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REPORT

492

# Financial Regulation: Bridging Global Differences



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## Session 492

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# Financial Regulation: Bridging Global Differences

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## Introduction

“International coordination has never been so challenging, yet never so important.” These straightforward opening words from one panelist capture the sentiment of both frustration and determination expressed by the attendees of Salzburg Global Seminar Session 492 on “Financial Regulation: Bridging Global Differences”.

Though the financial crisis of 2008 demonstrated the need for international cooperation to address the challenges facing multinational institutions and interconnected financial markets, early promises of commitment to transnational reform efforts have not met expectations. Despite the important steps toward global coordinated regulation that have been taken, in particular within the framework of the Financial Stability Board, these efforts remain insufficient. The post-crisis years have witnessed a divergence of approaches in the US and Europe, fears of a less rigorous regime in Asia-Pacific, and differences in implementation of rules. Over-reliance on soft-law principles and national implementation has allowed for transnational regulatory divergence, which, in turn, increases risk of regulatory arbitrage and raises concerns over our ability to successfully prevent and respond to financial crises in the future. The political window for agreeing to and implementing legally binding international frameworks in the wake of the financial crisis is growing increasingly limited every day.

Salzburg Global Seminar recognized that now is a crucial time to reverse this trend, while there is still impetus for reform and before divergences become further embedded in the evolving architecture of the international financial system. To this end, over three days in August 2012, regulators, bankers, economists, lawyers and other experts from different continents met to discuss recent trends in regulatory reform in the US, Europe and Asia. Participants debated the efficacy of the adopted and proposed reforms and explored the extent of convergence between different jurisdictions, highlighting key differences. They also reviewed the challenges to global financial supervision and international cooperation, changes in market structure, and discussed the major challenges in the area of supervision and resolution which regulators and supervisors will face in the years ahead.

Session participants represented an unusual mix of policymakers, academics, and practitioners who will have roles in assisting in the supervision of financial markets and advising rule-making bodies on regulatory reform initiatives. In the short-term,

**“Though the financial crisis of 2008 demonstrated the need for international cooperation to address the challenges facing multinational institutions and interconnected financial markets, early promises of commitment to transnational reform efforts have not met expectations.”**

these Salzburg Global Fellows can promote awareness of the importance of cross-border cooperation in their jurisdictions. Greater understanding of the costs of piecemeal and inconsistent national regimes can, in turn, help overcome widespread reluctance to engage in more formal and informal arrangements to create a more consistent global financial regulatory system. It is hoped that the insights and lasting relationships developed through Session 492 of Salzburg Global Seminar will lead to the formation of innovative regulatory reform proposals and promote greater cross-border cooperation and coordination in the future.

“Greater understanding of the costs of piecemeal and inconsistent national regimes can, in turn, help overcome widespread reluctance to engage in more formal and informal arrangements to create a more consistent global financial regulatory system.”



Program Director Tatsiana Lintouskaya welcomes participants to Parker Hall



## Setting the Scene: How Did We Get Here?

### History of International Financial Regulation

The session opened with a sweeping discussion covering the financial history of the international financial system from the creation of the Bretton Woods system to the present. This historical understanding was viewed as essential context for insight into the recent crisis.

The speaker began with an overview of the establishment of the Bretton Woods institutions and following period of stability and international cooperation in global financial markets. He then continued with the collapse of the Bretton Woods system with the US departure from the gold standard in 1971 and the turbulence caused by the failure of Bank Herstatt, which renewed concern about capital standards in the US and, more broadly, on a global level. The 1980s Latin American crisis and real estate crisis a few years later illustrate how the international consequences of these crises increased over time.

The increasing internationalization of the financial system led to the convening of the Basel Committee in the 1980s and the early efforts to create international capital standards. However, the speaker lamented that political pressures unduly influenced the structure of these capital requirements, as they continue to do to this day; this distortion of vital regulation by the political process was a recurring theme throughout the conference. The speaker cited the rejection by governments of high capital requirements against sovereign debt or mortgages and noted that some of the biggest weaknesses in financial markets today are based on investments in those two asset categories.

Despite the increasingly international nature of crises in the 1980s and new attempts at global financial rules, the regulatory environment drastically shifted in the 1990s – the US liberalization of banking regulations during this period has been cited as one example of the emphasis on deregulation that he felt characterized this period. Banks in Europe had historically been less restricted than their American counterparts in certain key areas; for example, banks in Europe could own industries and engage in both trading and investment banking. Though the speaker had believed that universal banking in Germany would cease to exist, during the 1990s he witnessed “American banks become more German” as they entered into trading and other business lines. At the same time, shadow markets in the US came to overshadow the traditional banking model. Large investment banks became comparable in size to the commercial banks, which in turn facilitated relaxation of banking laws to maintain the competitiveness of commercial banks.

**“The increasing internationalization of the financial system led to efforts to create international capital standards. However, political pressures unduly influenced the structure of these capital requirements, as they continue to do to this day. ”**

**“ The 1990s was a period of unprecedented financial innovation. Finance professionals believed that new products and activities increased their ability to diffuse and control risk. Though the economy was growing and improving, these new tools caused the markets to become more opaque and complicated. ”**

The speaker also observed that the 1990s was a period of unprecedented financial innovation. Finance professionals believed that new products and activities increased their ability to diffuse and control risk. Though the economy was growing and improving, these new tools caused the markets to become more opaque and complicated. The first credit-default swap (“CDS”) was invented in the mid-1990s. In 2005, the CDS market amounted to \$70 trillion against a credit of loans was less than \$10 trillion; there were therefore \$7 of insurance policy against every \$1 of loans. This innovation led to an overly complicated system that few understood.

The United States also incurred current account deficits throughout the 1990s, particularly through increasing imports from China. Housing prices increased and even ordinary people thought the path to success was to buy houses. Innovation in the 1990s, and confidence that finance professionals had evolved beyond the problems that had led to past crises, was at the core of the recent crisis. Despite the lessons of the 1970s and 1980s about the importance of cooperation, the speaker lamented that there has been less of the willingness to “think big” that led to the creation of the Bretton Woods institutions and the ensuing decades of financial stability.



Session co-chair Paul Volcker addresses the participants as fellow co-chair Jacques de Larosière looks on

Another speaker continued that the resulting situation has been especially difficult because the financial system is going through a deep adjustment process of deleveraging, which is to be expected after too much debt is embedded. There were three elements of deleveraging addressed by the speaker: households, governments, and banks. While this “debt hangover” is natural, overexpansion and overextension of debt was greater than in the past, and therefore takes more time to reduce.



The speaker also discussed the dangerous entanglement of the banking sector and government debt; if the government encounters difficulties and its paper is called into question, banks that hold that paper are hurt by this uncertainty as well. Governments need to reduce deficits and engage in reforms that will reduce public expenditures and reignite the economy. This deleveraging process, be it spontaneous or encouraged by financial regulation, has had a different impact on national economies. Deleveraging of the banking system in Europe has a much larger effect than in the US because of GSEs in the US. The speaker explained that, because of the development of the GSEs (Freddie, Fannie), the debt of US households directly accounted for by US commercial banks on their balance sheets is only 35%, whereas in Europe it is 93%. The speaker felt that these differences must be taken into account when pursuing international coordination in regulatory reform efforts.

## Lack of Credit and Monetary Discipline

In subsequent discussions, it has been noted that the decades prior to the crisis were marked by a great loss of discipline in the markets that paralleled a loss of discipline in the international monetary system. The first speaker, a former financial regulator, explained that regulators did not “think it was necessary to be tough” because the market was doing well. He said that throughout the 1990s and early 2000s, central banking policies and fiscal policies were based on the national belief that the market could take care of itself. Not only was this assumption false, but that lack of discipline in the international monetary system was a major contributor to the current crisis. Another speaker added that there was considerable pressure on home regulators to accept new products and practices, and that this pressure is still present today.

Several participants also cited the lack of monetary discipline as a factor in the crisis. One of them mentioned the “Greenspan put”, in which markets believed that, given the Fed’s history of providing liquidity under former Federal Reserve Chairman Greenspan, the Fed would do so again. There was therefore an investor perception of “put” protection on asset prices, which led to inaccurately high valuations and increased risk-taking.

Throughout the conference, one participant in particular highlighted the lack of credit discipline as a major cause of the crisis as well as a factor that must be addressed in reforms. He declared credit discipline “the missing piece in the jigsaw” and that there is currently an insufficient understanding of the role of credit supply in the crisis and how it should be managed going forward. He added that credit creation must be a greater factor in prudential supervision as well as in macro-prudential considerations while expressing concern that political authorities will be willing to demand the changes necessary to prevent the financial system from again beginning to create credit at a rate which is irresponsible for the system as a whole.

**“ The decades prior to the crisis were marked by a great loss of discipline in the markets that paralleled a loss of discipline in the international monetary system. Regulators did not think it was necessary to be tough because the market was doing well. ”**

**“Greater consideration of what might be done in a monetary union to avoid casualties of a single monetary policy is needed. For example, policies to reduce the appetite for borrowing in countries such as Spain or Italy could have been pursued instead of allowing the frenzy of low cost borrowing. ”**

The speaker acknowledged that there have been efforts to address weaknesses in credit discipline, such as the Basel III leverage ratio, however, more should be done to address this issue. For example, there is a capacity for credit creation in the system related to securities lending that is still not sufficiently constrained in a material way. Also, greater consideration can be given to heightened margin requirements on legal transactions and restricting the type of collateral available for collateralization. Together, these reforms may diminish the capacity of the shadow banking system and the banking system to expand credit separate from the central bank. He suggested that we consider a treaty around the idea of credit discipline given its central role in the crisis, but this idea was not pursued in greater depth during the conference.

This speaker also brought up the role of monetary policy and currency valuation in the crisis. As was well understood by both the speaker and other conference participants, too much external borrowing and lending without sufficient credit risk assessment of the quality of the borrowers was at the heart of the crisis. In particular, the speaker mentioned the risks caused by the pre-crisis rise in importing external capital, which was then passed on to local borrowers or for investment in real estate. These cross-border capital flows carried enormous risks that were not fully recognized at the time. In the years preceding the crisis, the speaker had been surprised that the relevant monitoring and regulatory authorities had paid little attention to this wave of externally denominated loans.

With past mistakes in credit discipline and monetary policy in mind, concerns about the eurozone were the subject of discussion as well. In the past, the official rates in Europe were relatively low. Moreover, the main countries responsible for the majority of the EMU's GDP had the most influence in fixing interest rates and, because they were not under inflationary pressure, interest rates were low. While low interest rates were not a problem for countries like Germany, the rates were far too low for countries that had expanding economies. In the early years of the EMU, interest rates in Germany were slightly above the nominal growth of its economy; in Spain or Italy, nominal interest rates were the same but they were well below GDP in nominal terms. Greater consideration of what might be done in a monetary union to avoid those casualties of a single monetary policy is needed. For example, policies to reduce the appetite for borrowing in countries such as Spain or Italy could have been pursued instead of allowing the frenzy of low cost borrowing.

## **Lack of Macro-Level Oversight**

Conference participants agreed that regulators and supervisors had failed to properly assess the vulnerability of the international financial system. One regulator explained that those responsible for oversight of financial stability lacked the data needed to make better judgments in the future and “It was like running a nuclear

power station without understanding what was in the pipes.” He felt that, while we are getting better at understanding the interconnections in the system, we still don’t know enough.

Another speaker from the EU explained that, prior to the crisis, there was no concern regarding macro-risks. The ECB did not have a way of measuring, identifying, or processing the issues that are now at the forefront of financial reform efforts. Another speaker explained that macro-level oversight is particularly important in the EMU. Discrepancies in monetary policy between, for example, Spain and Germany, could impact the stability of the entire EMU, rather than just those two countries.

This participant also pointed out that a 2000 report by the Financial Stability Forum called “Report of the Working Group on Capital Flows,” chaired by Mario Draghi, was very accurate concerning potentially problematic products and systems, and identified steps that central banks should take to avoid a crisis. These recommendations included frameworks for greater macro-level oversight, improved analysis and understanding of capital flows, and addressing the volatility of short-term debt. The problem, therefore, was not the failure to identify potential problems, but the lack of political will of governments and central banks to follow those recommendations. The speaker expressed concern that some of the items identified in the report have still not been adequately addressed. Given that the problems at the root of the crisis were identified in early 2000 but were not dealt with effectively, the participant asked what might prevent warnings from going unnoticed again. In response, another participant explained that new macro-level agencies, such as the Financial Stability Oversight Council in the US, the ESRB in Europe, and the FSB on a global level, are now in place and should address such warnings in the future.

