Chapter 8

Institutional Issues: The Locus of Regulation, Host or Home?

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The crisis occurred as a result of domestic regulatory failures. The supervisors who failed to consider the risks of Northern Rock or IKB did so on their own. However, there is a legitimate concern that our attempt to rectify these issues must be global first because finance is global, and second to lessen regulatory arbitrage. We conclude that while enhanced international cooperation is good, especially whilst markets remain global, the lasting solution is to make finance a little less global. We question whether a global rule setting body would be the best way to end regulatory arbitrage. It is important to remember that a form of global regulation was the path we were inching along: home country regulation of financial institutions in accordance with a global set of principles, coded into rules – the Basel system. Yet this system appeared to provide avenues for regulatory arbitrage that would not have been averted simply by widening the coverage of institutions and instruments.

Many non-market participants tend to think that, like risk, there is a single thing called regulation and you can have too little or too much of it. The reality is that regulation can be just different, rather than light or heavy. Are counter-cyclical capital charges that rise above average in the boom and fall below average in the slump heavier or lighter than raising the average level of capital? We think it will be more effective. Is a switch to mark-to-funding which links value-accounting to the length of period a holder can hold on to an asset, lighter or stronger, than requiring mark-to-market value accounting?

It is also hard to conceive of a single set of regulations that would be appropriate for very different countries. China, Russia, Bermuda, Mexico, Peru, all have different credit structures, financial needs and institutional capacity. Political priorities differ too. In India, for example, financial regulators are focused on financial inclusion; in other countries that would seem to lead to lax regulation for those who need it most. However, even if we were to have a single set of regulations, national enforcement will differ as national priorities and/or enforcement capacity differs. This would be one source of regulatory arbitrage. Another would be that home country regulators are champions of national interests. The U.S., the U.K., Iceland, Ireland and Luxembourg signed up to Basel's core principles and rules, but the expansion of U.S. investment banks into Asia after the Asian Financial Crisis, 'light touch' regulation in Britain, the international expansion of Icelandic Banks, the pursuit of international mutual funds in Dublin and Luxembourg were part of explicit or implicit national development strategies.

Options for Coping with Global Imbalances

Heribert Dieter

Most financial crises of the last three decades have been preceded by high inflows of capital into booming economies. Latin America in the late 1970s, Asia in the mid-1990s and the United States, Iceland and Spain in the current decade are examples of that pattern. Normally, the emphasis of the discussion is on the capital importers, but in this boom an increasing attention has been placed on capital exporters. Just days before the September 2009 Pittsburgh Summit of the G-20, President Obama has criticised China and Germany for selling ever more goods to the U.S. and expecting America to go ever deeper into debt in the process.

The principle that both surplus and deficit countries should be sanctioned was the core of John Maynard Keynes' plan for the Post World War II financial order. Keynes had suggested the creation of an international clearing union. Countries producing surpluses would have lost these claims after a certain period of time. Whilst today's international transactions are far too comprehensive to make the introduction of an international clearing union a realistic proposal, the principle that Keynes identified is still plausible. Surplus countries should contribute to the resolution of a problem to the rise of which they contributed.

Policymakers have been discussing global imbalances at various summits, in particular at G-8 or G-20 meetings, for decades. Unfortunately, they have been doing so without results. Instead, global imbalances have risen sharply this decade. The world current account imbalance, i.e. the half-sum of all deficits and surpluses of the 181 countries in the database of the IMF, had been relatively stable between the early 1970s and 1997. In that period, the world current-account imbalance oscillated around 1.2 percent of global GDP. Between 1997 and 2007, the world current account imbalance has almost tripled to about 3 percent of global GDP. Since voluntary corrections of the current account surpluses are not happening, the question arises whether there could be other options.

Indeed, measures that sanction surplus countries could be considered. One of these is that countries that produce large current account surplus over longer periods should have to pay a percentage of these surpluses to an international authority. Large surpluses could be defined as larger than four percent of an economy's GDP, and longer periods are defined as more than three years. A penalty of ten percent of the surplus in the fourth year would have to be paid by the government of the surplus country in Special Drawing Rights to the IMF.

