



The global architecture for effective financial regulation

by
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In 2008, the G20 set out a plan for managing the global financial crisis. More effective financial regulation was a key component. The G20 promised stricter regulatory standards and more coordination among regulators, facilitated by a stronger global architecture. The leaders created a new global institution – the Financial Stability Board – and called on the IMF and other existing international organizations to take supporting actions.

Critics argue that the world has been lulled into a false sense of security. The FSB is not a formal rule-making or enforcement agency, it could be disbanded by a press release of the G20. Clear lines of responsibility across international agencies have not been drawn. New regulatory standards are not being implemented. In short, global coordination is nowhere near where it needs to be.

What is the minimum global coordination required for national financial regulation to be effective? This question is addressed in this report which then examines the institutions delivering coordination and the implications for the FSB.

The report draws on the discussions undertaken on 30th June 2011 at a Global Economic Governance Programme workshop at Oxford University. The list of participants at the meeting is appended below. I am indebted to Stefano Pagliari and Rahul Prabhakar for their assistance in organizing the meeting, to several other participants for submitting excellent background notes for the meeting, and to Katharina Pistor, Eric Helleiner, Rahul Prabhakar and Michael Pomerleano for particularly detailed comments on a first draft of this report.

What is the case for global coordination?

Global finance has grown dramatically and become ever more interlinked. Inter-bank funding, both secured and unsecured, has created an interdependence across all countries with open financial sectors. The linkages are both deep and dynamic. The credit cycle has become strongly self-reinforcing on the upswing and on the downswing. Senior financial officials now speak of it being virtually 'impossible to know' the depth or scope of their financial firms' linkages with foreign firms.

Countries have different kinds of exposure. Some countries are hugely exposed to the collapse of large banks. For example, the four largest banks in the United Kingdom have balance sheets more

than four times the size of the UK GDP and the 2008 crisis demonstrated that the contingent fiscal liability is huge. The UK Independent Banking Commission estimates that the implicit UK public subsidy to the financial sector is at least £10 billion. Other countries are exposed in different ways. Kenya and Jordan, for example, are exposed not because of their national regulatory systems but because they are consumers of banks and financial services internationally. When they place their surpluses in banks in London or New York, they do so with the presumption that those banks will be safely regulated.

Yet neither Kenya, nor Jordan, nor some other 160 countries in the world have information about the extent of their vulnerability to failures in major financial centres. Not being members of the G20, the FSB, or the Basel Committees, they do not have timely access to information. Nor do they have influence over regulatory policies in major financial centres or the rescue operations home country regulators might take (or NOT take).

Regulation at the global level, even if strengthened, is not the cornerstone of adequate regulation: it is national efforts which will do the most work. In part this is because effective international agreements among major financial centres and governments are proving difficult to conclude. They mostly involve voluntary standards. There is little available information about compliance. The standards are not enforceable. There is no common, global fiscal pot to bail-out global actors. For all these reasons, governments across the world and their national regulators will find their own ways to reduce their vulnerability to catastrophic financial collapse. An important principle for global regulation is that global rules must not frustrate national efforts to move in a better direction. This is easy to say but it challenges several existing international agreements which aim first and foremost to protect free capital flows, whether in the European Union, in the GATS, and in some Bilateral Investment Treaties.

That said, global coordination is vital for any government to ensure financial stability within its borders. A crisis in another country can unleash a tsunami of spillovers and cross-border effects. Global coordination is particularly important in three key areas if national efforts to ensure financial stability are to be effective.

1. Securing financial services firms: reducing the public subsidy

The 2008 crisis revealed the extraordinary extent to which banks had extended themselves, ultimately on the back of public finances. The public costs of cleaning up after the crisis have led regulators to negotiate a new voluntary set of minimum agreed standards on loss absorbency measures (the Basel negotiations on capital and liquidity requirements), including special measures for systemically important financial institutions, caps on leverage, and arrangements for how international financial services firms would be wound up in the event of failure (from 'living wills' to the Dodd-Frank framework for permitting bail-ins and reorganization).