**“Prior to the crisis, there was no concern regarding macro-risks. The ECB did not have a way of measuring, identifying, or processing the issues that are now at the forefront of financial reform efforts. ”**



Jacques de Larosière during group work in the Seminar Rooms of Schloss Leopoldskron

**“21st century interconnected financial markets cannot solely be regulated at the national level, and national regulators must work together to strike the right balance between a level playing field and sufficient flexibility on the global stage. ”**



Fellows present their cases for and against the breaking up of banks to end “too big to fail”

## Initial Post-2008 Efforts

Participants agreed that, despite the weak economic recovery in many countries, present challenges should not weaken commitment to financial sector reform. Participants uniformly agreed that 21st century interconnected financial markets cannot solely be regulated at the national level, and that national regulators must work together to strike the right balance between a level playing field and sufficient flexibility on the global stage.

While important steps toward international coordinated regulation have been taken, conference attendees agreed that these efforts have been inadequate. As has been noted by one panelist, we have a global economy, yet differences remain rooted in a political world of nation states with embedded approaches to regulation, political pressures, and vested interests. This is true even within nations; for example, he cited the fragmented regulatory structure of the United States, which has 5-6 main regulators at the federal level.

Another speaker agreed, and added that this condition is inherent in the traditional model of financial regulation. For decades, arguably centuries, financial regulation has been national in nature; anyone doing business within a territory had to abide by the same rules of that territory. However, there is increasing cross-border activity, which leads to inefficiencies of coordination between nations. Before the crisis, a dialogue had begun addressing how to improve efficiency of cross-border business. This speaker outlined three pre-crisis approaches that had been explored: standardization (for example with respect to differences between the private and public market), exemptions for certain entities doing business in the home



country (either because the host had effective regulation or they were dealing with sophisticated investors in the home country), and recognition (which could be unilateral, bilateral, or multilateral). Recognition was particularly promising prior to the crisis because there was a joint statement by the EU and SEC that they would explore mutual recognition. However, this path stalled because any recognition was required to be EU-wide and some US regulators were reluctant to completely rely on all 27 EU regulatory structures. These early efforts to address the globalization of markets also slowed as the crisis led to a shift in attention from trying to make cross-border business more efficient to dealing with safety and soundness of domestic markets, risk, and oversight of financial institutions.

Another speaker declared that the G20 statement that “relentless and cooperative efforts over the past two years have delivered strong results” was unduly optimistic and cited several examples of issues that have not been resolved. For example, while Dodd-Frank says “thou shall not rescue a failing financial institution”, there is enormous skepticism that this commitment will be followed in practice. The Financial Stability Forum (“FSF”) has been expanded and evolved into the FSB, but this expanded membership will make agreement even more difficult because it is on a consensus basis. Discussion of credit rating agency reform has not led to significant change. Harmonization of derivatives and accounting standards remain problematic. Debates on size limitations for banks have also failed to produce consensus.

Another participant also listed several areas of concern. First, he pointed to America’s failure to fully adopt Basel II and II.5 and possibly Basel III as a very troubling sign for international coordination. He also found that, within Europe, there is clearly a movement towards flexibility and gold-plating. This failure to coordinate in part could be explained because national interests are more pressing when crises become more difficult for countries. In times of economic hardship and uncertainty, the speaker noted an increased risk of national interests derailing efforts at international coordination. The speaker explained that divergence in regulation is not the manifestation of strong states choosing to ignore otherwise agreed upon rules at the international level, but instead such rejection of global agreement is a sign of weakness. A strong national base for accepting concessions is needed for a harmonized regulatory system, which is particularly difficult to establish in times of crisis. This dilemma can be seen in Europe, where high spreads and the sovereign debt crisis have led to a retrenchment and compartmentalization of financial markets. However, the speaker stated that contrary to many others in the room, he is still a believer in the euro system and thinks it will survive. Current account imbalances are always at the origin of these tensions within monetary unions and exchange rate settings. Currently, Spain, Portugal, and Greece are substantially reducing these deficits, and therefore this major vulnerability is being addressed. He expressed his belief that

**“While Dodd-Frank says ‘thou shall not rescue a failing financial institution’, there is enormous skepticism that this commitment will be followed in practice.”**



**“Over time, as imbalances decrease and economic growth returns, there will be greater political will for the needed mix of national fiscal adjustment and some degree of solidarity in the monetary area. ”**

the fundamental disequilibria that lasted for almost ten years since the launching of the union are now disappearing and believes fiscal institutions are improving. Over time, as these imbalances decrease and economic growth returns, there will be greater political will for the needed mix of national fiscal adjustment and some degree of solidarity in the monetary area.

Another speaker, while noting progress thus far, argued that agreement on the central principles and building blocks is not enough to meet the requirements of today's global financial markets. He cited divergence in three main categories: details (such as capital requirements and derivatives markets), previously uncharted ground, and highly politicized areas (such as the Volcker Rule and a financial transactions tax). Regarding “divergence on the details”, the speaker discussed capital requirements and derivatives markets.

Speakers also observed the enormous pressures faced by the regulatory community, as bankers are arguing that the ongoing uncertainty is a reason to ease up on the regulatory pressure. One speaker with a background in both banking and in the public sector stated that most bankers say that the financial sector is being asked to do too much too soon and regulators should therefore slow the speed of regulatory reform. Rather than “too much, too soon”, this speaker and other conference participants worried that efforts thus far would be more appropriately described as “too little too late.” If there is a reproach to be made, it is that regulatory reform has not been faster. Another panelist expressed concern that energy is seeping away five years after the crisis began and the willingness to pursue large fundamental reform has diminished.

Yet conference attendees also recognized reasons for optimism. One speaker reminded the group that at first glance, “the picture doesn't look that bad,” as regulatory agendas have been closely aligned due to the efforts of international organizations, the G20 and FSB in particular. G20 nations are focusing on a number of key regulatory initiatives, including the reform of capital requirements, the establishment of global resolution regimes, derivatives markets, and close supervisory cooperation. Of the 36 measures of the FSB's latest status report on financial regulatory reform prepared for the G20 Los Cabos summit in June, 32 received a “complete” status.

Another speaker added that a huge amount of work has been done so far, despite the continuing enormous pressure on home regulators to accept new products and practices. He reminded the conference participants that the current mess was the result of a combination of innovation and competition in finance, forces that are still present in the financial system today. Therefore, we should not discount the successes that have been achieved in light of the pressure to delay and avoid new regulation.

Another speaker noted that the history of national regulation can also be a reason for optimism about the revolutionary nature of recent efforts. Even through the early 2000s, we have mostly lived in a world of isolated regulatory action and no peer review of the implementation of foreign rules, so we have achieved progress over time. Another seminar participant added that despite the disappointment over divergence in the implementation of capital requirements, we also should not downplay the relevance of the fact that Basel III is going to be the rule in most jurisdictions.

There was also a comment that regulatory divergence is not as bad as one might fear given the barrage of new regulation that has developed in recent years, and that the G20 has done a reasonably good job of promoting consistent frameworks and implementation.

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## Dangers of Divergence

It has been agreed that one of the most important challenges facing the financial regulation sector is that of transnational divergence, or inconsistent financial regulatory reform efforts across different jurisdictions. Several speakers discussed the dangers of such conflicting regimes, including arbitrage, fragmentation, and the increase in financing costs due to overlapping regulatory and compliance regimes. The main points addressed on this topic are discussed overleaf.

**“We should not discount the successes that have been achieved in light of the pressure to delay and avoid new regulation.”**



Salzburg Global's Program Director Tatsiana Lintouskaya (l) and President Stephen Salyer (r) with session faculty member Clemens Börsig

**“One of the most important challenges facing the financial regulation sector is that of transnational divergence or inconsistent financial regulatory reform efforts across different jurisdictions. ”**

## Re-Nationalization and Retrenchment

During his remarks on the effects of transnational regulatory divergence, one speaker outlined three ways financial institutions can react to this lack of international coordination. These include: arbitrage, live with them (swallow costs or pass on to clients), or capitulation (retreat from capital markets and cross-border activities). The speaker believed that the choice among these alternatives depends on the price-sensitivity of clients, tolerance of policymakers to regulatory arbitrage, and costs of compliance. He felt that based on his observations, more multinational institutions seem to think that the third option (capitulation) is the best. As a result, there are signs of fragmentation of international financial markets. For example, especially in Europe, the market shares of foreign institutions are shrinking, banks and securities portfolios are becoming less internationally diversified, and domestic funding sources have become more dominant.

One participant agreed with the observation that the current financial crisis has promoted re-nationalization of financial institutions. As examples, he cited the retreat of US investments and money market funds from the European market as well as national retreat within the European market, and observed that this retreat is encouraged to a degree by national regulators. Another speaker added that the banks retreating and reducing their international exposures is logical to a degree to reduce risk-weighted assets and leverage - it is often easier to reduce business at the periphery than at the center.

Another speaker agreed with the above observations, expressing disappointment that the markets have become much more segmented. Another speaker agreed with the observations about the retrenchment and increasing focus on national interest in the wake of the crisis. The US is now applying rules extraterritorially, including restrictions on certain financial activities. The American message to the world, according to this participant, is that the cost of doing business anywhere in the world with a US affiliate must comply with the US rules. This is, in a sense, the antithesis of global coordination.

In response, one participant asked why recent nationalization of banking markets is necessarily undesirable. He pointed out that French and German bank investments in Greek debt and the real estate market were some of the causes of the current crisis, and therefore in the long run it might be better for banks to concentrate on their own markets. In response, one panelist said that there is currently a European market for goods and to some extent for services, and that many believe Europe has benefited enormously from this common market. The problem in France and Germany was not the cross-border nature of the transactions, but proper risk assessment. The banks buying Greek bonds had not properly assessed the risk involved. These past mistakes do not mean that German banks should not have subsidiaries in Italy or should cease their business operations there. He repeated

that the issue is not regional concentration, but the assessment of risk; banks operating internationally have a positive effect on the economy, such as through increased competition for services and clients, which leads to improved quality. These benefits will be lost if this trend of retrenchment continues.

## Increased Cost of Doing Business

Several speakers warned of the costs of divergent regulations. Participants agreed that differing laws substantially raise the cost of setting up and doing business in two or more jurisdictions. These costs are largely fixed, so unless the bank can achieve critical market share, it will not be worthwhile to pursue many cross-border operations. Banks can also be in danger of being overwhelmed by the complexity of rules. Reputational damage can be very costly due to accidents, as can regularly be seen in the recent news. Complicated and overlapping laws can increase the difficulties of compliance, which may contribute to such errors.



Session faculty members David Wright, Edward Greene and Jacques de Larosière

**“The issue is not regional concentration, but the assessment of risk; banks operating internationally have a positive effect on the economy, such as through increased competition for services and clients, which leads to improved quality. These benefits will be lost if this trend of retrenchment continues.”**

## Arbitrage

Participants also expressed concern that “going it alone” would only lead to a migration of business and regulatory arbitrage. Such arbitrage is likely to undermine not only the integrity and efficiency of financial markets, but would also undermine financial stability. In particular, there is a threat of regulatory arbitrage as stricter rules set incentives for activities and risk to be pushed from the core of the financial system to the periphery. This could contribute to the growth of shadow banking. One speaker explained that the FSB has committed to conduct global annual monitoring exercises to assess global trends in shadow banking, and that recent reports show that the volume of shadow banking has already increased substantially in light of new regulations post-crisis.



**“‘Going it alone’ would only lead to a migration of business and regulatory arbitrage. Such arbitrage is likely to undermine not only the integrity and efficiency of financial markets, but would also undermine financial stability. ”**



Panelists (l-r) Masamichi Kono, Andreas Dombret, Jacques de Larosière and Michael Krimminger in Parker Hall

Other participants noted the importance of a level playing field in Europe in particular. One speaker from the EU explained that once a degree of flexibility is there to tailor the rules for the local market, there is tremendous potential for arbitrage as these markets are closely interconnected. Multiple sets of rules can create harmful distortions of competition within the EU. This potential for arbitrage plays a key role in the debate between regulation binding on the EU Member States or directives. Still, with both regulation and directives, application of rules needs to be policed to ensure a level playing field throughout the EU.