Of course, such a proposal raises a range of critical issues. First, the definitions used are arbitrary. Neither the ceiling of four percent of GDP, nor the three-year time frames are supported by hard economic rules. Second, one could argue that the export of capital is a private activity that the government of an economy cannot control. Whilst this is true in a narrow sense, a government has an obligation, or should have an obligation, to monitor and control the effects of the activities of its country's citizens for other countries. Just like governments take responsibility for, say, the proper behaviour of their corporate citizens abroad and prohibit corruption, a government has to accept responsibility for the production of large capital exports.

Third, critics might suggest that transferring taxpayers' money to an international organisation will be difficult in many societies. Whilst this is true, there is certainly no automatic transfer of money involved. Policymakers have a range of options at their disposal to discourage the export of capital.

They can make investing domestically more attractive, discourage saving, or they can encourage domestic consumption. In addition, some of today's capital exporters have failed to address major problems in their economy and a penalty on the creation of surpluses could provide an incentive for correcting these issues. Japan, for example, was unable to clean up the fallout from its own financial crisis and resorted to a zero interest rate policy, which in turn was a major source of instability since the mid-1990s. Another notorious exporter of capital, China, has been forcing its citizens into high savings because the country lacks an adequate system for both the financing of education and for retirement. Germany has been stimulating export growth without paying any attention to the consequences of that strategy for both its European partners and economies elsewhere. In all those cases, a penalty on sustained surpluses would focus policymakers' minds on a more sustainable and less aggressive economic model.

In essence, the proposed regime would address a major weakness of today's international financial order. Whilst in theory the production of surpluses would be self-correcting through currency re-alignments, in practice this has not worked. Japan has been manipulating its exchange rates by accumulating large foreign reserves. China uses an exchange rate that is set by the government, not by markets, and can do so because it implements restrictions on capital flows. Germany could produce surpluses without an effect on its exchange rate because it operates within the European Monetary Union, which as a group has not produced large surpluses vis-à-vis the rest of the world. Of course, an alternative to addressing global imbalances would be to ignore them. Taking this perspective, cross-border capital flows would simply not be an issue for policymakers, neither in the capital exporting nor in the importing economies. The risk of this hands-off approach is clear: frustration about the unwillingness of capital exporters to reduce their surpluses can easily spill over into the trade domain and can be used to justify protectionist measures. The liberal trade regime, which has proven to be of great benefit in particular to emerging economies in Asia and elsewhere, is too important to risk for the sake of enhancing the investment position of a handful of capital exporters.

We believe that host country regulation is best suited to address this kind of regulatory arbitrage in a way that best protects all countries – rich or poor, big and small. The idea is that all institutions carrying on financial activities nationally, raising funds from residents or investing in national assets or markets, must be regulated locally. An Icelandic bank could no longer operate in the U.K. as a branch, regulated in most part by the authorities in Iceland, but must be regulated in the U.K. as a stand-alone bank with sufficient capital for its activities in the U.K., and able to withstand the failure of its parent. The capital of all these local entities would be subject to a series of nationally focused rules such as macro-prudentially driven changes in capital requirements and additional capital requirements for currency or maturity mismatches between liabilities and assets.

Consider the rapid expansion of Swiss franc mortgages being issued by a large Swiss institution to Hungarian residents at seductively low Swiss franc interest rates. Under home country regulation of global rules, we would have to hope that the Swiss authorities are sufficiently concerned to act on an activity that poses no risk to the Swiss institution's survival, and that they are able to identify cross-border lending within a globally organised institution (note that from the perspective of the Swiss institution, it is a cross-border loan but not a currency mismatch as Swiss deposits are funding a Swiss franc loan).

Under host country regulation the lending institution would have to be a locally regulated entity. Debt contracts between local residents and foreign entities that are not regulated locally would be unenforceable. The nationally regulated subsidiary of the Swiss bank may be able to offer a Swiss mortgage to Hungarians

if the Hungarian regulators are content for it to do so. We may suppose that it would be allowed to do so if it were to set aside, locally, additional capital for currency and maturity mismatches between the asset and liability and, if this lending grew rapidly, additional macro-prudential capital. As a consequence, this would be a safer, rule-bound, more monitored and less attractive activity.

