# Mind the gap:

## can Europe and the US build a new global financial order?

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Now that the worst of the financial crisis is over, governments are considering how to prevent the next one. In the post-Lehman Brothers world, many banks are simply too big to fail, and continue to pose a systemic risk to the economy both home and abroad. With the global economy showing signs of recovery, attention is turning from emergency fire-fighting towards long term structural changes to the financial sector. The US Congress is currently considering a financial regulation bill, which is likely to pass in the first months of 2010. The European Union is further behind, but also expects to pass legislation this year. The UK, Germany and France are all in the process of reforming national regulation, in an attempt to reduce the risks that individual institutions pose to the financial system.

President Obama's proposal to directly limit the activities and size of banks will be hard to square with European reforms. Europeans are trying to 'tax' banks down to size, rather than break them up. They are moving towards a system of macro-prudential supervision with clear rules designating capital and liquidity surcharges for dangerously big banks, overseen by independent central banks and regulators. Policies to deal with the 'too big to fail' problem are looking increasingly patchy and unco-ordinated, with regulatory gaps emerging that global banks will eagerly use to their advantage.

These legislative approaches need to be more closely co-ordinated. At present, national treasuries and central banks are represented on the Financial Stability Board (FSB), which is in charge of alleviating global systemic risk, but it would be sensible for leading finance legislators to be represented too – the European Parliament and the US Congress could certainly benefit from more formal co-operation. The FSB should at the same time be given an enhanced stature by the G20. It should offer appraisals of the systemic risk legislation that is going to pass in 2010 and 2011 – national legislatures may find this unwelcome, but they should recognise that it is in all of their interests to find common solutions to the problem of global financial instability. In time, the FSB should be given the financial and human resources it would need to audit the international dimensions of national regulation, so that international rules keep pace with international capital flows.

## Introduction

Systemic risk is essentially a 'negative externality', which is a cost imposed on third parties by economic activity that is not reflected in its price. Currently policymakers are faced with the headache of exactly how to ensure the financial sector pays for the externalities it creates.

The problem facing governments follows the lines of a classic economic argument, between followers of the Edwardian political economist Arthur Pigou and of Ronald Coase, a University of Chicago law professor. According to Pigou, the best government response to an externality is to impose a tax or regulation so that the social costs of the activity are reflected in its price. But the difficulty, as Coasean critics have argued, is that the costs of government regulation or taxation to tackle externalities may often be larger than the original cost, unless the lost private benefit can be accurately measured. Global banks, which are becoming profitable again, are

increasingly emphasising these 'dead weight' losses to the economy from government intervention in their forays into the debate on financial regulation. These losses represent the cost to the banks and individuals who benefit from the *status quo ante*. Excessive regulation will lead to a dead weight loss larger than the cost of the original externality, reducing long term economic growth. Better, they argue, to let markets do the work – and they suggest that the price of risk will naturally be higher after the crisis.[1]

This poses a problem for liberals, who want to salvage the best parts of a globalised financial system by taxing and regulating the systemic risks that global banks create. There is no global 'government' to impose standardised regulation and stop mobile capital flowing between countries to take advantage of tax and regulatory loopholes. Individual governments seek to support competitive financial sectors, and draw in business from elsewhere. Regulatory curbs or taxes on bonuses, it is feared, will lead to an exodus of bankers. To avoid a race to the bottom, and to make regulation efficient and effective, it would thus be better to try to co-ordinate regulation being drawn up by national legislatures to close any gaps.

The Financial Stability Board (FSB) was charged by the G20 with overseeing the co-ordination of systemic risk regulation across borders. It is made up of central banks, treasuries and financial services regulators from G20 members, as well as countries with large financial sectors like Hong Kong and Singapore. In January 2010, it announced that its members would be subjected to a public peer review, with the Board naming and shaming countries that were exporting risk. This was to try to "foster a race to the top", according to Canada's deputy finance minister Tiff Macklem, who is chairing the process for the FSB.[2]

The two largest capital markets in the world, the EU and the US, are moving onto parallel trajectories after decades of divergent regulatory tendencies and regulatory competition. Before the crisis, the UK tended towards 'principles based' regulation by supervisors at banks and self-policing by the financial sector. The US combined a rules-based approach with the principle of 'let the buyer beware', which left some sectors very lightly regulated. Meanwhile France and Germany favoured comprehensive statutory regulation. There was also transatlantic regulatory competition: when it became clear that the EU 'universal bank' model was more profitable, the US repealed its Glass-Steagall Act that separated utility and investment banking. Now, however, both the US and Europe want to bear down on threats from global banks, upping capital requirements, imposing liquidity buffers, centralising complex derivatives, and creating cross-border insolvency regimes.

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But the US, the EU and its member states are doing so through national legislation, which imposes higher deadweight losses for global firms which have to cope with myriad regulations and tax codes. Furthermore when gaps emerge in the legislation, firms can take advantage. The US Congress is also unwilling to cede power upwards to international institutions or to a strengthened Federal Reserve which has oversight of financial regulation as well as monetary policy. It delayed the implementation of the Basel II capital requirements for two years while it deliberated, with several members arguing that international capital rules put US banks at a disadvantage. The European Parliament, for its part, has placed undue focus on hedge funds and short selling, neither of which were root causes of the crisis.

