THE TRANSFORMATION OF GLOBAL GOVERNANCE PROJECT

THE GOVERNANCE OF INTERNATIONAL BANKING

INSIGHTS FROM THE JOINT EUI-BOCCONI SEMINAR HELD ON 12-13 SEPTEMBER IN MILAN

Main Takeaways - George Papaconstantinou and Jean Pisani-Ferry

In 2009 then-Treasury Secretary Tim Geithner described the newly created Financial Stability Board (FSB) as the "fourth pillar" of global economic governance alongside the WTO, the IMF and the World Bank. In reality, the FSB is far from having the legal competences, clout and resources of the other three organisations. It serves as a coordinating body and as an intermediary between the political G-20 and the series of public and private bodies in charge of the various segments of financial regulation.

International banking regulation: A coordinate-and-review model

In this context, international banking regulation – a segment of global financial regulation – provides a telling test case for assessing the effectiveness and adequacy of international regulatory coordination. Its *modus operandi* is to set common non-mandatory standards, whose implementation is subject to external monitoring – in short a *coordinate-and-review* mechanism:

- Common regulatory standards (for, e.g., capital and liquidity ratios) are agreed upon within the framework of the Basel Committee for Banking Supervision (BCBS), a 28-members body hosted by the Bank for International Settlements. These standards are negotiated amongst participating governments, with significant indirect involvement of industry representatives;
- Participating countries or entities such as the EU are free to decide if and to what extent they transpose the standards in their legislation, while they remain fully responsible for their enforcement;
- The BCBS monitors both the legislative transposition of the agreed standards (adoption) and their effective implementation at jurisdiction and bank levels. It carries out quarterly compliance assessment reports, whose results are published. Other governments and market participants are therefore informed in real time of both the conformity of the national legislation with the agreed standards, and their actual implementation;

This micro-prudential regulatory coordination system is complemented by cooperation procedures for macro-prudential oversight and banking crisis resolution. However, these procedures are less formalised and as things stand they raise more questions than they provide answers. At any rate, there is no evidence one can rely on to assess their effectiveness.

The regulatory coordination system can be assessed from three complementary perspectives:

- *First, how effective is the overall harmonisation of financial stability standards?*
- *Second, how adequate is the regulatory framework resulting from international coordination?*
- *Third, how resilient to disruption emanating from outsiders is the prevailing regime?*

An effective harmonisation of banking solvency and liquidity standards

The answer to the first question is that *the overall harmonisation of banking solvency and liquidity standards* is fairly effective. Although not mandatory, the agreed standards are implemented in most participating jurisdictions, as illustrated by the general rise in capital ratios and liquidity ratios. Cases of non-compliance are limited. Furthermore, the system seems to have successfully passed an important test, as the US under President Trump has not significantly departed from commitments inherited from the previous administration.

There are several reasons for this qualified success. To start with, standards are negotiated by national regulators with the indirect participation of industry representatives. This ensures a high degree of ownership of the agreed benchmarks, which then serve as yardsticks of financial soundness. External compliance monitoring provides national regulators an incentive to implement them thoroughly; failure to do so is regarded by markets and the community of the other regulators as a sign of fragility. Banks themselves, especially international ones, have a strong incentive to anticipate the agreed compliance deadlines, in order to ensure high-quality ratings. In short, reputational concerns on the part of regulatory jurisdictions and the banks reinforce the effectiveness of an otherwise toothless regime.

The adequacy of international standards is however disputable

The answer to the second question, regarding *the adequacy of the regulatory standards resulting from international coordination*, is much less positive. Basel II, the set of regulatory standards agreed upon in 2005 that went into force shortly before the Global Financial Crisis, has gone down in financial history as a blatant case of regulatory capture: major banks had successfully lobbied for low, loosely defined capital and liquidity ratios, and an excessive reliance on the largest financial institutions' internal risk assessment models. In retrospect, Basel II regulation was evidently not demanding enough, not strict enough and not uniform enough.

Arguably, this failure – which contributed to the severity of the crisis – has largely been corrected with the substitution of the Basel II standards by those in Basel III. Nevertheless, even the Basel III framework can be criticised for regulatory limitations and gaps.

The regulatory regime is vulnerable to disruptions emanating from outsiders.

The answer to the third question regarding the *resilience* of *the existing regime*, is unfortunately that it is vulnerable. As for any sectoral regulation, economic agents outside its scope – fintechs, but also platforms and market places – benefit from relative regulatory leniency. The growing blurring of the distinction between "banks" and "non-banks" may provide a significant regulatory advantage to the latter, with the result that overall effectiveness is being diminished. The same applies, though to a lesser extent, to the participation in global banking of financial institutions not headquartered in the major advanced economies. These may benefit from excessive regulatory leniency or forbearance.