One speaker discussed the potential for arbitrage in favor of emerging markets, citing FSB research that has identified major gaps in national implementation in the emerging markets. Many of these markets were not affected by the crisis and therefore see little reason to impose tougher rules. Emerging market banks therefore have a double advantage; they will enjoy less stringent rules, and they will better absorb the impact of the new rules because of their relatively successful economies. Asian banks in particular will use this to their advantage and will expand their market shares starting with international lending markets. It is not widely noted that these emerging market banks have risen dramatically in international league tables. In 1999, European banks accounted for 42% of total market capitalization of the top 25 banks globally. At the end of January 2012, they accounted for 14%. In contrast, emerging market banks were not represented in the group in 1999 and now have seven spots on the list. Last year, Chinese banks accounted for one-third of all profits of the top 1000 banks worldwide, up from 4% in 2007. The share of profits accruing to European banks fell from 46% to 6%. Therefore, the speaker concluded that emerging markets will be less likely to adopt



new rules, while enjoying a competitive advantage against developed countries that do so. In turn, this may discourage nations from agreeing to, and/or adopting, international rules.

## Ring-fencing

Ring-fencing arose several times as one negative outcome if regulators fail to cooperate on regulatory reform. This ring-fencing could lead to inefficient mandatory structural reforms and preferential treatment of domestic creditors (in contravention of the FSB “Key Attributes,” which calls for treatment of creditors without respect to nationality or domicile). As one former regulator stated, “if you have a situation where two countries disagree, you will end up back in a world of ring-fencing”. He cited the potential for more ring-fencing as one key reason that cooperation is in everyone’s best interest. While the US already imposes a type of ring-fence, they may wish to make changes to their own regime to avoid ring-fencing by other jurisdictions. He stated that there was already authority in the US to do so; for example, with national depositor preference in the US, there is power under the law of the US to provide for protection of depositors even if they are located outside of the US. Still, there is government authority to prevent nationalistic maneuvers that could, in sum, cause greater harm than good for all nations. As the speaker explained, “it makes enlightened, self-interested sense” for the US regulators to work closely with other regulators, particularly in establishing cross-border frameworks to resolve global financial institutions and ensure that there is no incentive for jurisdictions to ring-fence. Concerns about ring-fencing are one key driver of regulatory cooperation in the resolution space, particularly between the US and UK, as (according to the speaker) over 80% of US companies that are overseas go through London in one fashion or another.

The greater potential for ring-fencing by small countries that host large international financial institutions has been noted. One speaker, who had a great deal of experience in working with small emerging market countries, particularly in Europe, stated that these countries had a great deal to lose from the failure of a large multinational financial institution with a significant presence within their borders. At the same time, these countries are justifiably concerned that operations within their borders, while significant to their relatively small economies, may be considered less significant to the large institution and therefore not be supported by the home state. This lack of confidence by small host states in home country support, and their vulnerability and exposure to such large financial institutions, substantially increases the likelihood of ring-fencing by these countries.

**“Ring-fencing could lead to inefficient mandatory structural reforms and preferential treatment of domestic creditors ”**

## Counterpoint

While participants agreed that regulatory divergence causes significant problems, several speakers questioned the extent to which international coordination was needed to address divergence. For example, the question arose at what point we should seek solutions that are internationally coordinated and at what point should we implement reforms on a national or regional basis. Germans are particularly strong believers in the subsidiarity principle, in which decisions are made at lower levels and it is considered best to avoid centralization of policymaking at the top level. Along those lines, one participant asked to what extent the G20 needs to take up all issues. It is important for the G20 to distinguish between issues it has identified that should be addressed at a regional level and those which require more international coordination. Therefore, despite the problems caused by regulatory divergence, conference attendees agreed that global regulatory bodies should be wary of greater complexity and taking on too much.

**“At what point we should seek solutions that are internationally coordinated and at what point should we implement reforms on a national or regional basis?,,”**



Salzburg Global Fellows Alfred Mifsud, David Wright and Charles Haswell

## International Organizations

In the wake of the crisis, several organizations took on new roles and responsibilities. Throughout the seminar, the roles played by these organizations in combating regulatory divergence, and the interaction between these groups, were debated in various contexts. Representatives from some of these international standard-setting bodies were able to offer invaluable insights into the ongoing initiatives of these organizations as well as current challenges. Issues of inclusivity, legitimacy, and formality of each organization were recurring topics throughout the three days. The problem of enforcement and implementation of the work product of these standard setters was also a recurring theme.

### Financial Stability Board

One panel of the Salzburg seminar was dedicated to the role of the FSB in promoting regulatory reform and addressed FSB initiatives to date, concerns about membership and sufficient global representation, effectiveness of peer reviews, the FSB's interaction with other standard-setting bodies, and its priorities for the future.

Several panelists began their remarks by addressing the evolution of the FSF into the FSB. The panelists uniformly commended this development and cited several improvements made in the transition. In particular, the greater legitimacy of the FSB was mentioned as a particularly important development. Since the crisis, G20 support significantly strengthened the FSB. In early 2008, the G20 took on many of the recommendations of the March 2008 FSF report, which was the first relatively comprehensive diagnosis for identifying weaknesses.

Panelists also spoke approvingly of the increase in membership that accompanied the transition from the FSF to the FSB as the G20 took ownership of this process. One panelist explained how, in April 2009, the G20 formally expanded FSB membership to include more countries and invested the FSB with a greater mandate to coordinate with international authorities and manage international standard setting. Members then made commitments to implement FSB agreements. In particular, one panelist "was delighted" that the European Commission, which had been kept out of the FSF, was asked join the FSB.

Given the FSF's failure to prevent the recent crisis, one panelist remarked that one might be surprised that the G20 returned to the FSF in the wake of the crisis. However, the speaker explained that, while the FSF did not prevent the financial crisis, it was a natural place for the G7 (and later, G20) to turn to create an initial diagnosis of what went wrong in the financial system and what regulatory steps should be taken. Panelists agreed that one initial strength of the FSF, and then the FSB, was in

**“While the FSF did not prevent the financial crisis, it was a natural place for the G7 (and later, G20) to turn to create an initial diagnosis of what went wrong in the financial system and what regulatory steps should be taken. ”**

its membership which is very senior and includes high-level members of IOSCO and Basel in addition to key national actors, and they are able to implement policies in this space. The fact that they are senior facilitates commitment. The G20 needed to convene heads of supervision, central banks, and finance ministers, and these were the members of the FSB. There were other international institutions such as the Basel committee or IMF, but these are also highly motivated by politics and already have specific areas of focus.



Panelist Edward Greene with rapporteur Elizabeth Broomfield

**“ One key advantage of the FSB is that its regular, high-level country meetings serve as a deterrent from pursuing national interest at the expense of other nations. ”**

The panelists agreed that one key advantage of the FSB is that its regular, high-level country meetings serve as a deterrent from pursuing national interest at the expense of other nations. When the G20 identifies an issue as a priority, the national bureaucracies pay attention. As one former regulator stated, “no country wants to look like a liar in this”. Panelists also agreed on the FSB’s importance as a strong coordinating body for global financial regulation and coordinating standard-setters and the cross-sectoral/horizontal issues which fall between many stools. The FSB is key in forcing the many practical authorities that need to come together to form a collective dialogue about what went wrong. If they do not form that collective dialogue, a very large number of conflicting regulations will result. Instead, the FSB has made an invaluable contribution by encouraging the formulation of model regulations in many areas working through its membership.

Panelists also addressed some of the recent initiatives of the FSB. The FSB plays a coordination role in addressing cross-sectoral regulatory issues in cooperation with numerous international standards setting organizations, such as IOSCO, the BCBS, and the IAIS. In particular, panelists discussed FSB initiatives addressing “too big to fail”, resolution systems, and oversight and regulation of shadow banking. The



FSB also reviewed standards for compensation in 2009, is involved in expansion of transparency, and is engaged in raising the bar for cooperation and coordination in crisis management. Peer reviews in the FSB are now being extended as well. National monitoring is likely to receive a lot of attention in upcoming years and the FSB is a leader in this area.

The panel also addressed the question of participation in the FSB. Panelists agreed that it is important for legitimacy and implementation that countries feel they have a voice in what happens in these narrow bodies. There are many ways of addressing that question; for example, the FSB has articulated processes for consultation, which provide the opportunity for many nations and organizations to voice their opinions to the FSB. The FSB has a changing nonmember chair who helps provide a voice for nonmembers. The FSB has over 30 member countries in the FSB and more in regional groups. In total, over 90 countries are therefore now involved in the FSB.

The panelists also addressed the FSB's future. One speaker closely connected to the FSB explained that they have recently moved to establish legal personality for the FSB. The working group has delivered its recommendations on the point and the G20 has decided to establish the FSB with legal personality in the form of an association under Swiss law. The G20 is therefore proceeding with this gradual approach to institutionalization of the FSB, rather than a treaty-based organization.

As in other panels, speakers expressed concern about waning political will going forward, as well as about implementation and the limits of "name and shame" peer review. While not problems that would be quickly solved during the Salzburg Seminar, greater consideration must be given to how implementation of the FSB's recommendations can be encouraged.

It has been noted that the FSB's economic capacity for research must be strengthened – and the FSB needs more economists and market experts who can effectively monitor global trends in financial markets. Also, coordination between the FSB and global standard setters will be key in tackling this implementation and enforcement issue.

Several audience questions concerned the role of the FSB in developing more formal global rules. One participant asked the panel if, given the growing global role of the FSB, it might be possible one day to establish one single supervisory global authority, recognizing that such a shift would require nations to cede a lot of sovereignty. A panelist responded that not only would such a goal be unrealistic in the short-term, but it was not clear that a single authority would be desirable, as centralization could lead to less competence, competition, and gaps. A single supervisor would only be effective in limited areas because national systems differ so sharply.

Another participant asked if the FSB had considered crafting a formal agreement governing those areas where there is a general consensus. The FSB could then

**“The FSB’s economic capacity for research must be strengthened – and the FSB needs more economists and market experts who can effectively monitor global trends in financial markets. ”**



facilitate the creation of a formal treaty or international agreement in order to implement those arrangements. Then you would have enforcement and implementation requirements that went along with those areas. A panelist responded that, while an interesting idea, this approach was not being pursued in the short-term. However, throughout the conference, the FSB was repeatedly brought up as a potential key player in any future international regulatory treaty framework.

## International Organization of Securities Commissions (IOSCO)

IOSCO's current projects were addressed in several panels. In particular, a panelist with in-depth knowledge of the workings of IOSCO offered invaluable insights into its current initiatives and future plans. This speaker explained that, in the past, market regulators or securities regulators were sometimes indifferent to systemic risk. Instead, these regulators acted as policemen of the markets, only acting after events and not in a preventive or preemptive fashion. IOSCO is now "redefining their role in the process" and will deal with more emerging risks ahead of the event rather than after. He also acknowledged the importance of a nuanced approach, as the securities market is not just another source of funding to support growth but also a source of risk. Being too restrictive would dampen growth, but it is essential that risks be studied and addressed to prevent another damaging crisis.

The speaker also discussed current initiatives and objectives of IOSCO. IOSCO is working to enhance the involvement of a wide range of members, consider different needs of members, and strengthen effective communication with members so that the voices from members, industry, and other relevant stakeholders will be properly heard. IOSCO is also working to prioritize projects to properly reflect the needs of all members. The speaker explained that these decisions will, in part, be based on information collected through surveys and dialogues.

IOSCO is also taking care to be inclusive, with particular emphasis on working to ensure that the real needs of emerging market jurisdictions will be taken into account. IOSCO is also working to ensure involvement of relevant securities and derivatives regulators with substantial power and influence in respective markets, to effectively promote globally-coordinated regulatory initiatives. These steps should enhance support for implementation of principles and recommendations by members (especially by emerging market jurisdictions).

