Architects of Stability? International Cooperation Among Financial Supervisors

Ethan B. Kapstein

Paul Dubrule Professor of Sustainable Development

INSEAD

The Argument

- Financial supervisors have achieved substantial success in building a “new financial architecture.”
- That supervisory structure should be viewed as a “work in progress” due to the (paradoxical) changes in the financial risk environment: (1) the emergence of large and complex financial institutions (LCFIs); and (2) the “atomization” or transference of financial risk onto firms and households.
- Further reforms are needed in financial regulation, with elected officials likely assuming a greater voice in future regulatory arrangements.

Why Cooperate?

- Public Interest approach: High levels of financial interdependence increases the risk of global contagion; international cooperation to produce minimum standards (eg for capital adequacy) therefore a necessity for financial stability. But despite interdependence in many issue-areas, level and type of international cooperation varies.
- Private Interest approach: Regulation as the outcome of political efforts (e.g. by firms and elected officials) to use state authority for personal ends. International cooperation in finance therefore viewed as effort to "level the playing field" for financial intermediaries. Casts skepticism on welfare benefits of international cooperation and instead urges "competition in regulation."
- My approach (following Sam Peltzman): Regulators pursue multiple objectives; *International cooperation among financial supervisors may therefore be defined as a multilateral effort to reconcile diverse demands for both a more level and more stable environment for global finance.*

How Is Cooperation Achieved?

- Financial cooperation has required a combination of "power" and "purpose":
- Power refers to exercise of US (and UK) financial market power, specifically the power to require foreign firms to adopt host country standards if they wish to access US and UK financial markets.
- Purpose refers to the political objectives of international cooperation: the search for both a stable and a level playing field.

Case Study: Basel I

- Origins of Basel capital adequacy accord in debt crisis and demand by US Congress that banks must increase capital as cost of any increase in IMF quota.
- US banks refuse to accept unilateral capital increase, especially in light of competition from weakly capitalized Japanese banks.
- US legislation requires FED to negotiate international capital adequacy standards.
- Thus, Basel I seeks to "level" and "stabilize" global finance.

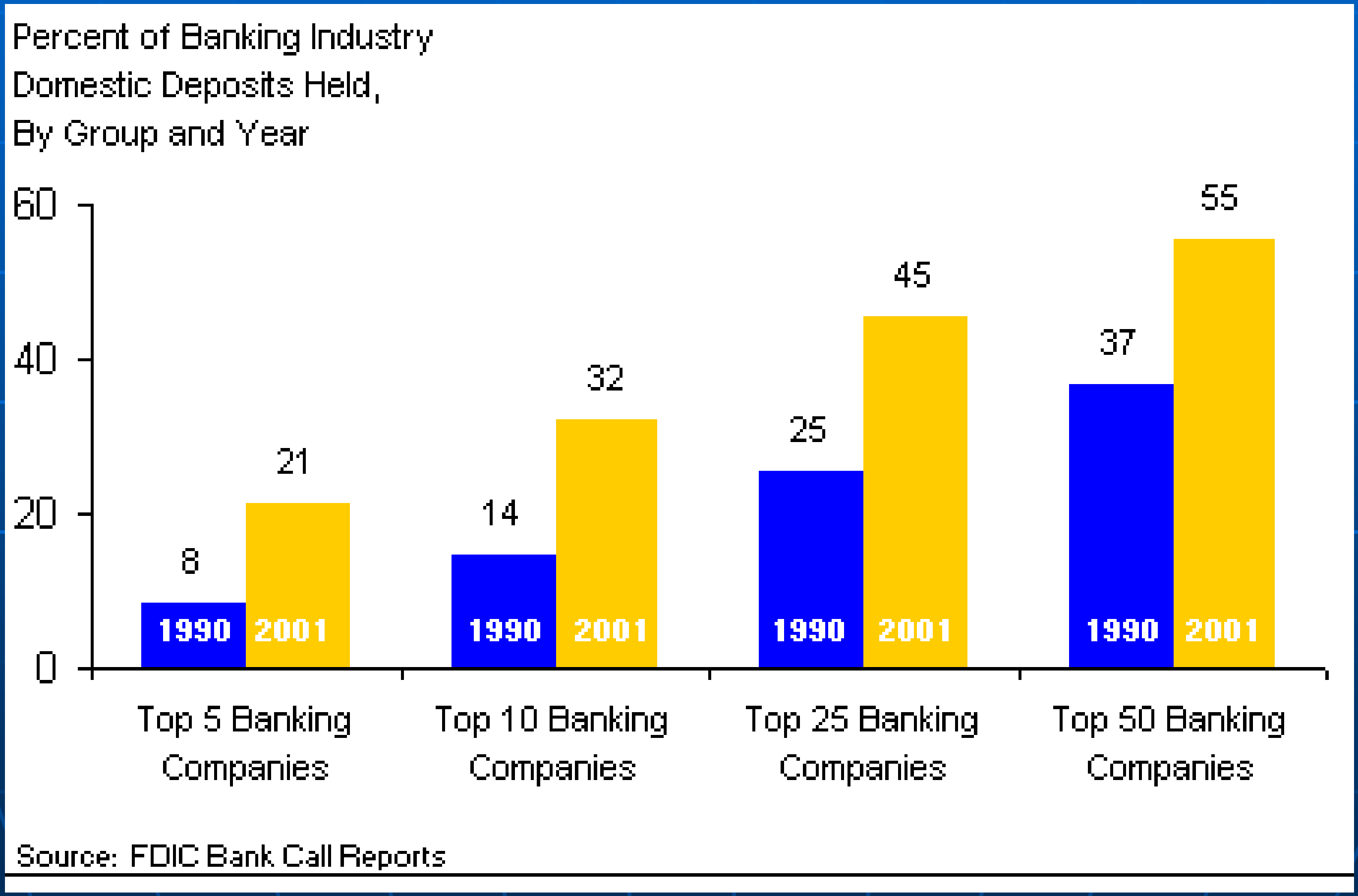
Mexico, Asia and the New Financial Architecture

