"Preventing the Next Financial Crisis: Coordination and Competition in Global Finance"

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It is amazing to consider the concept of the next crisis, when we are not even finished determining the causes and solutions for the most recent – and, I would argue, ongoing – financial crisis. So rather than attempting to predict what the next crisis might be, I will focus my remarks on identifying some key macro-trends that I believe will affect the development of international law and regulatory standards in the immediate future.

The three top trends are:

1. Economic stresses are generating significant centrifugal forces that make global competition among sovereigns in the finance field the dominant characteristic of our day. Obviously, this has significant negative implications for the EU, the G20, the IMF, and the myriad of supervisory standard setters at the global level.

2. Customary international law can provide some helpful guideposts to policymakers seeking to craft solutions that can address real political and economic realities in a pragmatic and effective manner.

3. But customary law can only take you so far. When real money is involved, I believe 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, although obviously the EU and Greece are redefining how that framework will operate. When the insolvent party is a financial institution, we need to be honest with ourselves that living wills, while useful for internal risk management and regulatory oversight purposes, have limited utility if a wind-down is required. A real risk exists that such instruments will only create roadmaps for ring-fencing and finance ministry frictions across borders

as sovereign undertake an unseemly and ultimately destabilizing dash for local cash to cover local liabilities. Local depositors may make unhappy voters, but making local depositors happy may create broader financial instabilities that benefit no one. Only formal agreements among sovereigns can limit the operation of local incentives.

Navigating through these trends will be a challenge for policymakers, financiers, and financial system users. I will address each in turn quickly. I am happy to answer questions or elaborate during the discussion period.

Economic Trends all point towards competition

It may be helpful from a terminology perspective if I make clear at the outset that I believe we are in Phase Three of a multi-phase global financial crisis.

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

- Phase Two was relatively short, running from the spring to the early autumn of 2008. This phase was characterized by stress in the 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 interbank market and the broader 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 have 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 to date has generally been perceived as being too high to bear. And so we have seen heads of state and government meeting 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.

Optimism about the prospects for multilateralism must be tempered by reality, regrettably. When push really came to shove, and finance ministries needed to determine how best to protect national taxpayers and voters, local interests in finding local cash to cover local liabilities have trumped all manner of high-minded multilateral or cross-

border negotiated principles. Consider the following Jerry Maguire ("show me the money") moments in the recent past:

- 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 rejected funding this.

- Belgium/France/Netherlands: The failure of Fortis Bank sparked an unseemly dismemberment of the institution along historical and geographic lines, once again trouncing traditional Home country regulatory principles.

- Lehman Brothers: According to former Treasury Secretary Paulson's new book, financing for Barclays to purchase Lehman Brothers that fateful weekend was withheld by British authorities, sealing the investment bank's march into insolvency.

- Greece: Germany's taxpayers have been understandably skittish about using their funds to bailout a weak southern neighbor. The same dynamic is playing out across Europe. 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 going forward.

- Group of Twenty: Among the many initiatives announced between its 2008 Washington, DC meetings and the 2009 London meetings, perhaps most disappointing was the fact that commitments to the global economy and open trade were ignored and openly flouted as trade barriers began to go up. It is possible that agreement on international accounting standards, particularly the treatment of fair market value and bank provisioning, could soon join this list of disappointments.

Although the underlying facts and circumstances in each of these situations are different, they share one common and important element: domestic economic necessity ended up over-riding diplomatic interests in comity and previously established frameworks focused on the Home country.

I raise these issues not to discourage, but to promote a clear discussion about what multilateral legal processes can, and cannot, reasonably achieve. Focusing on actual state practice will help define the realm of the possible for the Group of Twenty, the IMF, and other informal standard setters trying hard to keep the global system functioning beyond the current crisis.

The immediate future will not make the job any easier. Medium-term economic trends will likely amplify incentives for unilateralism among state actors rather than

reinforce shared interests in common outcomes. Deutsche Bank Research this week released a sobering report on sovereign debt sustainability from 2020 forward. Using rosy and conservative assumptions, they estimate that significant "unsustainable debt dynamics" exist within the major 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, predominantly between 2010 – 2015.

Servicing that debt and making difficult fiscal adjustments akin to what Greece, Ireland, and other smaller European countries have been undertaking lately will create major pressures on sovereigns to preserve local assets and promote the competitiveness of their local economies in the global marketplace relative to international partners. Such competition for scarce financing and business resources has major policy implications not just for trade policy. The research 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. And in the short-term, economic policymakers must address continued risks of deflation in certain key countries.

These harsh economic realities will constrain all policy choices in the foreseeable future 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 this kind of world, national governments will not find many areas where global coordination will be helpful to solving local problems. Where last year the Group of Twenty sought to mollify markets by talking about "exit strategies" from extraordinary fiscal and monetary support measures, the themes they will sound this year will focus on being sensitive to local market conditions and creating a multi-speed approach to exits. I personally think all speeds will be set on slow. Yesterday, some policymakers even announced retrenchment, as the ECB relaxed again its collateral policy in order to help support Greece and its European creditor banks throughout this latest crisis.

