the global level by the IMF and/or the BIS and to be made publicly available in an appropriate form.

Third, **new arrangements are needed to enable and adequately supervise globally integrated capital-market infrastructure.** The "plumbing" that underpins markets for securities and derivatives is a big determinant of cross-border integration. Most prominently, the new trend to have over-the-counter derivatives cleared by central counterparties, or even migrated to organized trading platforms, is to be welcomed, but it increases the risk of fragmentation along geographical or currency lines of markets that until now had achieved global scale. Central counterparties are systemically important and quintessentially "too big to fail" financial institutions, which raises the question of how some form of fiscal backstop could be put in place if their supervision were to be transferred to the supranational level.

However, ex-ante burden sharing, or a formal agreement by all or most jurisdictions concerned about how to apportion the cost of an international bailout, is easier to envisage in this area than in the case of banks, given the relatively straightforward nature of the activity. Therefore, global or supranational supervision may come earlier to clearing (and perhaps trading) platforms than to cross-border banks. It is also an arguably more pressing need, given these players' central role in shaping global market integration.

8. These points will be further developed in a policy paper on accounting policy, whose publication by Bruegel is forthcoming.

9. Before the crisis, only the United States and a few other jurisdictions such as Argentina, Mexico, and South Korea formally regulated and supervised credit rating agencies. Now Australia, the European Union, India, and Japan have introduced regulation in this area, and several others are in the process of doing so.

Fourth, **capital-market intermediaries require a global playing field**. We argued in the previous section that retail banking regulation can largely be tackled by individual jurisdictions. However, the activity of investment banks and many nonbank capital market intermediaries tends to be more globally integrated, which is bound to create tensions in a world in which supervision is reinforced but remains far from internationally consistent. Recovery and resolution plans, or “living wills,” are a promising novel idea to ensure orderly management of failing globally integrated financial institutions, but they may increase fragmentation in the absence of an international resolution authority. Moreover, investment banking arms of universal banks from large countries benefit from the government guarantee on their home-country deposits and access to central-bank funding to an extent unavailable to competitors from small countries, which may be “too big to save” given limited fiscal capacity at home, and to pure-play investment banks, which do not have access to such guaranteed funding. There is no obvious solution at hand, and we may have to live for some time with serious competitive distortions, with players from smaller countries being placed at a structural disadvantage. More public discussion is needed on these challenges, which have been insufficiently debated until now. A stronger international competition policy framework may be part of the answer in order to fight damaging economic nationalism of governments as well as predatory behavior by intermediaries.

All in all, the future global financial regulatory landscape is more likely to resemble a Japanese garden, with new details and new perspectives emerging at each step, than a centralized and symmetrical *jardin à la française*. Consistency will not be uniformly achieved, the boundary between global and local decision-making will remain controversial and in flux, and a spirit of experimentation and institutional entrepreneurship will be required. As political philosopher Francis Fukuyama

put it in a lecture in 2005 at Yale University, “Creating new institutions that will better balance the requirements of legitimacy and effectiveness will be the prime task for the coming generation” (Fukuyama 2006). This statement certainly applies to financial regulation.

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