The legislation now being passed on either side of the Atlantic also has gaps. European countries are moving towards a system of macro-prudential supervision with clear rules for capital and liquidity surcharges for banks that are of systemically dangerous size. The US is moving towards a more discretionary approach. On securitisation reform, the EU is planning to impose a 5 per cent retention rule, to make banks retain some of the risk when they originate loans and distribute them, while the US is proposing 10 per cent. Their plans for the centralisation of derivatives are also different: the Obama administration is calling for as many derivatives to be routed through independently owned central counterparties (CCPs) as possible, while European legislators are considering allowing clearing to be conducted by market participants themselves. On accounting standards, the transatlantic gulf is widening. In March 2009, the

1 R Coase, 'The problem of social cost', 1960.
2 Financial Times, 'Peer reviews aim to co-ordinate bank reforms', January 11 2010.

US Congress forced the US Financial Accounting Standards Board to water down 'fair value' principles to stop banks' balance sheets from looking so bleak, and the prospects for a single set of global accounting standards is looking further away than ever.

These legislative approaches need to be more closely co-ordinated. At present, governments are represented on the FSB through their treasuries, but it would be sensible for legislators to be represented too – the European Parliament and the US Congress could certainly benefit from more formal co-operation. The FSB, for its part, should consider offering appraisals of relevant legislation in the pipeline. Legislatures may find this unwelcome, but it would mitigate against dangerous gaps that would undermine the internationally shared aim of bearing down on the systemic risk that global banks impose on national financial systems.

This paper explains how this may be done. In section 1, it describes the twin problems of 'too big to fail' – global banks that cause such damage when they become insolvent that they must be rescued; and 'moral hazard' – the danger that banks are encouraged to take more risks because they know they will be bailed out. In section 2, it provides an analysis of the gaps in regulation in the bills that are making their way through the legislatures on either side of the Atlantic. Finally, it describes how the FSB can help the EU and US to fill in the regulatory gaps.

## 1. The scale of the 'too big to fail' problem

The collapse of Lehman Brothers laid bare the systemic risk that global banks can cause. When it went bust, the mortgages, credit card and money market loans, securities, swaps and derivatives that constituted its assets and liabilities provided the channel by which the contagion spread. Financial institutions that had lent to Lehmans, most notoriously the Reserve Primary Fund, found that they could no longer afford to repay their creditors in full. The Reserve Primary Fund 'broke the buck' the day after Lehmans announced bankruptcy, as its share price dipped below \$1 (the net asset value of mutual funds is always supposed to be greater than \$1) because of a \$785 million exposure to the bank.[3] The infection spread, because no one could be sure which institutions were exposed and by how much. The liquidity crisis that followed the collapse of the US sub-prime market became acute, and ultimately needed massive government intervention to allay it.

After Lehman Brothers, governments rescued banks by recapitalising them, providing extra insurance for loans and deposits, rushing through mergers and acquisitions, and buying up or insuring toxic assets that had become untradeable. Allowing them to go bust like Lehmans would have exacerbated the crisis. In the US, Bank of America bought Merrill Lynch, and took \$45 billion in bailout funds. Citigroup also took \$45 billion of government money. JP Morgan Chase bought most of the assets of Washington Mutual, and received \$25 billion through the government's Troubled Asset Relief Program. Goldman Sachs received \$10 billion.[4] In Europe, British bank Lloyds TSB bought its rival HBOS. British bank Barclays bought most of Lehmans' assets in the US. After a lengthy and acrimonious insolvency procedure, the Dutch-Belgian-Luxembourgeois bank Fortis was broken up along national lines, the Dutch government nationalised their part, while Belgium and Luxembourg sold their parts to French lender BNP Paribas – which received €5.1 billion in emergency loans from the French government. The Royal Bank of Scotland is 75 per cent owned by the British taxpayer. Consequently, governments now face the problem that there is less competition in the banking sector than before the crisis, and banks at present know that if they go bust the government will save them.

The too-big-to-fail threat spills across borders, directly through cross-border mergers and acquisitions, or indirectly through the enormous flows of cross-border lending. Governments are starting to collaborate to resolve the problem. In April 2009, the G20 called for the creation of cross-border 'supervisory colleges' for the world's most systemically important financial institutions. The FSB is in charge of the process and has drawn up a working list of those that must draw up 'living wills' explaining how their assets will be distributed should they go bust. This list has been leaked to the Financial Times (see chart 1).