IOSCO has also been developing several sets of policy recommendations and established guidances and, in addition, is working with countries on a bilateral basis. In particular, they discussed IOSCO's recent work on shadow banking, including consultations on money market funds and securitization, as well as research concerning financial market infrastructures. Several examples of IOSCO's

**“Being too restrictive would dampen growth, but it is essential that risks be studied and addressed to prevent another damaging crisis. ”**

work with other standard-setting bodies have been offered; for instance, IOSCO had recently worked with the Basel Committee to release a consultation paper on margin requirements for uncleared derivatives, and IOSCO's work on shadow banking had been delegated to IOSCO by the FSB as part of the FSB's shadow banking reform initiative. IOSCO also works with the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors through the Joint Forum of international financial regulators.

The IOSCO Multilateral Memorandum of Understanding (MMOU) was discussed in several panels as an example of success in international coordination as well as the limitations of international enforcement. Through this MMOU, IOSCO members pledged to provide each other with information and witness statements in an enforcement investigation. One speaker stated that the MMOU has been "quite effective in conducting joint enforcement of our markets of IOSCO members." However, it has been pointed out that the MMOU of IOSCO is not binding; instead, members are screened before they are allowed to enter, so only members expected to comply with the MMOU will be allowed to join. One panelist noted that all of the information exchanged over LIBOR was exchanged through this framework and that the MMOU contains a rigorous monitoring process that encourages enforcement. Moreover, IOSCO is now trying to build a dispute settlement system when there are difficulties. Several session participants suggested that IOSCO expand the MMOU and consider a broader exchange of information; rather than the current focus on information relevant for enforcement purposes, IOSCO could also facilitate information sharing concerning data required for resolution.

One challenge for IOSCO going forward mentioned both by IOSCO members and other participants is the likely rise of emerging nation securities markets. At the moment,

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Masamichi Kono presents on the panel 'International Coordination to Achieve Regulatory Reform'

**“In the fast-approaching multipolar world, IOSCO will face greater challenges in dealing with divergence in significantly more markets. ”**

there are only a few leading securities markets, which makes coordination and cooperation simpler. In the fast-approaching multipolar world, IOSCO will face greater challenges in dealing with divergence in significantly more markets. One speaker was worried about this development; given the difficulties in achieving cooperation today, he was pessimistic about coordination in this more complicated future.

Speakers and participants recognized that another challenge for IOSCO, as for other standard setters, concerned consistent implementation and enforcement. Because IOSCO has no enforcement powers, participants questioned how can it ensure that a large jurisdiction applies standards recommended by IOSCO.

## Bretton Woods Institutions

The Bretton Woods institutions also arose on multiple occasions throughout the conference, particularly the IMF. At the beginning of the seminar, the Bretton Woods institutions were invoked as examples of a political willingness after World War II to “think big”. Participants contrasted this unique historical moment with the response to the current crisis, in which they agreed that the scale of institutional reform was not nearly as grand. One participant noted that there was surprisingly little discussion of a new “Bretton Woods-like” institution in the wake of the current crisis, in particular expanding or changing the mandate of the IMF to give it international oversight of global financial institutions both on the regulatory side or with respect to supervision.

Some of the discussion addressed the future role of Bretton Woods institutions, particularly the IMF. One panelist discussed the IMF Interim Committee and its original conception as the supergoverning body of the IMF, giving the IMF broad authority and more force. However, the panelist noted the IMF executive board’s opposition to this plan and its continuing lack of disciplinary authority. Nevertheless, the IMF was suggested by a few participants as a vehicle for greater compliance and oversight on a global level. One participant suggested that the IMF staff be charged with certifying compliance with global rules.

## Primary Areas Requiring International Cooperation

### Accounting Standards

One session of the Salzburg seminar was explicitly dedicated to the issue of the G20's goal of reaching a single set of international accounting standards, though the issues addressed in that panel were also discussed throughout the conference. The panelists addressed the status of discussions between the International Accounting Standard Board (IASB) and the Financial Accounting Standard Board (FASB), obstacles to agreement, the consequences of failure to agree upon a single standard as well as issues of political oversight and accountability in standard setting. These items are addressed more fully below.

During the session on accounting standards, one panelist jokingly remarked that he “never thought he’d see the day when heads of state would be preoccupied by accounting standards.” Nevertheless, at the G20 meeting in 2009, the G20 called on standard setters to improve existing rules and accelerate the work on a single set of global standards. Despite the amusement expressed by several participants about the rather recent rise of accounting standards to the international stage, there was uniform agreement that the importance of robust accounting standards could not be overemphasized. However, despite the G20's call for a single set of international accounting standards and over a decade of efforts to this end, a single standard has yet to be achieved.

Many potential benefits of accounting convergence have been identified. These included: cost efficiency, reduction of time spent on discussions of accounting treatment, greater accountability of performance to shareholders, better identification of the risks and chances of prospective endeavors, and more efficient allocation of resources. A single set of standards would also minimize problems caused by potential piecemeal changes to accounting standards, especially in times of crisis. Speakers and audience participants also addressed the various failures of accounting prior to the crisis. The failure of accounting rules to promote adequate transparency contributed to gaps in regulatory oversight that led to the bubbles and arbitrage that both made the financial crisis harder to predict and exacerbated the resulting damage. Specific problems discussed included: insufficient disclosures on activities in special purpose vehicles (“SPVs”), difficulty in applying fair value accounting in derivatives markets, delayed recognition of losses associated with loans, issues involving the full range of off balance sheet financing structures (especially in the US because US GAAP allows more off-balance sheet structures than IFRS), and the extraordinary complexity of accounting standards of financial instruments, including multiple approaches to recognizing asset impairment. Moreover, these disparities may promote arbitrage,

**“Despite the G20's call for a single set of international accounting standards and over a decade of efforts to this end, a single standard has yet to be achieved. ”**



**“One of the challenges the regulatory community will face, absent a single set of standards, is assessing to what extent, and through what mechanism, there will be appropriate adjustments, filters, and carve-outs so the capital framework will come to something mainly equivalent when calculated under different accounting regimes. ”**

particularly with respect to regulatory capital requirements, as this difference clearly complicates comparability of institutions. Speakers acknowledged the well-understood fact that accounting practices allowed banking organizations to minimize their regulatory capital burden, and highlighted this issue as a key reason that a single set of accounting standards is so important.



Panelist Andreas Dombret with Fellow Gabriele Arnoldi

Discussing changes made to accounting standards in the wake of the crisis, one speaker felt that the IASB had “swiftly provided appropriate responses to the financial crisis and the call from the G20 for global standards,” particularly through the new standards for the scope of consolidation and measurement of fair value, accounting rules for financial instruments, and joint FASB-IASB ongoing projects for key areas such as recognition.

Multiple speakers addressed the relationship between accounting reform and capital requirements. One speaker said that one of the challenges the regulatory community will face, absent a single set of standards, is assessing to what extent, and through what mechanism, there will be appropriate adjustments, filters, and carveouts so the capital framework will come to something mainly equivalent when calculated under different accounting regimes. He stated that the complexity of this undertaking will be enormous. Another speaker was concerned by the dependence of effective capital principles on accounting rules, asking to what extent regulatory policymakers “delegate” how to calculate capital to accounting standards setters. It has also been observed that the calibration of capital over the last several years in Basel III was made without contemplating changes in the accounting framework and that, while the accounting rules are promoting the migration of more items back on to balance



sheets, these changes will have a massive impact on capital ratios. Many participants encouraged more coordination between accounting reform and capital requirements and, at a broader level, more coordination between the banking regulators and accounting profession. One seminar participant explained that this idea is not new; after the 1980s S&L crisis, there was a push toward having accounting standards relevant to capital, and compliance to have consistency in approach – that concept might be revisited now. Furthermore, we need to decide whether we want bank regulators forced to permanently work in a world of multiple accounting principles or to step back and consider a third approach - the last option could be a disaster, but the alternative would lead to significant differences in capital compliance depending on whether you use GAAP or IFRS.

Speakers acknowledged the progress in convergence efforts since the 2002 Norwalk Agreement, when the FASB and IASB committed to eliminating differences between accounting standards. In particular, one former regulator with detailed knowledge of the process helpfully outlined the history of this initiative. In February 2006, the FASB and IASB issued a Memorandum of Understanding (“MoU”) setting forth the relative priorities within the FASB-IASB joint work program in the form of specific milestones to be reached by 2008. In 2008, the MoU was updated. Meanwhile, in 2007, the SEC allowed for private issuers using IFRS to file financial statements without reconciling key figures to GAAP, as had previously been necessary. The speaker said that this reconciliation requirement change was a statement of US commitment to further development of IFRS convergence. A completion date had been envisioned for FASB and IASB to achieve full convergence by the middle of 2011, but the timetable was deferred for a variety of reasons.

However, speakers expressed severe disappointment that more progress had not yet been achieved, with one of them calling the failure to achieve a single set of standards “one of the most shameful indictments of the intergovernmental process,” given that, after a great deal of time and effort, “something as simple as international accounting standards cannot be achieved”. The fact that convergence efforts have stalled despite the G20’s repeated call for a single set of accounting standards is damaging to the global regulatory process. Despite convergence efforts between GAAP and IFRS being underway for years, an institution’s balance sheet could, for example, be one-third smaller under GAAP than it is under IFRS.

Seminar participants criticized the SEC decision not to issue a recommendation in 2012 concerning the adoption of IFRS, as had been expected. This failure to issue a recommendation and failure of the SEC to say what will happen next was a severe disappointment to the international regulatory community. Even conference participants from the US regulatory community agreed that the SEC had not met its obligation to provide some clarity in this area.

**“The failure of the SEC to issue a recommendation in 2012 concerning the adoption of IFRS and failure of the SEC to say what will happen next was a severe disappointment to the international regulatory community. ”**

**“IASB’s legitimacy may have been hurt in 2011 when individual countries were able to say that Greek debt should be marked deferentially. As long as that kind of practice is observed, it lowers the integrity of the process. ”**

A US speaker explained that there is currently no timetable going forward. The speaker stated that comparing the key findings, themes, and tone in the July 13, 2012 Staff Report (“Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers”) with the 2010 statement by the SEC clearly indicates a shift in tone over time. The 2012 Staff Report was a “127 page document that read like 127 reasons why you shouldn’t adopt IFRS.” The speaker found this report very negative and potentially disheartening.

There was also discussion about due process and legitimacy. Panelists agreed that it is important that the independence of the standard setter is maintained, but they must earn their independence based on robust due process that allows time for analysis and review of proposals. Despite historical criticism of both the IASB and FASB in this regard, but also that there has been a tremendous effort by both boards to do consultations with various stakeholders, including prudential regulators. Boards have since gone to greater lengths to address some of the criticisms about due process. The issues are very technical and do not lend themselves to reaching solutions quickly. One speaker remarked that stable funding of the IASB was necessary to strengthen its independence and legitimacy. Another speaker added that the IASB’s legitimacy may have been hurt in 2011 when individual countries were able to say that Greek debt should be marked deferentially. As long as that kind of practice is observed, it lowers the integrity of the process. The US was able to latch on to that for its skepticism.

Participants recognized that a global set of accounting standards implicates national sovereignty, which is one of the reasons that a single set of standards has been so difficult to reach; a single set of standards will require compromise without sacrificing fundamental features of accounting standards. Not all national ideas can or should be incorporated into the global standards. Still, a participant from the US expressed support for a continued role by the FASB in safeguarding the interests of US investors and markets.

Speakers also addressed the importance of enforcement, as there was consensus on the panel that a single set of standards is useless if enforcement differs. One speaker mentioned that more needs to be done to reduce diversity in global application and enforcement in addition to the work done on convergence. While IOSCO will play a role in this area, there must be more cooperation in trying to create and affirm the mechanisms to address concerns about the inconsistent application and enforcement of these standards. Operability, or confidence that the standards will actually work, was also cited by speakers as an ongoing issue.

Multiple panelists felt that, despite the concerns expressed, it was important not to allow the perfect to become the enemy of the good and that we should try to

make things better, not perfect. Accounting standard setters and policymakers are incorrectly aiming for perfection. There is also division about the right course, some believing that until you have confidence in consistent enforcement and the role of FASB, the threshold issues for some members of the SEC, you will not achieve the goal of one standard.



