The complexity of the regulatory response to the crisis

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Abstract:
While the 2008 financial crisis originated and first erupted in the United States, the response was organised on a global scale. After Lehman Brothers filed for bankruptcy on 15 September and an emergency bailout plan for AIG was announced the next day, the G7 Finance Ministers meeting scheduled for October seemed to be too little, too late for Gordon Brown, Angela Merkel and Nicolas Sarkozy, each of whom called for a "Bretton Woods II". To signal the urgency of the situation and the strength of their commitment, the heads of government of the G20 decided to hold a summit – the first of its kind. As the G20 represents 67% of the world's population, 85% of global GDP and certainly more than 90% of financial assets, this can be regarded as a global response. That first G20 summit was held in Washington, DC, in November 2008. Its closing statement enumerated vague proposals couched in conditional phrases. The outcome seemed to fall short of the stakes at hand, and a second summit was called for April 2009. The rapid deterioration in the global economy and the new Democratic administration in the US precipitated the G20 summit in London, which would lay out a detailed diagnosis and arrange the regulatory response.

In this paper, we will focus on the joint reform of financial regulation at the global scale, not on details of specific policies implemented by various national governments. After presenting the overall trend, which broke with the previous silo-based approach, we will review the outcome of the past ten years, then turn to investigate the limits of regulatory convergence.

Reforming financial regulation

The G20's mobilisation in 2008 came against a spectacular backdrop: after food riots in emerging countries that spring, with fears of rekindled anti-globalisation activism (which actually took shape later in 2011 with Occupy Wall Street), the heads of government were eager to demonstrate their solemn commitment to a reformist agenda. Over and above its symbolism, the agenda for the London and Pittsburgh summits was exceptionally far-reaching: setting up global financial regulation governance.

English version: Translation Centre of the French economy and finance ministries

An exceptionally far-reaching agenda

The closing statements of the London and Pittsburgh summits emphasised the need to devise a coherent, coordinated form of financial regulation that would avoid the regulatory arbitrage that had led to the crisis. Just before the crisis broke out, Allen and Gale (2007) had published a paper that showed the adverse effects of partial regulation: risks that are too costly for banks are sold on to insurers, who cannot always take the hit and are not subject to proper supervision. The subprime crisis and AIG's difficulties would quickly illustrate this two-step process. Thus, the G20 could not just tighten up regulations for the financial sector or unveil an updated list of ongoing or forthcoming reform plans. It had to have a coherent agenda. The London and Pittsburgh summits set lofty ambitions: "A return to the excessive risk-taking prevalent in some countries before the crisis is not an option." This was reflected in a programme that went beyond the ordinary scope of financial regulation.

Executive pay was indisputably a key point on the Pittsburgh summit's agenda, with six related items that would later be developed in the Financial Stability Board's (FSB) Principles and Standards on Compensation at Significant Financial Institutions (FSB, 2009). Basically, the goal here was to align the incentives for market operators with sound risk management practices. To do so, compensation policies must be reasonably transparent, determined by an independent committee, with bonuses spread out over time to prioritise medium- and long-term performance. Implementing these principles for bringing companies' goals broadly in line with those of employees has proven difficult. Christophe Moussu's article in this volume shows how bank executives resisted the increase in capital requirements, which they interpreted as a reduction in their performance measured through return on assets. Resistance from bankers ensured that these principles never became law anywhere. However, pay practices have apparently changed for the better. Cerasi *et al.* (2017) recently showed that executive bonuses have now been connected to risk metrics, and have declined sharply in investment banking, which is supposedly a riskier activity, and in the banks that had strengthened their risk management. Shareholder "say-on-pay" votes for listed companies have become widespread in the United Kingdom and the United States, but this trend had started just before the crisis (with the UK Companies Act 2006).