The structures within which financial services are provided and exported are also important. At the national level, some have proposed ring-fencing retail banking given that it is still largely a national activity and involves a lender-of-last-resort function: the UK Independent Banking Commission proposes a retail ring-fence. More broadly, the 2008 crisis exposed differences between banks with branches abroad (regulated by the home country), and banks with subsidiaries abroad (independent entities regulated by the host country), leading some to demonstrate that subsidiaries were less volatile in the crisis. However, these differences blur in Central and Eastern Europe. Host country regulation is compromised by consolidated regulations and home-host guidelines, which favour the parent banks' home countries. Furthermore, the subsidiaries' regulators are defenceless when the parent companies use leasing companies or direct lending to circumvent regulatory restrictions

imposed by regulators on subsidiariesⁱ. Subsidiarization may well also violate GATS commitments (although this does not pose a problem for countries within the EU, it certainly does for third countries and for those outside of the EU). The limits to what can be achieved through subsidiarization require more attention to be paid to alternatives which include: caps on bank size, higher prudential requirements for more internationally active banks, rapid resolution plans, and limiting the retain deposits for banks (eg in response to the Icelandic crisis).

Overall, private financial services firms must stand on their own two feet, as opposed to precariously balancing their highly leveraged activities on public financing. Workshop participants were almost all of the view that greater national stability (by imposing higher capital requirements and contingent capital bail-ins on banks) needs greater priority than the international competitiveness of banks. That said, few governments and regulators seem to be putting greater national stability ahead of the competitiveness of their banks. For this reason, global coordination is crucial. It must minimize the danger that external competitive pressures undermine domestic political support for prudentially appropriate levels of national regulation.

Global cooperation on standards needs to ensure governments in major financial centres raise capital and liquidity standards, and to combine with structural measures such as leverage caps, living wills, and ring-fences.

2. Upgrading regulation: avoiding the (de)regulatory race to the bottom

The 'race to the bottom' is a direct concern for governments. In financial centres, the risk is that countries seeking greater stability through tighter regulation, will find themselves doubly penalized. They could lose out as financial services firms relocate to less regulated environments, or (as occurs more often) relocate their activities through the proliferation of legal vehicles. They then find themselves facing growing offshore risks due to lax regulation elsewhere, even as they do their best to tighten their national regulation. For example, Deutsche Bank has 7000 legal entities around the world, largely for tax and regulatory reasons. This makes it exceedingly difficult for governments to resolve.

As a former Central Bank Governor has noted "there is a growing tendency to register transactions where funding and regulatory costs are lower". The regulation of one part of the financial services sector will likely drive activity into other parts. Coordination is needed beyond the perimeter of the banking sector and into the shadow-banking system to ensure that all financial centres work together e.g. to ensure safer and more transparent financial markets.

Global coordination needs to permit and encourage a 'race up' rather than a race-down. In the current debate too much weight is being given to 'avoiding protectionism' as national authorities attempt to protect financial stability.

3. Strengthening regulatory compliance and oversight, and improving the sharing of information

A third key area for coordination concerns compliance, and the sharing of information and cooperation in regulatory oversight. National regulators have 'surprisingly poor information' which is 'weeks old when what we need is real-time information for regulators'. As one regulator puts it reflecting on large global banks: 'we need full and equal access to relevant and timely information on both a subsidiary's and a parent bank's global position as well as each one's risks'. Current efforts are attempting to patch up deficiencies through international sharing and review arrangements.

These are important but also highlight serious gaps in the resources (staffing and other) and formal powers available to regulators.

Missing from the current debate about oversight and information is the fact that the regulators of subsidiaries also need information about parent banks, as the examples of Kenya, Jordan, and Central and Eastern Europe (discussed above) demonstrate. The global debate is still focussed on the major financial centres and the presumption that crises will transmit from badly supervised subsidiaries back to parent banks and their financial system. The 2008 crisis demonstrated that the reverse risk is at least as acute. Once parent firms are in trouble, they begin to withdraw capital from their subsidiaries and branches – and yet local regulators and officials may not have access to relevant information.

Finally, it is worth noting that deficiencies in supervision and oversight increase across other sectors. While banking supervision has its problems, in the words of one participant: ‘banking supervision is fairly proficient, securities regulation is less prudentially oriented (and more disclosure oriented), insurance regulation is mediocre, and supervision in the pensions sector is non-existent’. This is a serious issue. Much of the shadow banking sector is regulated only by securities regulators. However, this is not regulation in the pursuit of financial stability. This is regulation focussed on information disclosure and fraud prevention.

Better quality regulatory oversight requires strong and effective ways to coordinate and to exchange information in several key sectors. Yet more importantly, it requires that prudential considerations and overall financial stability are at the heart of the regulators’ concerns. This is not the case across all sectors.

What kinds of institutions do we have and do we need?

