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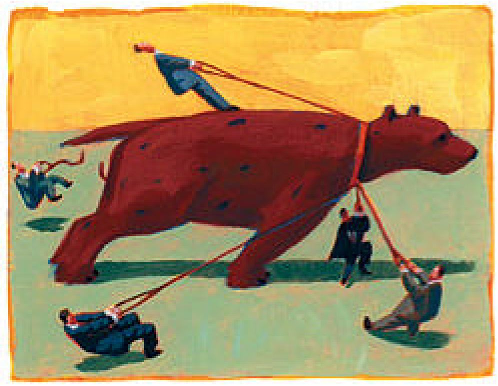
The regulator who isn't there

May 16th 2002
From The Economist print edition

Does a global financial system need a global regulator?



WHO regulates Citigroup, the world's largest and most diverse financial institution? With its operations in over 100 countries, selling just about every financial product that has ever been invented, probably every financial regulator in the world feels that Citi is, to some degree, his problem. America alone has the Federal Reserve, the Securities and Exchange Commission, the Commodities and Futures Trading Commission, the New York Stock Exchange, 50 state insurance commissioners and many others. Yet in a sense nobody truly regulates Citi: it is a global firm in a world of national and sometimes sectoral watchdogs. The same is true of AIG, General Electric Capital, UBS, Deutsche Bank and many more.

Might that be a good thing? Howard Davies, boss of Britain's Financial Services Authority, notes that it has become fashionable to think of regulators as Shakespeare's “caterpillars of the commonwealth, creatures who, far from adding value, get in the way of the market”. Naturally Sir Howard does not share this opinion. All the same, it seems clear that much of the dynamism in global finance during the past three decades has been due to fewer regulations on the movement of capital, particularly across borders, and on what can be done with it. For the most part, money is now free to flow wherever an opportunity presents itself, and has generally done so, leaving everybody better off than with heavy regulation.

Leaving capital free to move where it could earn the highest return also showed up over-costly or misplaced regulation: the money simply went elsewhere. For instance, because Japan prohibited the use of derivatives, options in Japanese securities were traded in more accommodating Singapore. As Japan gradually eased these restrictions, some of the offshore business shifted back to Tokyo. In general, competition for capital has encouraged countries to improve their regulation to appeal to mobile capital—although some, such as Malaysia, have resisted this pressure, and continue to impose controls on cross-border capital flows.

Strikingly, there has been no race to the bottom in regulation. Behind every great market is good regulation—whether by a government agency or organised by the market participants. Internationally mobile capital has tended to reward regulation that protects investors and minimises privileges for market insiders.

Broadly speaking, this has led to a convergence of regulation around common international standards, but this process is by no means complete, particularly for investment products sold to personal investors. The day when a global firm can sell the same simple stockmarket-index fund anywhere in the world remains a long way off. America remains reluctant to allow European securities exchanges to ply their trade via screens in America, even though technically this is now easy to do. “Outrageously protectionist,” comments one European regulator.

Given the political difficulties, the idea of a single global regulator is not on any serious agenda. That may be just as well: competition among regulators has some benefits. What is on the agenda, at least of the regulators in countries open to international capital, is to ensure that good information is available about the state of global markets and about financial firms' global operations. The FSA, for example, is able to regulate only Citigroup's British activities, but it will have a much better chance of doing it well if it knows enough about the health of the firm worldwide.

Information is already flowing more freely between different national regulators. Multinational institutions such as the International Monetary Fund, the Bank for International Settlements and the Financial Stability Forum all play a useful part in this, but it is bilateral communication between national regulators that matters most—and the global financial system is nowhere near as transparent to national regulators as it should be.

One reason is that no global consensus exists on what exactly should be regulated. For instance, in Britain reinsurers are regulated by the FSA, but in their home markets Munich Re and Swiss Re, the world's largest reinsurance companies, are mostly unregulated.

