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NOT ALL FINANCIAL REGULATION IS GLOBAL

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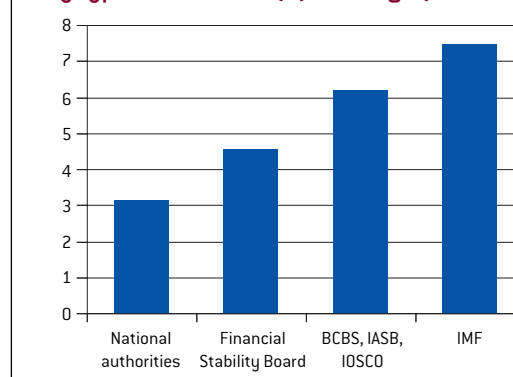
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SUMMARY The financial crisis has intensified the focus on financial regulation at global level, placing it at the top of the G20 agenda. However, global convergence is made more difficult by financial multipolarity, meaning the rise of emerging economies and its impact on decision-making at global level, and financial reregulation, or the trend towards stronger regulation of financial systems to buttress financial stability, particularly in developed economies. As a result, the ambitious objectives initially set by global leaders have so far not been turned into major international breakthroughs, and continued global capital-market integration can no longer be taken for granted.

POLICY CHALLENGE

The global harmonisation of all aspects of financial regulation cannot be achieved. Many elements of financial stability and customer-protection policy can be determined locally. Some competitive distortions and opportunities for regulatory arbitrage will remain inevitable. But action is needed at global level to prevent damaging fragmentation of capital markets. Policy makers should prioritise four key components: (1) building stronger global

Scoring of G20 financial regulation action points, by type of institution(s) in charge (max = 10)



Sum of scores on effectiveness, cross-border consistency and follow-up sorted by leading institution in charge. See Fig. 2 on page 5 for details.

public institutions, to get a comprehensive analytical picture, set authoritative standards, and foster and monitor the consistency of regulatory practice; (2) globally consistent financial information; (3) a globally integrated capital-markets infrastructure; and (4) addressing competitive distortions among global capital-market intermediaries.



AS THE SAYING GOES, ‘all politics is local’, but equally ‘all economics is global’ and regulation is one arena in which they meet and conflict¹. This has been particularly true for financial regulation in the wake of the unprecedented financial crisis. Financial regulation has been heralded as a top priority by the newly prominent G20. But almost two years on the feeling prevails, especially in Europe, 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 trade-offs.

1 THE RISE OF GLOBAL FINANCIAL REGULATION

‘Financial regulation’ commonly indicates a cluster of interrelated policies designed to ensure the proper functioning and the 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 in a strict sense about financial regulation.

Until the 1970s, financial regulation developed almost exclusively at national level. In 1974, the

international ripple effects of the bankruptcy of Germany’s Herstatt Bank led to the formation by the G10 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 US, 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 deemed 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 at the initiative of the private-sector 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 the pioneering decision of the European Union in 2000-02³.

Securities regulators coordinate at the global level through the International Organisation of

Securities Commissions (IOSCO), created in 1983 from a pre-existing 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 US and elsewhere after accounting scandals including the Enron collapse in the early 2000s, established the International Forum of Independent Audit Regulators (IFIAR) in 2006.

Beyond these sector-specific initiatives, the late-1990s emerging-market crises proved that vulnerable financial firms could cause international macroeconomic instability. In response, finance ministers and central bankers from developed and developing countries met in different forums, successively the G22 (1998), G33 (early 1999) and eventually the G20 (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 present crisis has further enhanced the status of financial regulation from a technical issue dealt with by specialised bodies to a matter of relevance for political leaders. The G7/G8, meeting since the 1970s, tended to focus on

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 G10, established in 1962, is composed of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the UK, the US, as well as Switzerland which formally joined in 1983.