Matthew Saal, Kathleen Casey, Paul Volcker and David Wright on the Schloss Terrace looking out to the Untersberg mountain

**“ Until you have confidence in consistent enforcement and the role of FASB, the threshold issues for some members of the SEC, you will not achieve the goal of one standard. ”**

One speaker suggested a hardline approach to drive convergence. He recommended that the US get rid of the FASB and set a deadline for its elimination. Therefore, if sufficient changes are not made by that time, it will simply be too late when the deadline is reached. As long as we have national accounting standard setters, one set will be difficult to achieve.

One participant suggested that optionality, or allowing large issuers to voluntarily report in IFRS, would be one way to address many of the cost and transition issues that have been raised. It would signal a continued commitment on the part of the US. Investors and issuers and others would then gain greater expertise and comfort with IFRS.

Despite the obstacles and unresolved issues identified in achieving a global set of standards, panelists also provided reasons for optimism. It has been noted that failure by the US to adopt a single standard could be a drag on the US capital markets and ultimately hurt the US. US cooperation is therefore more likely than many participants might expect because doing so would be in the best interest of the United States. There are also several SEC departures taking place, and the perspective of the new SEC commissioners regarding international goals will be critical in this process.



Panelists Douglas Flint, Clemens Börsig and Kathleen Casey

## Resolution Authority

Too big to fail was a recurring topic, which one speaker declared to be the “litmus test of financial sector reform”. Multiple speakers cited Mervyn King’s statement that financial institutions are “global in life, but national in death”. One speaker even remarked that “we’ve now seen banks like cajas that are national in life and international in death!” The debate and working group discussions, summarized later in this report, were also focused on international coordination and too big to fail. The section of the report below focuses on comments on the issue made outside these two working group sessions.

Speakers agreed that international coordination is essential in oversight of global systemically important financial institutions (“GSIFIs”). One speaker explained that national resolution regimes are stretched to their limits when resolving GSIFIs, and addressing this issue without causing systemic disruptions would only work if there is international cooperation. Speakers noted that, in the past, national supervisors would ring-fence assets and break them up or rescue them as separate entities along national boundaries. This led to systemic distortions and costs to taxpayers.

Many participants were encouraged by the FSB development, and the G20 adoption, of a new international standard for resolution regimes (the “Key Attributes”) which has been seen as a big step forward - for the first time at a global level, there are agreed-upon measures that should be included in national resolution regimes. The next step, however, might be more difficult but is just as important; these principles must now be implemented consistently across borders, which will require a great deal of work. Legislation must be more concrete than international standards. Without consistency and cooperation, we risk new problems in the event of financial institutions becoming distressed. One speaker said that the FSB’s current position is that more binding

**“Financial institutions are global in life, but national in death. ”**



mechanisms are not feasible without putting in place convergent regimes and incentives to cooperation.

This speaker said it has been acknowledged that the Key Attributes encourage the creation of a system that empowers and encourages the relevant national resolution authority wherever possible to achieve a cooperative solution with foreign authorities. At the same time, national legal powers will stay in place and there will be no mechanisms in place for joint action. According to the speaker, countries may need to abandon bankruptcy-like regimes for large global financial institutions and instead move to a more administrative regime comparable to what Dodd-Frank adopted which offers regulators enormous flexibility based on the experience of the FDIC. He added that regulators must be able to preserve a failing institution's important functions and minimize the cost of resolution and make shareholders and creditors bear the cost. To successfully resolve a GSIFI, regulators must have a broad range of resolution powers including the power to separate, operate, and sell systemically important functions. Absent such powers, even a willingness to cooperate at a global level will not be sufficient.

One speaker felt that finding a way of resolving financial institutions is an important part of a broader return to the principle of individual responsibility in financial markets, which in turn is a fundamental principle of capitalism. Those who take risks must also face the consequences of those risks. The speaker stated that the possibility of losses and defaults is a constituted element of any functioning market, and that financial markets must not be an exception to individual responsibility.

One US participant with expertise in both the US public and private sectors stated that the "Key Attributes" were based on the Orderly Liquidation Authority ("OLA") created by Dodd-Frank. He explained that, in 2008, it became clear that the US lacked a statutory framework that could resolve institutions that were not banks. The FDIC participated in actions that had a beneficial role in stemming the hemorrhaging, but the fundamental goal at the time was a short-term focus on certain institutions that would not be allowed to fail, and therefore required TARP capital.

He then explained key Dodd-Frank reforms in the resolution space to prevent another bailout, particularly Title II which gave authority for large companies to be closed by the FDIC similar to the FDIC's pre-existing authority to close insured depository institutions. The changes were principally designed to ensure that the Title II resolution process would match the bankruptcy process as much as possible, as Title II only applies if there is a conclusion by a top level of the US government that putting the failing company through bankruptcy would create a massive dislocation. The speaker also explained how these powers could be used to pursue a "bail-in" strategy, which is currently being contemplated and developed more fully by the FDIC. Under Title II, viable subsidiaries and affiliates of the holding company

**“Regulators must be able to preserve a failing institution’s important functions and minimize the cost of resolution and make shareholders and creditors bear the cost. ”**

**“Powers could be used to pursue a ‘bail-in’ strategy... It will preserve value, they now have a funding source in place to make this strategy viable, and in preserving foreign operations, there is no incentive for foreign jurisdictions to ring-fence. ”**

are meant to continue “business as usual”, which can help creditors of foreign subsidiaries such as the UK and Japan. Pursuant to this approach, operations would be done exclusively through subsidiaries at the lower levels and the holding company is a funding vehicle. The subsidiaries can therefore be moved relatively easily into a bridge to maintain continuity, while ensuring that shareholders and creditors of the holding company bear losses.

This strategy is particularly appealing in the United States, where financial institutions tend to be held within a top holding company that is primarily a funding vehicle, with operations done exclusively through subsidiaries at the lower levels. The strategy may be more complicated for European institutions with different models. The US regulators are working closely with key regulators, in particular the UK, given the high concentration of activity by US financial institutions in London.

The speaker explained that this strategy was particularly important for conference participants to understand, as it was a promising path forward in promoting international coordination in the resolution of a large financial institution. This process should promote international cooperation because, according to the speaker, it is in the interest of the US to pursue this approach; it will preserve value, they now have a funding source in place to make this strategy viable, and in preserving foreign operations, there is no incentive for foreign jurisdictions to ring-fence.

Discussing the new resolution planning requirement in the United States, it has been noted that these resolution plans will be submitted by certain large financial institutions, but they will be crafted through cooperation between the private sector, including counter-parties and exchanges, as well as regulators, to demonstrate how the continuity through this resolution-implementation process could be maintained. This process will ideally promote continuity and understanding by the regulators as well as in the private sector. If there are assurances that resolution is viable, it will affect private behavior and limit moral hazard.

Simulations among the regulators and the private sector can be very useful if they are not self-congratulatory exercises that assure that reforms are sufficient. Regulators ran simulations before the crisis, but the crisis showed how they were helpful but, at the same time, woefully inadequate. This problem was possibly due to lack of private sector involvement in planning discussions, which will be important going forward because the private sector expertise is key in crafting plans that have some relevance to what actually happens. Regulators have one perspective of what happens, but they evaluate institutions, whereas broker-dealers and other financial institutions are the parties that know what would happen on the street. As one speaker stated: “You are doing resolutions because you want a private market that actually has winners and losers. If you really believe in free enterprise, you need to ensure that anyone can fail.”



Wall Street Journal editor Matthew Karnitschnig with Michael Bradfield

Other participants agreed that the resolution system as it has been expanded by the Dodd-Frank legislation is now an impressive instrument. However, there was disagreement among participants concerning whether the US decision to act first in enacting Dodd-Frank was helpful or harmful. One participant argued that such a step is detrimental to international cooperation, and that the US should have worked with other jurisdictions before passing such fundamental legislation on resolution, which would require global coordination. He stated that Dodd-Frank is leading to serious international divergences and is not as responsive as it should have been to the call for G20 global standards. Whereas before the crisis we thought we would have a dialogue and integrated regulatory environment between the US and the EU, the US having gone first forces the EU to face what Dodd-Frank has done and then to decide – take it or leave it?

Another participant disagreed, and argued that someone needed to lead the way, and the US decision to pass Dodd-Frank may have been useful in creating a model framework that could result in a stronger international framework. Another speaker noted that “sometimes you have to be first” and that the US decision to take the first step demonstrates leadership on these issues.

## Corporate Governance and Compensation

Compensation and corporate governance were brought up by several speakers throughout the seminar. One speaker addressed banker remuneration and compensation as one of three key areas (in addition to shadow banking and resolution) that require international coordination. He stated that there have been

**“Whereas before the crisis we thought we would have a dialogue and integrated regulatory environment between the US and the EU, the US having gone first forces the EU to face what Dodd-Frank has done and then to decide – take it or leave it? ”**



“Good work needs to be rewarded with good money, but good work needs to be sustainable and responsible.”



Kathleen Casey speaks with Senior Salzburg Global Fellow Patrick Kenadjian

asymmetries in remuneration systems both regarding risks and rewards. These led to short-termism and excessive risk-taking as well as extreme absolute levels of compensation, leaving firms with less capacity to absorb losses when they materialized. He felt that “good work needs to be rewarded with good money, but good work needs to be sustainable and responsible.” To safeguard financial stability, remuneration in the financial sector must be better aligned to long-term value creation as well as prudent risk-taking. Specifically, the speaker felt that in the future, processes will have to include clawback arrangements. He expressed support for more to be done to develop the FSB’s work on principles for sound compensation practices and their implementation standards. The speaker, as well as other participants, stated that this issue was critical in changing bank behavior and culture and restoring accountability in financial markets.

He said it has also been noted that there is a correlation between failed firms, incompetent CEOs, and weak boards and that the cost of their mistakes to society is enormous. We don’t allow amateurs to drive trains and training is required to work in a nuclear facility, so why are the key actors shaping financial markets subject to fewer requirements? The time has come for regulators and supervisors to consider these issues more carefully, and FSA’s decision to begin vetting new board members of systemic firms is a positive development.

The speaker also stated that he had previously had more faith in industry codes of conduct and informal methods in the financial sector. However, in his opinion, this self-policing has failed. What is needed is a coordinated and convergent set of laws at the global level, rigorous monitoring of risk management practices, and



remuneration policies as well as a mandatory early-warning whistle-blowing role for auditors when they spot dangerous practices.

One participant asked about the power of regulatory authorities to remove management at institutions believed to be badly managed. One former regulator explained that there is a value to private enterprise and a company being able to make its own decisions. At the same time, there is authority for a regulator to perhaps push certain internal changes. Maintaining continuity is also important for the ongoing viability of failing institutions, so not all personnel should be removed in times of trouble.

Another speaker, with a long history of work in EU regulation, spoke about the importance of a coordinated approach to compensation reform in Europe. EU compensation reform would have a broad impact, affecting foreign firms in Europe, European firms in Europe, and international operations of firms that happen to be headquartered in Europe. Compensation is therefore one of a number of areas where an international coordinated approach is key because there will clearly be divergences in behavior as markets are impacted depending on where the origin of activity is taking place. Another speaker agreed that uniformity within Europe would be insufficient, and that compensation is a global problem that should be addressed at a global level.

**“Uniformity within Europe would be insufficient; compensation is a global problem that should be addressed at a global level. ”**

## Basel Capital and Liquidity Rules

The Basel rules cut across many of the themes and topics addressed at the seminar. Participants agreed that Basel capital rules played key roles in the creation of the 2008 crisis as well as the steps taken to prevent future institutional collapse.

One participant used a particularly interesting metaphor to address the issue of capital rules. The speaker began by stating that in 2011, Japan suffered a devastating earthquake and tsunami. There were two villages in northern Japan that were devastated. However, one village had a monument in the middle of the village that said “do not build houses below this point” and the villagers obeyed, never building houses below that point. That village did not lose a single life. The other village had a great public works project that built a very high breakwater that was supposed to resist any imaginable tsunami based on the knowledge of the time. However, that knowledge was outdated and the houses built close to the shore were washed away.

