

“Prospects for Coordination and Competition in Global Finance”

Barbara C. Matthews

Managing Director, BCM International Regulatory Analytics LLC

It is amazing to consider the concept of the next crisis, when we are not even finished with the most recent – and ongoing – financial crisis. These remarks focus on some key macro-trends that will affect the development of international law and regulatory standards in the immediate future. The three top trends are easy to identify. They are:

1. Economic stresses are generating significant centrifugal forces that make global competition among sovereigns concerning finance the dominant characteristic of our day.
2. Customary international law can provide helpful guideposts to policymakers seeking to craft solutions in a pragmatic and effective manner.
3. But customary law can only take you so far. When real money is involved, there is no substitute for formal agreements. Whether we call it “burden-sharing” or “cross-border resolution,” sovereigns must agree formally and in advance how national insolvency processes will function and what kind of information can be shared across borders. When the insolvent party is a sovereign, the IMF has in the past provided a framework for sorting out claims. When the insolvent party is a financial institution, living wills can be useful for internal risk management and regulatory oversight purposes but have limited utility. A real risk exists that such instruments will only create roadmaps for ring-fencing and finance ministry frictions across borders as sovereigns in crisis undertake a dash for local cash to cover local liabilities.

Navigating through these trends will be a challenge for policymakers, financiers, and financial system users.

Economic Trends all point towards competition

It may be helpful to note at the outset that we are in Phase Three of a multi-phase global financial crisis. It is unclear how many phases will exist before the crisis is over.

- Phase One covers the 2007-2008 period during which collapse of U.S. subprime mortgage markets created difficulties in the securitization market and for firms that were major players in that market. This takes us to the Bear Stearns bankruptcy.

- Phase Two was relatively short, running from the spring to the early autumn of 2008. It was characterized by stress in international money markets and the so-called “shadow financial system.” It ended with a 21st century run on interbank and money market deposits which brought the financial system in multiple countries to its knees.
- Phase Three began with the AIG bailout and the extraordinary, coordinated global central banking and finance ministry initiatives (predominantly in the U.S. and Europe) that achieved arguably artificial stability by effectively transforming private credit risk into sovereign risk.

Throughout these phases, stresses in the financial system generally provided ample justification for extraordinary global coordination through the Group of Twenty, central bank swap lines, and other measures. In an inter-connected global system, the price and risk of unilateralism has generally been perceived as being too high to bear. And heads of state and government have met 2-3 times per year to address a growing array of issues. We have seen policy convergence on a surprising number of technical issues from regulatory capital to OTC derivatives trading and clearing to tax collection to banker bonuses.

However, optimism about the prospects for multilateralism must be tempered by reality. When push came to shove, and finance ministries needed to protect national taxpayers and voters, local interests in finding local cash to cover local liabilities have generally trumped high-minded multilateral or cross-border supervisory principles. Consider the following recent Jerry Maguire (“show me the money”) moments:

- Iceland: The British unilaterally guaranteed all local deposits of the failed institution, standing the time-honored Home country principle of foreign bank supervision on its head...and then sought restitution together with the Dutch from Iceland. Iceland’s taxpayers and voters not surprisingly have so far rejected funding this.
- Belgium/France/Netherlands: The failure of Fortis Bank sparked an unseemly dismemberment of the bank along historical and geographic lines, once again trouncing traditional Home country regulatory principles.
- Lehman Brothers: According to former Treasury Secretary Paulson’s new book, support for Barclays to purchase Lehman Brothers was withheld by British authorities, sealing the investment bank’s descent into insolvency.
- Greece: Germany’s taxpayers have been understandably skittish about using their funds to bailout a weak southern neighbor. EU leaders are determining whether and how their currency union can extend the perimeter of cooperation to encompass sovereign liability management and domestic fiscal policy while trying simultaneously to craft credible control mechanisms to limit joint exposures.

- Group of Twenty: Despite many initiatives announced between its 2008 Washington, DC meetings and its 2009 London meetings, commitments to the global economy and open trade were openly flouted as trade barriers began to go up. Agreement on international accounting standards, particularly the treatment of fair market value and bank provisioning, may soon join this list of disappointments.