Trade-offs in international regulation

Analysis therefore suggests that international regulatory harmonisation through voluntary coordinate-and-review schemes involves three significant trade-offs:

- An *implementation-quality trade-off*: The closer the involvement of national regulators and industry representatives in regulatory design, the stronger the chances of thorough implementation. However, this may be at the cost of biases in the content of the regulation;
- A *thoroughness-coverage* trade-off: As for any regulatory club whose membership remains open to new applicants and does not provide defined advantages, stricter regulation may discourage certain jurisdictions to participate;
- An *ownership-resilience* trade-off: ownership is facilitated by the like-mindedness of participants, be it in institutional or sectoral terms. But to leave out the potential disruptors involves the risk of leaving out the problems they may pose outside the scope of the regulatory endeavour.

Main seminar discussion points

Global banking regulation: Why and how

The aftermath of the global financial crisis prompted regulators, legislators and industry actors to reflect on what went wrong, why, and what could be done. Cross-border finance had provided a massive credit boom, and leveraging enabled a huge amount of borrowing, facilitating the accumulation of risk and heightened vulnerability in the system. These features amplified the effects once the crisis erupted in 2008. Crises in the 1990s and early 2000s had been more contained, forcing authorities to rethink models and innovate.

As one participant pointed out, the alleged benefits of cross-border banking do not command consensus. They are not derived from a widely accepted theory, as for example is the case for trade). This helps explain why it is difficult to present a straightforward argument for global convergence of financial regulation: there are just as strong arguments for decentralising the governance of scaled-down and less internationalised banks. Assuming banks remain what they are, there seems to be some convergence around the notion of public goods in global finance. However, some reactions to the crisis aiming at securing these may have in fact exacerbated the downturn, from which the system is only just recovering ten years afterwards.

> *"There is no Ricardo of finance."*

The effectiveness and quality of global standards

Banking regulation post-crisis has been challenging to implement, and it is unclear whether it is effective. Most (if not all) participants agreed, however, that had the regulation in place now been in place before the crisis, the effects of the crisis might have been considerably lessened – but it would not have been averted. One participant noted that failings in banking regulation have run concomitant with a deeper shift in the nature of the activities of banks, from deposit collection and lending to more profitable asset management activities; another suggested that regulation might be more efficient by targeting banking activities rather than institutions traditionally understood as banks. One participant asserted that as financial crises are in fact inevitable, the point of regulation is to limit the burden to taxpayers when one strikes again.

Some participants were optimistic, noting several encouraging advances. Basel III standards have spread through a mix of peer pressure and international cooperation, increased capital and common equity requirements and liquidity ratios in a bid to ensure stability in the financial system. Regulatory consistency is monitored by the Basel Committee on Banking Supervision. A framework is emerging for the resolution of troubled cross-border banks. The EU has been building a banking union, strengthening its ability to prevent crises and deal with them.

Others were however more pessimistic about the state of current regulatory coverage. A rush to implement outdated and ultimately inappropriate structural measures took attention away from governance issues proper. Important issues (such as wholesale funding, money market funds, shadow banking, or special purpose vehicles) were more or less left out; national accountability was completely ignored. International measures clashed with national interests, decreasing political will to implement them effectively, spurring risks of regulatory competition and a race to the bottom. Banks now face poor returns on capital, and unless their profitability improves, their ability to perform intermediation functions might be impaired. Credit might dry up, impacting growth.

Basel III is a set of global standards that at least has the virtue of existing, allowing comparability across banking institutions. But, as one participant observed, it remains an empirical question whether there is, from a positive point of view, difficulty in attaining convergence; or, from a negative point of view, significant divergence. Different national circumstances in politics and the industry make the setting and implementation of global standards a thorny coordination problem. This is compounded by the fact that these standards now seem to blur the line between regulation and supervision. One participant mused that this reflects a deeper, "philosophical" shift in regulatory strategy from setting ratios and benchmarks for banks to defining and testing their capabilities.

The EU framework

As one of the epicentres of the crisis, the EU has responded by initiatives to strengthen its regulatory environment. The creation of the Single Supervisory Mechanism and the Single Resolution Mechanism have streamlined *ex ante* and *ex post* measures to ensure financial stability in the Eurozone. According to many participants, the emergence of the banking union in the EU has significantly consolidated the regional regulatory landscape. It remains incomplete however without a common deposit scheme, and the problem of sovereign exposure (the "doom loop") remains. National resistances hamper quick and effective implementation.