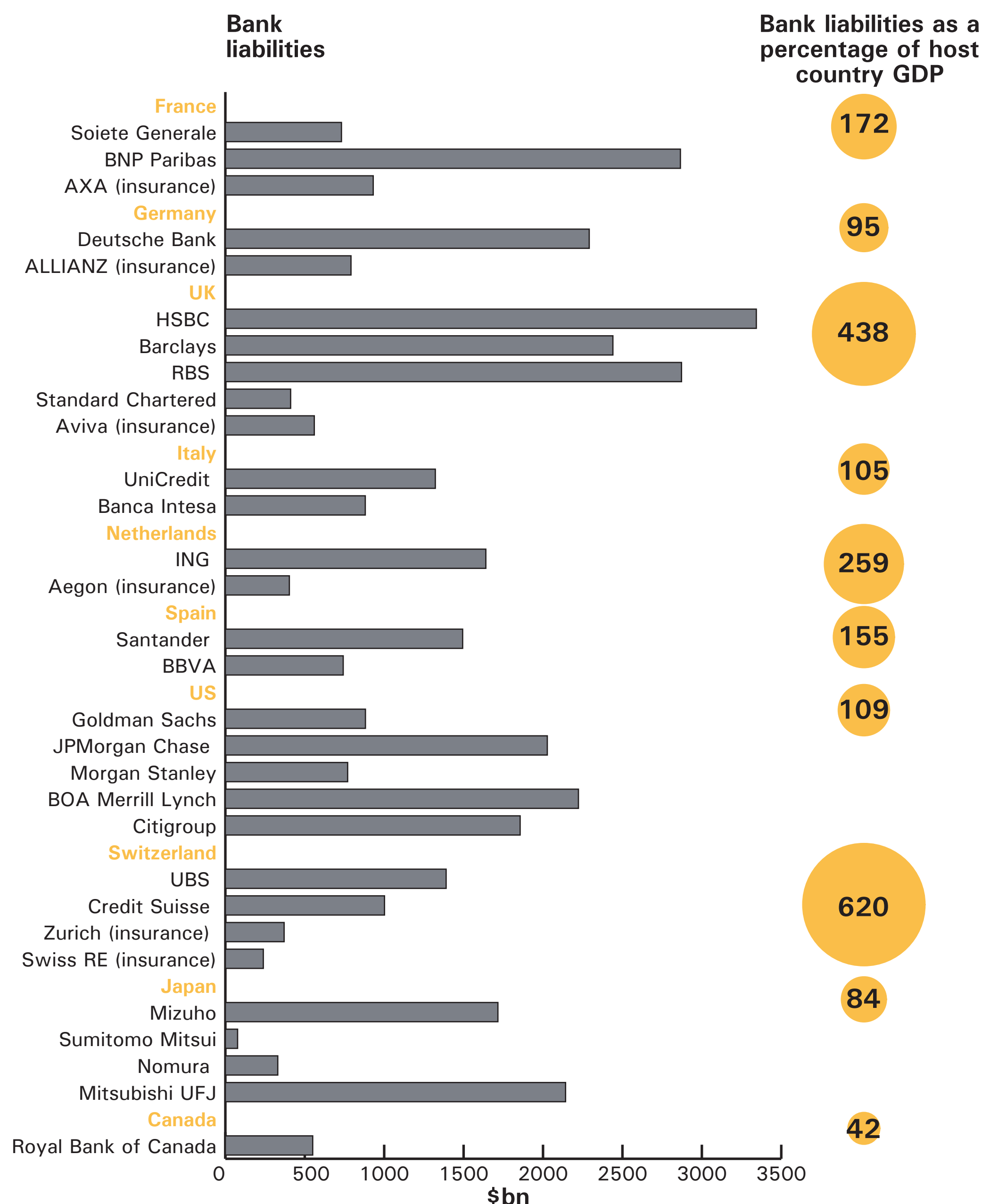
Several countries now host global banks whose liabilities are larger than their economies. This is not necessarily a problem if their banks have enough capital – but their explosive growth over the last decade has been down to a global under-pricing of risk.

There is a danger that the combination of a thin veneer of international co-

3 Financial Times, 'Lehman fallout hits money market fund', September 17 2008.

4 Bloomberg, 'JP Morgan, Goldman Sachs among 10 banks that repaid rescue funds', June 17 2009.

## Chart 1. FSB systemically important cross-border financial institutions




*Source: Thomson Reuters: banks' financial reports.*

operation at the G20 and predominantly national regulation will cause a reversion to regulatory and tax arbitrage, unless the FSB is given enough authority to oversee co-ordination. The G20 passed oversight of systemic risk to the International Monetary Fund (IMF) and the FSB, which were charged with assessing the global systemic risk caused by particular financial institutions. However, this does not mean they will be able to provide an exact formula. The IMF's team of economists have so far found it difficult to produce any concrete measures of global systemic risk, because "systemic events are intrinsically difficult to anticipate".[5] To do so would mean finding a formula to reliably beat the market, an unrealistic aim given the vast resources that banks expend in pursuing it.

Instead, the IMF has so far tried to spread best practice, by recommending that national regulators should perform regular internationally standardised stress tests of all systemically important banks.[6] Whether countries will do so is questionable: EU member states have been slow and unco-ordinated, with national supervisors stress-testing as they see fit, with little

5 C Capuano et al, 'Methods to identify systemic financial risks', voxeu.org, 23 April 2009.

6 IMF, 'Global financial stability report,' April 2009.

standardisation in methods or macro-economic assumptions, and with some publishing results and others not. When the EU held co-ordinated stress tests for its largest cross-border banks in October, the results were suspiciously more rosy than the IMF estimated.

Since the crisis started, the US-EU regulatory relationship has been rather fractious. The EU moved quickly to try to co-ordinate its members, introducing a range of new measures including: a deposit guarantee scheme directive, with the aim of halting destabilising currency flows; 'Solvency II', which created capital requirements for insurance firms; a requirement that credit ratings agencies submit to a European college of regulators, whereas previously they had been solely regulated by US authorities; and obliging all credit derivatives contracts affecting European markets be resolved through central counterparties on European soil. In a speech to the US Securities and Exchange Commission in April 2009, the then EU Commissioner for the internal market, Jörgen Holmquist, accepted that: "On your side, concerns have grown as we decided to move to regulate previously unregulated, or lightly regulated areas: rating agencies, credit default swaps market infrastructure or getting incentives right in the securitisation markets. In all these sectors, US firms are globally active, even leaders."[7]

The European measures have potentially negative impacts for non-EU, especially US, firms. Credit ratings agencies' charges will rise as they submit to two sets of regulatory authorities – most are based in the US. Credit derivatives contracts between European and US companies must now go through European exchanges, driving up costs – one exchange would have been more efficient.