- Robert Rubin’s Lessons from Mexico and Asia:
- Congressional appetite for financial leadership is limited;
- Burden of financial leadership must be shared with other nations;
- This requires a “new financial architecture” which includes, inter alia, minimum global standards for financial intermediaries.

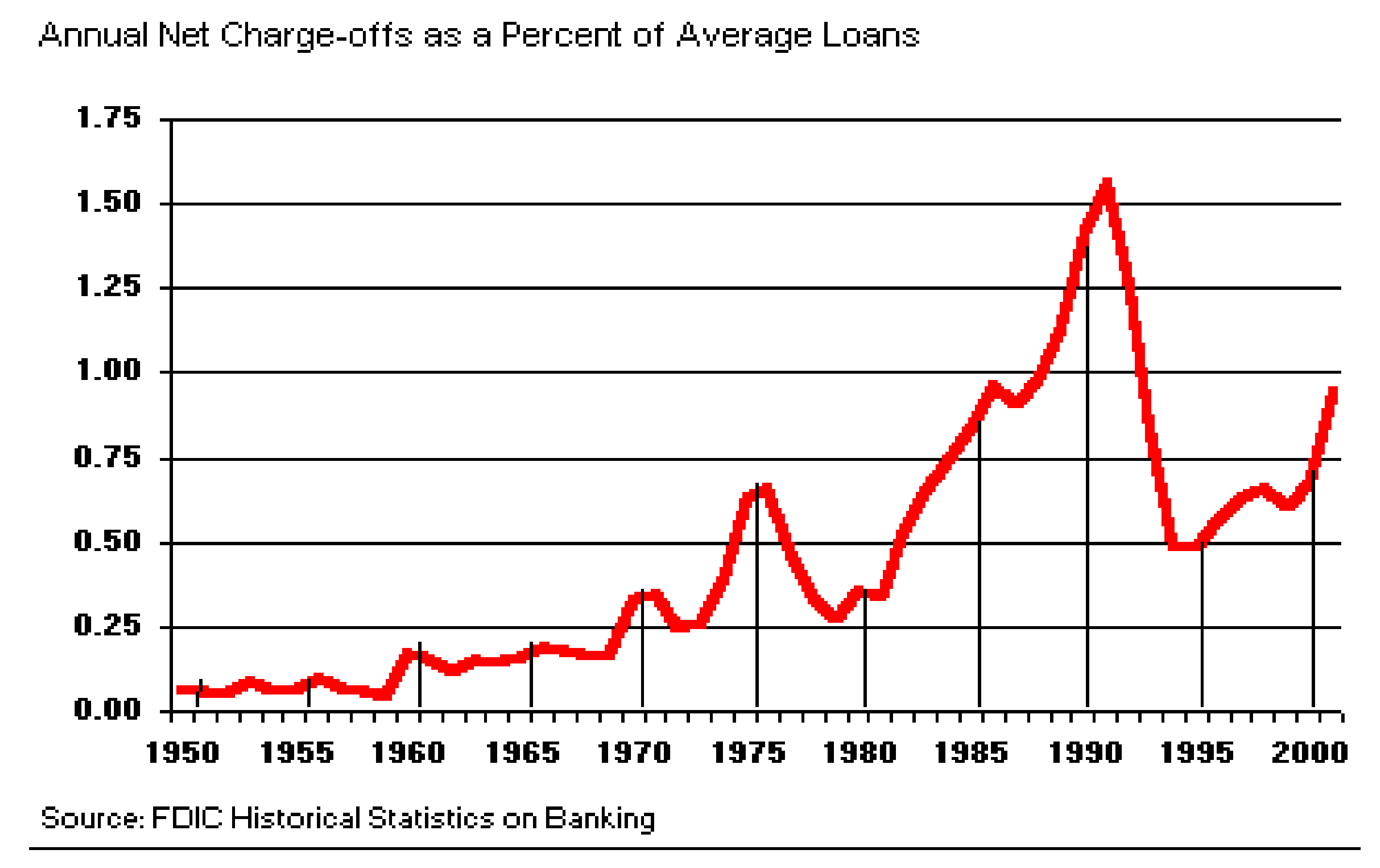
The Changing Financial Risk Environment

- The supervisory architecture remains a work in progress because of:
- Emergence of LCFIs
- Development of Derivatives Markets
- Transfer of financial risk onto households and firms whose absorptive capacity remains untested
- These developments suggest possible politicization of future financial crises!

Consolidation in US Banking



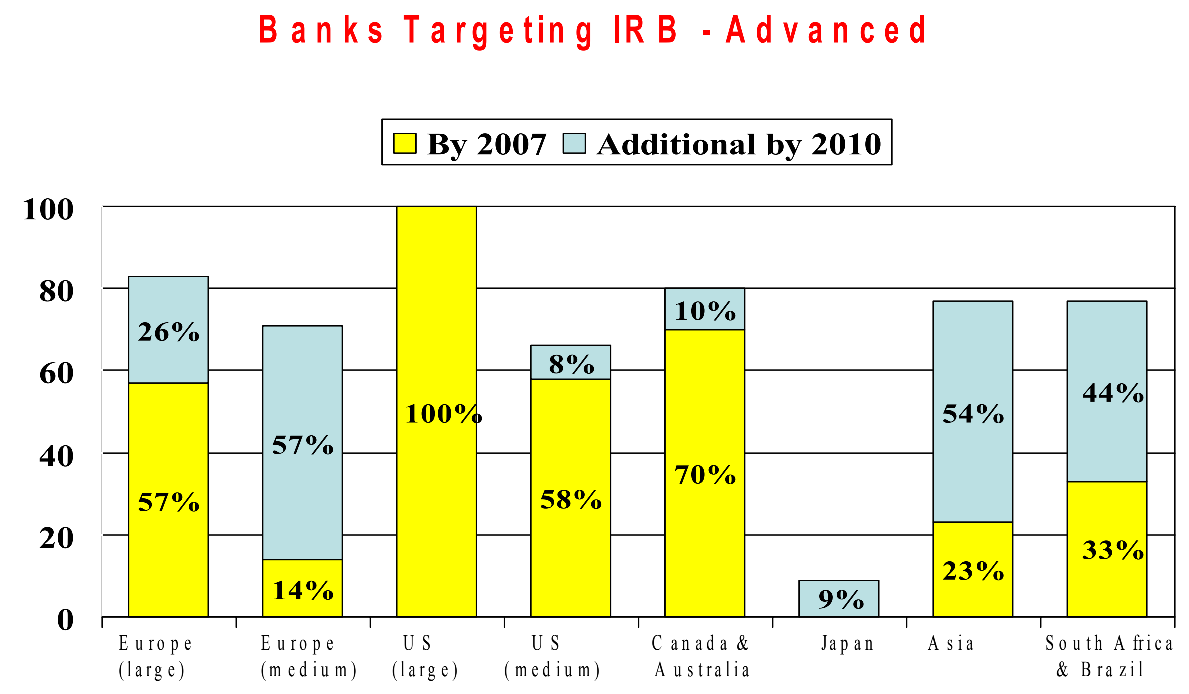
A Less Risky Banking System?



Basel II and Financial Stability

- Basel II's approach to risk-weighted capital represents a necessary, post-Basel I evolution, but it raises continuing questions; for example:
- Is the risk environment becoming more opaque with the growth in derivatives? If so, what "fixes" are needed?
- Is there a pro-cyclical bias in Basel II? If so, to what extent are domestic-level policy changes forthcoming that would, for example, counteract those effects?

Does Basel II Contribute to a Level Playing Field?



Source: FT Research study commissioned by Accenture, Mercer Oliver Wyman and SAP (2004)

Policy Recommendations

- Future financial crises may be highly politicized as firms and households bear burden of their exposure → this suggests that following steps might be contemplated:
- "War gaming" financial crises with relevant actors, including elected officials.
- Continuing refinement of Basel II to meet new challenges.
- Consideration of further institutional changes that may be needed in order to promote competition and prevent market domination by LCFIs or other financial intermediaries.

Conclusion

- “Our politics may not be well suited to coping with the new risks of the global economy” Robert Rubin, 2003.