The lack of formal intergovernmental rules on global finance is startling. Compare international trade which has increased in a sleepy way compared to the explosion of global finance. In trade, an intergovernmental structure for rule-making as well as for adjudicating disputes has been created. In global finance there has been no such evolution. The Financial Stability Board was created – and could be terminated – by a press release of the G20. It consists of less than two dozen staff with no formal enforcement powers.

In global finance there has been a remarkable and dramatic increase in private regulation organized by the industry itself (detailed in Mattli and Büthe, 2011). This private global regulation has been permitted, facilitated, and recognized by governments. Yet it is failing. First, private regulatory processes are not delivering standards and processes which command the confidence of all members: for example, Mattli details the significant gap in members’ confidence in the governance of the IASB. Second, and yet more importantly, private self-regulators are unlikely to sacrifice their own interests where the public interest demands it. Put simply, the three tasks of global coordination listed above are unlikely to be delivered by private standard-setting networks.

Government standard-setting networks in global finance have expanded. ‘Alphabet soup’ is used to describe them. One European regulator noted ‘we sit in endless committees with different alphabet labels, seeing the same people and doing the same business.’ Another regulator noted ‘70% of the membership of the various groups overlaps and about 70% of the agenda’. These are the overlapping committees created to develop standards, share information, and operate some form of peer review. As new groups are created, existing groups ensure they are represented on them. Hence, the overlaps. The irony is that the multiple overlapping committees in fact represent the very small number of countries invited to participate, creating a dense network of a few countries and

giving no voice to others: with some of the networks (eg the Basel Committee) being more exclusive than others (eg IOSCO).

Contrasting with the alphabet soup of committees, there are also several universal, intergovernmental organizations with some jurisdiction over parts of global finance. These include the International Monetary Fund, the World Bank, the WTO and GATS, and the United Nations. Each has formally defined membership rules and associated duties and responsibilities, formal rules and enforcement mechanisms, and procedural and decision-making requirements. They are good at knowable tasks, at creating formal obligations, and monitoring and implementation to achieve those outcomes. By contrast, the governance clubs or the committees mentioned above are created to focus on a particular function: they do not look at broader implications; they serve a specific purpose and hold together only as long as mutual interest prevails. They are not well placed to deal with uncertainties; nor are they responsive to rapid changes in the market place. Consider the FSB's predecessor, the Financial Stability Forum, which witnessed the build-up and bust of the global financial system.

Any proposals for improving the global architecture for financial regulation need to pay heed to the respective strengths and weaknesses respectively of clubs and universal intergovernmental organizations. Table 1 at the end of this report captures some of these distinctions.

What are the key elements of institutional design required for the key areas of global coordination listed above: securing financial services firms, upgrading regulation, and strengthening oversight?

Formal structures are important, even for governance clubs and informal committees. Rule-makers need to **maximize transparency** to ensure legitimacy through public scrutiny. They need to **use mandatory processes** to permit timely and informed access to deliberations. They need to **structure participation by key stakeholders** in the public and private sectors to ensure a balancing of stakes.

Getting the right people around the table with the right incentives and structures to share information is vital, particularly in a crisis. This does not mean just gathering those with the largest stakes: 'in negotiations on Greece, for example, the incentives of some of actors have been very focussed not on Greece's problems but on their own'.

Using an 'anchor tenant' to resolve crises was one idea tabled by Katharina Pistor. Citing the Vienna Initiative, she highlighted the role played by the EBRD in bringing stakeholders to the table (including countries outside the EU as well as banks, IMF, ECB and others). The result was an open forum in which problems were discussed and programmes developed on a country-by-country basis. The result was debated by participants. Proponents argued that it prevented the socialization of private debt. Opponents noted that it led to a huge infusion of public funds from EBRD, IFC, MIGA, EIB, EU, and national governments. However, in Central and Eastern European countries parent banks had withdrawn over 50 billion Euros from those countries, threatening a collapse of the financial system. For this reason, an infusion of funds was necessary. Key to the Vienna process was the fact that parent bank countries allowed their bailout money for banks to be used for foreign subsidiaries. This was critical, because otherwise host countries would have been saddled with the entire costs of the crisis. The key attributes of the anchor tenant role include: its capacity to identify and enrol critical stakeholders; to speak for the common interest; the ability to bridge disparate domains through coordination; the provision of procedural rules; and managing the communication of outcomes.