European legislative activity, however, has now slowed, as the EU seeks to hammer out the more difficult questions – whether the EU needs a common approach to capital and liquidity requirements, and sorting out misplaced incentives in the securitisation markets, in particular. The US regulatory reform programme has now overtaken the EU's – bills for a Financial Stability Oversight Council (FSOC), capital and liquidity requirements, derivatives trading and credit ratings agency reform are on their way through Congress, and will probably be passed in the first half of 2010. The US Financial Accounting Standards Board is considering ways to stop banks holding assets off balance sheets and to stop accounting rules from making banks' balance sheets look more healthy than they are in good times and more sickly in bad. All of these new rules, of course, will raise costs for European companies operating in or trading with the US.

7 J Holmquist, 'EU-US cooperation in financial markets regulation in times of crisis', April 13 2009.

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The solution: the US, the EU and national governments need to work much more closely together as they go through the process of regulatory reform. The G20 has worked best as a forum for emergency co-ordination to fight the crisis, and was at its most successful when it worked to co-ordinate fiscal and monetary stimuli, and to prevent members' financial sector rescues from destabilising each other. The group was also successful on some aspects of institutional reform. It set up cross-border colleges for all of the major international banks, and charged the IMF and FSB with monitoring global systemic risk and acted to co-ordinate best practice on pay and remuneration. But the very nature of the group makes it difficult to make progress on the specifics of policy co-ordination, primarily because the group comprises so many different developed and developing countries with varied financial priorities and demands. This is likely to get worse, not better, as the crisis recedes. The G20 will meet twice in 2010, and then once annually thereafter. It will probably increasingly become a forum for dialogue and agenda setting, not delivery.

## 2. Growing gaps in regulation

It will require much closer co-operation to resolve the combined 'too big to fail' and 'moral hazard' problems of global financial institutions. The US and EU member states are planning regulatory reforms

to be implemented over the next year which will inevitably lead to a series of potentially dangerous mismatches. These potential pit-falls range from 'macro-prudential' measures, capital requirements, securitisation reform, how to regulate 'over the counter' (OTC) derivatives, accounting standards, to how to wind down international banks.

## Macro-prudential measures

In recent decades public authorities have sought to control the money supply and the financial sector via two levers: monetary policy, and the regulation and supervision of individual financial institutions. But neither tool was able to prevent the build-up of bank leverage or the fast growth of the size of global banks' balance sheets in the years before the crisis. Interest rates remained low because central banks targetted inflation, which was subdued. Regulation and supervision focussed on the risks each financial institution was taking, rather than the risks being taken across the system as a whole, and the potential waves of default prompted by a large and highly connected institution going under.

To fill the gap, central bankers, regulators and supervisors are discussing ways of varying capital, liquidity and accounting rules depending on the institution's size and degree of interconnection and the point in the economic cycle – a process dubbed 'macro-prudential policy'. Briefly, a consensus is coalescing around authorities in each jurisdiction using stress tests to identify systemically important financial institutions that may cause waves of default in a downturn. The authorities could then impose further capital surcharges if the institution is over-leveraged, and liquidity surcharges if it had a problem with a large imbalances in the maturity of their assets and liabilities. These could also be varied according to the size of the institution.

However, European countries and the US are diverging on the details. Germany has handed power over macro-prudential policy to the Bundesbank, and the UK's Conservatives, who are likely to form a government this year, are planning to return some regulatory powers to the Bank of England after Labour handed them to an independent body, the Financial Services Authority. The US is considering a combination of macro-prudential rules as well as overall limits on bank size, and mandating that investment banks stop 'proprietary trading', whereby they used their short-term financing (which was cheap, because of their size) to fund long-term investments in mortgage-backed securities and the like. Furthermore, the macro-prudential measures will be more discretionary and consensus based than in Europe, with the Treasury, Federal Reserve, the Security and Exchange Commission, the Council of Regulators, and various other agencies voting on the FSOC to impose them. President Obama originally hoped that the Fed would oversee macro-prudential measures, but Republicans and some Democrats opposed giving the agency more power.

These differing institutional arrangements reflect divergent historical approaches to regulating the financial sector. In the US, a variety of agencies regulate different areas of the financial markets, with an emphasis on co-operation between firms and regulators, and with anti-trust agencies acting to prevent anti-competitive practices. Continental European regulators have tended to use formal rules that all financial institutions must comply with. Macro-prudential policy comprises both supervision and regulation, using capital and liquidity charges at an individual firm level to control risk-taking across the financial sector. Yet some clearly defined rules based upon aggregate financial data are necessary, and the regulator that makes them needs to be strictly independent to avoid financial sector lobbying.

President Obama announced in January 2009 that the US would force banks to choose to take insured deposits, or to engage in trading on markets. This is an attempt to separate the 'buy side' from the 'sell side' in investment. Investment banks, Obama proposed, would no longer be able to use deposits to trade – it could only do so on behalf of trading clients – ending 'proprietary trading'. This would mean they could no longer borrow on short-term money markets to fund long-term investments and trades. Hedge funds and private equity that buy securities, derivatives and other products would also have to be separate. He also announced that the administration was preparing to impose overall caps on the size of banks.