Although the underlying facts and circumstances in each of these situations are different, they share one important element: domestic economic necessity trumped pre-existing cross-border supervisory frameworks premised on the principle of Home country supervision.

Medium-term economic trends will likely amplify incentives for unilateralism among sovereigns rather than reinforce shared interests. Deutsche Bank Research recently released a sobering report on sovereign debt sustainability from 2020 forward. Using rosy and conservative assumptions, they identify significant “unsustainable debt dynamics” within the economies in the developed world. Financing the extraordinary stabilization actions of the last two years will require more sovereigns to borrow more from global markets between 2010 – 2015. Similar research has been published by the BIS and the IMF.

Servicing that debt and making difficult fiscal adjustments akin to what Greece, Ireland, and other European countries have been undertaking lately will create major pressures on sovereigns to preserve local assets and promote the their economies globally relative to international partners. Such competition for scarce financing and business resources has major policy implications beyond trade. The Deutsche Bank report concludes by observing:

“Should (fiscal) consolidation fail, policymakers in developed markets and some emerging markets may be tempted to look for other ways to fix the fiscal damage. Either they could tolerate a substantial acceleration in CPI inflation to inflate public debt and/or they risk severe adjustments in the real effective exchange rates.”

They are right, although of course individual members of the eurozone do not have the exchange rate mechanism available to them.

These harsh economic realities will constrain all policy across the developed world, from budget allocations for social safety nets to regulatory policy decisions on the kinds of activities commercial banks and hedge funds may (or may not) undertake. In such a world, national governments may not find many areas where global coordination will help solve local problems. Where last year the G20 sought to mollify markets by talking about “exit strategies” from extraordinary fiscal and monetary support measures, their themes this year will focus on being sensitive to local market conditions and creating a multi-speed approach to exits. Retrenchment is likely, as witnessed by the

ECB's continuing relaxation of its collateral policy to help support Greek and European banks. Knowing the trajectory, it should not surprise anyone that the regulatory reform proposals in the U.S., Europe and globally all point banks and regulated financial institutions towards becoming major, larger purchasers of sovereign debt. In sum, we are about to live through a time when the "crowding out" effect we all learned about in economics classes will be real. Sovereign funding needs will create more incentives for competition than for coordination regarding regulatory and economic policy matters in the near- to medium-term.

Customary International Law

Although the overall paradigm is bleak from an internationalist's perspective, pockets of convergence in sovereign interests can and will emerge on discrete policy issues. And in those pockets, for those that follow and care about the development and evolution of international economic law, the times will be rich with state practice establishing new norms at a pace not seen for years.

This audience does not require a detailed explanation of either customary international law, its origins or the extraordinary moment in history that led to the creation of the IMF and the other Bretton Woods institutions. For those interested in more detail, let me refer you to my rather lengthy article in the current issue of the Chicago Journal of International Law. It describes how I believe customary international law generally, and the law of the sea in particular, can provide policymakers and international lawyers with good examples of how best to proceed – and what to avoid – when crafting new international norms in the current environment.

Today's discussion focuses instead on those areas where economic interests can converge. In those areas, the case for the development of real international customary law through the Group of Twenty process is strong. Led by heads of state and government diversified across geographic and development levels, the normative, standard-setting activity undertaken by the G20 regarding economic policy, financial regulation, and other issues carries a weight and credibility other informal organizations lack. Strong consensus followed by convergent if not identical policy and legislative actions within national or (in the case of the EU) regional rule-making processes demonstrates the value of proceeding informally in the finance space, where speed is often the essence of effectiveness as well as efficiency.

Despite the heated political rhetoric, strong convergence exists globally on major regulatory policy issues that will affect the structure of finance globally for the next generation, including:

- Elimination or, at the very least, significant contraction of over-the-counter derivatives markets;
- Significant restrictions on "speculation" by a broad range of financial market players;

- Creation of more liquid yet less dynamic financial intermediaries;
- Increased government access to a broader range of financial data from a broader set of market participants.

Group of Twenty political endorsements of international norms addressing these and other issues will create a framework of customary international law and the normative certainty financial markets crave without the cumbersome processes associated with negotiating treaties. Group of Twenty endorsement of the work product produced by informal international groups such as the Basel Committee on Banking Supervision will also provide those groups the credibility they need to continue functioning in a world increasingly incentivized by debt burdens to seek national solutions.

