University of Glasgow

Uses of the Past
in
International Economic Relations

UPIER

The Development of International Banking Regulation and Supervision: why has it failed?

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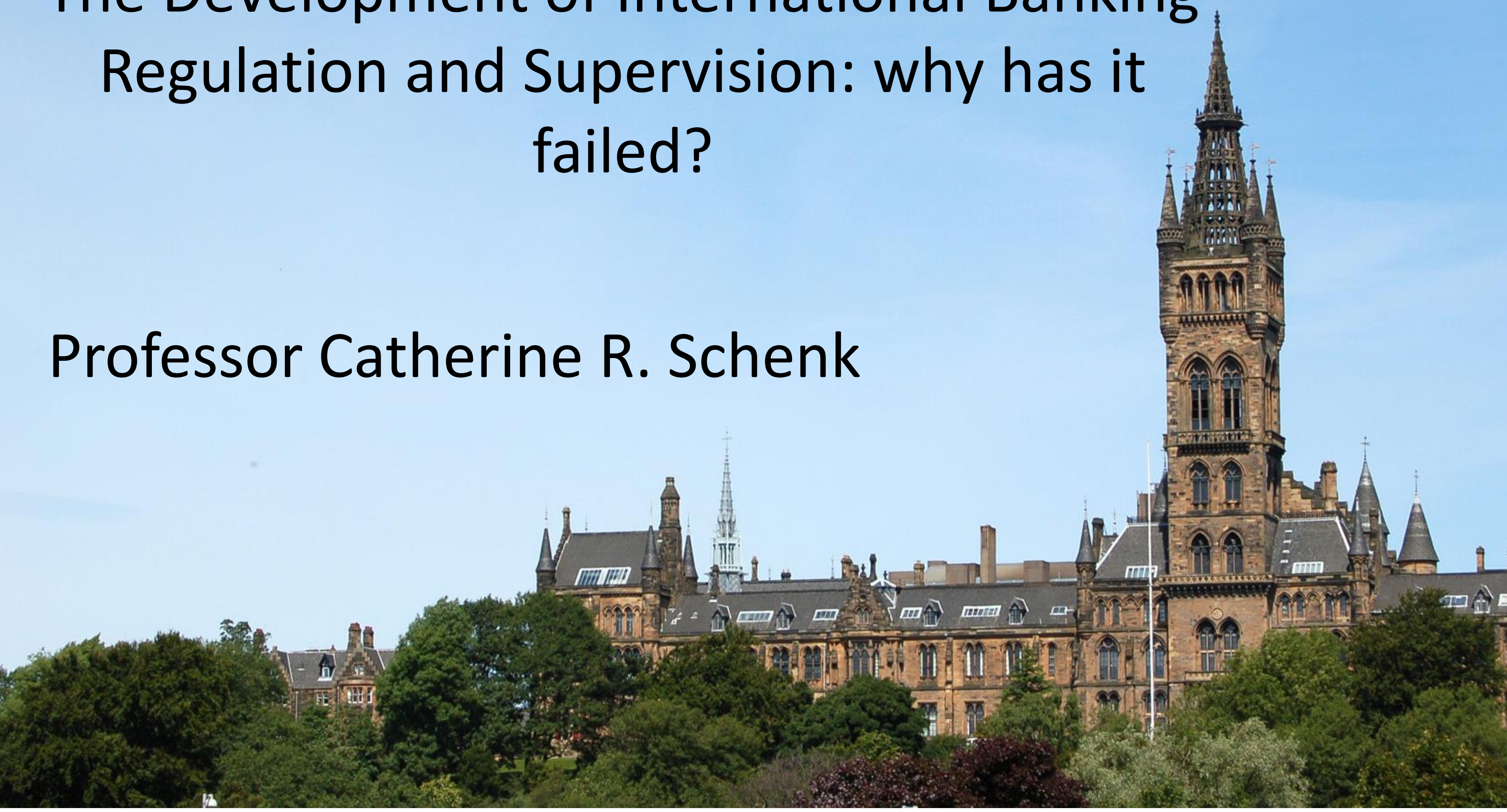


Why Regulate?