This more interventionist, discretionary approach is replicated in the Financial Stability Oversight Council (FSOC). The US Congress is unwilling to hand the Federal Reserve powers to enact over-arching rules to control risk-taking of systemically important institutions. Instead, it proposes that the FSOC should stress test each institution it deems systemically important, and then come to a consensus on what capital and liquidity surcharges should be enacted, through a vote if necessary.[8] The

8 US House of Representatives, 'Wall Street and Consumer Protection Act of 2009', Section 1002.

House argues that such overt intervention in the financial market by the state requires strong democratic processes, with several agencies engaged in mutual oversight and control.

If other countries do not enact similar legislation, they may find that their carefully crafted capital and liquidity surcharge rules will be ineffective, as their 'universal banks' would be able to use deposits, insured by regulators, to fund long term investments, and have a significant competitive advantage over US trading firms.

But Europe is moving towards a rules-based system of capital and liquidity surcharges that vary depending on the size and interconnectedness of financial institutions, as opposed to US proposals to cap the size of banks, limit their activities, or impose discretionary charges. A growing consensus is emerging that price stability and financial stability are interconnected, and that central banks need greater powers to curb systemic risk in order to protect their inflation targeting mandate. The German Bundesbank argues that: "Smoothly functioning financial markets are a prerequisite for effective monetary policy and, by extension, for achieving price stability." Because central banks are lenders of last resort and watch over the levels of liquidity in the money markets, the Bundesbank argues that they are "better able to assess possible domino effects than a separate supervisory authority".[9] The Bank of England agrees, stating that: "The judgements required to set macro-prudential policy would … be not unlike those required to operate monetary policy. They would be based on a quantitative evaluation of broad trends in the macro-economy, the financial system, and crucially, the interaction between them." The Bank of England also suggests that it would move towards a system of relatively clear and simple rules for prudential surcharges. While institutions' assets and liabilities would be risk weighted by the micro-prudential regulator, the macro-prudential regulator would then use that data to impose surcharges, based on clear rules about how much liquidity and capital would be required to offset the size and interconnectedness of the institution. If the rules are not clear, the Bank of England contends that banks will face uncertainty about how much capital and liquidity they will be required to hold should they expand their balance sheets in certain sectors, and they may hold higher precautionary buffers of liquidity and capital than is necessary.[10]

9 Deutsche Bundesbank, 'Financial stability review', November 2009.

10 Bank of England, 'The rule of macroprudential policy', November 2009.

*Different prudential surcharges will provide ample room for regulatory arbitrage.*

The mobility of capital across borders makes these differing approaches problematic. The US may end up with a less stringent and transparent regime than European countries, if the less independent members of the FSOC find it difficult to push through surcharges once economic growth returns. That said, the lack of transparent rules in such a system may make US financial institutions hold 'precautionary buffers', as the Bank of England warns.

Either way, different prudential surcharges will provide ample room for regulatory arbitrage. Financial institutions in less regulated countries could offer marginally cheaper financing to banks, households and corporations elsewhere, diluting their macro-prudential regulations. Multinational corporations could also take advantage of cheaper financing in one country and then lend on to subsidiaries and branches based in others.

## Capital requirements

The Basel regulatory accords set international standards in capital requirements for all "internationally active banks", and promote common practice in regulation and supervision to discourage arbitrage.

Basel I, which was agreed in 1988, tried to make banks accumulate adequate capital to cover their credit risks, by providing a sliding scale of different assets' risk weights. At one end, the committee assigned cash, central bank deposits, and OECD government debt a 0 per cent risk weight. At the other, it gave private sector debt, non-OECD bank debt with maturity above one year and capital instruments at other banks, capital assets at other banks and other more risky assets a risk weight of 100 per cent. Once all the assets of the bank had been risk weighted, it was compelled to build an 8 per cent capital buffer.[11]

Basel II, published in 2004, recognised that the capital requirements of Basel I did not sufficiently make banks' balance

11 Basel Committee on Banking Supervision, 'International convergence of capital measurement and capital standards', July 1988.

*Before the ink was dry, Basel II was out of date. Securitised products, derivatives and other complex assets were not sufficiently taken into account.*

sheets less exposed to risks across different types of assets. It used a much more complex model to define the risk that a bank's balance sheet faced within each risk weight. This included:

- 'the probability of default': the amount of defaults on that particular type of product in the previous year should be taken into account.
- 'exposure at default': this would estimate how much the bank was owed at the point of any given default, given the size of its exposure.[12]

If a new Basel process is undertaken, it is questionable whether it will have a significant impact on making banks safer if it is implemented as it has been in the past. Different jurisdictions implemented the Basel II accord at different times. In particular the US was very slow to take it up. The plethora of agencies in the US that regulate financial institutions argued between themselves over their remits and which recommendations they should adopt. The process was further delayed by Congress, which deliberated for two years on the accord, while Republicans argued that US banks would have to retain more capital than their overseas competitors. Representative Spencer Bachus, for example, said: "As I understand it, despite the US implementing Basel II differently to other countries, American banks will still have a higher capital requirement than their foreign competitors. If this is correct, surely this is a major competitive disadvantage."[13] All parties finally agreed on a proposed timetable in September 2006 with a start date for compliance of April 1, 2008.[14]

