The Future of International Financial Regulation

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Summary

- The article summarises the challenges confronting attempts to strengthen global financial regulation and to build a stronger international financial regulatory architecture.

- Members of the G20 must respond to several challenges that make a robust global financial regulatory regime elusive: restoring self-discipline to the financial industry, preventing regulatory arbitrage, enhancing cross-border supervision of financial institutions, and promoting macro-prudential supervision.

- Choosing an appropriate framework for effective international governance will be critical. The case for a global financial regulator will increasingly become stronger as single national governments and regulatory networks show themselves to be ill-equipped to supervise and regulate cross-border markets. Efforts to establish such a global financial regulator must build upon regional and multilateral arrangements to improve international regulatory networks and ensure legitimacy and public accountability.

- Another development that will affect the future of international financial regulation is the return of competitive pressure on financial markets. As the effects of the recent financial crisis recede into memory, policymakers and regulators will seek to make their national financial markets more attractive to investors, issuers and cross-border financial services providers, threatening to undermine or reverse current efforts to strengthen the international financial regulatory system.

- Anticipating how the nature of cross-border financial services will change in the future also will be crucial to the future of international financial regulation.
CII Introduction: Discussions on strengthening regulatory standards at the international level are becoming increasingly important given the global impact of the recent financial crisis and ensuing economic recession. The cross border nature of many firms’ operations and their reach, combined with the risk of regulatory arbitrage undermining national policies, demands cooperation and coordination between states and regions. This latest addition to our international series explores the challenges confronting these discussions and their implications both politically and economically.

In April 2009, the leaders of the G20, meeting in London, pledged “to strengthen financial regulation to rebuild trust.” The leaders’ communiqué promised an unprecedented level of cooperation to reform the regulatory framework governing the international financial markets. What the G20 leaders did not make clear in London, or at their following summit in Pittsburgh, is what this regulatory framework should look like, and a year after the London summit this question remains unanswered. The current aim is to deliver concrete proposals for the Seoul G20 leaders’ meeting in November, but is this realistic? What might be the reasons for delay and what changes are likely to emerge?

The UK, US and European Union have announced significant regulatory reform efforts in their respective jurisdictions.

The fact that the future of international financial regulation remains uncertain is not due to a lack of ideas for regulatory reform. The United Kingdom, United States and European Union, for example, have announced significant regulatory reform efforts in their respective jurisdictions. In the United Kingdom, the Financial Services Authority (FSA) and HM Treasury under the former Labour government, and the Conservative Party when it was in opposition produced detailed analyses of the causes of the recent financial crisis and put forward several proposals for improving the UK’s financial regulatory system. These proposals have included the FSA’s Supervisory Enhancement Programme and plans promoted by the Conservative Party to assign the Bank of England responsibility for prudential regulation. At time of writing, details of the new Conservative-Liberal Democrat coalition government’s financial regulation policy are still forthcoming, however it is clear that the FSA’s role will narrow, consistent with the Conservatives’ earlier manifestos recommending cuts to the FSA’s responsibilities.

In the United States, different plans to restructure the US financial regulatory system have been offered by President Barack Obama, the House of Representatives and most recently the Senate in the form of a bill sponsored by Senator Christopher Dodd. The proposals have recommend, among other things, the elimination of the federal thrift supervisor, the creation of an interagency oversight council to regulate systemic risk and the reallocation of the supervisory and consumer protection powers of the Federal Reserve Board as well as new regulatory initiatives, such as the Volcker Rule. At time of writing, Congress is preparing a final bill that reconciles the House and Senate versions and will be submitted to the President for signature.

Meanwhile, the European Union is currently debating the implementation of the de Larosière Report. Pursuant to the report, the European Union would create two new EU-level bodies, the European Systemic Risk Board and the European System of Financial Supervisors.

Regulatory activity also abounds at the international level. The Financial Stability Board (FSB), established by the G20, is pursuing an ambitious agenda of regulatory reforms. The FSB, working with the Basel Committee (Basel) and International Organization of Securities Commissions (IOSCO), has organized working groups composed of national regulatory representatives to address such issues as establishment of higher capital and liquidity standards, reform of compensation practices, improvement of transparency in the over-the-counter (OTC) derivatives markets, definitions of systemically important financial institutions and plans for resolution of such institutions, and improvement of global supervisory and regulatory standards.

Four basic problems of global regulation

If there is such a high level of regulatory reform activity, why does the future of international financial regulation remain so uncertain? The reason is national regulators’ failure to agree on how to address four basic problems of international financial regulation.