- Overcome market failure in financial markets
  - Information Asymmetry between borrowers and lenders
  - Adverse Selection
- Public interest/protect depositors
- Private information as a financial asset
- Systemic vulnerability: ex ante vs ex post solvency, contagion
- Role of banking and financial systems in economic growth and stability
- Banks as conduits of monetary policy

Why not Regulate?

- Market forces are most efficient at allocating capital
- Caveat Emptor for all but small savers
- Moral Hazard: encourages excessive risk-taking, increasing systemic risk
- Complexity of institutions makes monitoring and enforcement costly
- Speed and agility of financial innovation undermines effectiveness, waste of resources
- Regulatory arbitrage (within and between markets)

Forms of Prudential Regulation

- Constraints on type of business operation (ring-fencing, prohibitions on proprietary trading)
- Transparency and reporting (e.g. balance sheets)
- Capital/Asset Ratio
  - enhances resilience
  - increases owners' burden
  - Reduces profit
- Risk Weighted CAR
  - Calibrated to the risk profile of portfolio

International Transmission of Crisis

- Simultaneous Global Incident: capital crisis (e.g. 1982 Sovereign Debt Crisis)
- Interlinked Banking Systems: liquidity crisis
  - Multinational Banks
  - Inter-bank deposits system
  - Subsidiaries, shadow-banks
  - Settlement systems (CHIPS, SWIFT, CIPS)
  - Trust (discrimination against categories of institution)
- International spread of public panic (e.g USA 1931-3)

Challenges of Global Regulation

- Cross-border information sharing among national supervisory authorities
- Regulatory arbitrage (off-shore markets, tax havens)
- Distinctive (persistent) national banking cultures and systems
- Complexity of inter-bank, inter-sector flows, financial conglomerates

Private information an asset

Complexity/Opacity of processes

Self-Regulation

Specialised technical skills

Trust in market discipline

Information Asymmetry

Collect and Share Information

External Supervision

Macroeconomic Stability

Systemic Vulnerability

1960s Models of Supervision

- UK - centralised
  - informal
  - Power/communication through discount window
  - no statutory powers
  - No claim, no blame
- USA – decentralised, complex (OCC, FDIC, Fed, State Banking Authorities)
  - informal relations still important
  - Power/communication through discount window
  - 1976 collect information on overseas branches of US banks
- Reflects structure of banking system, Response to crises and Interest groups (Calomiris and Haber, 2015)

Product and Process Innovation

- Eurocurrency market, CDs, interest rate swaps
- Liability Management:
  - Traditional focus on asset driven liability management (seek deposits to meet demand for loans)
  - Demand for credit exceeds ability to attract deposits -> shift to focus on liability management (more non-deposit liabilities)
  - 1970s move to Treasury function: liability & asset management in ST wholesale markets
- Internationalisation: branches, subsidiaries, consortia (heightened competition/panic)

1968 Lloyds Bank: internal review

‘Lloyds Bank Europe [LBE] has perhaps one year, or at most two years, in which to carve out a substantial, profitable place in international banking for itself and to get its structure in shape’…’must be able to build up a foreign exchange and interest arbitrage operation “out of nothing” and make it profitable…and altogether go out actively to get business, rather than wait for it to come’

Within 5 years: victim of rogue trading in Lugano branch (requires BoE support, revised internal and external procedures)