The speaker stated that this breakwater can serve as an example of a capital buffer, believed to be sufficient given knowledge of past crises. Taking into account events in the past is not enough to predict the scale and nature of future hazards. The wall of capital or liquidity will likely wash away. Instead of a focus on a percentage point here or there, the speaker argued that greater emphasis should be placed on better risk management and emerging risks.

**“Even when rules are commonly agreed upon in Basel, uniform implementation is not guaranteed and arguably unlikely. ”**

Several participants noted that the early Basel rules were not only ineffective, but also inadequately risk-weighted mortgages and sovereign debt, thereby encouraging over-investment and flawed risk assessments in these areas. This insufficient risk-weighting was in part a product of political pressures and government policy, and therefore an example of undue influence of the political process in enacting robust reforms. The problem also demonstrated the limits of ex ante understanding of where crises might arise, and the limits of human knowledge and foresight in crafting new capital requirements. Panelists expressed dismay over the amount of time it took to craft Basel II following the recognition that Basel I was insufficient.

The limitations of the soft law nature of the Basel rules were also addressed. Even when rules are commonly agreed upon in Basel, uniform implementation is not guaranteed and arguably unlikely. Several audience questions and panelists brought up the U.S. delay in Basel II implementation, its failure to apply Basel II to all banks, and the differing implementation of Basel III worldwide. Such deviations could lead to arbitrage across jurisdictions.

At the same time, not all comments related to the Basel rules were negative. One speaker reminded participants that Basel rules had been adopted in many countries, despite the lack of a strict enforcement framework. Furthermore, panelists expressed optimism about recent changes in Basel III, such as the introduction of leverage and liquidity requirements. Basel III also applies to all banks in America, unlike Basel II. However, some participants criticized the slow phase-in of the liquidity requirements; the liquidity coverage ratio and net stable funding ratio are not expected to be fully implemented until 2019.

The Basel rules also arose in the discussion of accounting convergence; a single set of accounting standards will be valuable in comparing implementation among jurisdictions. It will also be important in improving comparability of data, such as capital and leverage ratios, among institutions. Uniform capital requirements will be extremely difficult to achieve so long as different accounting standards are used in different jurisdictions.

## Combating Divergence

### Supervision vs. Regulation

The role and relationship of supervision and regulation was a recurring theme throughout the conference. As one speaker explained, regulation is the result of the action of legislators, governments, and administrative agencies that have the power to make rules. Supervision, in contrast, is the role of overseeing the application of those regulations.

This distinction was revisited throughout the seminar. In particular, there was disagreement over whether supervisory and regulatory powers should be structurally separated or, in contrast, held by one authority responsible for both roles. In connection with the crisis, some felt the bank regulators who had adopted regulations and were also responsible for supervision were not effective supervisors. However, one speaker expressed concern that, if supervisors only reviewed the application of regulations, they would not be as connected and invested as if they had made the regulations. The supervisor might also not grasp some of the nuances that were contemplated during regulation drafting.

Another speaker, on the contrary, advocated complete separation of supervision and regulation using the example of France where the regulation is not in the hands of the Bank of France, which is instead primarily responsible for supervision. The speaker felt that if one party is both writing and applying a regulation, there may be a conflict of interest or perhaps hesitancy to apply the regulation in certain contexts. However, the speaker clarified that the supervisor should have some role in the design of regulation, but the final responsibility for regulation is in the government and “not in the hands of the local police.”

As one participant from America noted, this separation would be a profound change in the US, where, for example, the Federal Reserve writes regulations and then supervises the entities subject to those regulations. As another American participant elaborated, if the supervisor is implementing the regulation, that supervisor should also be drafting the regulation because they need to understand how it is being applied. One key element of this system is a “back up”; in such a system, there is ideally protection in the form of another party (i.e. an additional regulatory or supervisory agency) in a support role who can take action in the absence of effective oversight by the primary supervisor. In this way, there is a check on that primary supervisor. As an example, the speaker cited the latent power of the FDIC for backup supervisory oversight over banks, though the speaker added that this power has never been used as it should have been.

**“If one party is both writing and applying a regulation, there may be a conflict of interest or perhaps hesitancy to apply the regulation in certain contexts. The supervisor should have some role in the design of regulation, but the final responsibility for regulation is in the government and ‘not in the hands of the local police’.”**

**“Leaving the institutions responsible for applying the rules is tantamount to “light touch supervision” which is insufficient; supervisors have to be much more active, especially post-crisis. ”**

Another participant explained that some of the differences between the UK and US approaches to this issue are because the UK operates a principles-based regime and the US is rules-based. In the UK system, there are general rules that, to a degree, are up to the individual institutions to apply and the regulators just set the general framework. The specifics of how those principles were carried out were left more broadly to the institutions. In the US, there is a rules-based approach in which the regulators determine how to implement those rules. In response to this insight, one participant stated that whether you adopt a principles-based or rules-based approach, the implementation is what is important.

A speaker with considerable expertise in the EU legislative process explained that the EU Commission presents legislation to the Council of Ministers and to the European parliament which is then made more precise at an operational level. The next level is the executive branch and then the detailed implementation to address some technicalities. The speaker also felt that leaving the institutions responsible for applying the rules is tantamount to “light touch supervision” which is insufficient; supervisors have to be much more active, especially post-crisis.

There was also discussion of whether supervision or regulation should be emphasized in post-crisis reforms. One speaker argued that more consistent implementation is needed, not more details in regulations which are already complex (possibly excessively so). Instead, supervision should be tightened, as supervisors are always several steps behind financial innovation. The speaker objected to the premise that the rules prior to 2007 were inadequate to deal with the crisis arguing that there were, in all likelihood, rules on the books prior to 2007 that would have prevented the crisis, but it was the failure by supervisors to apply these regulations that led to the financial breakdown. The speaker called upon participants to consider why these rules were not applied. It was suggested in the discussion that one aspect of this supervisory failure may have been the revolving door of regulators as private sector bankers and lawyers.

Another participant addressed the importance of specific individuals in supervisory roles. He explained that improved supervision required “getting the right people with the right skills” into those positions and that effective supervision is more than just “checking boxes”. A certain level of sophistication is necessary for effective oversight of complicated financial markets. However, another speaker responded that the significantly high salaries of employees in the private sector, when contrasted with the salaries for public servants, was a significant challenge to the recruitment of qualified individuals for supervisory roles. Those in charge of compliance in the private sector are also not as well-paid as those in the executive part of the bank or in trading.



## Hard vs. Soft Law

Several speakers focused on different forms of international cooperation to combat divergence, including mutual recognition, convergence, or a treaty. Comments on these points are summarized below.

One speaker listed several issues that he believed merit very serious consideration when addressing global divergence. First, more consideration should be given to sanctions regimes because global punishment for violation of financial rules, with few exceptions, are far too low and there is no sufficient deterrence as recent scandals appear to demonstrate. Ponzi schemes, insider trading, money laundering, and other scandals are appearing in the news every day. These scandals strain trust in financial markets. We need to look more seriously at financial market abuse and he hopes the G20, FSB, IOSCO, and other relevant international organizations will push for greater reform in this area.

Second, improved implementation and enforcement are also crucial for strengthening the global regulatory edifice. For example, IOSCO has no enforcement powers and therefore can do little to ensure that a large jurisdiction applies standards recommended by IOSCO. The speaker called for more thought dedicated to the tools necessary to improve this situation, such as a step by step approach toward non-binding mediation and information sharing. The speaker also cautioned against a multiplicity of working groups of all sizes and global regulatory competition whenever a new issue arises. There is often a rush to create groups and seize competence in light of new challenges, when often there are existing structures in place that could be utilized.

The speaker concluded his remarks by outlining several options for international coordination. One option was the creation of informal arrangements, such as relying upon supervisory colleges. While there is an agreement that we should have colleges of supervisors, the speaker encouraged participants to consider what powers the supervisors should have and how that authority would be applied in practice. The speaker also brought up more formal arrangements between these colleges of supervisors, including information sharing agreements, as another alternative. Though even with this approach, the colleges would still not be able to intrude on the power of the national regulator to make a decision with respect to supervision or resolution of the entities over which it has primary oversight. Finally, the speaker mentioned a treaty-based approach, citing UNCITRAL as a possible model.

One speaker expressed his opinion that the selection of the best approach, such as mutual recognition, a treaty, or enhanced supervision, depended on the particular issue. For example, OTC derivatives regulation marks a vastly different challenge from resolution authority or capital and liquidity regulations, where similar legal frameworks were already in place before the regulatory reform process began.

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**“A formal structure is necessary to give national regulators confidence in a globally coordinated resolution, thereby avoiding protectionist measures such as ring-fencing, forced subsidiarization, and enhanced capital requirements, that would lead to less efficient global institutions. ”**

OTC derivatives regulation is incredibly complex and diverse, covering a range of substantially different products and markets. Therefore, achieving harmonization in this field of regulation would take years, if it were even possible. This speaker argued that mutual recognition might be the best approach for OTC derivatives. In contrast, capital and liquidity requirements have relied on harmonization of national regimes. To promote harmonization, uniform capital and liquidity rules should focus on mechanisms to promote rigorous monitoring, detecting, and remedying of noncompliance with the agreed-upon standards.

For resolution, however, the speaker strongly believed that a more formal legal structure such as a treaty was necessary. He suggested exploring ways in which some form of agreement among supervisors could be created which could be binding for dispute resolution at a place like the FSB. Such an agreement would need to address supervision and allow power to intervene and deal with a bank close to insolvency. The speaker felt that a formal structure is necessary to give national regulators confidence in a globally coordinated resolution, thereby avoiding protectionist measures such as ring-fencing, forced subsidiarization, and enhanced capital requirements, that would lead to less efficient global institutions.

Addressing past efforts related to mutual recognition, it has been pointed out that the experience of EU integration showed that achieving the goal of substantial equivalence in complex policy areas is extremely difficult (with the EU responding to this problem by instituting mutual recognition). By comparison, the US has been very reluctant to engage in mutual recognition, with a notable exception being its recent MOU with Australia on broker-dealer regulation.

With respect to mutual recognition and standardization going forward, IOSCO will be critical. In particular, the powers under the MMOU will enhance the ability of regulators to cooperate in a cross-border situation. To address global financial institutions, the speaker explained that we have to ensure that regulators have the power to cooperate, share information, act together, and take steps at the request of the home country regulator in the host country. Until this happens, the market will not believe that policymakers and regulators have truly ended too big to fail.

One former regulator said that stronger international coordination and enforcement “might take some salesmanship to sell the idea in the US.” He suggested that one possible path would be to get banks and academics on board with the idea of a treaty, then get a Congressman to take the lead. Still, success might also require a change in personalities in key positions, particularly in the US Treasury in 2013.

Drawing on his experience in the regulatory community, a former regulator stated that the difficulties of international coordination are challenges that have vexed policymakers in the industry for many years. Regulators do not coordinate when

they perceive it would be to the disadvantage of their constituents, including the public and legislature. This self-interested behavior is true whether or not you have an agreement in writing to coordinate. The speaker explained that this self-interested decision-making process of national regulators, particularly in resolution authorities, comes particularly with the fear of the unknown, but may also be present with a clear-eyed appraisal of the situation. He claimed that, in some ways, it is a textbook example of the tragedy of the commons; we collectively benefit from international coordination but individually may benefit more from rejection of coordination by pursuing narrow interests. However, in resolution, the common good and national good really do coincide, which is a reason for optimism in this area. The speaker continued by saying that realistically, a treaty-based approach

**“We collectively benefit from international coordination but individually may benefit more from rejection of coordination by pursuing narrow interests. ”**



Panelist Andrea Enria

cannot occur without parallel steps forward through greater harmonization and coordination. He felt that these options are not mutually exclusive. While the speaker agreed that a treaty is preferable, he cautioned against ignoring incremental steps such as confidence building measures in the meantime and reminded participants that successful international treaties have in the past been initiated with a great number of confidence building exercises that require certain steps against national interest and later build up to a treaty that is more lasting and binding.