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

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



Table 1: Major crises and international financial regulatory initiatives

First world war/German reparations	BIS	1931
Great Depression/second world war/post-war reconstruction	IMF, World Bank, OECD	1945-48
Herstatt Bank failure	BCBS	1974
Latin-American crisis/savings and loan crisis	Basel Capital Accord	1988
Transition in ex-communist countries	EBRD ⁵	1991
Asian financial crisis	FSF, FSAP, G20	1999
Enron/various accounting scandals	IFIAR	2006
Current crisis	G20 Summits, FSB	2008-09

international macroeconomics and trade, but G20 summits 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 G20 summit declaration (November 2008). In April 2009, G20 leaders extended the FSF to major emerging economies, and renamed it the Financial Stability Board (FSB). The memberships of the BCBS and other Basel-based committees were also extended to include all G20 countries.

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 only 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 regu-

lation remains a comparatively immature component of international economic policy.

2 THE NEW CONTEXT: MULTIPOLARITY AND REREGULATION

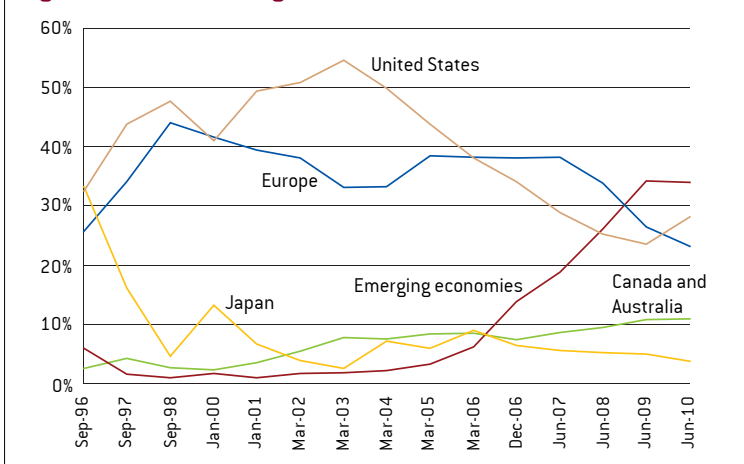
Policy outcomes will be shaped by two major shifts, which we may call financial multipolarity and reregulation. The first predates the crisis but was arguably reinforced by it, while the second is a direct consequence of it.

By **financial multipolarity** we mean that the geography of global finance is rapidly evolving from a mainly North-Atlantic focus towards a much broader canvas. Notwithstanding the 1980s bubble in Japan, the joint dominance of the US and Europe in financial matters has long looked resilient, in spite of the rapid catch-up growth of emerging economies. But the centre of gravity of global finance is now moving eastward. Among the world's 100 largest listed banks by market capitalisation, the share of emerging markets has surged from almost none to more than a third, more than either the US or Europe (Figure 1), part of which 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 for the moment, these new entrants represent a major change in the global landscape.

Looking at global financial centres rather than firms, a similar picture

5. European Bank for Reconstruction and Development

Figure 1: Global 100 largest listed banks, distribution 1996-2010



Distribution of aggregated market capitalisation by country of headquarters. Source: FT Global 500 rankings, authors' calculations.



emerges: Table 2 shows that Asian centres are hot on the heels of London and New York in the global pecking order.⁶ 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 towards multipolarity, with a resulting shift of power in the global financial policy debate, even if emerging countries have been discreet in these so far. An additional factor is that the crisis has dented what previously seemed to be western intellectual leadership in financial matters.

Financial reregulation refers to the heightened concern of policy-makers in developed economies about financial stability, and corre-

sponding disillusionment about the economic benefits of unfettered finance, leading them to constrain the financial industry in new ways. For example, the US Dodd-Frank Act of July 2010 introduces significant changes in many areas and contrary to most suggestions from the financial industry⁷. The EU has similarly initiated new financial legislation. In emerging economies, finance is typically more tightly regulated, and in many cases largely or almost totally state-owned⁸. Several such countries may in the years to come move towards further liberalisation of their financial system to boost credit development and growth⁹. But this is unlikely to hamper the drive towards 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 trend towards liberalisation and reliance on market discipline during the two decades that preceded the crisis. The new trend does not mean that no financial activities will escape regulation in the years ahead, but it is nevertheless making its impact felt and is attracting solid cross-partisan political consensus in most major developed economies.