Challenge I: The Eurodollar Market

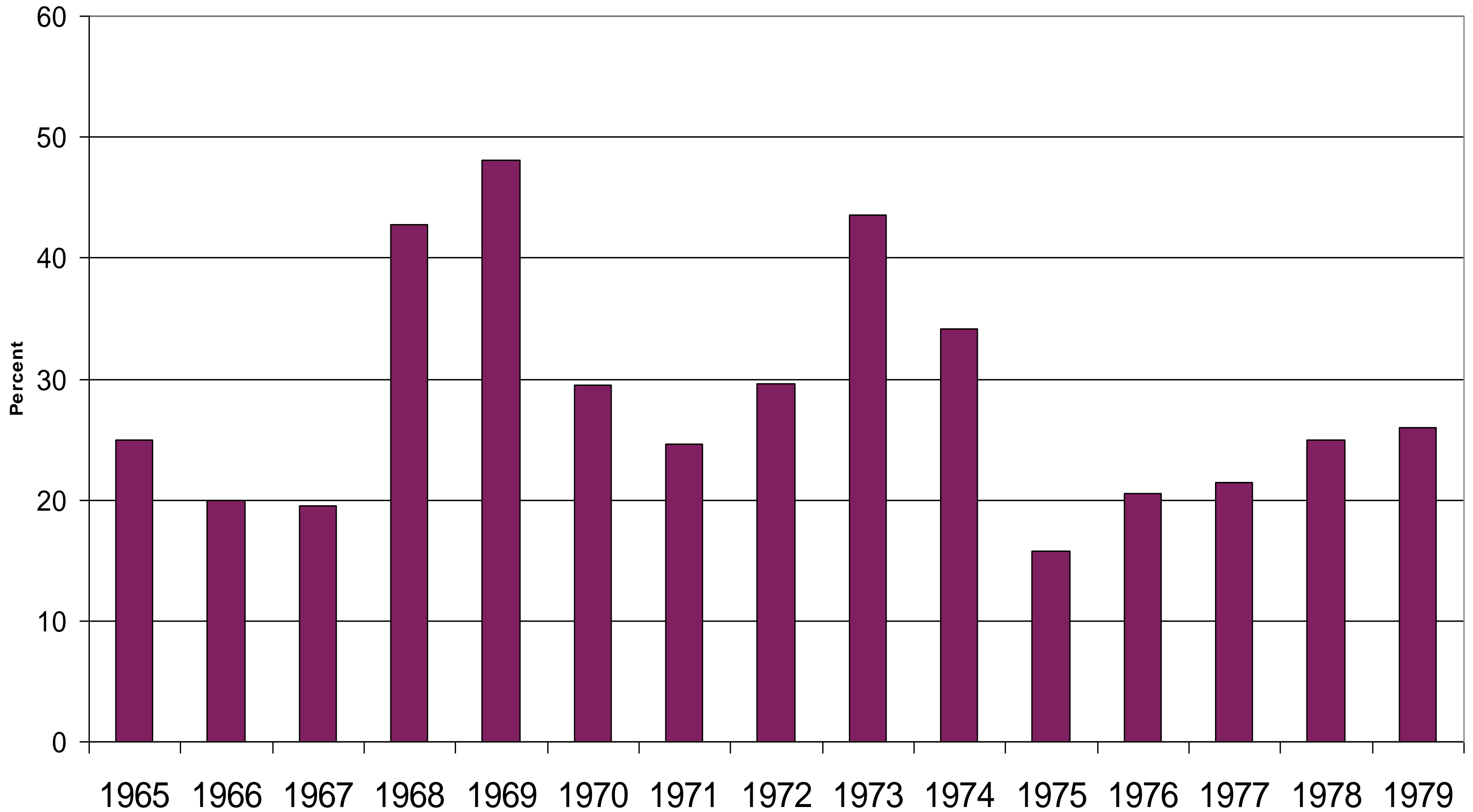
Product and Process Innovation: Unsupervised, unregulated cross border banking and financial market

Why didn't the authorities regulate the Eurodollar Market?