A second important topic on the G20 agenda was non-cooperative jurisdictions. Obviously, there is no point in strengthening regulation if the companies subject to such regulation can simply move to other unregulated jurisdictions. As a result, the London summit proclaimed: "The era of bank secrecy is over." Johannesen and Zucman (2014) have shown that, unfortunately, automatic information exchange has mainly resulted in fortunes being shifted to countries that were not bound by such rules. The development of the Internet has partly overshadowed the problems of the 2000s, with the G20's commitment and the issues of tax and regulatory competition among EU Member States being set aside due to the issue of taxation of the global web giants. Suffice it to say that the reformist agenda laid out in 2009 has not been entirely and successfully implemented. Reform efforts rapidly focused on "financial stability" understood as "stability of the financial sector".

Global financial regulation governance

To ensure that progress was made on reforms, the London summit decided to place the Financial Stability Board (FSB) in charge of monitoring implementation. As the successor to the Financial Stability Forum, the FSB is a light organisation (with around 30 staff) that drafts discussion guidelines and monitors implementation of the G20's decisions. It calls on experts when needed. For instance, it cooperates with the IMF for supervision of systemically-important financial institutions, with the Basel Committee on Banking Supervision (BCBS) for banks, and with the International Association of Insurance Supervisors for insurers. Olivier de Bandt's paper in this volume provides an update on the regulation of systemically-important financial institutions. The G20 has also called for the FSB to work with the International Accounting Standards Board (IASB) to draft accounting standards and with the Financial Action Task Force (FATF) on tax evasion. These processes have produced substantial written documentation, both upstream (such as guidelines and conceptual frameworks) and downstream (annual reports).

The coordination organised on a global scale by the G20 and the FSB has been replicated at national level. Thus, the US set up the Financial Stability Oversight Council (FSOC), the EU the European Systemic Risk Board, and the French government the High Council for Financial Stability (*Haut Conseil de Stabilité Financière*). The FSOC brings together the heads of US regulatory agencies and has the power to circumvent supervisors and to intervene directly. By contrast, the EU and French entities operate more as providers of expert advice to the ECB and the Banque de France, respectively. They contribute to macroprudential supervision; Agnès Bénassy-Quéré's paper in this volume takes a closer look at this topic. In short, these cross-cutting entities are more venues for the circulation of information than decision-making bodies.

How has the FSB furthered the agenda defined at the London and Pittsburgh summits? We will turn our sights to this question in the next section.

Outcome of the past ten years of reform

The symbols of the Herculean efforts to reform the financial sector are the Dodd–Frank Wall Street Reform and Consumer Protection Act and the EU's 42 different Directives and Regulations aimed at regulating the financial sector and adopted between 2008 and 2017. The FSB's 2017 annual report, "Implementation and Effects of the G20 Financial Regulatory Reforms", summarises the effects these measures have had with regard to the agenda decided at the G20 summits. The reforms launched in 2009 have had the following effects:

- Strengthened capital for banks; refer to Marie-Anne Barbat-Layani's paper in this volume for details on achievements in this area.

- Banks’ short-term liquidity guaranteed thanks to the liquidity coverage ratio (LCR); however, implementation is still uncertain for the net stable funding ratio (NSFR), which aims to reduce the liquidity risk on a one-year horizon.

- Rules for resolution clarified (note that in this case, “resolution” refers to the specific procedure for dealing with financial institution failures), especially in the EU, the G7 and the Asian “Dragons” for the banking sector, and the EU and the Asian Dragons for the insurance sector.

- More stringent requirements for systemically-important institutions, in terms of capital requirements and supervision, as well as resolution planning; this mainly applies to the EU and the G7.

- OTC derivatives regulated via trade reporting and centralised clearing, albeit not yet for all G20 countries. Margin requirements are even less harmonised (granted, not all countries have futures markets).

- In shadow banking, the FSB has worked with the International Organisation of Securities Commissions (IOSCO) to publish recommendations for regulating money-market funds (valuation using fair value, liquidity management) and securitisation (aligning stakeholders’ incentives with the originator/sponsor retaining 5% of the total issuance of securitisation products).