> *"Having uniform regulation without uniform supervision is like having a lighthouse and not switching it on."*

The EU's regulatory preference goes to heavier supervisory demands, focusing on structural issues. In an underlying divergence in preferences, the US prefers a lighter touch with more emphasis on personal responsibility within banks. But both face the same regulatory dilemmas: the question of the distribution of costs that regulation can imply, and the fact that a desire for reinforced supervision requires a more complex system. Keeping supervised institutions at arms' length means the supervisor will have less information at their disposal, whereas a more embedded supervision is costlier and makes regulatory capture that much more of a risk.

One participant noted the critical role of big data in supervision efforts and expressed concern about the EU's data protection regime towards that end. Taking a broader view, one participant highlighted the potential for regulatory divergence inherent in supervision activities, since they entail a degree of subjective appreciation for the situation at hand, based on different methodologies and different underlying interests.

What should be done at global level?

Several participants were in agreement that global regulation should be concerned with core issues, leaving detail to the national level; many however recalled the concomitant risk of regulatory divergence. One participant expressed sympathy towards the agenda of international regulatory convergence, but called attention to its prior failures and path dependency. Increasing the footprint of international regulation could provoke a backlash; and transnational supervisory colleges were mentioned as a type of structure capable of handling a lean regulation agenda at the regional level.

On the issue of divergence in enforcement, another participant noted that whereas taking repressive measures against bad conduct within banks is relatively robust, enforcement of prudential regulation is weak and contested. The EU itself has been found materially non-compliant with Basel III, and has not yet faced pressure sufficient to enact corrections. While one participant asserted that this is a case of significant divergence, another felt that it is relatively unimportant and that the development of the assessment process outweighs it.

One participant identified two major challenges for regulatory convergence: the place of China in the international banking system; and the Trump administration. China's banking sector is now the largest in the world, but remains almost completely opaque and detached from global regulatory standards. While it is moving towards global integration, control of the banking system remains largely politicised: benignly, this can be considered a stabilizing factor; or malignly, as a worrying lack of rule predictability and supervisory transparency and honesty.

On the American side, thus far, the Trump administration has not initiated significant regulatory divergence, despite President Trump's manifest aversion for multilateral methods. Deregulatory action has only brought supererogatory American standards down to match lower global ones, despite heated rhetoric from Trump loyalists like Congressman McHenry, who sent a letter in January 2017 to then Chair of the Federal Reserve System Yellen, demanding the US withdraw temporarily from all international financial regulatory bodies until President Trump could appoint officials that "prioritize America's best interests".

Divergence appears limited for now, though this may be the result of a relatively hierarchical structure of global finance, thus far dominated by large players from selected jurisdictions. Most participants agreed that there are two more pressing issues. First is the complexity of regulatory coordination: domestically with other policies, internationally between regulators, and at both levels for macro policies. Second is citizens' hostility towards international financial regulatory efforts, stoked by populism: one participant pointed to the current backlash against elites, wondering whether such regulatory efforts were not merely "shuffling chairs on the Titanic."

Macroprudential Coordination

The counterpart of higher interconnectedness is systemic risk. Following the global financial crisis, a consensus emerged on the necessity of macroprudential policy to help prevent crises (or at least smoothen financial cycles and improve bank resilience). MacroPru policies aim at complementing the microprudential approach, which is oriented towards ensuring safety and soundness of individual financial institutions. MacroPru regulation is actively implemented in a number of jurisdictions, even though its objectives, contours and effectiveness are hotly debated.

While recognising that it has had positive effects on real estate markets and credit growth, one participant was critical of macroprudential regulation as designed until now. He deemed it too focused on banking institutions and the real estate sector, and too limited to the national level. It was pointed out that national supervisors often have little incentive to stop build-ups of known causes of financial imbalances (such as credit or real estate booms) until spillovers become egregious; and that build-up of less well-understood causes of imbalances (due to maturity transformation or shadow banking for example) remain unaddressed. Another participant noted that macroprudential policies are "necessary, but not sufficient," as they do not deal with problems such as regulatory capture or leakages, or "credit populism".