- Bank of England caught by surprise (fait accompli)
- Breaks spirit but not letter of exchange control
- BoE is confident in personal guidance framework to encourage prudent behaviour: **trust and moral influence**
- Too **complex** for Treasury, defer to Bank of England
- Danger of **regulatory competition**, loss of business
- Enhances London as an IFC (but Treasury does not hesitate to restrict other capital transactions)

'however much we dislike hot money we cannot be international bankers and refuse to accept money' (Bank of England 1961)

Growth of Eurocurrency Market



Efforts at coordinated response fail

G10 Central Banks debate controlling the market REJECTED

- Bank of England and Fed resist European pressure to introduce controls or to formalise prudential supervision
  - » Market is useful source of liquidity for US MNCs, source of revenue for London
- BIS begins to collect data on the size of the market but no consensus on need for prudential supervision
- System is robust to a default crisis in 1963 ('salad oil flap')
- International Risk Centre for data exchange rejected 1965
  - Banks would not comply, priority for national systems and for informal relations between regulators and bankers
- Bankers arrange limited self-regulation: fears of contagion
  - Currency and maturity mis-match, large inter-bank element, lack of transparency about credit-worthiness of ultimate borrowers

Market Shocks 1973-1974

- End of pegs to US dollar – February/March 1973, £ floats from 1972
- Commodity price inflation (before and after OPEC oil crisis October 1973)
- Asset market bubble (housing, stock markets)
- Regulatory changes:
  - Competition and Credit Control in UK 1972
  - Multi-Bank Holding Company Act in USA 1970