Consider an international hedge fund, private equity or mutual fund with head quarters in the Caymans. To raise funds from the U.K., Germany or India, or to invest in any of these countries they would have to have a locally regulated entity. How a hedge fund is regulated will differ from how a bank is regulated, depending on the nature of its activities. If a hedge fund is acting like a highly leveraged bank it should be regulated like one. But if it is a small, unleveraged, investment fund for experienced investors only and therefore with minimal systemic properties, it would not be regulated like a bank but like an investor.

Consider U.S. investors wishing to invest in the Indian stock market. They would have to do so through an Indian investment entity that would be locally regulated (as they do now). This regulation would be focused either on protecting local investors or, in the case of the international investors, minimizing the macro-prudential risks of lending that is concentrated by sector or time. The local entity would probably face local restrictions on the degree of leverage and currency and maturity mismatches of its assets and liabilities. These regulations may serve to make some markets less volatile, and as a result more attractive to underlying investors, creating a race, not to the bottom, but to the middle in regulation.

Our approach to regulation will have an effect on cross-border capital flows. It will generally dampen cross border flows between currency areas because of the additional capital requirements for currency mismatches and the administrative requirement to set up or invest via an entity or entities regulated where funds are raised and where they are spent; it will dampen cross-border flows of short-term capital because of additional capital requirements for maturity mismatches; it will dampen inflows during a national boom because of the additional (macro-prudential) capital requirements for lending during booms; and it would support capital inflows during a credit recession because of the lower capital requirements for lending during a credit recession.

Is this a license for financial protectionism? We would argue not. In our proposed regulation we make no distinction between where the parent is located, the only distinction concerns the activity. An Australian bank operating in Germany would face the same regulation as a German bank operating in Germany. If both banks lent to the same sector using the same instruments and the Australian bank's German subsidiary was entirely funded by German depositors, and the German bank was entirely funded by borrowing short-term dollar funds from international markets, the Australian Bank's German subsidiary would have lower capital requirements.

Ensuring that host country regulation did not lead to financial protectionism would be an important task of global regulatory bodies, perhaps best exercised through a peer review mechanism. While in practice the best defence from the predatory activities of a large lender is host country regulation and not home country regulation, we recognise that there is scope for larger lenders to bully small states or to try and arbitrage local regulations. So another task of global regulatory bodies would be to ensure that foreign regulators help domestic regulators pursue their legitimate national regulation and do not undermine it.

Institutional Issues: Rules versus Discretion

Financial regulation combines legal rules and principles-based administrative discretion. The effectiveness of the mix depends on the legitimacy of those who promulgate and implement the regulatory framework, and of the process by which it comes about. Rigid rule systems are prone to collapse under stress, and therefore lack credibility; unmoored discretion can turn into arbitrary exercise of power and often lacks transparency and invites capture. The challenge is to achieve the optimal mix for a given regulatory objective and political context.

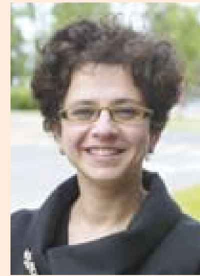
We believe that a greater emphasis on rules is appropriate for host regulation at the national level. Such rules must be coordinated internationally to reflect the demands of financial integration. Coordination should produce agreement on common principles, a process by which the principles would change over time and a forum for peer monitoring and implementation.

We view the emphasis on principles at the international level as a necessary response to the diversity of national legal regimes, economic and political imperatives, the rapid evolution of financial instruments and markets, and the urgency of sensibly harmonised reform. We also believe that principles-based international regulation is more effective where it takes the form of soft law: a set of informal norms and fora that do not rely on judicial enforcement, but rather on the buy-in of its constituents.

The argument for host regulation in this report recognises the diversity of legal regimes, and the technical and political capacities of states. This means that weak and under-resourced states will be among those charged with regulating the activities of the world's largest and most sophisticated firms. To address this, we suggest that multilateral institutions should assist developing countries with capacity building (as outlined in greater detail in Box 5). On the flipside, global institutions will have to contend with a multitude of applicable governance regimes. We believe that such costs do not outweigh the benefits of regulating instruments, activities and institutions in the context where they have the most direct impact. But making host regulation more rules-based will help mitigate the costs.

