RESHAPING THE INTERNATIONAL FINANCIAL ARCHITECTURE

A paper for the discussions of the IBA LPD Banking Law Committee in Madrid

"*If a man knows not to which port he sails, no wind is favourable*"
Seneca

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The clarion call for overhauling finance regulations and reaching a true international body of rules as well as creating international systemic risk supervisors started to be heard soon after the financial meltdown initiated with the collapse of Lehman Brothers.

The European Commission did not ignore such call and almost a year after, on September 23, 2009, it has adopted a package of draft legislation that is intended to help restore confidence, safeguard financial stability and generate strong and sustainable economic growth within the European Union through a stronger financial supervision at both the macro-prudential and micro-prudential levels.

For theses purposes, the proposed draft legislation foresees the creation of two new institutions within the already crowded European institutional diagram: **(i)** the European Systemic Risk Board (the "**ESRB**"), and **(ii)** the European System of Financial Supervisors (the "**ESFS**").

It is not the purpose of this article to elaborate on the nature and functions of these new institutions. However, to better judge whether the European Union is heading towards the right direction in the pursue of a useful financial architecture, we think it is necessary to make at least a brief reference to the goals and objectives of these new institutions.

The ESRB:

The ESRB will be responsible for the macro-prudential supervision. Its role will be to monitor the soundness of the financial system by identifying and assessing risks with a systemic dimension to the stability of the financial system as a whole. A crowd of 61 institutions (including the president and vice-president of the European Central Bank, the governors of national central banks, the ESFS and national supervisors) will be represented in its board. Fortunately, a wink to efficiency has been given and a much narrow steering committee will assist the decision making process of the ESRB board. The ESRB will lack binding powers and the most it will be able to do is to issue risk warnings and recommendations of remedial actions as it has been conceived as "*a body drawing its legitimacy from its reputation for independent judgment, high quality analysis and sharpness in its conclusions*". It will mainly abide by the principle "comply or else explain" and its work will generally not be made public (in order to avoid warnings becoming self-fulfilling prophecies). The creation of the ESRB is in line with other multilateral efforts to prevent systemic crisis, such as the Financial Stability Board by the G20.

The ESFS:

The ESFS, on the other hand, will be in charge of supervising individual financial institutions through a network of national financial supervisors working with three new European Supervisory Authorities (the "**ESAs**") for the banking, securities and insurance and occupational pension sectors (these new authorities being the European Banking Authority or EBA, the European Insurance and Occupational Pensions Authority or EIOPA and the European Securities and Markets Authority or ESMA). Fortunately, the ESFS will take over the existing advisory powers of the three financial services committees at EU level: the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Supervisors (CEIOPS) and the Committee for European Securities Regulators (CESR). A real word-search puzzle!

The most important role of the ESFS will be, however, to contribute to the harmonization of financial supervision in the EU by **(i)** proposing binding technical rules towards a common rulebook; **(ii)** monitoring consistent application of rules by national regulators (even by drawing up interpretative guidelines); **(iii)** determining coordination and effective management of "*emergency situations*"; **(iv)** ensuring that national supervisors take due account of interest of other Member States in case of disagreement over actions or inactions where the relevant legislation requires cooperation, coordination or joint decision making and **(v)** exercising direct supervisory powers for credit rating agencies.

The ESFS will not, however, impinge on the micro-prudential supervision powers of Member State regulators (this clearly capping the potential of the ESFS).

Those are the pillars on which the prospected European financial reform rest. There are, of course, certain aspects of the proposed legislation that will have to be further discussed and fine tuned. Even more, there are matters where a consensus will necessarily have to be reached if the proposed legislation is to be passed successfully. Matters such as when an "emergency situation" occurs, the settlement of disagreements and the discretion of Member Estates to invoke their tax immunity come to mind.

Action on "emergency situations":

For instance, the proposed legislation contemplates that whenever an "emergency situation" occurs and the coordination role assumed by the relevant ESA is not sufficient to guarantee the correct functioning and integrity of the financial system, it will have the power to require the national supervisor to take action. There is no definition of "emergency situation" (it is left to the discretion of the European Commission). It needs to be emphasized that any anti-crisis actions will be taken (if so) at the recommendation of European bodies, but at the cost of the relevant State Member's tax payers (just like ordering a meal and asking next table people to pay the bill!). This has been pretty obvious in this crisis: rescue plans implemented in respect of banks have been funded by the relevant home country authorities (hence, at the cost of tax payers in the parent bank home country) with the exception of Fortis Bank (in which Belgium, France and the Netherlands paid the bill).