> *"It's all about mortgages and housing credit"*

Macroprudential policy raises a host of coordination issues. It was observed that these concern both coordination across policies and coordination across jurisdictions. The latter is difficult because macroprudential policies may involve significant spillovers (especially when credit markets are dominated by foreign banking institutions) and because instruments have to be tailored to the specificities of different credit markets. Participants touted the governance of MacroPru policy efforts as a modestly successful example of a transnational regulatory network, cautioning however that it would be difficult to scale up to global governance.

Some participants were critical of macroprudential policies *per se*, asking whether they were not redundant in the face of monetary policy. They did admit however they might be useful in the limited case of an exogenous shock where monetary policy stays unchanged. Speaking against this view, one participant pointed out the relevance of macroprudential policies in the Eurozone, doubting whether monetary policy can "fill in all the cracks": where there is a single monetary policy, macroprudential policies can tend to the national level.

Another participant concurred, suggesting that "the fact that monetary policy goes in all the cracks is part of the problem, not part of the solution," recalling that these policies appear to deal primarily with the real estate market. Echoing this, one participant recalled that central banks have several instruments at their disposal, and that the issue is calibrating them so they complement each other. The same participant warned that since financial stability is a public good, it is imperative to connect practitioners and the general public, and to reduce complexity in the system for better governance and transparency.

Cross-Border Resolution

Ten years after the global financial crisis, a strong point of consensus which has emerged is that formal procedures or frameworks are necessary to resolve financial institutions in distress, especially those that engage in banking activities across borders. None such framework existed pre-crisis, and the several bank collapses, starting with Lehman Brothers, demonstrated that disorderly insolvency is an unaffordably costly event. Now, firms and authorities have realized the need for clarity and transparency in managing a bank's failure and assigning costs. One imperative that has emerged, in the face of citizen's backlash, is to avoid bailing out institutions with public funds, even if they are deemed "too big to fail".

Cross-border resolution presents particular problems however. An international border between parent and subsidiary means that there is more than one responsible supervisory authority. Appreciations on the viability of the institution and who has the power to decide that resolution is required necessarily vary, as well as how resolution liquidity and new equity should be provided. This is the inevitable consequence of information asymmetry and diverging interests. There are good reasons to be sceptical about how adequate current resolution instruments are in an international context. The important time dimension in resolution, also questions how long the perspective of institutions and regulators should extend regarding the viability of a troubled institution. One participant warned that *"when there is a liquidity crunch, timing constraints don't conform to models"*.

One participant called attention to the problem of ensuring continuing operations after resolution, prompting a discussion over the ultimate objective of the process. Many participants agreed that resolution should not necessarily imply liquidation and exit: in the EU at least, resolution aims to salvage what is salvageable. Many also agreed that liquidity could be provided by central banks if the institution undergoing resolution is solvable, though there was debate over how long it should be extended and under what conditions.

> *"The thrust of resolution in the EU is about rescuing; not winding up and bankruptcy"*

Some participants criticised current resolution frameworks. One likened resolution requirements as *"making banks carry their own coffin, which might not even fit in the end"*; another wondered whether the resolution process was not mostly for psychological benefit. Broad consensus was reached in characterizing resolution as financial reconstruction, useful to manage situations of a globally systemically important bank failing. It is less than clear however whether resolution strategies could treat a generalised crisis: situations where public intervention is necessary to backstop liabilities and eventually recapitalise the system can still arise. While the development of resolution regimes in all jurisdictions (except China) is a notable achievement, they are not a panacea.

Challenges of Digital Transformation

Digital transformation is profoundly reshaping banking activities, while regulation can only hope to play catch-up fast and smartly enough to avoid potentially dire outcomes. Information technology and the huge amounts of data it requires and processes are being used to disrupt traditional banking activities. Cryptocurrencies challenge the very idea of fiat currency, while the blockchain technology they are based on has the potential to radically disrupt banking infrastructure. The threat of cyberattacks has become the new normal for banks, with potentially serious consequences for global financial stability.

> *"Pandora's box is open"*

One participant raised three aspects of transformations due to big data for consideration. First, that big data will be used to devise new financial services; second, that big data will increasingly condition market entry and the landscape of competition within the sector; and third, that these changes will have implications for systemic risk and regulatory efforts. A banking model of the future was sketched out, based on a small number of platforms (due to high entry costs), resembling Amazon, providing products, services or applications relying on data storage and analysis (with much lower entry costs), creating an environment with more competitive prices at every stage.

