

## Commentary: How Should Financial Market Regulators Respond to the New Challenges of Global Economic Integration?

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It would be wise to acknowledge right at the start that the question Tom Hoenig has posed this morning is very difficult. As I was reflecting on how to approach answering it, I recalled a technique which it was often useful to adopt at university—when in doubt yourself, cast doubt on the assumptions behind the examiner’s question. So, one might begin by asking whether there really are any new challenges for regulators posed by Global Economic Integration or, indeed, whether there is anything new about the extent of interaction between national financial markets at the beginning of the 21st century? Haven’t we seen it all before, around a hundred years ago?

There are, indeed, those who argue that the world of 1914 was more tightly integrated than ours is today, that the globalization of capital was far in excess of what we observe at present—with 40 percent of British national saving invested abroad in 1907, for example.<sup>1</sup> Furthermore, that our generation can claim no monopoly of crisis or contagion. Kindleberger lists no fewer than twenty two financial crises and panics between 1870 and 1914.<sup>2</sup> And these crises variously involved banks, government bonds, commodities, private bonds, and private equity. (I can find no record of a 19th century hedge fund crisis, but that may only be an issue of nomenclature). Contagion, too, is not a new phenomenon. The financial crisis of 1847-1848, the year of revolutions in Europe, led to the failure of

several hundred banks and companies spread across the UK, Continental Europe, the U.S. and India.

If you share this analysis, much of what is written about today's unique challenges of globalization is so much globaloney.

There is clearly something in this line of argument. As an historian turned amateur regulator, perhaps I am bound to find it a little appealing. But I do not go all the way with the *déjà vu* all over again school of thought. Indeed, I rather share the assessment in Bordo, Eichengreen, and Irwin's 1999 paper, snappily titled "Is Globalisation Today Really Different Than Globalisation A hundred years Ago?"<sup>3</sup> (The use of prepositions is not the only barrier that divides the U.S. and the UK, but it is a big one). They conclude that commercial and financial integration before World War I was more limited. In particular, there was nothing like today's integration of short-term capital markets and nothing to match today's gigantic foreign exchange turnover.

So, I am ready to accept the premise that there are new challenges, even for the historian regulator with his back turned firmly to the future. But I would also want to enter a plea for a perspective of another kind. We must keep the global dimension of regulation in proportion.

The Financial Services Authority is probably as internationally-oriented a regulator as any in the world. The nature of London's markets oblige us to be so. Of the 400 or so banks we supervise, for example, almost three quarters are foreign-owned. Lloyd's of London, and the London Insurance Market, are almost entirely focused on international business. More international equity trading, and more foreign exchange trading takes place in London than in any other city.

When I assembled the Authority from its component parts three years ago, I asked for an inventory of all the international organizations and standing committees to which we collectively belonged. The inventory took a little longer to produce than I had expected—

because the number of such groups of which we are the UK member is now 130. Although at the time of this count we had recently to accommodate the arrival of the Financial Stability Forum and its Off-FSF-spring. So, we must get a grade A for international effort: Our accumulation of frequent-flyer miles is second to none.

And yet, when I look at the objectives given to us by the British Parliament—maintaining market confidence, protecting consumers of financial services, promoting public understanding of the financial system, and reducing financial crime, I find that two are very largely domestic and the other two substantially so. And if I mentally flip through my top half-dozen current preoccupations, only one—the regulation of merged exchanges in Europe—is an issue that simply cannot be undertaken without effective international collaboration. Even in our open markets it remains true that most transactions that are directly subject to our regulation, and certainly almost all those where we are acting to safeguard the interests of individual savers, investors, and policy-holders—our ultimate *raison d'être*—are domestic in nature.

Against that background, I find arguments such as those deployed by John Eatwell and Lance Taylor, in their recent book *Global Finance at Risk*, to argue the case for a World Financial Authority with regulator powers to be, at best, ahead of the game.<sup>4</sup> The same is true of the arguments advanced in Europe for a pan-European securities regulator. And at worst, they could deflect us dangerously from the main practical tasks we face.