3 LIMITS AND PRIORITIES OF INTERNATIONAL COLLECTIVE ACTION

The consequences of financial multipolarity and reregulation may be more profound and wide-ranging than has often been acknowledged. They make global financial regulatory harmonisation a more distant prospect than was the case before the crisis. It is easier to harmonise when there is hegemony of one country or one bloc than when many diverging voices need to concur for a decision to be made. It is also easier to harmonise 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 differ from one jurisdiction to another.

Today's multipolar financial world is one in which levels of financial development vary hugely. As a consequence, not only do preferences differ but governments' interest in financial regulation, and technical capacity to discuss

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

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

8. Patrick Foulis, 'They Might Be Giants : Special Report on Banking in Emerging Markets', *The Economist*, 15 May 2010

9. See for example, 'A Hundred Small Steps: Report of the Committee on Financial Sector Reform', headed by Raghuram Rajan, Government of India Planning Commission, 2009

International Financial Centres Development Index		Global Financial Centres 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

Source: Xinhua-Dow Jones IFCD Index, July 2010; Z/Yen and City of London, 7th Global Financial Centres Report, March 2010.



it, are also 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 regulatory issues on which developed countries can negotiate an agreement and then impose it upon 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, harmonisation efforts might only lead to weak global standards, necessarily complemented by tougher rules in countries with higher regulatory expectations.

The shift to reregulation also transforms the position of several actors, and especially the EU. In the previous phase, EU institutions were instinctively internationalist, as global initiatives could be effective drivers of intra-EU harmonisation. The adoption of IFRS in 2000-02 is a quintessential case. It enabled unification of accounting standards throughout the EU, 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 by growing tensions between the EU and the IASB (which themselves dampen the prospects of IFRS adoption in the US), but also by other cases such as the Alternative Investment Fund Managers Directive proposals. Reregulation is making the EU more unilateralist, as the US has

been for a long time.

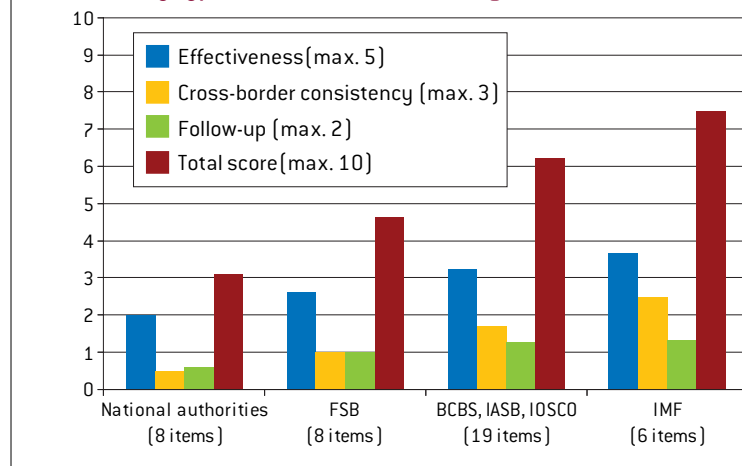
The combination of financial multipolarity and reregulation also reduces the relative effectiveness and increases the complexity of soft coordination, which in turn gives more salience to formal, often legally grounded processes. The high level of voluntary cooperation among central banks throughout the crisis provides a counterexample, but unique specificities of central banking mean this cannot provide a template for regulatory policy.