Other participants debated whether more competition was always positive, highlighting that new entrants and new products could bear significant, or even systemic risks, while escaping regulatory attention. Another underlined the enormous advantage to incumbent platforms, questioning the extent of predicted disruption and envisaging rather a slow eviction of riskier activities from the industry. Yet another was sceptical of the Amazon analogy and professed to be unconvinced about comparison in cost structures. Many agreed however that fintech would soon catch the attention of regulators, most likely due to consumer protection issues: as one participant asked, *"Who is responsible if an algorithm gives bad advice?"*

Another participant underlined the similarities between the technology and banking sectors, in that they both establish sophisticated platforms to match supply and demand. In their ideal state, the empirically-derived methods and procedures in both are highly standardized, scalable, fault-tolerant, safe and secure, structured around quality with robust testing and clear methodologies to do so. Both try to operate in organized and relatively transparent ways, relying on trust to exchange information globally. This is a solid basis for synergies, which the industry is already taking advantage of; the same participant estimated that IT staff in large banking institutions represented up to a quarter of the total workforce, and that it is standard for US boards to include at least one person, or even a committee, with some expertise in technological stakes and issues.

On the other hand, traditional banking institutions are also under siege by tech firms moving into banking territory. They remain protected for now by a "wall" of sector-specific regulation, reserving their exclusive right to accept deposits: as one participant asserted, *"The deposit contract is the linchpin [of banking activities]… Whichever fintech company offers to accept deposits is a bank and should be regulated as such."* However, banks have had to face major disruptions such as losing exclusivity of the management of payment systems and the rise of peer-to-peer lending (especially in China), bypassing commercial banks and the central bank system in settlements. Another concern is cryptocurrencies, though one participant dismissed them as speculative assets, not currencies, assuring that "Currency needs the power of the state. Fiat currency cannot exist without it."

Banks are apprehensive of this complex and fluid environment, and some are asking for regulatory action and enforcement, while potential systemic risks are still poorly understood and the full implications of current changes are not yet clear. Some participants argued that heavy regulation on some issues was an appropriate response to slow financial innovation, *"a train going at 200 mph"*. Others argued instead that the absence of regulation can work positively, not granting legitimacy to the use of an instrument (like cryptocurrencies) by not giving it regulatory ground to establish itself.

All participants agreed that digital will be the point of focus of future banking regulation, but differing emphasis was put on the equilibrium between on one hand risk and innovation, and on the other regulation and the contested concept of systemic risk. Most agreed that supervision would have to evolve as well in a more global direction. Overall, there was consensus that reforms in the governance of international banking need to ensure they are fighting the battles of tomorrow, not those of yesterday.

Adrien Bradley

- ## PROGRAMME

12 SEPTEMBER

19:30 - 20:00	*Welcome apéritif*
20.00 - 22.00	*Dinner, speech and working session: Global dimensions of banking regulation* Introduction by **Elena Carletti** | Bocconi University and Florence School of Banking and Finance, EUI Guest Speaker: **Vítor Constâncio** | Former ECB Vice-President

13 SEPTEMBER

09.00 - 09.10	Introduction by **Donato Masciandro** | Bocconi University and **Jean Pisani-Ferry** | EUI
09.10 - 11.00	**First session: Regulatory Convergence or Divergence** Introductory remarks: **Martin Hellwig** | Max Planck Institute, **Nicolas Véron** | PIIE
11.00 - 11.15	*Coffee break*
11.15 - 12.45	**Second session: Crisis Prevention: Macroprudential Coordination** Introductory remarks: **José Manuel Campa** | Banco Santander, **Luiz Awazu Pereira da Silva** | BIS
12.45 - 13.45	*Lunch*
13.45 - 15.15	**Third session: Crisis Management: Cross-Border Resolution** Introductory remarks: **Mark Flannery** | Warrington College of Business, **Andrew Gracie** | formerly Bank of England
15.15 - 15.30	*Coffee break*
15.30 - 17.00	**Fourth session: Challenges of Digital Transformation** Introductory remarks: **Jan-Pieter Krahnen** | Goethe University of Frankfurt, **Lara Warner** | Credit Suisse
17.00 - 17.45	**Wrap-up session** Introduction: **George Papaconstantinou** | EUI and **Jean Pisani-Ferry** EUI

▪ PARTICIPANTS

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José Manuel Campa	Banco Santander
Vítor Constâncio	Former Vice-President of the European Central Bank
Paolo Fioretti	European Stability Mechanism
Mark Flannery	Warrington College of Business
Federico Fubini	Corriere della Sera
Francesco Garzarelli	Goldman Sachs
Andrew Gracie	Formerly Bank of England
Martin Hellwig	Max Planck Institute for Research on Collective Goods
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Spyridon Zarkos	European Banking Authority