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Plenary session 2: Think global, act local

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The title of this session is "Think global, act local". It asks what's to be done with the global financial system to increase regulatory consistency and reduce barriers. We are also asked about the prospects for a global financial industry rulebook.

These questions echo complaints from global banks, who say that overdone regulation in response to the financial crisis, which is often different in each of the financial centres where they operate, is simply too much to bear. The banks don't normally say that this is reducing their take-home pay. They instead talk about the bad effects on real economies and growth as this is more likely to get a sympathetic ear.

These issues all stem from decisions made by the leaders of the Group of Twenty (G20) back in 2009 about the global financial reforms they thought would be necessary to prevent another crisis. It's common knowledge that these reforms have been implemented very unevenly in different places. On top of this important reforms such as the Volcker rule in the US and bank ring-fencing in Europe weren't even on the G20 agenda. So, at first sight it looks as if the banks have a point.

The US Treasury Secretary Jack Lew weighed in on this subject at the G20 meeting in Sydney last month, asking for far more coordination over how countries impose financial market regulations.

Gillian Tett, commentator at the Financial Times, wrote about this shortly afterwards. She said that "Secretary Lew might as well have called on pigs to fly or bankers to become nuns", and she remarked that "the unpalatable truth is that almost every step towards coordination has been offset by a step away elsewhere". Her conclusion was that the G20 needs to recognise that full coordination is a fantasy.

I think this is spot on, but also that the reasons why we are in this state of affairs are barely understood. This morning I want to get into some of these reasons, and try to inject some realism into the whole debate.

Before kicking off I should also mention that I chair a new task force on cross-border regulation set up within the International Organization of Securities Commissions (IOSCO), the global club of market regulators now being led by Greg Medcraft, chairman of the Australian Securities and Investments Commission (ASIC). The task force was the brainchild of ASIC, and is a testament to the adventurous Australian spirit, optimistic in the face of adversity. Optimism is essential here because its very hard job is to try to guide regulators on how they should deal with each other across borders when their rules collide. We knew this work would be very difficult, not least because it would be touching on the limits and privileges of national sovereignty, which is a super sensitive area. I'll come back to this task force later.

I want to spend the rest of my time today on why political realities and competing interests in the high stakes game of global finance have altered the initial G20 vision of a set of global, top down harmonised regulations to stop future crises. And which the financial industry would have loved to have seen reflected in a global rulebook.

First, let me give you some real world examples of the patchwork of inconsistent and conflicting national regulations that have replaced this global vision, which explain why we are where we are.

In the world of banking, cross-border money flows increased about ten times between 1990 and 2007, to around $5 trillion. In 2012, the figure was about a third of that. This was partly the result of deleveraging. But it was also because national regulators have been busily ring fencing their banking systems in the knowledge that cross-border banks were an important channel for transmitting the mortgage crisis in the US and the sovereign debt crisis in Europe.

As Mervyn King, former governor of the Bank of England, put it a while back, "global banks are international in life but national in death." This seems to me to be an analogue of the comment that risk takers in banks privatise the profits but socialise the losses. He then had in mind the huge losses imposed on UK customers of the collapse of the Icelandic banks. This and similar experiences elsewhere explains the efforts of leading financial centres to stop local bank operations from relying on the capital , liquidity and regulatory oversight of a foreign parent, which put simply, could no longer be trusted. The Federal Reserve Bank of the US (Fed) has now forced large banks to subsidiarise in the US, which has greatly upset big EU banks. And the UK is doing something similar with local branches of foreign banks.

I need hardly say that this does not seem to sit well with the global effort to eliminate the “Too Big To Fail” hazard posed by big global banks. This effort is work in progress, but is premised on forced creditor bail-ins at parent companies, without resorting to publicly funded bailouts, all of which are meant to be implemented through cross-border agreements between regulators. The purely national approach adopted by the Fed may be as effective as this global one. But it makes you wonder about the total bill charged to real economies by slamming global integration into reverse gear, when compared to the as yet unknown costs of possible bailouts in future crises.

The reversal of global financial integration challenges a great promise of globalisation, where low-saving countries could find the finance to fund essential investment by borrowing abroad. The implication is greater self-sufficiency in the future, which may on one view may be no bad thing in light of the recent volatile cross-border capital flows.