Consistent application of increasingly harmonised rules:

As regards the settlement of disagreements between supervisors, it has been designed a two-stage process: if a national supervisor disagrees on the contents of an action or inaction taken by another national supervisor where the legislation requires cooperation, coordination or joint decision, the relevant ESA will act as a mediator and help supervisors to come to an agreement. Failing this, the ESA will then be entitled to adopt a decision requiring either or both of them to take action or refrain from taking action in compliance with Community law. If any such concerned supervisor fails to comply with the ESA's decision, the proposed legislation foresees that the ESA will be able to adopt an individual decision addressed to the relevant financial institution concerned requiring the necessary action (provided that the matter deals with any European legislation having direct effect on individuals and natural bodies). The outcome of this may be that the financial institution in question received two contradictory requests: one from the national supervisor and another one from the relevant ESA. What should the bank do then?

A similar proceeding has been proposed to ensure consistent application of Community rules by financial institutions. In these cases, if the national supervisor has not correctly applied the Community rules and does not follow the requirement made by the relevant ESA, the Commission will take a decision requiring the competent national authority to comply with Community law. If, still, the decision taken by the Commission is not observed, the relevant ESA will be able to adopt an individual decision addressed to any relevant financial institution requiring the necessary action, provided that compliance thereof is necessary to ensure the functioning and integrity of the financial system and that the matter deals with any European legislation having direct effect on individuals and natural bodies.

These matters will not be easy to agree upon particularly if, as we have witnessed, in times of crisis each country watches over itself (or better said, the relevant government in power watches over its voters with the next elections in mind).

European draft legislation in line with worldwide trends?:

In any event, both institutions complement each other and are regarded by the European Commission as the basic vehicle to lead the way towards the goal agreed at the Pittsburgh G-20 Summit of strengthening the International Financial Regulatory System. A goal that is intended to be reached through an agreement on an international framework of reform in the following critical areas: **(i)** building high quality capital to mitigate pro-cyclicality (agreeing by the end of 2010 international rules to improve the quality and quantity of bank capital and to discourage excessive leverage as well as harmonizing the leverage ratio to ensure comparability); **(ii)** reforming compensation practices to support financial stability in the long term (i.e., to align compensation packages with the creation of long-term value); **(iii)** addressing cross border resolution and systemically important financial institutions (with the aim of establishing crisis management groups for the major cross border institutions and a legal framework for crisis intervention); **(iv)** improving over-the-counter markets (so that all standardized OTC derivative contracts are traded on exchanges or electronic platforms, where appropriate and, cleared through central counterparties); **(v)** achieving a single set global accounting standards and complete the convergence by June 2011; and **(vi)** improving tax transparency and exchange of information so that countries can fully enforce their tax laws to protect their tax base.

The underlying principle governing the reform is a systemic approach to financial regulation that will inevitably result in the implementation of anti-cyclical measures. Much has been already said about these measures and we would like to echo some of the alternatives that have been put over the table.

For instance, everybody seems to agree that the moral hazard of the "*too big to fail*" that certain big banks and financial institutions may rely upon as a result of the recent bail outs will be coped with both "*living wills*" that will force them to plan in advance their own collapse and capital supplements to avoid temptations of taking excessive risks. On the paper it sounds like a good solution, but maybe those who strongly advocate for it have not thought about the consequences or externalities of such an alternative. As for the living wills, we are not sure about the practical difficulties for a bank to design in advance its own collapse (or will the relevant government design it?) As regards the higher and better capital demand for the banks, before agreeing on a ratio it should be considered that the likely consequence of demanding a higher capital would be a constrain of credit (thus, economic) growth and even the proliferation of unregulated shadow banking.

Other proposals seem to favour a situation in which capital of banks will be contingent and long-term debt instruments previously issued would automatically convert into equity upon the occurrence of certain conditions (i.e., the system is in crisis as determined by the relevant systemic risk supervisors and the bank's capital ratio falls below certain level), thus converting an undercapitalized bank into a solvent bank at no cost for tax payers.