This is not, however, the preamble to a robust defense of the status quo. I am by no means satisfied by the way the international regulatory system—if one can glorify it with such a term—operates in practice. There are many inefficiencies, inconsistencies, gaps, and even the occasional black hole. But I doubt if there is a single silver bullet solution. Instead, we need practical progress on a broad front, indeed ten broad fronts.

I recognize that ten points is rather a lot to make in a short presentation—indeed perhaps nine too many. So, I will be very brief and try

to collapse a few into each other. I tried to dream up a helpful acronymic mnemonic for my ten points, but the best I came up with was “Great Piles,” which I found rather uncomfortable, especially for an audience of sedentary folk like yourselves.

So, I’ll abandon the hemorrhoidal acronym, which would have had me begin with “G” for gaps, and start, instead, with “A” for accounting standards and “T” for transparency, which go together like a horse and carriage.

- One crucial implication of globalization is the renewed importance of internationally agreed and implemented standards of disclosure. But transparency and disclosure—and, indeed, regulation itself—will mean little if the financial numbers on which such disclosure is based are themselves unsound. The Basel Capital Accord and its soon-to-be-born son also depend crucially on accurate accounts. So, the work of establishing globally agreed International Accounting Standards, where Paul Volcker has now picked up the baton as chair of a new set of trustees for a reformed IASC, is of the highest importance. And there is a lot of work to do before we have a set of accepted and implemented standards, though the IOSCO endorsement in May was a crucial step forward. We now need both the EU and the U.S. to take a lead in the use of international standards, which will be the most persuasive means of promoting their use elsewhere.
- On the transparency front, we look for progress in Pillar 3 of the revised Capital Accord and in the multidisciplinary working group on enhanced disclosure chaired by Peter Fisher of the New York Fed. We would also like to see the President’s Working Group recommendations on hedge fund disclosure, endorsed by the FSF group I chaired, implemented by the CFTC and in Congress. With complementary action from authorities elsewhere, including in offshore centers, this should give us, and more importantly other market participants, a better understanding of the extent of leverage in the financial system.

- Third comes implementation of standards and codes. There is no shortage of Codes of Practice. Like London buses, they tend to come along in twos and threes, usually not going where you want. But we know, and the Asian crisis underlined the point, that their implementation around the world is patchy, and the code-pushers—the Basel Committee et al.—have no enforcement teeth. The school solution to this problem is that the IMF should put its muscle behind these codes, alongside its other tasks. I hope that will work, and that the fund has the resources to push the work forward expeditiously. We shall see. But I am not optimistic. And, of course, the fund’s leverage over OFCs—not typically borrowers or even members of the IMF—is weak.
  
- Fourth comes “S” for supervision (and points five and six can be shoe-horned in here). We would like to see a shift of effort in international regulatory fora from setting standards, to consideration of how complex global institutions can be supervised in practice. Much useful work has been done by the joint forum on the practicalities of consolidated supervision, and on reconciling the different ways of calculating consolidated capital ratios. The forum has also recommended the identification of a coordinator for each group.
  
- But we would like to go further and establish, my fifth point, a lead supervisor for each globally active group with firmer responsibilities. This is, of course, an area where there is no Anglo-Saxon consensus. U.S. investment banks—or, indeed, some other large U.S.—based financial conglomerates—(viz GE Capital & AIG etc.) are not currently subject to consolidated supervision. If we could fill in that gap, and a few others, and ensure that there is a lead supervisor with responsibility for the capital soundness of each group, there would be scope for much more mutual reliance, my sixth point. That should reduce the duplication of effort internationally and free up scarce resources. It is sad to have to note that, at a time when high-quality supervisors are in short sup-

ply everywhere, so much effort is still wasted on monitoring the safety and soundness of sub-consolidated structures by both lead and solo supervisors.