Self-discipline

The first problem is how to restore self-discipline to the financial industry. The willingness of governments to rescue troubled financial institutions during the financial crisis under the belief that they were too important to fail has created an unhealthy expectation that governments will continue to guarantee the soundness of the largest institutions.

The task [defining systemically important institutions] is extremely difficult since their relative importance depends on a variety factors including size, interconnectedness with other financial institutions, amount of outstanding obligations and nature of financial activities conducted.

To the extent a government guarantee exists, regulators must define which firms qualify as systemically important institutions. Such a task is extremely difficult since the relative importance of institutions is a dynamic condition depending on a variety factors including size, degree of
interconnectedness with other financial institutions, amount of outstanding obligations and nature of financial activities conducted. To the extent governments wish to avoid having to make good on any guarantees, regulators must determine how to impose tougher supervisory and regulatory standards on such firms and, more importantly, remove the moral hazard problem that accompanies the expectation of such guarantee.

Regulatory proposals concerning resolution authorities, higher capital adequacy and liquidity requirements, supervision of the shadow banking system, employee and executive compensation arrangements, bank fees, proprietary trading restrictions and even financial institution size limitations are meant to address this problem. Each proposal is designed to relieve governments of the financial cost of bailout or to align the interests of firms with those of the regulators. One possible scenario is that a tougher regulatory regime applied to systemically important institutions acts like a “tax” on such institutions’ operations, incentivizing them to seek ways to avoid being considered systemically important.

The ability of cross-border financial institutions to shift operations and services among jurisdictions means that any new forms of regulation must be in coordination with other countries.

Regulatory arbitrage

The second problem is regulatory arbitrage. National regulators will not pursue new regulatory initiatives for fear of driving financial activity offshore. The ability of cross-border financial institutions to shift their operations and services among jurisdictions means that any new forms of regulation must be in coordination with other countries. This need makes it essential for national regulators to work through international bodies and regulatory networks like the FSB, Basel and IOSCO.

The problem of regulatory arbitrage also exacerbates differences between the more developed Western countries and emerging economies. As Europe and United States debate tougher regulation, their regulatory strategies may be inconsistent with the interests and regulatory objectives of Brazil, China, India, the United Arab Emirates and other countries with rapidly developing financial markets. Europe and the United States are attempting to include the leading emerging economies into discussions concerning the design of any new international regulatory framework, but also must accept that the outcome of such discussions may be an international regulatory framework that is less robust. The establishment of the G20 and FSB to replace the G7 and the Financial Stability Forum represent important first steps in this direction, but their achievements to date have been limited.

Cross-border supervision

Third, national regulators must address the problem of cross-border supervision. One of the great problems of international financial regulation is setting up a comprehensive regulatory framework to oversee financial institutions that operate and sell products and services across borders.

At best, sharing supervisory responsibility among a group of regulators reminds one of the fable of the three blind men and the elephant...

Since the early 1990s, Basel has advocated comprehensive supervision of cross-border financial institutions by the home country supervisor. In theory, the home country supervisor is in the best position to oversee all operations of a financial institution with branches in different jurisdictions. The recent crisis, however, raised questions about the capabilities and resources of some home regulators to adequately supervise the operations of complex multinational firms. Most notably, the UK FSA has been highly critical of the performance of the Icelandic financial supervisor in overseeing those Icelandic banks that accepted deposits from customers in the United Kingdom and other jurisdictions.

In addition, host country supervisors expressed concerns about their ability to protect their own markets if they cannot monitor the operations of major branch operations. In light of these doubts about the efficacy of home country supervision, the FSB has recommended the formation of supervisory colleges to oversee thirty large cross-border financial institutions. Such colleges aim to have home and host supervisors share supervisory responsibility.

The reliance on supervisory colleges, however, offers an imperfect solution to the problem of cross-border supervision. In order to be effective, supervisory colleges depend on almost perfect coordination and information sharing by and among all members of the supervisory college. At best, sharing supervisory responsibility among a group of regulators reminds one of the fable of three blind men and the elephant where each person sees only his part of the elephant, failing to recognize the beast.

A single global financial regulator infused with the powers of national regulators would be the best match for cross-border firms but it would require an unprecedented degree of inter-state cooperation plus independent legal authority, making it politically unfeasible.

It is also helpful to recall that Basel’s original adoption of the principle of home country supervision stemmed from frustration with a previous college of supervisors – the college that oversaw the operations of the ill-fated Bank of Credit and Commerce International. Thus, colleges of
supervisors may be no more effective at supervising cross-border financial institutions than home country supervisors.

Ideally, a single global financial regulator, infused with the powers of national regulators and ability to assert jurisdiction across countries, would be the best match for cross-border financial institutions, but such a global regulator would require an unprecedented degree of cooperation among countries and independent legal authority, making it politically unfeasible.