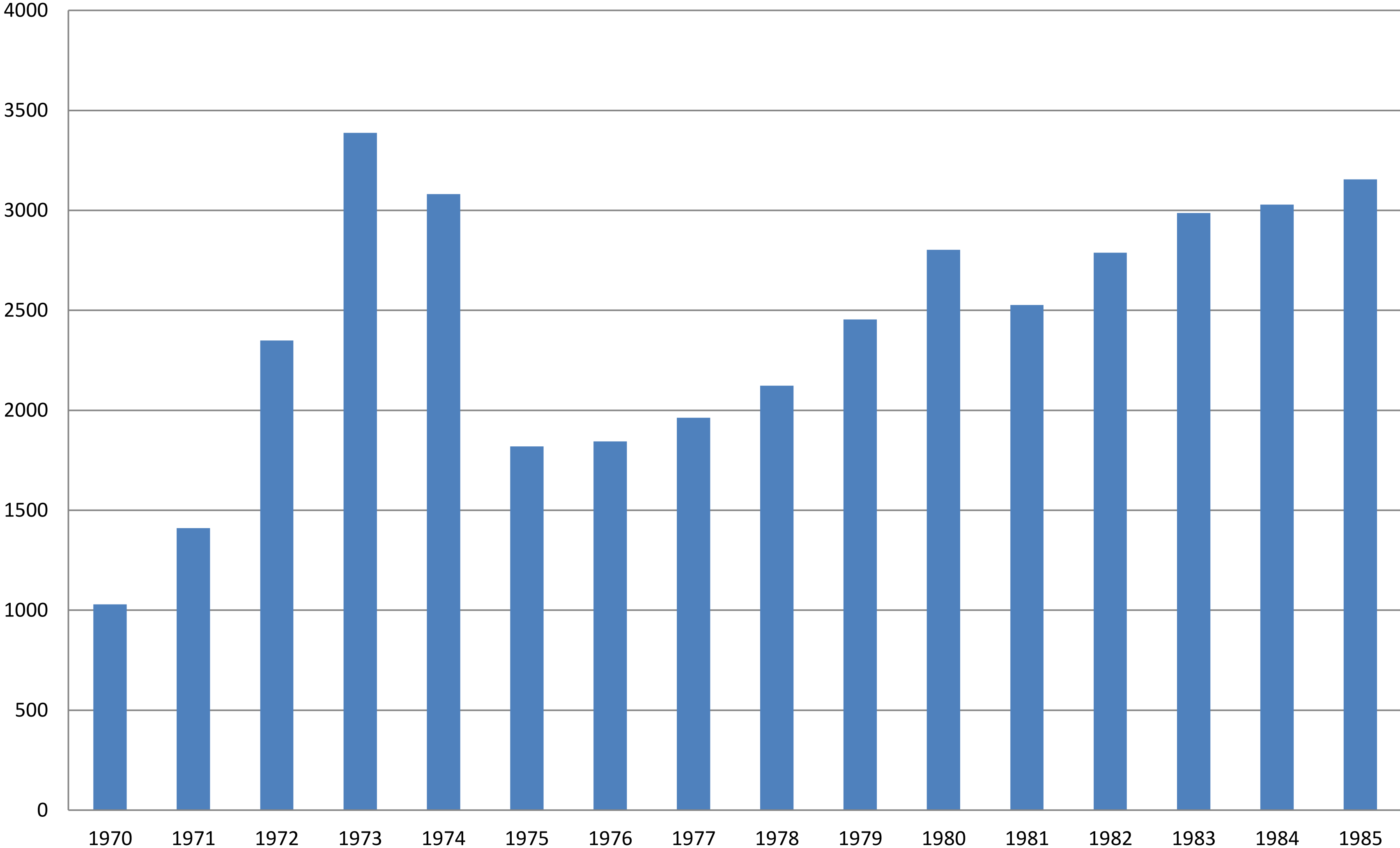
New Risks

Challenge II: Secondary Banking Crisis 1974

- Change in Financial Environment
  - Huge expansion in multinational banking (branches, subsidiaries, international consortium banks)
  - End of fixed exchange rates increases risk
- Volatile USD prompts crisis: Who is responsible for international banks?
  - Herstatt Bank allowed to fail in Germany June 1974
  - Israel British Bank allowed to fail in London July 1974 (ex post bailout)
  - Franklin National Bank bailed out by Fed Sept 1974
- US/UK vague pledge of LoLR support for Euro$ market
- Basel Committee on Banking Supervision: end 1974

1974: International Bank Crisis?

- Bank Failures
  - San Diego, Franklin National, Herstatt, Israel-British
- Bank Scandals and Losses
  - Westdeutsche Landesbank Girozentrale, UBS, Banque de Bruxelles, Lloyds Bank, NatWest
- Mainly exposure of widespread and costly fraud as bubbles burst and markets reverse
- Illiquidity, credit contraction, recourse to discount windows in US and UK, suspension of CHIPS and erosion of trust among banks


CHIPS: Average Size of Transaction USD '000s
4000
3500
3000
2500
2000
1500
1000
500
0
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985

Globalising markets require new models

- External Regulation/Supervision
  - BIS: G10 central bank governors call for ‘Early Warning System’ and sharing of best practice
  - National banking legislation reformed: long and contested process (1979 UK Banking Act)
- Self-Regulation
  - Lloyds Bank/BBA consider market based system of checks on correspondents
- Mixed Model
  - International banks pledge liquidity for subsidiaries
  - December 1974 BoE Guidance
  - O’Brien Letters (1975, 1978, 1979) from BBA ‘embodiment of BoE recommendations’

Committee on Banking Regulations and Supervisory Practices

- Early Warning System: abandoned
  - Blunden: no new international ‘structure similar to those that already existed in individual countries’.. ‘(a) an international early-warning system must be based on national early-warning systems. (b) the Committee should itself be the focal point for an international early-warning system’ (March 1975)
- Exchange rumours: controversial

- ‘the Japanese delegation could not commit itself either to passing on rumours to other committee members or to the idea that action should be taken if rumours about a Japanese bank were received from other members of the Committee’
- ‘it was hard for [Fanet] to imagine that information based simply on rumours, or even on accusations, could be transmitted to the supervisory authorities of other countries’

