THE TRANSFORMATION OF GLOBAL GOVERNANCE PROJECT

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THE GOVERNANCE OF INTERNATIONAL BANKING: REGULATING FOR CRISES, PAST AND FUTURE

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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 G20 and the series of public and private bodies in charge of the various segments of financial regulation.

1. **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 their effectiveness is disputed. 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?*

2. **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.

3. **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.

4. **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.
5. **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 the problems they may pose outside the scope of the regulatory endeavour.