In resolving the 2008 crisis, global leaders have made much of 'peer review'. Previously, the global architecture relied heavily upon a division of labour with memoranda of understanding between regulators setting out guidelines. The new architecture attempts to build-up peer review. Ideally this

will permit governments to coordinate and monitor one another without creating a lock-step. But in the financial sector, peer review has been a very weak force, as highlighted by the crisis (various evaluations have highlighted the failings of peer review), and more recently by the lack of progress in implementing remuneration standards agreed in the Basel process. To be more effective, peer review needs to be open and transparent so as to bring other forces to bear on governments and the private sector.

More robust enforcement at the global level is a far away prospect unless a creative way is found to leverage the vast information, expertise, staff, and authority of the financial services sector itself. Within the current architecture, financial intermediaries have strong incentives to engage in a race to the bottom and re-flag their operations to benefit from low cost regulation. Much more creative thinking in law and political economy is required to think about how to confer on global financial services firms' material interests in monitoring one another and monitoring how effectively governments across the world are upholding agreed-upon standards. This currently occurs in trade, where industry associations are key in gathering information which founds cases taken to the dispute settlement mechanism.

What are the implications for the Financial Stability Board?

The FSB is at present a governance club. Governments have not delegated authority to it, nor endowed it with the resources or mandate to take formal action. As noted above, it was created and could be terminated by a press release of the G20 (recall how quickly the FSF was replaced). This leaves the FSB with an important but limited role in helping forge standards for securing financial services firms, upgrading regulation, and strengthening oversight.

Five ways to strengthen the FSB

First, perhaps the simplest recommendation is **more staff**. As mentioned above, less than two dozen staff are currently attempting to fulfil the G20's expectations of the FSB.

Second, **a wider membership and a greater formalization** and institutionalization of the FSB could sharpen its ability to facilitate the necessary coordination described in this note. This would include a formal basis (eg treaty) for the institution to exist, with formal rules and duties of membership, ensuring more universal representation. It is worth noting that the FSB is setting up Regional Consultative Groups which link non-member observers from Latin American, Eastern European, African, and Asian countries, to major existing member states from their region. This is an effort to provide a channel for input into FSB discussions (as well as to promote adherence among non-members with FSB standards, about which more below).

Third, the processes of the FSB, specifically in its standard-setting role could be more open. **Transparency** is an important way in which the FSB could leverage greater information, stakeholder and political support. Crucially, a lack of transparency can cement 'groupthink' among policymakers. Opponents of transparency argue that it could impede frank and open discussion. However, the experience of publishing the minutes of the UK's Monetary Policy Committee suggests otherwise. Transparency might also make agreement more difficult because participants will negotiate with an eye to constituencies outside the room from whom they could face backlash. However, the recent history of financial regulation suggests that without transparency too many eyes were trained exclusively on major banks and financial services sector firms. Equally the fear that transparency will reveal too much information to financial services firms seems ill-placed given how readily and easily major financial services firms in practice acquire the documents and deliberations of ostensibly secret public deliberations. A lack of transparency is simply resulting in asymmetric access.

A fourth improvement for the FSB would be **the use of mandatory processes, and more structured participation of public and private sector actors and other key stakeholders.**ⁱⁱ These lessons can be drawn directly from the experience of standard-setting in the European Union.

A fifth way to strengthen the FSB would be to **enhance its capacities for rule-making and enforcement.** These are almost impossible for the FSB as currently constituted. The Charter of the FSB lists obligations to abide by international standards but the meaning is not made clear. If a member does not abide by a standard (e.g. remuneration standards), what are the consequences? The FSB has neither the delegated authority to make rules, nor the capacity to monitor compliance, nor any formal powers to enforce. That said, the FSB is being expected to monitor 'rules' coming from organizations with the same, if not greater, deficiencies (such as the Basel Committees, IOSCO, the IASB and so forth). If minimum coordinated standards are to be enforced, there might be two possible routes.

Within the existing framework, the FSB's capacity to enforce could be strengthened by using membership as a carrot and stick, so that poor compliance could lead to membership being revoked (of the organization as a whole, or of a committee) with good behaviour earning places on committees and suchlike. At the same time, peer review (as discussed above) could be strengthened. In the words of one official, peer review must go beyond 'mutual back-scratching'. At the very least peer review should not be subjected to a unanimity principle (this used to be a requirement for the acceptance of trade dispute adjudications but was reversed in 1994 when a reverse consensus became required: ie a consensus is required to reject a report). Crucially, both these ideas work only inside the membership of the organization. The FSB's efforts to promote wider adherence of its standards through the above-mentioned Regional Consultative Groups is an important recognition of the limitations of its current membership. Wider, universally accepted standards would require more countries to be involved setting the standards (as argued by Andrew Walter in his memo) as well as in monitoring and overseeing their compliance. For this reason, our second recommendation on expanding membership is a crucial one.