Regulating Financial Contracts
Anna Gelpern

This financial crisis is a crisis of private contracts: mortgage, securitisation, and derivatives, among others. Consenting adults are normally free to agree as they please in the privacy of their conference rooms. Assuming it meets certain minimal formal criteria, the product of their negotiation gets the moral and legal presumption of 'contract sanctity'. Yet not all private agreements get the privilege of state enforcement. Few courts would compel performance of a suicide pact, a prostitution contract, or a conspiracy to fleece an elderly granny. Until recently, gambling debts were unenforceable in most common law jurisdictions. And on rare occasions, such as insolvency or financial crisis, contracts that are perfectly innocuous when made can be modified or invalidated retroactively because they become socially harmful, or come to interfere with the exercise of public policy.



Mortgages, securitisation and derivatives contracts have received bad press of late. This is understandable: in the run-up to the crisis, they became vehicles for very bad behaviour, ranging from fraud and gambling with other people's money, to unsustainable leverage that helped bring down entire financial systems. However, as this report observes, every financial crisis in history has found its own contractual bête noire. Banning or restricting specific financial instruments ex ante is at least insufficient and potentially harmful as a regulatory paradigm. It can create a temporary illusion of safety (ridding the world of a weapon of mass destruction!), but it locks regulators in a perpetual game of Whac-a-Mole – ceaselessly hammering on new instruments that arbitrage the latest ban.

There is no easy answer to this dilemma. Regulation should encourage appropriate risk taking, and discourage socially harmful behaviour, which can manifest itself in any number of formal instruments, and which can vary depending on who holds the instrument. It takes a lot more work to identify and manage private contracting patterns – ways in which diverse financial

actors use different instruments – in real time than to simply ban some contracts. Solutions such as requiring advance approval for financial innovation similarly operate in the dark. More often than not, the risk profile of an instrument is unknowable in advance. Moreover, any economic arrangement can be formally documented in countless ways. And some sensible instruments can become 'toxic' over time, simply because they get too big and widespread. This is true of some derivatives contracts in this crisis, just as it was of gold indexation in the 1930s. Yet innovation is both unavoidable and indispensable. It is as capable of producing socially useful financial products as socially harmful ones. This means that a good part of contract regulation will be retrospective, and some will come in a meltdown.

When crisis hits despite the best regulatory efforts, most governments face a choice between allowing mass bankruptcy and using public funds to subsidize performance by insolvent or illiquid contracting parties. Some choose instead to rewrite contracts ex post, wholesale, particularly where their enforcement would harm the macroeconomy. This is a distributional choice. It is also one that must be seen by regulators and market participants as part of the background landscape of norms governing finance.

Financial stability requires regulators to have the capacity to detect when a private contract becomes a vehicle for destructive behaviour, and then to withdraw the privilege of enforcement. Provided governments do not abuse this tool, this risk alone might help deter bad behaviour.

The benefits of rules are especially palpable in a weak institutional environment, but they also have important advantages in sophisticated markets where claims of regulatory complexity can disempower regulators and the public. Rules tend to be more transparent to their subjects and beneficiaries alike. This facilitates monitoring by the affected constituencies and the general public, as well as private enforcement and informal sanctions, even if public enforcement is lacking. If the rules are a product of regulatory capture, they also make capture more apparent at home and abroad. Similarly, breach is more visible in rule systems. On the other hand, demonstrable compliance with rules can boost public faith in regulatory institutions, creating a core of legitimacy that may in turn make it easier for regulators to exercise discretion on the margins.

Rules work best where their goals and the activities they govern can be defined with enough specificity. We believe that the risks of any given financial activity can only be defined in the context of that activity. Even basic activities such as secured credit, housing finance, deposit-taking and simple credit insurance can have widely different risk profiles in poor, middle-income and wealthy countries. From a macro-prudential perspective, patterns of financial activity may affect different economies very differently. National regulators are in the best position to assess the precise risk that an activity poses to their financial system and macroeconomic management, and to devise rules in response. In contrast, broadly applicable international rules are more likely to key off formal similarities among instruments and institutions, oblivious to or consciously disregarding the substance of the risks they present in a particular setting for the sake of a diplomatic consensus.