What is macro-prudential supervision?

The final problem is to understand how to conduct macro-prudential supervision. There exists broad agreement that regulators must concern themselves not only with the soundness of individual firms but also with the soundness of the economic and financial system as a whole. The European Union is considering a proposal to create a European systemic risk board. In the United States, recent proposals have centred on the creation of an interagency council of federal regulators to oversee systemic risk and to broaden the supervisory responsibility of the Federal Reserve Board. Part of the core mission of the FSB is to provide a forum for the identification of possible systemic threats to the global financial system.

One answer is that macro-prudential supervision consists of macroeconomic oversight, prudential regulation (monitoring of individual financial firms and markets) and market intervention (service as lender or guarantor of last resort).

But all proposals are disappointingly vague concerning what actually constitutes macro-prudential supervision. One answer is that macro-prudential supervision consists of macroeconomic oversight, prudential regulation (monitoring of individual financial firms and markets) and market intervention (service as lender or guarantor of last resort). One illustration of this lack of agreement on the mechanics of macro-prudential supervision is the question of who should serve as the macro-prudential supervisor. The debate generally has centred on whether macro-prudential supervision is a function of a prudential regulator, a central bank or both. In the United Kingdom, for example, the former Labour government recommended in the HM Treasury White Paper of June 2009 that the FSA, a prudential regulator, and the Bank of England, a central bank, should jointly be responsible for macro-prudential supervision. This matter became an (albeit minor) issue during the recent general election, with the Conservatives promising to scrap the FSA.1 Following the election, the new Conservative-Liberal Democrat coalition government have already said they will assign to the Bank of England “oversight of micro-prudential supervision”. In the European Union, the current European Commission proposal for the European Systemic Risk Board is to give almost complete voting control to the European Central Bank and national central banks with only observer status to the national prudential regulators. However, debate over this proposal and the implications for central bank independence currently continues in the Council of Ministers and European Parliament.

In the United States, macro-prudential supervision would be handled primarily by the Federal Reserve Board under the oversight of a council of prudential regulators and the Fed chaired by the Treasury Secretary. Similar disagreements exist in other countries, and many emerging countries have not even begun addressing this issue. These disagreements at the national and regional levels hinder the likelihood of the creation of a global macro-prudential regulator. The unsettled question of who should serve as macro-prudential regulator underscores the elusive nature of macro-prudential supervision.

Addressing the challenges

What are the implications of this attempt by the leading economies to address the four open questions of international financial regulation? I would like to focus specifically on three issues that will influence the future of international financial regulation: international governance, financial market competitiveness and future of cross-border financial services.

Games nations play: international governance

International governance refers to the international legal framework that will regulate the international financial markets. The continued development of international financial markets and increase in financial activity outside of Europe and North America will force policymakers to address how to govern the international financial markets. The G20, FSB, Basel, IOSCO and International Monetary Fund are among the most important parts of the current international financial architecture, but they are quite limited in their powers. In the future, we can expect international governance to be shaped by three developments.

Agreements on financial regulatory standards between the EU and US would become de facto global standards given that those financial markets are currently the largest in the world.

1 For more information on the different political parties views on financial regulation going into the election, see Election 2010 Special: What the Parties Say, by Stephen Timms, Mark Hoban and Vince Cable, CII Thinkpiece no.37 (April 2010).

First, international governance will develop through a competition between multilateral arrangements and bilateral arrangements. The difficulty in reaching agreement in multilateral bodies, however, will drive countries to advance regulatory objectives through bilateral arrangements.

Examples of bilateral arrangements include the EU-US Financial Markets Regulatory Dialogue, China-US Strategic Economic Dialogue and recently announced India-US Economic Dialogue. Bilateral arrangements are attractive because it is easier for two countries to find common ground and agree on common regulatory standards in bilateral talks than in multilateral forums. The effect of having regulatory standards set by bilateral frameworks is that the international financial regulatory system may become fragmented if competing bilateral networks establish different regulatory standards. In addition, some bilateral arrangements will be more powerful than others. Agreements on financial regulatory standards, for instance, between the European Union and United States would become de facto global standards given that Europe and the United States are currently the largest financial markets in the world. Other countries may demand that such discussions be held in multilateral forums instead.

The case for a global financial regulator will become stronger as single national governments and regulatory networks show themselves to be ill-equipped to supervise and regulate cross-border markets.