Yet even before the ink was dry, Basel II was out of date. Securitised products, derivatives and other complex assets were not sufficiently taken into account. The current crisis has exposed further problems. Basel II underestimated the impact of an unusually widespread systemic crisis, because it decreed that the probability of default should be based upon the previous year's data, rather than long term data that included the rise and fall of credit and asset price bubbles. The accord also forced banks to raise more capital as the crisis spread and the number and scale of defaults rose, exacerbating the credit crunch. It relied on easily gamed systems for determining risk – in-house analysis, and the international credit ratings agencies which were beholden to large financial institutions for their business, and which did not always have access to all the data for default rates. Furthermore, financial institutions circumvented the regulations by holding many assets off balance sheet in investment vehicles, by understating the risk of their assets, and by relying too much on wholesale funding which had a low risk weight. Basel II also let European banks hold too many 'hybrid securities' – a form of subordinated debt with some equity characteristics – as part of their Tier 1 capital. These turned out to be much less shock absorbent than common equity.

Any new Basel accord would have to deal first with the technical problems of Basel II and also with countries' compliance. There has not yet been an announcement from the Basel group about whether they will issue another accord, which would anyway take several years to negotiate – by which time it will have been superceded by national and EU legislation. Instead, the US and EU members could learn lessons from each other's experience of the crisis, and co-operate to ensure that best practices are followed, and that regulation is broadly symmetrical and follows similar principles, which will reduce compliance costs for financial institutions. Following Spain's example, capital requirements should be anti-cyclical, with banks building up capital in good times to be run down in bad.[15] European banks' resistance to changing the rules about what counts as Tier 1 capital should be overcome: hybrid capital should be replaced with fresh equity. The UK's liquidity rules make banks retain a liquidity buffer in local government bonds and cash in case other sources of funding freeze up. Also, the UK is phasing in the rules slowly over time, so banks have time to adjust – a device others can use for both liquidity and capital requirements to bear down on systemic risk without threatening the recovery of the financial system. The FSB is co-ordinating this process, and threatens to 'name and shame' countries that do export risk. But it could also offer advice on how legislatures could speed

12 Bank of International Settlements, 'An explanatory note on the Basel II IRB risk weight functions', July 2005.
13 Risk Magazine, 'Concern continues over Basel II in US', October 10 2006.
14 North Carolina Banking Institute, ' US adoption of Basel II and the Basel II securitization framework', February 2008.
15 A Ittner, 'Introducing counter-cyclicality into prudential regulation', October 23 2009.

the implementation and co-ordination of capital and liquidity rules.

## Securitisation reform

Making securitisation safer by forcing issuers to retain some part of the default risk of the underlying loans is meant to encourage the originators to scrutinise the underlying loans more closely. Too many securitised products before the crisis were given AAA ratings by the credit agencies, because issuers did not pass along information, either through reluctance or because they were not monitoring the loans. Issuers, for their part, took the assets they had securitised off their balance sheets, claiming that all of the risk had been passed to the end investor. But when the crash came, many banks bailed out the 'Special Investment Vehicles' they had created to turn the original loans into securities, which were supposed to run as independent entities. At the time of writing, the US House of Representatives has passed legislation requiring issuers to retain 10 per cent of each pool of securitised products to resolve this.[16] The Senate has to pass its own legislation, so this is not yet law. The European Parliament, while unlikely to legislate until later this year, is currently proposing that issuers should retain 5 per cent.[17] The fact that the EU is considering mandating a lower retention, which will make securitisation in Europe cheaper – and capital may flood in from the US to take advantage, increasing the total liquidity risk in the European system.

## Derivatives

There is a consensus on both sides of the Atlantic that OTC derivatives should be traded on central counterparties. A central counterparty takes the loss if one party to the exchange defaults before it is completed. These derivatives are useful to banks and companies because they could use them to hedge against 'known unknowns' about the future – interest rate and exchange rate changes or factor prices of production. And because they could be tailored to each party's appetite for risk, they oiled the wheels of the globalised economy. The problem was that OTC derivatives are by their nature non-standardised, and difficult to put onto a centralised clearing system which normally requires a small number of relatively standard instruments. As a result, 'counterparty risk' is significantly

*There is a consensus on both sides of the Atlantic that OTC derivatives should be traded on central counterparties, but disagreement on the details of how this should be done.*

larger than for exchange traded financial instruments. Instead of everyone trading through the exchange – and therefore only needing the exchange to be solvent for the trade to be secure – OTC derivatives produce a chain of smaller individual counterparties. If one party to a trade goes bust, the other has no way of recouping their losses, and would in turn suffer losses, which can ricochet through the whole system. If the system is centralised, a single default is collectively insured and has no such knock-on effects.

As noted above, the EU has already mandated that credit default swaps be routed through exchanges.[18] It is considering proposals that other standardised over-the-counter derivatives could be put through 'multilateral trading facilities' (MTFs), which bring together third party traders as a central counterparty does, but which can be run by market participants like investment banks, and which are more lightly regulated than exchanges. The EU passed the Markets in Financial Instruments Directive in November 2007, which allowed securities to be traded on MTFs with certain rules to improve transparency. Now it is considering doing the same for derivatives.[19] The US is trying to push more derivatives onto independent central counterparties, by mandating that banks and swap dealers may only hold a 20 per cent stake in a central counterparty.[20] This difference matters: independent clearing houses may try to offer cheap rates to attract business and then get themselves into trouble, while investment banks and funds that own central counterparties may prefer not to use clearing, to maximise profits from tailored derivatives.[21] If the US insists on independent central counterparties, and the EU goes for bank

16 American Securitization Forum, 'Comments and suggested revisions to subtitle F of the credit risk retention act of 2009', November 3 2009.