- ‘[Baeyens] could not be expected to warn other countries in case he should learn about the difficulties of a Belgian bank; but at the same time he would be glad to be informed by other Committee members when there were rumours about a Belgian bank’
- ‘there should be a moral obligation to report the potential areas of difficulty to the countries that might be affected’ (Galpin BoE)

Blunden submits personal paper in June 1975: members exchange phone numbers

Basel Committee

- Early Warning System abandoned
- Supervisory Gaps: Host vs Home
- Basel Concordat – September 1975: inconclusive: reliance on communication

  ‘it is not possible to draw up clear-cut rules for determining exactly where the responsibility for supervision can best be placed in any particular situation’

- Capital Adequacy (Basel I): negotiated closely with banks, long delay to be introduced

Blunden: Chair of Basel Committee 1977

- ‘The banking system of a country is central to the management and efficiency of its economy; its supervision will inevitably be a jealously guarded national prerogative. Its subordination to an international authority is a highly unlikely development, which would require a degree of political commitment which neither exists nor is conceivable in the foreseeable future’
  - Has this changed?

Lurching to another crisis

- 1974 BoE tells banks to improve their internal systems: ‘our approach remains flexible, personal, progressive and participative’
- Sept 1974 IMF warns of looming sovereign debt crisis: identifies lack of information/CAR risks
- 1977 BoE urges banks to move out of long term sovereign lending to avoid ‘sudden freezing over of private international finance’
- 1977 Fed proposes central collection of data on international bank lending to enable risk assessment – rejected by banks
- 1978 consolidated country exposure of UK banks published
- May 1982 Basel Committee guidance for banks to consider for country-risk analysis – too late: Mexico defaults August 1982

Regulatory Generals Fight the Last War

- 1982 Sovereign Debt Crisis prompts Basel I 1988 (applied by 1992)
  - Emphasis on sovereign debt risk leaves system vulnerable
  - Still relies on national interpretation and implementation of guidelines
  - Pushes banks to off-balance sheet operations
- 1997 Asian Financial Crisis prompts Basel II 1999
  - 5 years to develop, more elaborate, not well suited to all systems (capital requirements, supervision, disclosure)
  - Delegation to rating agencies to calibrate capital adequacy
  - Residential property mortgages treated as A+/AA- rated
  - Discretion for local supervisors to interpret rules
  - Complexity delays implementation (expensive)
- 2008 Crisis: ‘Enhancements’ to Basel II (January 2009)
  - Trading book risk, securitisation, off-balance sheet exposure

Immediate Focus of Reform

- Distribute the burden
  - Taxpayer (industry bail-outs, fiscal stimulus)
  - Nationalising capital (but not control) of banks
  - Shift lending risk to government (loan guarantees etc.)
  - Savers, pensions bear brunt of QE
- Limiting Pro-cyclicality of Financial Markets
  - Graduated capital adequacy
  - Tobin-style ‘sand in the wheels’
  - Macro-prudential focus (challenge to policy sovereignty)
- Underlying structural causes (global imbalances)
  - Reform of IMS: 1970s, 1980s, 2009, 2017
  - Surveillance of spill-over effects

Why Does International Financial Regulation Keep Failing?

- Barriers to information flows (privacy, complexity, consolidation)
- Lack of commitment by national authorities to relinquish sovereignty
- National approach reinforced by the variety of institutional structures (political and legal as well as financial)
- Cooperative planning prompted by crisis but incentives for implementation recede as urgency eases
- Regulation is backward looking
- Financial innovation to evade constraints spreads quickly
  (can increase risky behaviour)
- All recognised in 1970s: WHAT HAS CHANGED?

What has Changed?

- Proliferation of overlapping agencies: (collecting or melting barriers?)
- Innovation/Diversion/Ring-Fencing: (shadow-banking, increased fragility?)
- Focus on SIFIs (is any bank too small to matter?)
- National focus of implementation
- Basel III:
  - CAR - Special focus on complex securitisation risks and leverage (the last war?)
  - Stress testing

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