Several speakers agreed about the role that confidence building measures might play to eventually create a more formal legal structure in the longer term. There was widespread agreement among participants that information-sharing was one confidence building measure that could be developed to pave the way for a more binding international agreement. One participant stated that information-sharing



Salzburg Global Fellow Catherine Shiang speaks from the floor in Parker Hall

**“Even if a treaty is necessary for resolution, a treaty is not sufficient for resolution. ”**

must be conducted in a way that preserves the confidentiality of the data, because companies will not want to share information unless it is treated confidentially. There are different rules for sharing information internationally and we need to move forward and get into the weeds about how this will be achieved. A participant added that data is available and is being processed by central banks for monetary policy. More thought must be given to bringing that data together and making that data available to the FSB and internationally. It is also important that this data be usable to calibrate risk more accurately and then set capital requirements more accurately. One participant noted that even if a treaty is necessary for resolution, a treaty is not sufficient for resolution. Even if resolution is done pursuant to a treaty, it requires levels of information-sharing that are currently difficult. A treaty would be preferable because it provides certainty, but absent confidence building measures to show your counterpart will take certain actions, one cannot have complete confidence that there will be implementation of the treaty obligation. Furthermore, even if there is implementation, it would not be optimally successful unless those confidence building measures include information-sharing.

A speaker from the private sector agreed, stating that the “chances of an international treaty are low so it’s good to begin with other measures.” The speaker said that the first step in this process should be to identify common interests. The world is getting more complicated and in 20 - 30 years, the US capital market may no longer be the dominant one. We should start with everyone looking at this from a purely nationalistic point of view, including economic interest, political interest, and societal interest. Starting there, the speaker believed that cooperating more intensely at the global level makes imminent sense for everyone including the US.



This speaker also felt that a treaty was not necessary for successful resolution of cross-border financial institutions if all international institutions would conduct business through subsidiaries like some banks (for example HSBC) have been doing for decades. The speaker found it surprising that the international community has rejected a system where international activity is conducted through independently capitalized, centrally funded subsidiaries. Under such a system, one could have mutual recognition of regulatory frameworks and recognize that the local regulatory authorities, treasuries, and central banks will bear the consequences of their own regulatory failures and successes without it impacting the global financial system. While critics of this structure argue it is too expensive, the speaker pointed out that it is not as expensive as another crisis.

However, a speaker who had spoken strongly in favor of treaties argued that subsidiarization assumes that the subsidiary can be resolved without any contagion effect on a global basis and without involving regulators in other jurisdictions. There is no consensus as to whether this approach avoids contagion. Therefore, even with greater subsidiarization, a coordinated approach is needed to keep the entity alive even if one of the entities in a particular country is a subsidiary and is in trouble. Another speaker noted that any treaty or multilateral initiative must be forward-looking, because even if we achieve full uniformity in definitions, there will be new instruments and new practices that will make new standards irrelevant quickly. Processes must be in place to address this problem, such as peer joint analysis across jurisdictions, before giving a regulatory blessing to these products and practices. Participants agreed that, whether pursuant to a treaty or soft law, rule-making at a global level is not sufficient. For the agreed reforms to be effective, they must be translated into national reforms and regulations in a consistent manner. One speaker pointed out that, even with consistent standards at a global level, the machinery with which we transpose and apply these standards varies across countries, as do national processes and methodologies for analyzing risk.

## “One Size Fits All”?

While there was complete consensus among participants that greater global cooperation and coordination in financial regulatory reform is critical, there were debates concerning the extent to which uniform rules are necessary. One speaker remarked that since the characteristics of each country’s financial systems differ, it would not be appropriate to apply completely identical rules in each country or region. The speaker called for a balance between providing consistency and sufficient flexibility for the irregularities of differing financial systems. In other words, we want consistency, but not “one size fits all”.

Another participant added that a uniform set of rules and regulations would deprive us of international regulatory competition. While this speaker argued in favor of such

**“Since the characteristics of each country’s financial systems differ, it would not be appropriate to apply completely identical rules in each country or region. [There should be] a balance between providing consistency and sufficient flexibility for the irregularities of differing financial systems. In other words, we want consistency, but not ‘one size fits all’.”**

**“To facilitate harmonization, emphasis should be placed on ensuring that each national authority has the statutory provisions needed to take necessary action, such as trying to close a company when it is close to insolvency, or to charter a bridge bank. If you have a common approach to these powers, you have a common language. ”**

national experimentation and international regulatory competition, he was not in favor of a race to the bottom in which countries are undercutting each other. Instead, the speaker clarified that he meant assessing the merits of differing regulatory approaches and measures undertaken by other countries and learning from one another. The speaker mentioned the FDIC as an example; the FDIC in America has gained an extensive wealth of experience in resolving failing financial institutions, which European authorities could draw on when implementing their own resolution regimes in Europe.

Agreeing that “one size fits all” was not always desirable, one speaker spoke in favor of harmonization. To facilitate harmonization, emphasis should be placed on ensuring that each national authority has the statutory provisions needed to take necessary action, such as trying to close a company when it is close to insolvency, or to charter a bridge bank. If you have a common approach to these powers, you have a common language. As an example, he cited developing resolution plans for cross-border institutions. These are not check-lists or the guaranteed ways of making something happen. “You would be a fool for relying upon the strategy for governing your every move, but you would be a fool not to have a strategy.” Another speaker agreed that harmonization should be a major focus, and we should not concentrate on one size fits all, but more consistency, which may be achieved through confidence-building measures, better risk management, and supervision.

However, one panelist explicitly disagreed with those saying that “one size fits all” isn’t, in general, the right way forward. While this may be true in certain situations, as a whole he felt that there are many key areas that do require one size fits all. For example, he supported establishing a true uniform metric for measuring solvency in critical banks. He also cited capital as an example of where uniform metrics should be used. For example, in 2011 the EBA noticed that there were areas where the measurement of capital differed across jurisdictions, such as in risk-weighting. There have been subsequent reports by analysts that risk weighted assets are so different across countries that they are unreliable. The EBA has since found that certain institutions and countries are consistently more lenient. Risk-weighting of sovereign exposures was a mistake, and it was unfortunate that this mistake applied to the entire banking system, but the speaker reminded the participants that, absent uniformity, there will be regulatory arbitrage. The speaker felt that keeping even marginal flexibility on rules is not effective enough, and that we need the same definitions and same reporting requirements so the risks are comparable across jurisdictions.

## Cross-Border Resolution Proposals

Significant time was spent at the seminar discussing the form a treaty-based approach would take. In addition to the working group sessions focused on this

issue (summarized later in this report), two panelists brought up examples of recent proposals to address cross-border resolution through a formal legal instrument.

One speaker described the proposal by Peter Wallison at the American Enterprise Institute based on the idea of company incorporation. In the US, most corporations designate the state of incorporation. Under Wallison's proposal, a bank at the top level would select the jurisdiction in which it would be resolved if necessary. There would then be a treaty in place in which other countries would acknowledge and respect this choice. If HSBC selected, for example, Hong Kong with which to be "incorporated" for resolution purposes, other countries would follow the Hong Kong resolution regime as well as the power of the Hong Kong regulator. The speaker acknowledged that the proposal was highly unlikely and also had major potential for regulatory arbitrage. However, the speaker suggested that the idea might be more feasible if limited to certain jurisdictions that did have robust oversight with respect to resolution. Even if the idea has little chance of being implemented, the speaker hoped that the proposal could be used to stimulate ideas.

Another speaker recommended an international framework centered on regulating international activities of banks. Under his proposal, banks and bank holding companies ("BHCs") would have to carry out international banking activity in a separate legal entity or subsidiary of that entity. The agreement would not cover domestic banking activity, to avoid what would be perceived as too much interference with sovereignty. The agreement would define international banking activity and be subject to amendment by agreement of the steering committee or FSB or some other designated governing board. The agreement would cover prudential rules prerequisite to engaging in international banking activities, including requirements related to leverage, capital, derivatives, equity, and operational risk. Then, only the banks or BHCs that complied with these requirements could engage in international banking activities.

For this proposal to be successful, the speaker explained that there would need to be a global supervisor to determine if the banks or BHCs were in compliance. For example, the IMF staff could be charged with certifying bank and BHC compliance with the treaty agreement rules on a regular basis, such as twice a year. Without their certification, a bank or BHC could not engage in international transactions. One mechanism of enforcement would therefore be that all banks and BHCs would be required to block the transactions with banks or BHCs that did not have that certification. There could also be a tax on transacting with an entity that lacked certification, though it is unclear what would be done with the money from the tax. The speaker admitted that the administrative problem of enforcement would also have to be addressed.

**“We need the same definitions and same reporting requirements so the risks are comparable across jurisdictions. ”**

**“How do you create an international focus in a world where power is dispersed? ”**

The panelists then engaged in a discussion of whether efforts should begin with a bilateral or multilateral treaty. One speaker suggested that we start with Europe and the US deciding on their common interests. Other conference participants argued that any treaty should be done at the global level. The world is changing and some participants were skeptical that a bilateral agreement could be easily expanded to the global level.

## Taking the Lead

Throughout the conference, the diminishing role of the US and the rise of emerging markets were recurring themes. While there was agreement by participants that someone with authority must take the lead in global regulatory efforts, there was concern expressed that such leadership might be difficult to find in the future's increasingly globalized and multipolar world. As one speaker asked, how do you create an international focus in a world where power is dispersed? As one participant noted, the power of the US on the international financial stage was diminished by the crisis and has continued to decline. He stated that, in the past, “When the IMF and US have a difference of opinion, the IMF gets in line.” But, as the speaker noted, the world has changed and this is no longer the case.

One participant from Asia expressed hope that China will become more involved. Still, no participants cited China as a potential leader on international cooperation in financial reform.

One speaker, citing the opening comments of the conference about the Latin American debt crisis in the 1980s, noted that that crisis was handled through leadership in the US (in particular through the Fed) and leadership of the international community under the aegis of the IMF. Together, they managed the crisis in a way in which both the public and private sector's financial resources were utilized to control a problem that would have otherwise resulted in a disaster for the international financial system. The speaker questioned whether such a feat would be possible today and where such leadership would come from in the future.

However, one speaker noted that while it is easy to criticize the US, they have also shown leadership and a willingness to cooperate. Furthermore, because the emerging markets are becoming more prominent and US influence on the international stage will decrease with time, it is in the US interest to act sooner rather than later to influence the development of international financial frameworks. Therefore, despite the many reasons for pessimism, over time the US will recognize that international cooperation is not a sign of weakness, but essential to continuing its role as a global leader. This realization will, in turn, encourage greater leadership from the US on the international financial stage.



## Debate: Is the surest solution to “too big to fail” to break up the big banks?

The second day of the conference culminated in a debate addressing the resolution “Is the surest solution to ‘too big to fail’ to break up the big banks?” What followed was a lively hour and a half of vigorous debate that, in the end, led to a close vote in which the resolution ultimately failed. Nevertheless, the three debaters on both sides demonstrated both intellectual rigor and eloquence in the articulation of their points, which are summarized below.

### In Favor

Those speaking in favor of breaking up the banks relied on the fundamental point that current reforms have not adequately addressed “too big to fail” (“TBTF”) and the present prospects for change in the upcoming years are not promising. They therefore argued that reliance on new measures alone was insufficient and that a significant step forward was needed to create a system in which financial institutions may fail without posing danger to the entire market. Speakers pointed to the designation of GSIFs by the FSB as evidence that the market has concluded that they are TBTF and that national and international supervisors lack necessary cross-border mechanisms to resolve them successfully. Moreover, the numbers alone are evidence that certain banks remain TBTF. In the US, the five largest banks are now 20% larger than before the crisis and represent 70% of US GDP. One of these banks would not be permitted to fail today despite what has been achieved to date under Dodd-Frank.

The speakers in favor of breaking up the banks focused on many of the dangers of TBTF. One speaker warned of the dangers of oligopoly in banking. Drawing on his background in the life sciences and pharmaceutical industry, he illustrated how concentration of resources and capital among only a few large key players would limit innovation, as only those largest companies would have the capability to produce new and useful products. The speaker expressed concern that the banking system will be mainly comprised of huge organizations that do not innovate because they do not have to do so. They will behave independently of other market participants and independently of the customers and regulators, which would lead to a less productive and efficient financial system.