Customary International Law is Not Enough

Informal, pragmatic political solutions at the G20 will not be sufficient to address all our challenges. For all its inefficiencies and problems, I believe there are two areas where there will be no substitute for formal, binding, enforceable international agreements if not actual treaties: burden-sharing/cross-border financial institution insolvency and information sharing.

Burden-sharing/cross-border insolvency: The challenges posed by the insolvency of a cross-border financial institution are well-known in the banking business. The Basel Committee was created in the early 1970's to address issues raised by the insolvency of Germany's Herstatt Bank, whose insolvency wreaked havoc on the FX market. The closure of the criminal bank BCCI reinvigorated efforts by a dedicated set of lawyers in the early 1990's to generate international insolvency standards. It tells you how successful these efforts were that today neither example is raised as providing answers when attempting to address the issues raised by the bankruptcies of Fortis Bank, Icesave and, of course, Lehman Brothers.

Many have suggested that "living wills" could address the issues raised by this latest string of insolvencies. I do not agree. Living wills would require a financial firm's management to provide to regulators a roadmap of corporate structure and suggestions for how operations could be wound up. Such documents will not be legally enforceable in national bankruptcy courts. If sovereigns choose instead to create special insolvency procedures for select financial institutions (as suggested, for example, in the new Senate legislation), those national standards will apply to the local winding-up of a financial firm.

I doubt that any court or government insolvency administrator would make legally binding and enforce the private wishes of bank management expressed in a living will. More importantly for this audience, the international spillovers from national insolvency administration would be significant. The Senate bill recognizes this and specifically contemplates requiring a study concerning the international implications of a

specialized insolvency procedure applied to a foreign firm in the U.S. Finally, living wills will not address a key market failure on display in London: counterparties were unaware (because they had not read their contracts or had not consulted their lawyers) that English law permitted Lehman Brothers to use collateral that had been pledged by counterparties to support trading positions. So when counterparties asked for the return of their collateral upon Lehman's bankruptcy, those unfamiliar with English law were surprised to learn that they had no right to a return of their collateral.

Consequently, I believe living wills will only create roadmaps for local authorities to ring-fence assets, create subsidiarization requirements, or otherwise require larger local pools of liquidity easily subject to national jurisdiction. This is not the place to discuss whether localizing capital and liquidity generates or undermines a bank's maturity transformation function. But it is the place to observe that if the trendline continues, moving towards local solutions potentially stands on its head on of the foundations of international banking supervision created by the Basel Committee in the early 1970's: consolidated Home country supervision.

Pressures on national financial supervisors to create local liquidity and capital pools demonstrate the lack of trust among supervisors globally. More importantly, these policies demonstrate the lengths to which local authorities will now go to protect local treasuries and local taxpayers from the burdens associated with supervisory failures beyond their control from abroad. The trendline is clearly away from burden-sharing. In the language of economics, the goal is to contain spillover effects from bad decisions abroad and protecting the integrity and financial stability of the local market place. This is not a good trend if you believe that globalization and global finance provide benefits for companies and consumers worldwide.

The need for certainty in defining the potential scope of Home and Host state bailout obligations will lead us ultimately towards more precisely defined international agreements on the topic. This is a place where informal gentlemen's agreements will only create confusion and chaos – neither one of which is conducive to financial stability.

If you doubt this, consider the supposedly easier issue of sovereign insolvency. The headlines have been dominated by the difficulty Greece is experiencing in global bond markets and inside the EU system. While it is true that the Maastricht Treaty prohibits the EU from bailing out eurozone members, it is also true that the EU Treaties also provide mechanisms for eurozone Member States to marshal financial resources to support their common currency. [Author's note: Since the ASIL annual meeting, such a mechanism relying on Art. 122 of the Lisbon Treaty as indeed been established.]

If the treaties provided an answer, why was there such dithering in Europe on a solution for Greece? Because German tax payers do not want to shoulder the financial burdens imposed on them by their southern cousins who misled in their official statistics and have more generous social welfare systems. Also, France opposes proposals that would create more stringent tools and criteria for eurozone oversight of national systems.