- Recommandations have been published for a range of topics. In addition to executive pay (mentioned above), these topics include clearing, the handling of data gaps, etc.

- Lastly, the FSB has launched new harmonisation efforts, such as insurance capital standards, which are to be the insurance sector’s equivalent to the Basel agreements for banking supervision.

The overall outcome of this reform and harmonisation process is that financial institutions have become more resilient and better supervised, market participants better informed about the characteristics of securities, and regulators about all transactions (cross-border transactions, in particular, are less uncertain and much better coordinated). In this volume, Michala Marcussen notes how much we have achieved by dispelling the risks of another financial crisis. However, building on the work of Allen and Gale, Jean-François Lepetit asserts that regulation has been strengthened in precisely the places where it was already quite sound, with systemic risks accumulating in other “dark spots”, in parallel finance driven by securitisation, in particular.

Faced with regulatory efforts of varying intensity, we can express some optimism by noting that the jurisdictions with the highest regulatory standards are entering previously-unexplored territories and then sharing their experiences. This is notably the case of the EU, which has a strong lead in fund and insurance regulations (see Hertig’s paper in this volume and Douady *et al*. 2017). However, the grand ambition of preventing regulatory arbitrage through overall harmonisation has not yet been accomplished, and we can wonder if we have not reached the limits of the convergence process.

Limits of convergence

The G20 partners have been unable to agree on important topics such as deposit guarantees or the separation of banking activities. These two topics were added to the agenda circa 2012, after the initial momentum of the London and Pittsburgh summits had waned. While we can use the term "regulatory cycle" to describe the strong post-crisis appetite for radical measures that weakens as the crisis becomes a thing of the past, we can also distinguish between cooperation difficulties and regulatory competition.

Cooperation difficulties

Cooperation does not occur spontaneously. Legal frameworks are different and tend to develop differently, whereas regulatory watchdogs seek to act autonomously rather than conferring with their peers. To illustrate these difficulties, we could look at the fintech sector landscape and refer to the paper by Antoine Souchaud and Héloïse Berkowitz in this volume. This complexity can be illustrated with the example of cryptocurrencies, which were issued in large quantities in 2017. In the US, cryptocurrencies are classified as securities for investment purposes provided they are issued in exchange for payment and their value depends on the actions of a third party (these criteria are known as the "Howey test"). This is therefore the case for tokens sold as vouchers for purchasing a product that is still being developed. In Europe, such "utility tokens" are considered to be prepaid sales and not "transferable securities" within the meaning of MiFID II (Article 4.1.44). However, in the US, the tokens only come within the remit of the Securities and Exchange Commission during an initial coin offering (ICO); ordinary transactions involving tokens are supervised by the Commodities Futures Trading Commission. This twofold distinction does not exist in the EU. As this example shows, without clear political determination, it seems unlikely that the EU and the US will spontaneously settle on the same terms to designate and regulate cryptocurrencies.

Yet political determination can sometimes act in opposite directions, as seen with the example of US sanctions against Iran. In 1996, the EU adopted Blocking Regulation No. 2271/96 to protect its firms "against the effects of the extra-territorial application of legislation adopted by a third country", but this text served more as a bargaining chip in a negotiating process. At present, the regulatory aims of the EU and the US appear to be diverging to such an extent that financial regulation may have become an instrument of competition policy.

A return to regulatory competition?