Non-financial firms with big financial operations do not fit comfortably into the current regulatory framework anywhere. Enron, which has been plausibly described as an investment bank or hedge fund with an energy business on the side, was not regulated in America. In Britain, the firm itself was not regulated, but its financial subsidiaries were monitored by the FSA. There are big question marks over who regulates the growing number of firms now transforming themselves into financial behemoths, modelled on GE with its huge GE Capital operation. Hedge funds and other highly leveraged institutions are regulated lightly in most countries, and not at all in America. A proposal by a presidential working party for tougher regulation of hedge funds, prompted by the collapse of Long-Term Capital Management, was unexpectedly blocked in Congress.

Too much of a good thing

A second problem, at least in foreign eyes, is that America has too many different regulators. Whereas Britain has merged its numerous financial regulators into a single authority, and several other countries around the world are moving the same way, America continues with its plethora of different regulators for different parts of the financial-services industry. It seems doubtful that any of them has a good overview of what is happening in America's financial system as a whole—though the Fed claims it gets all the information it needs, one way or another. During the Clinton administration, regulation often took place on the golf course between Mr Greenspan, Arthur Levitt, the chairman of the SEC, and Robert Rubin, the Treasury secretary. All the same, single foreign regulators would find it easier to resolve cross-border issues with a single American counterpart.

Some American regulators defend their multiple system, despite the considerable duplication it entails, mainly on the ground that regulatory competition keeps them keen and lean. Certainly, the superiority of the single, consolidated regulator has yet to be proved. According to a report published last year by the Centre for the Study of Financial Innovation, “There is a pervasive mood of discontent in the City with the FSA: people find it bureaucratic, intrusive and insensitive.”

Still, the current division of labour among the different American regulators is hard to justify. Why, for instance, should the SEC oversee trading on stock exchanges and the CFTC trading on futures exchanges when the regulatory needs of all exchanges are essentially the same? And why is insurance regulated not federally but at the state level, mostly by elected insurance commissioners? Nobody really thinks this makes sense, but the system survives because each regulatory body has its own supporters in Congress. In some respects, an inefficient regulatory system suits powerful financial firms. The Glass-Steagall laws, which kept banks, investment banks and insurers separate, survived a dozen attempts in Congress to scrap them—until 1998, when Travelers, an insurer, merged with Citibank, which immediately ended its expensive lobbying against abolition. They went soon after.

One senator who thinks that a single regulator along FSA lines would be good for America's capital markets is Jon Corzine, a former boss of Goldman Sachs. “I hope to get consolidation of American regulation on to the agenda,” he says, “but it will need a bigger crisis than Enron to make it happen.”

So far America's cumbersome regulatory system does not seem to have retarded the development of its markets, but in the long run it may prove costly, particularly if—and it is a big if—the European Union succeeds in fully integrating its capital markets and introducing appropriate regulation. America has long boasted of having the most efficient capital markets in the world, and to date that has broadly been true. But its unwieldy system of multiple regulators could become a competitive disadvantage should Europe develop a better, less costly regulatory mousetrap.

Regulatory competition

Indeed, it is possible that pressure from the EU will help to consolidate American regulation. Under a forthcoming EU directive, any financial conglomerate operating within the Union will have to choose a main EU regulator who will be responsible for global supervision of the firm. In practice, the European regulator for the big American firms, such as Goldman and Citi, will probably delegate by requiring the firm to nominate one of the American regulators as its “co-ordinating regulator”, which would become a de facto single national regulator for the firm.

Even if the infrastructure for effective global regulation were in place, huge challenges would remain. Some are of an intellectual sort. “How much failure should a regulatory system allow?”, asked Sir Howard Davies in a recent speech. He did not supply an answer, beyond saying it should be more than zero, and less than would cause system-wide collapse. Another regulator reckons that the ideal would be “a trickle of little problems, to keep people aware of the risks”. It may be a tribute to American regulation that Enron was actually allowed to go bust, and luckily this does not appear to have had system-wide consequences. Some countries might have tried to organise a rescue; indeed, even the Fed has a reputation for keeping alive firms that should have been allowed to die.