17 Financial Times, 'Skin in the game', November 1 2009.

18 International Organisation of Securities Commissions, 'Unregulated financial markets and products', May 2009.

19 EurActiv, 'EU courts US dealers with flexible derivatives rules', 6 July 2009. European Commission, 'Ensuring safe and sound derivatives markets', July 2009.

20 Goodwin Procter, 'Proposals for broad regulation of derivatives emerge in Congress', November 2 2009.

21 The Economist, 'Over the counter, out of sight', November 12 2009.

*Banks that have become too globally interconnected and large to be allowed to fail should pay the cost of their bankruptcies themselves.*

and fund-owned clearing, the EU may end up with a majority of non-standardised OTC business, which has proved profitable in good times but very dangerous in the last crisis.

However, at the time of writing, various banks and financial institutions in the US are lobbying hard against the attempt to strengthen regulation by Congress and the Obama administration. At present, the US is including foreign exchange derivatives in its proposals, despite the fact that foreign exchange derivatives markets did not freeze in the crisis. Foreign exchange traders and companies that use foreign exchange derivatives – such as the construction equipment manufacturer, Caterpillar – have complained about the extra cost of international trade that the proposals will make them bear.[22] As banks and corporations start to make profits again, it will be difficult to drive through reforms.

The timing of legislation will be different too. Europe is considering proposals to regulate derivatives next year, but Commission proposals to introduce centralised clearing will pass through the European Parliament this year, once the new Commission has had a chance to rewrite them. By then pressure may grow from corporations and financial institutions looking to avoid the extra costs that centralised clearing will impose on derivatives trading, and the regulatory authorities in London, Paris and Frankfurt may have less stomach for the fight. The US, European Union and national authorities need to move together to ensure that no regulatory gaps arise which could allow risky activity to flourish in one jurisdiction – risk that is likely to spill over into other jurisdictions.

## Accounting rules

At present, there are two sets of rules governing how banks should report the inner workings of their balance sheets: the International Financial Reporting Standards, which all EU countries, Canada and Japan, and around 70 other countries use, and the US's Generally Accepted Accounting Principles. It has been a long standing gripe for accountancy firms, banks, hedge funds and insurance companies that they have to deal with two codes. When the financial crisis deepened in the autumn of 2008, it appeared that the two sets of principles were converging. The two boards that oversee them, the International Accounting Standards Board (IASB) and the Federal ASB, agreed to stand firm against politicians' and banks' attempts to relax their 'fair value' principles, which insist that the current market value of many assets are used in their reports of profits and losses. In such a downturn, these rules tipped many banks into insolvency. Then in March the US Congress forced the FASB to water down its fair value rules.

Since then, the gap between the two has grown. Brussels is insisting that the IASB should issue new principles in 2010. The board is currently proposing that more liquid assets like government bonds could be accounted for in a way that smoothes the cycle, with prices lower than market value in a boom and higher in a bust. More risky assets, however, would still have to be accounted for at fair value. This makes sense (as long as the liquidity risk of government debt can be accurately assessed). But the FASB is under less pressure to strengthen its rules, and the US government has gone quiet on the idea that it might switch to IASB principles.[23]

## Winding down cross-border banks

In an ideal world, banks that have become too globally interconnected and large to be allowed to fail should pay the cost of their bankruptcies themselves. Yet there is little chance that governments will agree on overarching rules for bailing out or winding down global banks, given that, in reality, they have to provide support if they do go bust. However, banks will be encouraged to take more risks if governments guarantee their safety.

The colleges are therefore considering making the 30 systemically important institutions write 'living wills', which would clarify how they should be wound down, and how their remaining assets should be disposed of in the event of insolvency. This idea is popular in policy circles, but there are problems. Gillian Tett of the Financial Times points out that because banks "excel in regulatory and tax arbitrage, and all that cross-border complexity and opacity enables them to exploit such loopholes with ease," making them write their own wills would also force them to be much

22 Financial Times, 'Forex banker alarm at US plan for clearing', November 19 2009.

23 Financial Times, 'Converging codes', October 23 2009.

more transparent, and make jurisdictions co-operate to prevent regulatory and tax arbitrage. This is a good thing, but would entail unprecedented collaboration – and as Tett points out, regulators are "picking their fights" at the moment, in the face of renewed financial sector lobbying.[24]

There are other problems: banks would have to constantly update their wills as they expanded in some areas and contracted in others, which would require a good deal of information sharing and common purpose between the national supervisors that make up the international colleges. This is also no bad thing, but major challenges will have to be overcome – not least the tendency of financial institutions' home supervisors to treat them as 'national champions', and to try to fend off foreign supervisors who favour tougher scrutiny.[25] The wills would have to be drawn up in secret, or banks that have to write 'living wills' would face highly volatile share prices and borrowing terms as their balance sheets were picked over by the financial markets. Furthermore, no two financial crises are alike, and 'living wills' based upon previous cross-border insolvencies may be irrelevant without extensive stress-testing and constant revision.