Of course, if cross-border lending is subdued, this puts pressure on capital markets to fill the gap. Greg Medcraft has rightly pointed out on many occasions that market based finance will be increasingly important to real economies. Capital markets must fund not only long-term pension liabilities but also plug the big lending gaps for vital infrastructure development, as well as the growth of small and medium-sized enterprises (SMEs), where there is a pressing need across Asia.

The problem is that capital markets are also under pressure. And again this is in part due to national regulatory approaches that are close to those of the bank regulators. Just one recent example will do. The sharp end of cross-border conflicts between securities regulators is in the obscure but vast world of over-the-counter (OTC) derivatives. Reforms in this area were a key part of the 2009 G20 global reform agenda because derivatives were at the heart of the bailout of US-based American International Group (AIG).

A recent study from the International Swaps and Derivatives Association (ISDA), which is the trade association for derivatives dealers, showed that cross-border rules issued last year by the Commodity Futures Trading Commission (CFTC), a US regulator , had resulted in a 77% drop in volumes of cleared euro interest rate derivatives between EU and US dealers because they caused European dealers to stop transacting with their US counterparts. This obviously sucks more liquidity out of the system. There are lots of other examples.

So what is really going on?

A bystander would think we have all taken leave of our senses. The drive to localise finance, thereby increasing the costs in the system and strangling the ability to provide efficient finance globally, seems totally at odds with the whole G20 idea of reforms driven at the global level, as well as global rulebooks and harmonisation.

And on top of that, localisation seems to challenge the explicit aims of the G20 six years down the track, which in Sydney last month set a new goal to lift collective gross domestic product by more than 2% above current expectations. Perhaps unsurprisingly in light of what I have said so far, Joe Hockey, the Treasurer of Australia, said that "there was recognition that we have to address some of the zealotry for market regulation that might be prevalent in some jurisdictions".

This is music to the ears of big banks. Goldman Sach's COO, Gary Cohn, who was also in Sydney, said that "overregulation and inflexibility could slow down economic growth, increase shadow banking and create a liquidity crisis that might sow the seeds for the next financial crisis.

We all know that financial firms are desperately trying to put the legal costs of serial misconduct and rampant risk taking behind them - even as the forex investigations gather pace. They hope to emerge squeaky clean on the sunlit uplands of a growth agenda, where more liquidity means more business. Apologies for the triple mixed metaphor, but I hope you know what I mean.

So where are we headed - another phase of deregulation similar to that which contributed to the last crisis in order to rev up growth, or a growth ambition neutered by regulation which aims to avoid a repeat crisis?

Frankly it is too early to tell so I won't even hazard a guess.

What I can do is far less ambitious, but could give a clue to the answer. And that is to say why I think Gillian Tett of the Financial Times was right that the G20 needs to recognise that full coordination is a fantasy.

The unfortunate truth is that the financial crisis not only destroyed trust between customers and banks, it also laid bare the fact that there is a big trust deficit between countries when it comes to financial regulation. And on top of that we lack any global financial institutions that have real authority to drive a harmonised, tough global reform agenda from the top down - whether at the Financial Stability Board (FSB) or at the global standard setters.

I know that this assessment seems a bit provocative. But we should judge people by their actions rather than their words, and the actions that have accelerated regulatory fragmentation speak for themselves. Global multilateral agencies without any firm basis in public international law - which basically requires a treaty - are going to find that attempts to advocate soft law solutions will be met with little more than polite interest from heavyweight countries. At the same time national regulators in the aftermath of a crisis will furiously put in place their own rules designed to protect their own populations, and no one else's.

And you can't blame them - national regulators are only bound by duties found in their own laws which do not normally take account of the interest of other countries or any ambitions for globalized financial regulation.

I should also say that there seems to be a serious disconnect between a G20 ambition expressed in the communique from the Sydney meeting and the lack of basic tools necessary to achieve it. The communique said that the leaders would "implement reforms in a way that promotes an integrated global financial system, reduces harmful fragmentation and avoids unintended costs for business". They also said that "we commit to cooperate across jurisdictions with a renewed focus on timely and consistent implementation." Nothing much is said about how this will be done outside derivatives - it appears that national regulators, and their global clubs such as the FSB and IOSCO, are just expected to make this happen.

A big problem is that governments have not followed through on their aspirations expressed at international meetings at a political level back home. First, if national regulators are to be given the wherewithal to act globally, national legislation must be amended to say so. Second, credible financial regulation operating at a harmonized international level can only be founded on legally effective treaties. Both of these are the job of governments who have conspicuously failed to deliver - or even try. They have basically passed the buck to regulators whose hands are tied by existing local legislation.

