

Chapter 18: Executive Summary

International Alignment of Financial Sector Regulation

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Background

Many of the policy recommendations being put forward to repair national financial architectures will prove to be ineffective – or at least their edge blunted – if there is a lack of international coordination among central banks and financial stability regulators in implementing them. This issue is important; although cross-border banking and financial flows are extensive, much of bank and financial supervision remains national. There is some consensus on prudential aspects of regulation such as capital requirements and their calculation, but there is hardly any consensus on the core set of principles driving the regulatory stance to providing guarantees and intervening in markets and the banking sector.

The Issues

Complications that could arise from lack of coordination between national regulators are many. These complications are largely due to regulatory arbitrage across national jurisdictions: i.e., if institutions are more strictly regulated in one jurisdiction they may move (their base for) financial intermediation services to jurisdictions that are more lightly regulated. But given their interconnected nature, such institutions nevertheless expose all jurisdictions to their risk-taking. Individually, jurisdictions may prefer to be regulation-lite in order to attract more institutions and thereby jobs. For example, they may adopt weak accounting standards to allow opacity of off-balance-sheet leverage, not require OTC derivatives to trade through a centralized clearinghouse, allow systemically large institutions to grow without imposing a significant additional “tax”, and grant generous bailout packages during a crisis.

- A “beggar-thy-neighbor” competitive approach to regulation in different countries – or even their failure to coordinate without any explicit competitive incentives – will lead to a race to the bottom in regulatory standards. This will end up conferring substantial guarantees to the financial sector, giving rise to excessive leverage- and risk-taking incentives in spite of substantial regulation in each country. Such an outcome should be avoided at all costs. The problem is one of externalities, and the case for coordination is therefore a compelling one. However, is such coordination feasible? If yes, what form will it take?

We believe it is highly unlikely that an international financial sector regulator with power over markets and institutions will emerge in the foreseeable future; countries are simply not willing to surrender authority. It remains unrealistic to expect that an international central bank will be able to close down a large part of the financial sector of a country or determine monetary or fiscal policy for a country; or that international civil servants will supervise or inspect national financial institutions. Indeed, such centralization may not be necessary and may even be undesirable. The issue is one of externalities and coordination may suffice. If national regulators can agree upon a core set of sensible regulatory principles, then the constraints imposed by such alignment would reduce regulatory arbitrage through jurisdictional choice substantially, even if specific national implementations of the principles vary to some extent.

Policy Recommendations

Our recommended steps to achieve such international coordination for designing the blueprint of global financial architecture are thus as follows:

Central banks of the largest financial markets should convene first, and agree on a broad set of principles for the regulation of banks. These principles should cover the following themes:

1. Each central bank should carve out a dedicated role for a powerful LCFI regulator that is in charge of supervising and managing the systemic risk of large, complex financial institutions.
2. The supervisory and control apparatus of each LCFI regulator should feature:
 - a. Coordinating with financial sector firms to provide long-term incentives to senior management and traders and other risk-taking employees;
 - b. Fair pricing of explicit government guarantees such as deposit insurance and, where implicit government guarantees are inevitable, limiting their scope by ring-fencing activities of guaranteed entities;
 - c. Standards for transparency and accounting of off-balance-sheet activities and centralized clearing for large OTC derivative markets to reduce counterparty risk externality;
 - d. Imposition of a systemic risk “tax” on LCFIs, that is based on the aggregate risk contribution of institutions rather than their individual risk exposures;
 - e. Agreement on overall objective and design of lender-of-last-resort facilities to deal in a robust manner with liquidity and solvency concerns; and,
 - f. Agreeing on a set of procedures to stem systemic crises as and when they arise based on clear short-term policy measures (such as loan guarantees and recapitalizations that are fairly priced and impose low costs on taxpayers), and long-term policy measures (such as the shutting-down of

insolvent institutions, providing fiscal stimulus, and addressing the root cause of financial crises – e.g., mortgages in this case).

3. Next, central banks should present their joint proposal with specific recommendations to their respective national authorities, seek political consensus for an international forum such as the Financial Stability Forum or a committee of the BIS to coordinate discussion and implementation of these principles, and monitor their acceptance and application.

A commitment to such a process will generate a willingness to take the outcome seriously, and hopefully pave the way for international coordination on well-rounded policies that balance growth with financial stability as efforts get under way to repair national financial architectures.

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