The second challenge of international governance is ensuring those international regulatory bodies that play a leading role in setting forth the international legal framework are legitimate and publicly accountable. As international bodies, like the FSB, play a more significant role in setting regulatory standards, pressure will grow on these bodies to become more transparent and welcome the participation of non-state actors. Such pressure will change the operation of such bodies. If forced to become more transparent, the FSB will have to subject its decisions to notice and comment procedures, permit the participation of outside interest groups and hold public meetings. Such openness may make the FSB more politicized and less flexible in responding to regulatory problems.

The third challenge of international governance is the institutionalisation of international financial regulatory bodies. Currently, the leading international bodies that engage in financial regulation, particularly the FSB, Basel and IOSCO, are “networks” of national regulators and policymakers. They serve as forums through which national regulators share information and discuss common rules and standards. In theory, international institutions would be better positioned to regulate cross-border markets, but national governments naturally are reluctant to cede any regulatory power over their own markets to a supranational authority. Nonetheless, the case for a global financial regulator will increasingly become stronger as single national governments and regulatory networks show themselves to be ill-equipped to supervise and regulate cross-border markets.

Financial market competition

Another development that will affect the future of international financial regulation is the return of financial market competition. In the run-up to the recent financial crisis, policymakers in financial centres around the world spoke frequently about the need to make their financial markets more competitive and to make their large cities leading financial centres. In the United Kingdom, the desire to make London the top financial centre in the world influenced the FSA’s decision to introduce principles-based regulation. In the United States, concern about the relative decline of New York’s position as a global financial centre, inspired US Treasury Secretary Henry Paulson to propose a complete overhaul of the US regulatory system.

Efforts to make financial markets more attractive focused on making regulatory requirements more flexible and less costly, encouraging the development of new financial products and providing financial incentives to firms looking to expand operations. Since the financial crisis, policymakers no longer openly speak about financial market competitiveness, but rather discuss policies designed to restrict the activities of financial firms and subject them to greater supervisory oversight.

This broad agreement by the G20 to consider more substantial regulation of the financial industry is spurring the international cooperative efforts we see today. However, will such cooperation continue when policymakers once again focus on the competitiveness of their own financial markets? As financial markets stop being viewed as drains on national treasuries and once again as generators of economic growth and tax revenue, international agreement on regulatory standards may become much more difficult, undermining the international financial regulatory framework.

The future of cross-border financial services

Finally, the future of international financial regulation will depend on the future of cross-border financial services. In the past two decades, cross-border financial services changed dramatically due to the expansion of proprietary trading operations, the rise of financial supermarkets offering securities, banking and insurance services, and the growth of the shadow banking system, especially hedge funds and private equity funds. These developments outpaced the regulatory capacity of many regulatory systems, some operating on assumptions of how financial services were provided 70-80 years ago.

Anticipating how cross-border financial services will change in the future will be crucial to the future of international financial regulation. Likely factors that will influence the future of cross-border financial
services include the growth of retail financial markets in China, India, and other emerging economies, the shift in investment capital from Europe and North America to East and South Asia, the movement of trading activity away from London and New York, the growth of sovereign wealth funds, and the continued increase in numbers of sophisticated investors seeking higher returns across borders.

Not only will national regulators need to interact more frequently, but there needs to be transfers of technical and legal expertise to those countries developing financial markets.

Financial regulators will have the burden of ensuring that the regulatory strategies and practices developed in Europe and North America are adopted and implemented swiftly in emerging economies. Not only will national regulators need to speak to each more frequently, but there needs to be transfers of technical and legal expertise to those countries developing their financial markets.

One of the lessons of the recent crisis is that national financial systems are inextricably interlinked—both across functional lines, across markets and across borders. Financial crises that result from regulatory failures in one jurisdiction will rapidly spread to other jurisdictions. Consequently, the world’s largest economies need to develop an international regulatory framework to better oversee financial markets. In order to do so, policymakers must agree on solutions to the core problems outlined above. Failure to do so will only leave the global financial system vulnerable to future crises.

If you have any questions or comments about this thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact: Laurence Baxter, CII Head of Policy & Research: laurence.baxter@cii.co.uk or by telephone: +44 (0)20 7417 4783.

Appendix: Summary of the International Financial Regulatory Architecture

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IMF = International Monetary Fund; WTO = World Trade Organization; G20 = Group of Twenty; G8 = Group of Eight; FMRD = US-EU Financial Markets Regulatory Dialogue; FSB = Financial Stability Board; Basel = Basel Committee on Banking Supervision; IOSCO = International Organization of Securities Commissions; IASB = International Accounting Standards Board; ISDA = International Swaps and Derivatives Association


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How much financial services regulation is appropriate to protect the public while promoting a free market? This has been a key debate within the industry and government in recent years. Karl Snowden examines various aspects of regulation, including what can and cannot be done to avert crises and produce the best outcomes.

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