Hard National Rules and International Soft Law

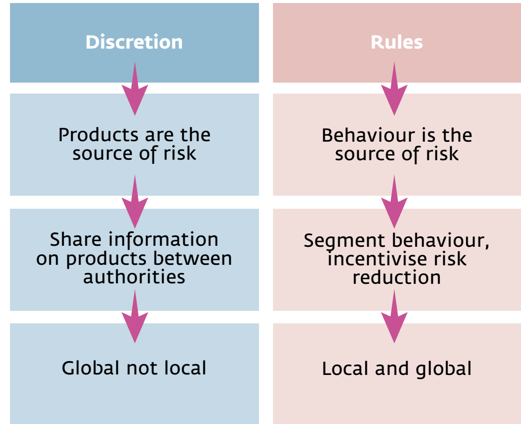
The advantages of rule systems at the international level are more attenuated. There is no single global context for financial activity, no cognizable global constituency, and no single global risk profile for an instrument or institution. Public and private institutions alike may seek to coordinate globally the management of similar or related risks that present themselves in different local contexts. However, the subjects and tools of risk management, and the politics of making regulation legitimate, vary considerably. Similarly, macro-prudential regulation is cognizant of the global economy, but must target the national cycle.

The process of negotiating international norms also works best where the objective is guiding principles, rather than specific rules. The Basel capital accords demonstrate the perils of specificity at the international level. National regulators come to international fora with the interests of national constituents in mind. They proceed to trade concessions, and produce a patchwork of rules that protect their respective domestic interest groups more than the system as a whole. The result is neither harmonised nor stable. Moreover, because global regulation is based on a very thin and fleeting commonality of subject, it is also very fragile. Thus many aspects of the Basel II accords were obsolete even before they were fully implemented.

Nevertheless, global coordination of host-country rules is absolutely essential. As we note later, this is because instruments and activities spill over national boundaries, and the activities of financial actors and national regulators in one jurisdiction can have a dramatic impact in many others. A country's inability or unwillingness to regulate risky behaviour can affect not just, or even primarily, its own citizens, but can create a 'hub' for risk production whose costs are borne by others. Regulators must have the capacity to identify transnational activities and the way in which their peers address them, so as to determine their impact in their jurisdictions.

Such coordination is most likely to succeed if undertaken through informal channels and fora, rather than formal, treaty-based international institutions. Norms and principles that are not frozen in time, but can evolve organically with global finance, are more durable. Achieving the necessary legitimacy and binding force at the international level is rightly cumbersome. Reforming treaty-based institutions is legally and politically daunting: witness the challenge of changing the voice and vote structure of the International Monetary Fund and the U.N. Security Council, in contrast to the overnight expansion of the Financial Stability Board and the displacement of the G-7 with the G-20. Finally, we believe that to the extent implementation must be local, political accountability should also run through local channels.

Fig 6: Local and Global Financial Regulations



We suggest that there are two streams of regulatory activity that break down neatly across the local and global frontiers. Figure 6 represents these streams of regulation. On the right hand side we have a focus on host country regulation where the stress is on the regulation of behaviour rather than on products. The Commission believes that within a rules-based context a focus on regulating specific products will simply lead to innovation and evasion. The past decade of regulatory permissiveness within many OECD economies to accommodate financial innovations for their competitive advantage suggests that a product focus would quickly become redundant within national rule-making. Instead we suggest that market segmentation according to institutional type makes more sense. Within this system host country rules may differ across types of institutions and encourage them to take on board different types of risks. National regulatory authorities would then be responsible for the regulation of local financial institutions as well as observing how international institutions playing under their house rules operate. For the global level we envisage a stronger focus on discretion and information sharing rather than rules-based mechanisms. This would be politically expedient. As stated, a focus on products does little to curb financial volatility, but information sharing on what kinds of financial products are of global systemic importance is useful for national authorities and international institutions. Such a system would encourage diversity and learning to curb systemic risks.

BOX 3: Differences from Host versus Home Country Regulation: Iceland versus India

The case of Iceland demonstrates the enormous inadequacies of 'home' country regulation. Iceland is a very small island state with just 300,000 inhabitants. Prior to the introduction of deregulated banking, Iceland's economy thrived on the exploitation of fishing rights and some industry. After a few years of economic boom the country went spectacularly bust and had to be bailed out by the IMF and bilateral packages, which totalled about 50 percent of Iceland's GDP. Iceland has been home to three very aggressive private banks – Kaupthing, Landsbanki and Glitnir. In 2007, these three banks alone held loans equal to nine times the size of the Icelandic economy. This represented a major jump from 2003, in which the loans totalled 200 percent of GDP. Iceland's membership in the European Economic Area meant that the country's banks could tap European savers. One bank alone – Landsbanki – attracted $8.2 bn from foreign internet depositors, which represents 50 percent of Iceland's GDP.