This speaker also explained how the current “TBTF” system would foster this counterproductive consolidation, as investors will be more likely to trust key members that they believe have the guarantee of taxpayer money. These large banks want people to believe they will be bailed out, so they can benefit from this implicit guarantee through more favorable debt terms at the potential expense of smaller banks. Because a select number of participants know they will be bailed out,

**“Concentration of resources and capital among only a few large key players limits innovation, as only those largest companies have the capability to produce new and useful products... The banking system will be mainly comprised of huge organizations that do not innovate because they do not have to do so. ”**

**“This super concentration will keep growing and probably accelerate, thereby only increasing the risk posed by these institutions over time. ”**

competition in the banking sector is distorted; the current TBTF institutions also engage in more risky practices and take on more risk. Another speaker remarked that the TBTF banks and increased banking sector consolidation also leads to concentration of risk. As one speaker asked, “Does society want to put many of its eggs in a small number of baskets?” This side argued that this super concentration will keep growing and probably accelerate, thereby only increasing the risk posed by these institutions over time.

Those in favor of the resolution also argued that breaking up the banks was an important step in reducing the political influence of large institutions. One speaker argued that many of these banks are not being broken up because of the political influence they exert. Moreover, the political influence of a few large institutions could prevent the implementation of needed reforms to the financial sector, which, in turn, would undermine financial stability and prosperity.

Those in favor also argued that many of the points made by the opposition assumed that breaking up the banks would lead to multiple small, unstable institutions. However, reducing the size of TBTF banks did not require creating many very small banks, but instead more stable “medium sized” institutions. One speaker pointed to the Deutsche Bank balance sheet of over 2 trillion and growing, observing that the institution could literally be split into two banks and they would still be very large. Another key point made in favor of smaller institutions was the idea of “too big to manage.” The JP Morgan “London Whale” was used as an example of the difficulty a large institution might face in managing and monitoring risk. This side argued that a smaller institution would be less complicated and better able to monitor its risk.

## Against

Those against the resolution were more optimistic that current reforms have sufficiently addressed too big to fail. When pressed on the question, this side argued that even if there are TBTF banks, the relevant question is whether the “best” response is to break them up; even if current proposals leave much to be desired, we should continue to pursue these reforms (such as the EU RRD and SIFI framework) and not circumvent them entirely by breaking up institutions.

Moreover, this side argued that breaking up the banks would be tantamount to admitting defeat; if banks must be broken up, then reform efforts thus far have been fruitless and there is little confidence that future regulatory and oversight changes can address the problem. How would recent changes, such as the SIFI framework, be addressed if SIFIs are broken up? Why bother with international resolution mechanisms if the banks are just going to be broken up?

This side also cited the operational and procedural challenges presented by plans to break up the banks. First, where would this break up take place? In all jurisdictions or one country at a time? This side argued that there may be other areas that are considered TBTF, such as CCPs, insurance companies, investment banks, non-bank broker-dealers, money market funds, and even Fannie Mae and Freddie Mac. Why should we break up banks, but not these institutions? One speaker asked how “too big” would be defined – asking “what is too big, and what is sufficiently small?” Another speaker asked if the opposing side was contemplating separating commercial and investment banking, noting that Lehman was a non-bank broker-dealer, so separation would not have solved that problem.



Michael Krimminger takes the microphone during the “Too Big To Fail” debate

One speaker argued that it is impossible to have a bright-line ex ante as to where to draw the line on TBTF. An institution which fails has a signaling effect if it happens at the point where the system is fragile enough that it can have a “Minsky moment,” decreasing risk tolerance and perpetuating runs. Furthermore, size alone may not determine whether a bank must be bailed out; small banks may also be too systemically important to fail, especially if they are interconnected and following the same strategy. One debater argued that “No bank is really too small to save.” For example, even with deposit insurance, there are many people who keep all of their money in deposits; are we going to let people lose their life savings? This side argued that therefore the relevant risk wasn’t size, but overall risk, which can be created by both large and small institutions. One speaker declared that the FSB GSIFI designations were a mistake and overemphasized size; at some point in time, any bank can be systemically important.

This side also argued that breaking up the banks fails to address the underlying causes of the crisis: concentration (in asset classes), correlation, contagion, confidence, and

**“What is too big? And what is sufficiently small? „**

**“Promotes stability claiming that we have not seen a very large bank fail precisely because they are large and can therefore manage capital more effectively and efficiently, provide better service to customers, and be more diversified. On the contrary, their diversification and size allowed them to avoid dependence on one region or sector. ”**

connectivity. For example, contagion and connectivity would not be helped by “more dominos on the board.” It has even been argued that breaking up the banks could exacerbate some of these problems: correlation would be worse because smaller banks tend to be more correlated than larger banks because they cannot be as diversified. Confidence would be undermined more by the failure of multiple small institutions; as the speaker said, depositors would be made especially nervous “waking up every morning and hearing another small bank had failed.”

One speaker from a major financial institution also pointed out the benefits of size, such as economies of scale and improved services for multinational clients, who can transact with one institution for many of their needs. A research report by a Federal Reserve Bank found that there are very significant economies of scale due to size through diversification. Moreover, the existence of large banks is evidence of their utility; if the market concludes a particular business model is better, the market will continue to use that model. We have chosen as a society to have global corporations that are in multiple countries as well as global supply chains. One might argue that large global financial institutions to match these global corporations and economies are not just helpful, but necessary.

This speaker also argued that size promotes stability claiming that we have not seen a very large bank fail precisely because they are large and can therefore manage capital more effectively and efficiently, provide better service to customers, and be more diversified. On the contrary, their diversification and size allowed them to avoid dependence on one region or sector. This speaker also argued that the regulatory supervisory architecture has improved over time, which means that we can have larger institutions than we might have thought in the past.

This side also argued that breaking up the banks and resulting limitations on bank capabilities could increase the size of the shadow banking sector. This threat is even more probable if banks are subject to size limitations and non-bank entities are not.

This side also stated that large financial institutions do not distort competition because the market is competitive on a local or regional basis. Large multinational institutions can and do face stiff competition at a more regional level, where they may face large competitors that simply lack their multinational reach and reputation.

The negative responders also pointed out that the burden of proof was on the affirmative to not just show that breaking up the banks could be helpful, but that doing so was the best way to end TBTF. This side concluded their argument by saying that the surest solution to TBTF is not to break up the big banks, but to let them live and provide their services to the global financial markets. Rather than break up the banks, the focus should be on tighter regulation and better risk management to provide for large, successful banks that are not too big to manage.



## Working Groups: A treaty-based multilateral supervisory framework – what might it look like?

The session culminated in a working group reports session in which participants discussed how a treaty-based multilateral supervisory framework might work in practice. Below are the conclusions from the working groups.

Despite the disagreement and vigorous debate within each working group, quite a few points of consensus emerged. There was agreement that the colleges of supervisors are currently weak and inadequate for the task at hand. While participants agreed that a treaty is desirable, there was consensus that this long-term objective should not be the only focus, but instead should run parallel to short-term, more achievable steps that might make a treaty in the long-term more feasible. As one illustrious seminar participant said, “focus on what you can do to establish credibility now” but participants also agreed that long-term objectives should not be ignored.



Douglas Flint and Charles Haswell during the working groups

**“While a treaty is desirable, there was consensus that this long-term objective should not be the only focus, but instead should run parallel to short-term, more achievable steps that might make a treaty in the long-term more feasible. ”**

To work toward this, there was discussion of starting from basic principles and areas of consensus. In particular, it was agreed that everyone must recognize principles that are in the common interest; the FSB’s Key Attributes are an example of how such agreement is possible. The countercyclical buffer under Basel, in which countries have agreed on cross-border cooperation in the implementation of this buffer, is also an example of how such agreements are achievable.



Fellows Sherika Ellis, Mayanna To and Patrick Kenadjian during the working groups

**“‘Name and shame’ would be insufficient in ensuring that, in a time of crisis, it would be as effective as a treaty, without a stronger enforcement mechanism. ”**

Participants also discussed what these basic principles might be. One such principle was information sharing. Currently, information sharing is insufficient and everyone agreed it must be improved. Participants discussed the IOSCO model and perhaps extending the model, or even making it binding. Another agreed-upon principle discussed by working groups was equal treatment of creditors regardless of nationality. Participants also suggested more work on agreed definitions to better understand and compare creditor hierarchies in a cross-border setting.

Participants also discussed the idea of annexes to any agreement, as has been done in other international treaties outside the financial sector. In this approach, parties would start with an agreement that included many countries, and then add annexes for subgroups. This optionality would promote agreement while also allowing for flexibility.

Participants also addressed the issues presented by differing structures of financial institutions. For example, one working group debated whether models should be developed for resolving institutions based on structure (so different agreements and plans would be used for an institution with a subsidiary model like HSBC), while a different model would apply to an institution with a more centralized structure. There was also a discussion of the advantages of the subsidiarized structure and whether this model should be encouraged.

Different enforcement mechanisms were also addressed. Groups discussed “name and shame,” which has been relied on in the past, such as through FSB peer review, and in the US approach to money laundering. There was concern that “name and shame” would be insufficient in ensuring that, in a time of crisis, it would be as effective as

a treaty, without a stronger enforcement mechanism. There was agreement in one working group that a strong enforcement mechanism would be very difficult to create in the context of relying on “name and shame,” and some suggested it might be an element of the treaty to put in place at a later time.

One suggested means of encouraging global compliance could be through capital charge discounts and penalties based on resolvability of an institution’s structure. Several participants supported this suggestion because it incentivizes resolvability but allows choice. For example, HSBC does not allow cross-guarantees, which decreases the likelihood of cross-defaults. One participant suggested that banks that do allow cross-guarantees might be required to hold more capital because of the increased risk they incur due to this practice.

Both groups addressed the idea of a potential dispute resolution mechanism. In particular, one group suggested the creation of a global supervisor, who would ensure consistent implementation and also serve as a forum for the settlement of disputes. The global supervisor would also be involved in the drafting of global principles to ensure an informed and nuanced approach to enforcement.

Working groups also discussed what parties should be included in a potential treaty. While participants agreed that ideally everyone would be involved, most attendees recognized that such a large group might not be the best starting point. One participant suggested starting with a coalition of the willing based on common interests. Then, signatories could impose capital charges or other penalties on non-participating countries. One participant noted that in the US, 85% of American bank business conducted outside the US is in London, and therefore a good starting point might be for an understanding between the UK and US. While this would be less useful for GSIFs outside these two countries, it could serve as a model for future agreements.

Participants also addressed the issue of burden sharing, noting that it remains a critical impediment to cooperation. Even with a treaty requiring cooperation in a cross-border resolution, inevitably liquidity would need to be provided. The source of this liquidity will be a difficult issue, and participants agreed that more consideration must be given to this matter going forward.

As one participant stated, a perfect system is not required. Rather, confidence in an imperfect system is far more important. We need people to believe in a reformed system and to behave as if the system had been fixed. In doing so, with or without a treaty, we would convince the banks that they can fail, stemming moral hazard and encouraging greater risk management, and in turn promoting a more resilient financial system.

**“A perfect system is not required. Rather, confidence in an imperfect system is far more important.”**



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# Salzburg Global Seminar

Salzburg Global Seminar was founded in 1947 by Austrian and American students from Harvard University. Convinced that former enemies must talk and learn from each other in order to create more stable and secure societies, they set out to create a neutral international forum for those seeking to regenerate Europe and shape a better world. Guided by this vision, we have brought over 31,000 participants together from 160 countries for more than 500 sessions and student academies across cultural and ideological barriers to address common challenges. Our track record is unique – connecting young and established leaders, and supporting regions, institutions and sectors in transition.

Salzburg Global's program strategy is driven by our Mission to challenge present and future leaders to solve issues of global concern. We work with partners to help people, organizations and governments bridge divides and forge paths for peace, empowerment and equitable growth.

Our three Program Clusters - Imagination, Sustainability and Justice - are guided by our commitment to tackle systems challenges critical for next generation leaders and engage new voices to 're-imagine the possible'. We believe that advances in education, science, culture, business, law and policy must be pursued together to reshape the landscape for lasting results. Our strategic convening is designed to address gaps and faultlines in global dialogue and policy making and to translate knowledge into action.

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Our exclusive setting enables our participants to detach from their working lives, immerse themselves in the issues at hand and form new networks and connections. Participants come together on equal terms, regardless of age, affiliation, region or sector.

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