Outside of the existing framework, a more creative way to deal with enforcement is devise incentives for private actors to monitor and pursue compliance by governments with regulatory standards. This would be ideal since the financial services firms themselves have the information, expertise, resources, and staff to do this. Why would they? They might seek to monitor and push for regulatory compliance for several reasons: (1) firms might themselves be consumers of financial services and wish for assurance; (2) they might be hosted in a regulated jurisdiction and seeking to level the playing field in others; (3) they might be newcomers to a sector and seeking to ensure that all competitors are treated equally; (4) they might have reputational assets bolstered by demonstrating the value they place on good regulation (see Mattli and Woods, 2009). Mobilizing private resources in global financial regulation will take further creative thinking, such as around how to create global rights among states that would be enforced indirectly by the private sector (as occurs in the dispute settlement mechanism in trade). The present system does the opposite, combining voluntary standards which are not adjudicable, with government bailouts.

A final issue discussed in the workshop was global resolution regimes. This is a tough area. One proposal was that the FSB could play an 'anchor tenant' role in the resolution of crises, as described above. Others discussed a more robust global bankruptcy regime. Opponents pointed out that beyond international legal agreement, it would take changes in national laws, the training of national bankruptcy personnel, and a change in culture to bring about a global system. The IMF has pushed hard for a better resolution regime in the past. Currently it is exploring how to ensure some degree of burden-sharing. For example, as part of its G20 work, the IMF has produced a paper on

the taxation of banks such as by a bank levy or financial activity tax (on banks' profits and the wage bill). The UNCITRAL law (coordination model) and possible UN involvement were raised.

The hard constraint on resolution is governments who wish to protect their own over-exposed financial services firms. This was as true in the 1980s debt crises as it is in the eurozone today. EU insolvency regulation was not relevant to the 2008 crisis perhaps because no government wanted their bank to go into insolvency: 'they preferred pouring in public money or selling off the bank'. More specifically, however, bankruptcy regimes do not work well for financial intermediaries. Instead something like the FDIC regime is required, where a bank can be seized overnight and transferred to new owners to avoid the spectre of a run on the bank.

The FSB is not intending a global insolvency regime. Rather it seeks to minimize the prospect of crises by way of standardizing regulation and peer reviews and – in addition – mechanisms for crisis resolution, in particular of systemically important financial institutions. In this matter, global coordination is required to set out the powers and tools government could use, and then have all major jurisdictions adopt resolutions regimes that have these key attributes. An insolvency process would need to underpin the regime but many other tools would be relevant. Financial institutions would need to prepare for the fact that they may need to be 'resolved' - hence to accept resolvability assessments. Living wills will be mandatory for all these institutions and each has a resolution part which involves a cooperation agreement among governments in respect of that institution.

PARTICIPANTS IN THE WORKSHOP

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- **Toukan, Umayya** – former Governor of Central Bank of Jordan (until November 2010)
- **Turner, Lord Adair** – Chairman of the UK Financial Services Authority
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ⁱ Katharina Pistor makes this case.

ⁱⁱ The organization is about to release a massive ‘compendium of standards’ in which they touch upon good practices in the setting of standards.

Selective Overview of Institutional Design in Global Economic Governance
(With thanks to Rahul Prabhakar for compiling this table).

	International Monetary Fund	Basel Committee on Banking Supervision	International Organization of Securities Commissions	World Trade Organization	Financial Stability Board
Membership	Universal: 187 countries	Club: 27 countries	Universal: 182 countries	Nearly universal: 153 countries	Club: 24 countries and 6 standard-setters
Transparency	High: “Voluntary but presumed” publication of country documents; 98% agreed to publication of data (2009)	Low: Public comments displayed; opaque/exclusive deliberations in working groups, Committee meetings	Low: Meetings publicly announced, briefly summarized; observers may attend annual conference	Medium: Meetings announced and summarized; access to legal documents related to dispute settlement	Low: Press releases of conferences; minimal identification of participants’ views
Monitoring	Mandated membership duty (Article IV); regional and multilateral surveillance	Minimal	Minimal	Light, centralized monitoring; Trade Policy Review Mechanism; regional agreements monitored	Country peer review reports (volunteered by Spain, Italy, Mexico); thematic review reports
Enforcement	Borrower conditions; suspension	Moral suasion	Self-assessment	Dispute Settlement Mechanism/Appellate Body decisions confer retaliatory rights on members	Moral suasion