Even worse from a harmonisation perspective, legislations from the Dodd-Frank in the US to the European Market Infrastructure Regulation (EMIR) in the EU - which regulates derivatives and market infrastructure - all have been used to export US and EU law to other countries in a manner that is basically extraterritorial. This has been done in a way which takes little account of other laws with which they come into contact, or international soft law standards. This results in an extremely complex scramble for solutions by regulators and the financial industry to the inevitable conflicts that then arise. These real life actions by governments and regulators are 180-degree away from the ambitions for consensual global solutions voiced by them at the G20 meetings, but are perfectly understandable if you realize why this has happened.

An academic paper published in January by John Coffee of the Columbia Law School in the US provides an excellent insight into what's been going on. It's fairly provocative stuff - at least for those who still cling to the idea of multilateral agreements about global rulebooks. This is what John Coffee says.

First, there is no such thing as global financial regulation implemented through networks of cooperating multinational institutions applying broad principles of soft law - and nor can there be anytime soon.

Second, only the US and the EU have the right incentives to properly curb systemic risk, because only they are the most exposed to it. No one else really cares.

Third, big financial institutions are extremely mobile and can easily park their higher risk operations abroad and beyond the regulatory reach of the US. This is the US take on the AIG's failure.

Fourth, some nations find it in their interest to profit from regulatory arbitrage by operating as financial casinos to attract these risky operations, which then rebound on the home country when things go wrong.

Fifth, it's not good enough just to regulate the operations of domestic financial institutions overseas, but also foreigners who transact with them abroad, as they are not only too big to fail but also too interconnected to fail.

Sixth, the financial industry and foreign financial casinos will pursue aspirational and distant soft law standards at an international level, seemingly in tune with G20 aspirations, hoping that this will blunt real regulation in national laws and delay implementation, giving more time to lobby around the growth agenda.

Finally, the only way to get adequate international standards is for the EU and the US to assert extraterritorial authority to gain the leverage necessary to embed their own solutions at the international level. Otherwise international bodies will be slow to act as they will never achieve high levels of consensus. He also remarks that the EU is pursuing an extraterritorial agenda which is just as aggressive as the US.

I just want to quote one statement from Coffee's paper:

"Less regulated jurisdictions are essentially free-riders, who are expecting (perhaps shrewdly) other nations to bear the costs (including costs of massive bailouts) of preserving economic stability from systemic risk. These free-riders may be aided and abetted in their resistance to the need for stronger regulation by precisely those financial institutions that most want to escape stronger regulation. In a globalized world, market participants ....can escape confining regulation so long as they can delay major financial nations from acting. Rhetorically, those opposed to financial reform can unite around a favourite defensive rallying cry, which is that international regulation must not precede consensus".

So, if the EU and the US agree bilaterally on common standards, they can simply deal with the rest of us by stopping their own financial institutions from trading in markets that don't conform. And this is based on the assumption that the EU and the US together have overwhelming market power to force compliance in other countries.

This view was also reflected in a paper published by the EU and US Atlantic Council late last year, which said that "only when the US and EU are able to act in unison will they be well positioned to export their policy preferences".

As for those who still aspire to global harmonisation, Coffee dismisses this as a "plea frequently invoked by, and has become the most effective weapon of, those seeking to delay systemic risk reform".

So where does this leave us?

First, there is little doubt that the rejection of global solutions by the EU and the US in favour of national ones, and the use of extraterritoriality to export these when the EU and the US fear contagion from overseas - perhaps Asian flu - fits the reality I see on the ground.

Second, this approach pays no real attention to legitimate Asian policy preferences. The burning need in this part of the world is a new financial architecture to lower dependence on banks and unlock domestic savings to fund a $750 billion annual new infrastructure requirement across 32 countries, and to finance loan-starved SMEs.

Added to this is the patronising assumption that "the west knows best", and implicitly that the financial casinos are here in Asia, ripe to be forcibly recreated in the image of the US and the EU. Unless I have been dreaming, I thought that bank deregulation, a credit binge calculated to support a political agenda encouraging widespread home ownership for those unable to afford them, supported with a promise of never ending price increases, all had something to do with the crisis. And also that this happened in the US and the EU. I also vaguely recall that a virus of securitised sub-prime loans incubated in Wall Street, rated by conflicted US private agencies as safe and then spread across the world, was also part of the picture. But then again, I may be mistaken and it was all the fault of financial casinos elsewhere. Fortunately, Asia was sufficiently resilient after its own crisis in the 90's to fight off the infection with little harm done.