Hence, there is little reason to believe the colleges will put an end to the intergovernmental and international shareholder wrangling that followed the collapse of cross-border banks in 2008, unless London, Washington, Berne, Paris, Tokyo and Berlin maintain the political will to act in concert in the coming years.

After originally moving in the same direction, the European and US approaches are diverging. In October 2009, Timothy Geithner, US Treasury Secretary, proposed legislation that will allow the authorities to monitor all institutions considered too big to fail, and would allow the regulator to take over and restructure or wind down those in danger of insolvency.[26] If these insolvency regimes could be joined up with co-ordinated action to bear down on regulatory and tax arbitrage, it would be possible to more effectively tackle the cross-border risk created by global banks. Germany is moving towards a resolution regime based upon an administrative takeover of close-to-insolvent banks by a single prudential regulator, housed at the Bundesbank.[27] If the legislation makes it onto the statute book before the 2010 general election, the UK government is considering making systemically important banks write 'living wills'.

24 G Tett, 'Why the idea of 'living wills' is likely to die a quiet death', August 14 2009.

25 N Véron, 'Les collèges de superviseurs financiers, vraie ou fausse solution?', La Tribune, November 26 2008.

26 Wall Street Journal, 'US seeks power to force even strong banks to shrink', October 30 2009.

## Conclusion: How legislatures can co-operate

In order to make banks safer, capital and liquidity requirements, derivatives and securitisation reform, accounting rules and insolvency procedures need to be tackled in a systematic way, and internationally. But in seeking a reform of international financial regulation, liberals face a conundrum. First, the liberalisation of finance across borders allows more lenders and investors to be matched up with potential borrowers and investments, and liberals would like to encourage it. But we would also like to ensure that the cross-border risk that financial institutions impose is effectively reduced, through taxes in the form of capital requirements, or via regulation of asset markets that does most to spread risk. Because this risk is too complex to quantify in a simple formula, it is necessary to pursue these aims through institutions which have the legitimacy to make recommendations based upon a judgment of the risks different countries are imposing on each other. This entails delving into the power politics of international relations. As the growing gaps between US and European regulation show, unless the they can work together, it will be very difficult to bear down on systemic risk. Because regulation is essentially a tax upon an externality, the legislation and democratic debate about it is necessarily taking place primarily at the national level. National governments are unwilling to co-operate unless it is clearly in their interests to do so.

While gaps in regulation are emerging, and are likely to get larger as the crisis recedes and financial institutions become more profitable and more vocal in their lobbying efforts, the broad trajectory in regulatory approach is similar. All governments recognise that the twin problems of 'too big to fail' and 'moral hazard' need to be tackled. They agree on the need for a new pro-cyclical approach to capital and liquidity requirements with higher capital requirements for more risky activities, and more rules for retaining liquidity. Both sides also agree that issuers of securitised products need to retain some of the risk on their balance sheets. And while there are differences on derivatives and accounting rules, they are not insurmountable.

27 Financial Times, 'Germany eyes bank regulation reform', October 5 2009.

*We are in danger of reverting to the status quo ante, where banks take advantage of poorly co-ordinated and ineffective rules, which are not updated quickly enough to keep pace with financial innovation.*

The problem is largely institutional. The experts on financial regulation in central banks, regulatory authorities and national treasuries are moving towards consensus on many issues, and are being well co-ordinated by the FSB. But the legislation that will shape the powers that these authorities will have is being driven – understandably – by politicians who have to answer to local constituents and party political pressures. Congressional suspicion of the Federal Reserve and international authorities may end in a weak macro-prudential policy and slow co-ordination of tougher capital and liquidity requirements with the rest of the world. The European Parliament and the US Congress are offering up different rules on securitisation, accounting standards and centralising derivatives.

The FSB should be invited to make recommendations to legislatures and national governments to ensure that the legislation granting powers to regulatory authorities does not limit international co-operation. Without a line-by-line analysis of all the bills going through parliaments to ferret out any regulatory gaps, national governments will find that pressing down on one bubble will inflate one elsewhere. The FSB has a secretariat based at the Bank of International Settlements in Basel, which collects data on international capital movements. The Bank of International Settlements has the expertise to provide a rigorous analysis of the potentially destabilising capital flows that would arise given mismatches in national legislation. It should be based upon historical data on international capital flows to avoid regulation and tax, which would provide the basis for projections given differing legislation on capital and liquidity requirements, macro-prudential rules, accounting standards and plans to make securitisation and derivatives safer. It should also provide an analysis of the risks that jurisdictions' different legislative timetables impose, and make recommendations for co-ordinating phase-in periods.

As the global regulatory process needs to become more alert to its own flaws, and more willing to constantly update itself to keep up with international capital flows, it would be helpful if systemic risk legislation was joined up. The FSB's 'naming and shaming' process is helpful, but the crisis of 2008-9, and the dangerous payments imbalances and regulatory gaps that led to it, has shown that the world needs to move towards frequent discussion between legislators, executives, central banks and regulators in an international forum with a secretariat providing analysis *before* legislation passes, and constantly updating regulators and politicians about the need to reform. We are in danger of reverting to the status quo ante, where banks take advantage of poorly co-ordinated and ineffective rules, which are not updated quickly enough to keep pace with financial innovation.

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