In sum, even where treaty arrangements permit EU sovereigns to help (and sanction) each other, political will is weak to use those authorities.

The sovereign case should have been the easy case because the IMF which was created after World War II precisely to address some of these cross-border financial stability issues at the sovereign level. The hostility of many EU leaders to having this global multilateral entity perform its function, even after it became clear that the EU alone might not have the funds to address the Greek (or other sovereign) difficulties, is a warning about the limits of multilateral solutions generally and gentlemen's agreements in financial markets specifically.

Cooperation can still work, but it will be tricky to negotiate. The solution reached in Europe calls for the IMF to serve as a junior partner to the EU in sorting out Greek finances. This subordination of the global to the local interest makes sense from a political perspective, particularly if the priority is to preserve credibility in the management of a common currency. The ability of the eurozone members ultimately to act together in support of the common currency can also provide a heartening example that cooperation is still possible, even among sovereigns with such differing economic interests as Germany and France. But for those that care about the continued ability of the Bretton Woods institutions to serve their intended function globally, one must worry about the subordination of the multilateral global facility to a regional one, particularly in light of the pre-existing regional arrangements in Asia under the Chiang Mai initiative.

Whether the IMF or some other entity at the international level should address cross-border private sector insolvencies is an issue for another day. One could just as easily ask whether the ICSID model might provide useful guideposts. In the interim, national leaders are creating living wills and potentially national insolvency procedures that will increase the potential for conflicts of law to arise in the event of an international insolvency. Will it take another crisis to generate sufficient political support for an international approach to such insolvencies? I don't know, but I hope not.

Data sharing: I think we can all agree that the current financial crisis was caused in part by inappropriate reliance on quantitative finance, particularly misunderstandings about the informational value both of historical data and the model outputs. A serious re-consideration is underway in the risk community and the economics profession on these topics.

It is particularly ironic then to see that governments, the IMF, the BIS, and at the G20 seek to increase reliance on these models to identify systemic risks. Naturally, increased transparency is a good thing. Models used properly can be useful in identifying risks and providing parameters for making informed judgments (rather than being misused as a substitute for judgment). Regulators have every right to require meaningful information of market participants so that government can do its job.

But official data collection processes are already ramping up and, in some instances, moving faster than formal authority. Consider:

- DTCC provided all data in its trade repository regarding trading in Greek sovereign bonds to any and all regulators that requested it, and even some official sector entities like the European Commission that technically are not financial market regulators.
- Federal Reserve Governor Tarullo indicated in a speech recently that the Fed is creating a new in-house data collection entity inside the Fed to facilitate its supervisory functions.
- The Senate reform legislation proposes the creation of an “Office of Financial Research” inside the Treasury Department” to support the work of the systemic risk oversight council.
- The IMF, the BIS, and the EU are all undertaking comparable data gathering efforts or signaling that they will do so shortly.

The flip side of data collection is data privacy, which is another highly charged political issue globally. Different standards apply to the sharing of information across borders for law enforcement and regulatory purposes, particularly in the U.S. and Europe. The potential for competition among regulators in informal colleges or lack of coordination in data collection standards only increases as regulators come under political pressure to safeguard local financial market stability and to minimize potential contingent liabilities of the local treasury from foreign financial spillovers. The potential for turf wars, duplicative or incoherent data requests, and conflicts of law is high. This is an area where we would all benefit from clarity and formal standards at the sovereign level, where informality and customary international law cannot provide sufficient solutions.

This is not an easy prescription. Anyone who has followed the convoluted and politically charged negotiations between the European Commission, the European Parliament and the U.S. regarding financial data sharing for law enforcement purposes knows that the issues are very difficult and politically charged. But if private sector firms are not clear on what data must be shared with which official sector entities, or where the data goes after it has been delivered to a regulator, the prospects for continued or mounting lack of trust among sovereigns will only increase as sovereigns compete with each other for scarce financing to cover their fiscal positions.

Conclusion

In sum, the prospects for coordination are dwindling and the prospects for competition are increasing, even as the G20 starts thinking about its June meeting and even as the eurozone members band together to find a financing solution for an unpopular partner. The consequent risks for the global economy thus remain elevated generally, as do the prospects for increased cross-border policy friction. The need for real international law solutions – both informal and formal – has never been higher.