As I see it the way forward for us regulators is pretty clear.

For a start, we have to acknowledge the reality that a global rulebook will not happen anytime soon, and the world will never be frictionless.

We also know that some in the financial industry who are keen on the idea of a global rulebook may be motivated by the hope that efforts to achieve things on an international level instead of locally will be like the quest for the holy grail: worthy but fruitless absent enabling laws and treaties. Delay will allow more opportunity to roll back national legislation around the rhetoric of growth and liquidity. So, regulatory effort at this level may be misplaced, especially as the G20 governments haven't given us the treaties and other tools to do the job properly.

We should also recognise that there has been much good done at a national level to increase safety and soundness in the financial system, all based on enforceable national laws which are bound to differ as they are products of different political processes. Not all of these result in cross-border regulatory conflicts - they just add cost as the price of more safety.

Where these laws do collide, work is now being done between regulators at a practical level to sort this out through negotiation. Even the most hawkish of extraterritorial advocates, such as the CFTC, are using measures to dis-apply their own laws when conflicts occur when they judge a foreign law to be sufficiently strong to contain the situation. This is where jargons like "equivalence " and "substituted compliance" are heard.

This is also where the IOSCO task force I am chairing comes in. Rather than pursue the elusive multilateralism, it will acknowledge the mainly national regulatory responses to the crisis I have described. It will then seek to identify better ways in which regulators can assess foreign regulatory and enforcement regimes as being of sufficient quality to enable them to rely on them instead of exporting their own laws. I mentioned earlier that the Balkanisation of finance was a symptom of a lack of trust between different national regulatory systems. The work of the task force aims to restore some of that trust by encouraging ways for one system to get to know another one thoroughly, then deferring to it and eventually sharing supervision. We also hope to encourage some benchmarking to international standards adopted by IOSCO.

Some see this as another way in which the financial industry might focus lobbying pressure. This is because it's an obscure process which could lead to degraded regulation if, push comes to shove, a country is reluctant to refuse recognition of another's system for fear of embarrassing the country failing the test. All I can say at the moment is that we are aware of this issue and will do our best to deal with it.

Finally, it is important that we resist the notion that a one size fits all approach exported from the EU and the US to Asia is remotely a good idea. It rather assumes that Asian countries are regulatory and political vacuums with no different priorities to the west. Nothing could be further from the truth. The Atlantic Council report I mentioned earlier did at least acknowledge that growth in Asia and the accompanying rise in demand for capital will be accompanied by a decline in EU and US regulatory power, as more deals are done in Asia. It also admitted that Asian policy preferences will differ from the EU and the US because of different histories and stages of development.

So, one of the most important projects is to ensure that Asia embeds the right type of regulation to fireproof a system that cannot easily be gamed by the financial industry, whilst ensuring that the market financing rules are geared to the specific needs of Asian growth.

This is now at the heart of the work of the Asia Pacific Regional Committee of IOSCO, which I also chair. It aims to agree a collective Asian roadmap to foster capital market development. To give you just one example - unlike the EU and the US, Asia generally wants the size of its derivatives markets to grow in order to risk manage more sophisticated capital markets. But some are concerned that premature or clumsy regulation could kill off small but growing derivatives markets, or transfer deals to the EU and the US. The chilling effect of Basel III on Asian credit, as well as the benefits to financial inclusion of some types of shadow banking, are also part of the story.

There is no doubt that six years on we are at a crossroads. It is hard to see how greater ambition for accelerated growth will play out alongside the mainly national rather than global regulatory responses to the crisis, particularly as these could weaken as they collide across borders or are scaled back in the hunt for growth. This has already happened in some areas, such as the Basel III risk weights.

I have referred to John Coffee's blunt paper quite a few times, and will give him the last word on these threats.

He said that "in all likelihood, failure will not be caused by forthright opposition to reform, but rather by delay, piecemeal compromise, and low visibility decisions that eviscerate the formal rules. The public has a short memory. But the industry never forgets."

I am confident that we regulators will never forget either - which just leaves the politicians.

Thank you.