Knowing the trajectory we are on, it should not surprise anyone that the regulatory reform proposals in the United States, Europe and globally through the Basel Committee and elsewhere all point banks and regulated financial institutions towards becoming major, larger purchasers of sovereign debt and encourage them to continue serving as major players and market makers in foreign exchange markets. Similarly, the position taken by the EU regarding the role that foreign non-EU hedge funds and private equity firms should play (or not play, as the case might be) in their financing markets should not be a surprise.

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 across the policy space in the near- to medium-term.

Customary International Law

Although the overall paradigm will be bleak from an internationalist's perspective, I do believe that pockets of convergence in sovereign interests can and will emerge on discrete policy issues. And in those pockets, for those of us 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 and 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.

For purposes of today's discussion, I will focus 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 Group of Twenty with respect to economic policy, financial regulation, and other issues carries a weight and credibility other informal organizations have lacked. Strong consensus followed up by convergent if not identical policy and legislative actions within national or, in the case of the EU, regional rule-making processes demonstrate the strength of proceeding informally in the finance space, where speed is often the essence of effectiveness as well as efficiency.

Despite all 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. The main areas include:

- 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;

- Taxation of financial institutions (a tax on bank balance sheets seems the likely outcome from the IMF study conducted at the G20's request); and

- Increased government access to financial data from a broader set of market participants.

Group of Twenty action in these areas is creating international norms, a framework of customary international law, and the normative certainty financial markets crave without the cumbersome processes associated with negotiating treaties….even if the substance of the norms may not be supported by financial market participants. Group of Twenty endorsement of the work product produced by groups such as the Basel Committee on Banking Supervision will also give those informal international supervisory 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 Group of Twenty level will not be sufficient to address all the challenges posed by the current economic and political climate. 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. These areas are: burden-sharing/cross-border financial institution insolvency and information sharing. A few words on each….

Burden-sharing/cross-border insolvency: The challenges posed by the insolvency of a cross-border financial institution are well-known to us in the banking business. The Basel Committee was created in the early 1970's to address policy 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 thorny issues associated with 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. The living wills proposals posit that a financial institution's management would provide to regulators a roadmap to corporate structure and suggestions for how operations could be wound up. Such documents will not be legally enforceable in national bankruptcy courts. To the extent that 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. Beyond the legal issues, that management would be discredited. More importantly for this audience, the

international spillovers from national insolvency administration would be significant. The Senate bill recognizes this and specifically would commission a study to understand the international implications associated with a specialized insolvency procedure applied to a foreign firm in the United States. 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 rehypothecate collateral.

Consequently, I believe living wills are most likely to increase cross-border policy friction and competition by creating roadmaps for local authorities to ring-fence assets, create subsidiarization requirements, or otherwise seek to require larger local pools of liquidity easily subject to national jurisdiction. This is not the place to discuss whether localizing capital and liquidity can undermine the maturity transformation and risk intermediation functions of banks nationally or globally. But it is the place to observe that if the trend line continues, moving towards local solutions potentially stands on its head on the foundations of international banking supervision first created by the Basel Committee in the early 1970's: consolidated Home country supervision.

Political pressure from the Group of Twenty on national financial supervisors to create local liquidity and capital pools demonstrate the lengths to which local authorities will now go to insulate local treasuries and local taxpayers from the burdens associated with supervisory failures beyond their control from abroad. In the language of EU-level politics, the trend line is clearly away from burden-sharing, despite yesterday's landmark eurozone decision regarding Greece. In the language of economics, the name of the game is to contain spill-over 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 European example does provide some helpful guideposts along the way. For example, specific portions of the treaties governing the EU authorize the governments to act together in the way they did last night, despite the Maastricht Treaty's prohibition against bail outs. Rather than rely on that clarity weeks ago, EU leaders made vague and informal statements about supporting Greece. These statements were insufficient to quell market doubts, leading ultimately to the creation last night of specific structures to support Greece and for institutional action to enhance economic policy coordination and economic governance within the eurozone. It demonstrates concretely that in certain circumstances, informal agreements and assurances only create confusion and chaos in the capital markets, neither one of which is conducive to financial stability.

If the treaties provided an answer, why was there such drama? Because German tax payers do not want to shoulder the financial burdens imposed on them by their southern cousins. In addition, France opposed proposals that going forward more stringent EU tools and IMF engagement, in part because France itself is a deficit country potentially subject to such strengthened procedures. In sum, even where formal treaty arrangements exist that permit EU sovereigns to help each other, political will at best is

weak to do so. And when the political will is expressed in general, informal terms, the resulting confusion only contributes to the crisis. More formal processes are required.