What are the threats? Overregulation, innovation-killing, increased administrative burdens:

The above is lovable, but is it possible that banks, obliged to hold more capital than the market requires, will have an incentive (again) to switch to unregulated activities. Even if the regulators count with new resources (by means of new rules and watchdogs), do we really think that banks or players in the financial system will not subvert capital requirements by designing new products (thus inventing new risks) that may be over passed by the regulators or not sanctioned appropriately? As the economy recovers, this phenomenon will grow more and more.

Having a worldwide harmonized legislation requires countries to give up part of their sovereignty. Are all countries ready to do it or is it feasible considering that the regulated financial institutions and the markets where they operate do not remain stationary or passive and that the surrounding circumstances will be invariably different in the future?

We are trying to regulate the markets in the hope it will help us to avoid (or at least to mitigate) certain risks, but in doing so maybe we are incurring in a another risk and that is no other than converging in a rigid and/or wrong set of rules.

Don't get us wrong. We do believe that we have probably suffered the most serious and disruptive financial crisis since the 1929 crack and that it is in the hands of regulators to reduce chances of future crises in the future. The proposed European legislation and the G-20 goals represent a great step forward. However, the eager to regulate is usually stronger when the markets are at the bottom (when the risks have been substantially reduced) and everybody supports remedial action only to come back, a couple of years (or maybe months) later, when the markets are at the top (with a much higher risk) to the faith on the "*invisible hand*" that makes the markets autoregulate.

Looking backwards to the different crisis we have had so far and the different reactions of the world and the international institutions, we are not sure if the proposed reshaping of the financial institutions through over-regulating the markets will help us achieve the desired sustainable growth and market stability. How is it possible to impose a single body of rules on countries with so different cultures and values? Will overregulation kill innovation and market stimulus? Will that hit market economy working? Is there someone around which seriously believes that there is any economic system alternative to the market economy?

We do see overregulation as a threat and are sympathetic to the thoughts of much criticized Fed's former chairman on this[1]. Believe it or not, banks play and will always play a vital role in society and overregulation may prove to be costly. If it is decided to globally harmonize the capital requirements for banks, fine with us. But whoever undertakes such a noble endeavour must know that the relevant ratio should be a trade off between the economic benefits of higher bank capital in reducing the instability and the economic cost of higher capital that will be reflected in higher intermediation margins[2]. And there is always the risk of undermining the competitiveness of banks at the expense of those countries that decide not to swallow the minimum capital requirement and the migration of financial activities to less regulated institutions (sounds familiar?).

The current system is not perfect. However, before starting to dance with the "blame it on the banks" song we should also recognise that regulators failed in this crisis as they did not exercise the powers they had to tackle the irrational exuberance (the most notable being the acknowledgement of mistakes made by the SEC with respect to the Madoff case).

Interestingly enough, in the wake of the crisis it can be verified that in average, hedge funds, which are light regulated entities, have performed better than commercial banks that are much more regulated. So, maybe the principle that lack of regulation is at the root of the crisis is not that convincing and that the problem of regulations is regulators themselves who get caught in the same bubble mentality as private investors and consumers[3].

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1 GREENSPAN, A.: "The Fed didn't cause the Housing Bubble" in *The Wall Street Journal 3/11/2009:* "*Our challenge in the months ahead will be to install a regulatory regime that will ensure responsible risk management on the part of financial institutions, while encouraging them to continue taking the risk necessary and inherent to any successful market economy*".

2 LORD TURNER: The Turner Review. A regulatory response to the global banking crisis.

3 BECKER, G.: "Financial Regulations" in the Becker-Posner Blog 9/03/2009.

Markets and the surrounding circumstances continuously evolve. There will always be countries that sitting in their comfortable GDPs will value financial stability (at the expense, perhaps, of sacrificing financial innovation). Others, on the contrary, may look at the richest countries and conclude that before committing to a sustainable growth, they first have to reach that superior level and that, inspired by Adam Smith, the pursue of their own interests would eliminate inefficiencies allocating rights where they would benefit the greater society without anyone dictating them what is "good".

Perhaps, to have a likely idea of where the financial system will be in 3 years from now we should simply follow the advice of David Rothkopf (former senior official in the Clinton Administration) and take both the US and China's position on the current crisis and draw a line somewhere in the middle. Talk to you in a couple of years.

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