- A further linked point, my seventh, is the need in a number of countries for simplification and rationalization of national regulatory structures to match the changing nature of markets and financial institutions. Our own simplification in London has been rather rigorous, of course. In our hot-headed Latin way, we jumped from one of the most complex and Balkanized regulatory structures to the simplest—in one go. It is far too early to judge whether this is the right approach for us, let alone others. But a single regulator certainly facilitates international collaboration. And I note with pleasure that there are improvements in coordination between regulators, and sometimes consolidation, under way in many countries. I am not talking here solely, or even largely, about functional regulation. There are many other curiosities to iron out. There are, for example, countries in which the direct regulation of stock exchanges is carried out by one agency, while another is responsible for international relations. It is hard to avoid the conclusion that in the developed world as a whole, there are too many separate agencies designed at a time when the financial system was very different.
- Eighth—we are now within sight of home—we believe there remain a number of important gaps in the regulatory system. I will not list them here—nested lists are unattractive—but just give one “for instance.” Reinsurance companies are directly regulated in some jurisdictions but not in others. Given the increasingly complex interaction between banks on the one hand and insurers and reinsurers on the other—as risks are transferred—think of Cat bonds, Cateputs, and other feline friends—this seems highly unsatisfactory. I am glad the FSF is interesting itself in this issue. Insurance regulation is a territory ripe for the application of sound economic principles, and one to which the agencies responsible for the

stability of the system as a whole—whether central bank or regulators—should pay greater attention.

- My ninth point concerns enforcement. In part, I have covered it already in the sense of enforcement of standards and codes. But we also need to think harder about the more basic enforcement of regulation, especially in a world in which the Internet allows much easier cross-border investment and active investor solicitation. In Europe we have now set up a network called FESCOPOL (the policing arm of the Forum of European Securities Commissions). If we want to make regulations stick internationally, and prevent a web-based race to the bottom, we need to ensure that mutual reliance includes an element of mutual enforcement.
  
- I know that, for a largely U.S. audience, in moving beyond the ninth point I am into extra innings, so I must be extra brief. But my tenth point is a crucial complement to the others. It is the importance of educating investors and savers in the implications for them of globalization, and its brother, the New Economy and in the limits of regulation. I recall that the fundamental purposes of regulation are to promote confidence and market efficiency and to protect consumers of financial services. One firm conclusion we have reached at the FSA, as we examine the implications of our broad spread of responsibilities, is that we can nudge and push here and there, we can put grit into the machine, or add oil when circumstances demand it. But the best guarantees of stability are investors, and, indeed, managers of financial firms who understand the risks they are taking on and know how to manage them. We are, therefore, planning a significant redistribution of effort toward outreach programmes targeted at investors of all kinds. We need better to explain to people what a system of regulation can and cannot deliver and, indeed, help them distinguish between what is regulated and what is not. Regulators have to recognize that their régimes are increasingly avoidable and must demonstrate that they add value to investors and savers and capital raisers. I believe it is possi-

ble to do so, but it may require big changes in some places, including London.

This has been, I know, a very hasty canter across a wide territory. But if you can't allow yourself the freedom to do that in Wyoming, where on earth can you?

## Endnotes

<sup>1</sup> Estimate quoted in *Two Waves of Globalisation: Superficial Similarities, Fundamental Differences*; Richard E. Baldwin and Philippe Martin; NBER Working Paper No. 6904, January 1999.

<sup>2</sup> Kindleberger C.: *Manias, Panics and Crashes*. Wiley, New York, 1996.

<sup>3</sup> *Is Globalisation Today Really Different than Globalization a Hundred Years Ago?* Michael D. Bordo, Barry Eichengreen, Douglas A. Irwin; NBER Working Paper No. 7195, June 1999.

<sup>4</sup> *Global Finance at Risk: The Case for International Regulation*. John Eatwell and Lance Taylor. Polity Press, 2000.