Figure 2 scores the 39 financial regulation action items in the first G20 summit declaration. For each item, we have graded effectiveness of implementation, cross-border consistency and follow-up initiatives until now. 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, accentuated by differences of financial-industry structures across jurisdictions (such as the dominance of universal banks in the EU, 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 can compete fairly on all markets, independently 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 several key countries (possibly including the US, UK and Switzerland) in spite of the achievement of concluding such a

Figure 2: Scoring of implementation of financial regulation action points in the November 2008 G20 Declaration, by type of main decision-making institution



The data and methodology are detailed in Stéphane Rottier and Nicolas Véron, 'An Assessment of the G20's Initial Action Items', *Bruegel Policy Contribution* 2010/08, available on www.bruegel.org.



complex agreement in a fairly limited timeframe. Similarly, 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 US, will predominantly belong to the national (or EU) level.

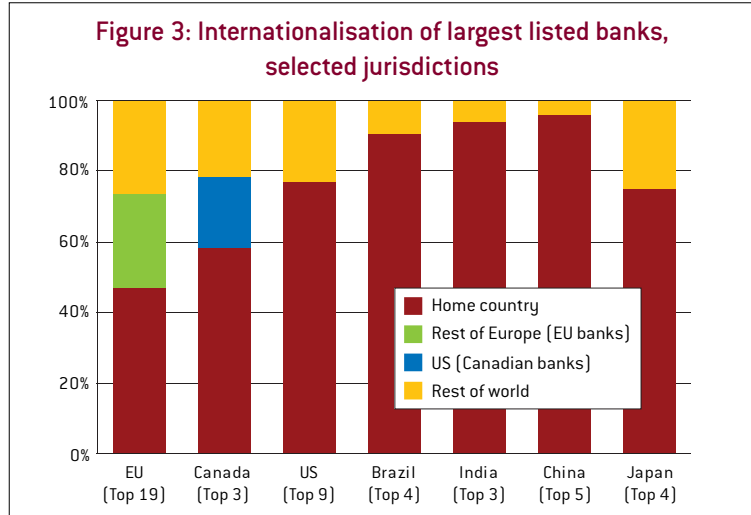
Fortunately, many aspects of financial stability policy can be effectively tackled at local level, and diversity of approaches can even be beneficial. As Figure 3 illustrates, the international activity of large banks is typically less than one-quarter of the total. The main exception is the EU, where 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 Santander illustrate that international synergies can arise from the leverage of technological prowess or consumer service know-how, even with locally capitalised and funded retail subsidiaries that are subject to disparate supervisory standards. As for cross-border retail branches, they are a generally disappearing species following the Icelandic experience.

However, some crucial regulatory concerns can only be addressed at global level. Without adequate

10. See for example Dani Rodrik and Arvind Subramaniam, 'Why did Financial Globalization Disappoint?', IMF Staff Papers 56:112-138, January 2009

11. International Monetary Fund, 'Repealing the Benefits of Financial Globalization', discussion paper prepared by the Research Department, June 2007

12. See William Cline, *Financial Globalization, Economic Growth, and the Crisis of 2007-09*, Peterson Institute for International Economics, May 2010, for a development of this argument and extensive literature review.