Of course, it is an illusion to assume that the government of Iceland could have ever been in a position to guarantee the national and international activities of these banks. Like other relatively small economies – Switzerland comes to mind – home country regulation hits logical limits in such a context. The operations of large, internationally operating banks cannot be guaranteed by small economies. As Iceland demonstrates, home country regulation fails in an environment of aggressive business practices. However, Iceland not only demonstrates the limits of home country regulation, but also of monetary policy. The authorities in Iceland did notice the overheating of the economy, and they did notice the reckless behaviour of both the banks and their citizens, which simply went deeper into debt. However, interest rate policy proved to be an inefficient tool. Raising interest rates did not result in a reduction of borrowing, but instead altered the type of borrowing: instead of borrowing in kronur, ill-advised Icelanders borrowed in Swiss francs or even yen to finance their consumption – a costly error indeed. The bill to the taxpayer of the failure of Iceland's banks may eventually cost the country's taxpayers 80 percent of GDP.

The Indian banking system, which has come out largely unscathed from the financial sector meltdown, demonstrates some of the advantages of host country regulation. Only one private sector bank, the ICICI, has a limited exposure of about $250 million to CDOs and this was quickly handled by using the reserves which the bank had provided for. Even with practically no exposure to subprime mortgage based instruments, the Indian banking sector saw some significant movement of deposits from the private to public sector banks as depositors sought the relative safety of government owned banks. This does perhaps point to the desirability of deposit guarantees to prevent bank runs. While this may result in some moral hazard issues, it would seem logical to consider such an arrangement especially after the recent crisis in which practically all deposits did end up receiving a government guarantee, though often after the run on particular banks had been precipitated.

There are three predominant reasons for the Indian banking sector to have escaped the negative impact of the crisis. First, Indian commercial banks were simply not active in global markets and, as pointed out above, had very limited exposure to complex instruments and derivatives. This can be construed as safety through weak or limited global integration of the domestic banking sector which also characterizes Chinese commercial banks, for example. Second, the Indian banking sector is covered by host country regulatory framework where foreign banks are allowed to operate provided they follow all the domestic regulations and adhere to specified prudential norms. This has allowed the regulator to implement an active monetary policy with the triple objective of macroeconomic stability (inflation control), growth promotion and

financial sector stability. As a result of this three pronged approach the Reserve Bank of India (RBI) has been able to factor in financial sector concerns in its overall policy stance. Third, the RBI has been pursuing an active and non-dogmatic regulatory regime that is well grounded in the Indian conditions. This is best reflected in the RBI stipulating a higher capital provisioning requirement by commercial banks for their advances to the real estate sector since the middle of 2007. This was done to prevent the real estate bubble from getting completely out of hand. Finally, the existence of sector specific regulators (separate for capital markets, insurance, banking and pension funds) seems to have delivered a more effective and responsive regulatory regime with each regulator being able to focus more sharply on the sector specific issues as they emerge. Fears of regulatory arbitrage being misused by financial sector operators have not borne out so far. On the other hand, the Indian banking sector can be seen to be relatively underdeveloped when compared to the banking system in other countries. This is reflected in several ways. Despite the Indian economy now ranking as the eighth largest in the world, the largest Indian commercial bank is the State Bank of India (which is owned by the Government), which ranks only 64th in the world. The next largest bank does not figure in the top 100. The credit to GDP ratio in India is much lower not only when compared to advanced economies but also in comparison to similar emerging economies. Finally, financial inclusion remains rather low, with reportedly 60 percent of rural households being outside the banking system and the great majority of small and medium sized enterprises having to borrow from the informal credit market at exceptionally high rates for meeting their investment and working capital requirements. Therefore, the way forward would be to achieve a good balance between further liberalising and moving towards an arms-length regulatory regime and further refining the supervisory and prudential norms for achieving an even more effective host country regulation framework.