Understanding whether the level of risk is getting too high has become harder now that so much risk is being transferred out of the banking system. Andrew Crockett, general manager of the Bank for International Settlements, worries that regulators and financial firms alike are better at judging the relative riskiness of different instruments, institutions and counterparties than the total risk in the system.

The problem has been brought to the fore by the technology bubble, and the fear of a wider American equity bubble. Do regulators know when a bubble has formed and the financial system is becoming dangerously imbalanced? Probably not with enough certainty to base policy on. What is clearer is that aggregate risk ebbs and flows with the economic cycle, says Mr Crockett. Credit officers tend to lend too much in good times, heating up the economy, and then cut back too much in a downturn, making things worse. One way to get round this, Mr Crockett suggests, would be to require banks to set aside higher amounts of capital during economic booms than during recessions, to make risk-taking less pro-cyclical.

How much capital financial firms should set aside against risks going wrong is the trickiest decision international regulators have to make. Since 1988, big banks have been abiding by the Basel capital regime, which links the amount of capital they have to hold in reserve to the riskiness of the loans they make. However, the categories of risk are too undifferentiated: banks have to set aside as much capital against a loan to Microsoft as to a Hungarian dotcom, as much against a loan to America as one to South Korea. Banks have also discovered ways to use derivatives and other securities to allow relatively risky loans to qualify for a low-risk, low-capital treatment. Regulators fear that a large part of the growth in the use of derivatives and securitisation by banks may stem from evasion of regulatory controls.

Basel 2, a more sophisticated version of risk-based capital rules, is now in the pipeline. It is meant to apply not only to big banks but to all banks worldwide, and to all investment firms in the EU. There is also talk of an insurance Basel before long. But Basel 2 has met with considerable opposition, partly because it is too complicated, partly because some countries disagree over how much capital should be set aside against some sorts of loans. Germany wants a lower capital requirement for loans to small businesses, for example, because bank loans are their traditional source of funding. The launch of the new regime, originally scheduled for 2004, has already been delayed until 2006, and even that may prove to be optimistic. Meanwhile, the banks are operating with a capital regime that does not work as intended, but may be lulling regulators into a false sense of security.

In determining regulatory capital, Basel 2 would give an important role to credit-rating agencies such as Moody's and Standard & Poor's. How good their ratings are is the subject of much debate. As an alternative, banks will be encouraged to use their own in-house credit ratings. But regulators still mistrust the use of quantitative credit-risk models to set regulatory capital. They need better techniques and better data, especially in Europe.

Many big banks already use quantitative models to assess how much capital they need to set aside against portfolios of marketable securities. These “value at risk” (VAR) models typically measure the most the firm could lose in a day, judging by past performance, but they tend to underestimate the frequency with which really bad days occur. There have been half a dozen “perfect storms” in the market in the past decade, during which VAR calculations proved useless in predicting losses. Stress-testing portfolios against imaginary perfect storms remedies some of the weaknesses. But modelling credit risk in this way is much harder, not least because data about past credit performance are scarce.

Another market-based system of regulation has also received some attention. If banks issue short-term subordinated debt that is traded every day and has to be refinanced regularly, and can stay in business only as long as the debt is refinanced, then the market will in effect regulate the bank. Lenders will not finance a bank they think is in risk of default. Alas, the only country to have tried it so far has been Argentina, where the government's fleecing of the banking system after its debt default rather spoilt the plot.

Regulators are only too aware that the sheer complexity of the financial system imposes practical limitations on what they can do. Increasingly, they are having to rely on the private sector to assist them in their regulatory task. They simply do not have the capacity to find out what risks are being taken inside a large international bank unless it tells them.

Caveat emptor

All this suggests that, just as market failures are an inescapable feature of free-market capitalism, so too may be regulatory failures by its watchdogs. The first line of regulation should be those whose money is at risk. In an important sense, Enron was regulated by its bankers. Alas, they made a lousy job of it. The best piece of advice to market entrants is “buyer beware”.

As it is, buyers often seem to be positively reckless, not least in the stockmarket. Recent years have seen the return of the sort of financial bubbles that many economists and regulators thought had gone forever. Why are bubbles back, and can anything be done to prevent them?