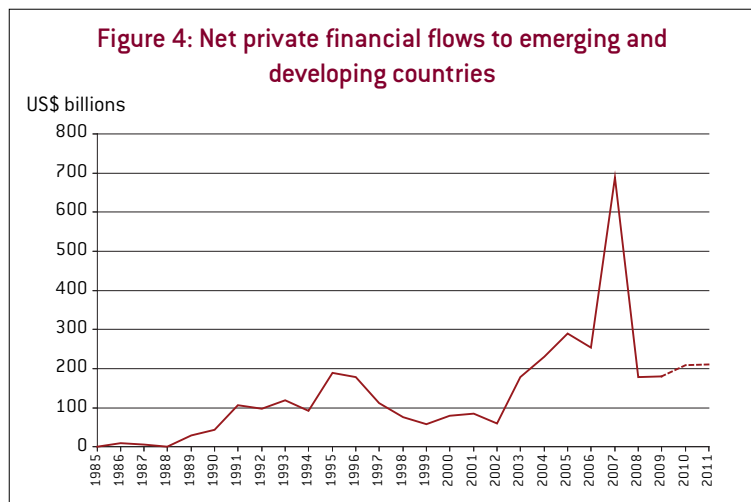


Average distribution of total 2009 revenue. Source: corporate reports; authors' calculations. Mauricio Nakahodo's research assistance is gratefully acknowledged.

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 economies¹⁰. The Asian crisis in particular has led international financial institutions to step back from advocating unlimited openness to foreign capital flows¹¹. But for developed economies, and increasingly for emerging economies as well, there is wide agreement among economists that the cross-border capital market integration has a signifi-

cant 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 providers¹².

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,



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



and no single power can exert sufficient leadership, benevolent or otherwise, for consistency to be ensured. The crisis itself has stalled the growth of cross-border financial flows to emerging countries, as Figure 4 illustrates. Available data suggest that the same is true of global capital flows more generally¹³.

4 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 G20 has a major role to play 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 to Asia. Key pillars of a global financial body's strength include: a transparent governance framework that clearly sets out its mission, properly identifies its stakeholders, and makes it accountable to them; adequate and stable financial and human resources, avoiding funding mechanisms that could be leveraged by special interests to compromise the body's independence; sufficient access to relevant information, for which formal commitments by national or regional authorities may often be indispensable; and practice that is consistent with its proclaimed aims. Specific recommendations along these lines are outlined in the following paragraphs.

Second, **globally consistent financial information** is crucial. To start with, the IASB needs a sustainable strategy and governance model to attract more trust from its stakeholders, especially investors which are the primary users of financial reporting. Instead of having each of its standards made mandatory everywhere, an overly ambitious aim in the short term, it should insist on universal recognition of voluntary IFRS adoption by those issuers which desire it. It should also monitor better how IFRS are applied, in liaison with local authorities. Such measures are needed to prevent the risk of this unique experiment in global standard-setting being derailed¹⁴. Equally important is to ensure better consistency of audits. Currently, audit firms are only regulated at 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. The creation of 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 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 US (May 2009) and EU (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, the public supervision of rating agencies, which is spreading at a rapid pace¹⁵, should be strongly coordinated at 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

13. See McKinsey Global Institute, 'Global Capital Markets: Entering a New Era', September 2009

14. These points will be further developed in a forthcoming Bruegel publication on accounting policy.

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



increased. Governments and supervisors should make a credible commitment to provide much more detailed, reliable and frequent information, to be pooled at 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 organised trading platforms, is to be welcomed but also 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 supranational level. However, this is an area where *ex-ante* burden-sharing, or a formal agreement by all or most jurisdictions concerned on how to apportion the cost of an international bail-out, is easier to envisage 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.

Fourth, **capital markets 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 of many non-bank capital markets 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 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 fund-

ing. There is no obvious solution to 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 discussion is needed on these challenges. A stronger international competition policy framework may be part of the answer to fight damaging economic nationalism by governments as well as predatory behaviour by intermediaries.

All in all, the future global financial regulatory landscape is more likely to resemble a Japanese garden, with new details and perspectives emerging at each step, than a centralised and symmetrical *jardin à la française*. Consistency will not be uniformly achieved, the boundary between global and local decision-making will remain in flux and controversial, and a spirit of experimentation and institutional entrepreneurship will be required. As Francis Fukuyama, a political scientist, 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’¹⁶. This general statement certainly applies to financial regulation.

The views expressed are those of the authors and not of their employers. The authors are grateful to all those who reviewed the draft of this policy brief.

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16. Published in Francis Fukuyama, *America at the Crossroads*, Yale University Press, 2006