An initial example of regulatory competition could appear in the so-called Basel "IV" package; Marie-Anne Barbat-Layani's paper in this volume goes into greater detail, but put simply, even before Donald Trump was elected, the US was pleading for a change to prudential rules for banks. Instead of banks' own internal risk models, the US is in favour of a leverage ratio. This change would not just mean using a different denominator for the capital ratio; it would challenge the banks' entire business model. The US financial sector's setup encourages banks to shift securitised assets off their balance sheets, whereas European banks keep loans on their balance sheets but select borrowers with the lowest default risk. If it is no longer possible to encourage banks to choose the best risk profiles, then the banking sector's loan production model must be revised, and the European model looks unsuitable for global competition. Insofar as the so-called Basel "IV" has been in talks since 2014, we can consider that year to be when joint efforts ended and a new period of regulatory competition began.

Promoting one's own organisational model is one thing, but failing to comply with previously-agreed obligations is another. Since Donald Trump's election, the US government has clearly adopted a policy of deregulation. For instance, Trump's appointees to head federal agencies have changed the majority consensus within the FSOC, which has voted to remove major insurers from the list of systemically-important financial institutions, thus unburdening them from the related requirements of the FSB. More recently, the Economic Growth, Regulatory Relief, and Consumer Protection Act (nicknamed the "Crapo bill" after its sponsor, Republican Senator Mike Crapo) raised the asset threshold for automatically classifying a bank as systemically important (and thus applying the strictest level of oversight). Banks with assets of more than USD50bn (the former threshold) and less than USD250bn (the new threshold) have thus benefited from deregulation. It looks very likely that more such deregulating moves will occur, increasing the profitability of US financial institutions – albeit at the risk of one of them collapsing. We can interpret the Trump administration's policy as an attempt to boost the competitiveness of financial institutions by reducing the regulatory burden; the cycle that began with the G20's London summit has thus reached its turning point. Nevertheless, we cannot yet speak of a "race to the bottom" by G20 members.

The race to the bottom has begun, though, in peripheral jurisdictions whose attractiveness is rooted in the fact that they derogate from joint rules. Cryptocurrencies have opened a breach in the financial sector at the very moment when anti-money laundering rules were becoming uniform, thanks notably to the threat of US sanctions. While the traditional banking system agreed to curb the expansion of cryptcurrencies by refusing to accept cash from digital currency exchanges, the government of Malta has quite clearly opted for a loose legal and supervisory regime. In May 2018, three pieces of legislation were published, including one law that gives legal personality to IT protocols (Innovative Technology Arrangements and Services Act, 2018 – *Government Gazette of Malta,* No. 19,994 – 22 May 2018). Malta's goal is to attract investments and jobs related to the development of fintech apps, as it did previously for gambling, by authorising activities that are not permitted in other EU Member States. (In 2016, the gaming sector contributed 12% of Malta's GDP.) However, a project of this sort does not seem very cooperative inasmuch as it requires an easing of anti-money laundering standards and the principle of non-anonymity for the end beneficiaries of financial transactions – just after the European Parliament voted in favour of such rules for commercial firms… but not for IT protocols.

These fresh examples of non-cooperative behaviour within the EU, along with the Trump administration's efforts to manipulate regulations for competitive purposes, apparently indicate that the unanimous support for using regulation to end the financial sector's excesses has crumbled. We must not forget the progress achieved by the G20 in terms of strengthening the capital bases of financial institutions, boosting transaction transparency and improving supervision. Yet new channels for opaque and poorly-regulated financing may appear and threaten this progress. Indeed, it is in the essence of financial innovation to offer simpler, more discreet and less costly solutions. As such, the idea of resolving problems once and for all is just an illusion. Does this mean that we have returned to the pre-crisis status quo? No, because regulation has been harmonised in many fields, with the risk of a systemic crisis now looking less credible. Nevertheless, in China, shadow banking has built an enormous house of cards around property and corporate lending; elsewhere, abundant liquidity has fuelled asset bubbles; everywhere, the risk of IT failure is a source of anxiety… Faced with these ever-changing risks, one of the achievements of the 2009 regulatory response is the creation of venues for exchanging information at national and global levels. Each of these venues raises awareness, transmits signals and disseminates best practices – as well as questions. In this era of global communication, we all have something to contribute.

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