The sovereign case should be the easy case because, of course, in addition to the EU internal arrangements, we have the IMF which was created after WW II precisely to address some of these sovereign stability issues. The level of hostility among many EU leaders to having the 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 eurozone sovereign) difficulties, is a warning about the limits of global multilateral solutions generally and gentlemen's agreements specifically.

Cooperation can still work, but it will be tricky. The solution reached last night in Europe calls for the IMF to serve as a junior partner to the EU in sorting out Greek finances. This kind of 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 an independent 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 (a surplus Northern country) and France (a deficit Southern country). 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. I look forward to the session on ICSID later today. In the interim, national leaders are creating living wills and potentially national insolvency procedures that will, in the near term, 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 hope not.

The twists and turns in Europe also reflect a more subtle point. Part of the reason for the current crisis in Europe is the uncertainty regarding the balance between responsibilities of Home and Host states both to undertake effective financial regulation and to implement consolidated Home country supervision in a manner that limits the size of problem in the event that difficulties arise in any particular institution.

The weaknesses of concern were not just in Greece itself. The weaknesses emanated as well to banks in the eurozone that had invested in Greek bonds or served as market makers for Greek bonds as well and to Central and Eastern European economies where Greek banks are major players. The interconnections among these banks make them all vulnerable to instability in Greece. And after the Icesave and Fortis bank experiences, there was little faith left that a workout process regarding the exposures

would be as gentlemanly as the gentlemen's agreements voiced by European leaders when attempting to support Greece.

This insecurity about the balance of power between Home and Host state regulators (and their treasuries) I believe will lead us ultimately to more formal burden sharing arrangements than currently provided under the Basel Committee minimum standards. The solution announced in Europe yesterday in many ways is a stop-gap measure; national state-owned banks (where they exist) will bear the brunt of financial support for Greece. The economic burden-sharing will ultimately need to be paired with regulatory burden-sharing, a process that will cause us all to reconsider carefully whether local fiscal authorities will remain comfortable with Home-state regulatory systems where weaknesses can materially increase losses abroad. Clarity through formal agreement, rather than informal colleges of supervisors, is the likely outcome.

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-think is underway in the risk community and the economics profession on these topics.

And so it is particularly ironic to see that the policy response inside governments, the IMF, the BIS, and at the G20 is to increase reliance by policymakers on models in order to identify systemic risks. Let me be clear. Increased transparency is a good thing generally. Models used properly can be useful in identifying risks and providing parameters for making informed judgments (rather than being misused as a substitution for judgment). Regulators have every right to require meaningful information of market participants so that government can do its job.

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

- Just this week, DTCC indicated that it will provide all data in its trade repository to any and all regulators that request it, and even to some official sector entities like the European Commission that technically are not financial market regulators.

- Federal Reserve Governor Tarullo indicated in a speech last week that the Fed is in the process of creating a new data collection entity inside the Fed to help execute 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 undertaking comparable data gathering efforts or signaling that they will do so shortly.

The flip side of data collection is data privacy. Different standards apply to the sharing of information across borders for law enforcement and regulatory purposes 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 to minimize the potential contingent liability of the local treasury associated with foreign spillovers. The potential for turf wars, duplicative or incoherent data requests, and conflicts of law is high. This is an area where clarity and formal standards at the sovereign level are necessary, where informality and customary international law cannot provide sufficient solutions.

This is not an easy prescription, I know. Anyone who has followed the convoluted and politically charged negotiations between the European Commission, the European Parliament and the United States over the sharing of financial data for law enforcement purposes knows that the issues here are far from easy to resolve. Media reports indicate that negotiations continue to this day. But the fact remains that if private sector entities are not clear on what data needs to be shared with which official sector entities, or where the data goes after it has been delivered to a financial regulator, the prospects for decreased trust among sovereigns (what do they know that I don't know about the entities operating in my back yard?) will only escalate exactly at a point in time when they will be in competition with each other for scarce financing to cover their fiscal positions. Clarity from policymakers now about information sharing among regulators across geographic boundaries and about what information is shared with the IMF and the BIS would help decrease this kind of potentially destabilizing anxiety.

Conclusion

In sum, I see the prospects for coordination dwindling and the prospects for competition increasing, even as the Group of Twenty starts thinking about its June meeting and even as the eurozone members band together to find a common 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. Devoting attention to areas where economic interests can converge to generate credible common directions, standards and international agreements will yield significant dividends in terms of keeping the global economy functioning through the remaining phases of the current financial crisis. I do not think it is practical to consider crafting a new set of Bretton Woods agreements to address today's challenges, especially in areas where state practice is not yet well defined. I am not an idealist. But I do believe that creativity combined with clear assessments of common economic interests can help define areas where ambiguity (constructive or counterproductive) can be replaced with solid, clear cross-border obligations that contribute to systemic stability.

I thank you for your attention and look forward to hearing the views of this august and thoughtful group on how international law can help forge positive outcomes going forward.