The locus of financial regulation: home versus host[1]

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Abstract

If the G's are the world economy's steering committee, the step from G7 to G20 broadened the democratic legitimacy of this committee. But it has also been associated with a shift in influence towards a group that share little else than economic power: they have diverse experiences, challenges, cultural perspectives and starting points. This is particularly the case in the field of financial regulation. Reflecting this, the action in financial regulation action across these countries in recent months - despite all the language of global regulation - is increasingly local. The prospect of the new global being quite local has dismayed "internationalists". But it need not. This paper challenges the dichotomy of more global versus more local. It argues that financial internationalism - greater co-operation by nations for the benefit of all - is better served by institutions that help to integrate diverse systems than those which try to enforce one-size-fits-all approach to very different countries.

It is often forgotten that it was international banks that persuaded regulators of the benefit of global rules, applied by a single home country regulator, that tried to established a level playing field for banks. But the benefits accrued largely to the banks in the boom, and proved an avenue for contagion during the crash. Local regulation may prove a safer way to regulate financial systems, in particular by allowing regulation to be more responsive to national economic conditions and cycles. It is likely that a shift back to "host" from "home" country regulation will act as a drag on international capital flows. The instinct of economists is that the cost of this is uncertain, suspect and conditional - especially when compared to the attendant cost of financial crises.

Host country regulation does not mean no role for international institutions, like the newly minted Financial Stability Board. It suggests a more nuanced role, potentially encompassing the policing of international market infrastructure, financial protectionism, information free-flow between regulators and a convergence of regulatory principles and a consolidation of regulatory instruments. An informed, and collegiate process of integrating different financial systems will be a more resilient system than one that tries to enforce a single rule book across inherently different countries.

Introduction

From G7 to G20 and the FSB

New global governance arrangements were forged in the white heat of the 2007/8 financial crisis. Following the first G20 Leaders conference in November 2008, and the second in April 2009 and the creation of the G20's mirror image in regulation, the Financial Stability Board, the locus of international economic governance appeared to have slipped from G7 to G20.

[1] The ideas behind this article were developed through conversations with Andrew Baker, Mark Blyth, John Eatwell, Louis Pauly, Charles Goodhart, Eric Helleiner, Len Seabrooke, Andrew Schrumm and Paola Subacchi, many of which took place in Bellagio in March 2010.

A narrow assessment of the origins and displacement of the crisis would not automatically lead you to such a development. The brunt of the financial part of the financial crisis was confined to the United States and Europe, the core of G7, not G20. India and China felt the after-shock waves, but their banking systems were largely unaffected and their economies are now experiencing "V" shape recoveries while the G7 follow an "L". But like all financial crises there were many related issues that went beyond the geography of the immediate crisis[2]. There was the earlier food crisis and energy crises and the spectre of large global imbalances, largely between the US, on one side, and commodity and manufacturing producers on the other: Germany, China, Russia, Saudi Arabia and Brazil for instance.

There is the conspiracy story that the crisis was too big for the "old" powers to manage. They would need the "new" powers, to "bail" them out either through credits to the IMF or imports. Buying that bail out by distributing some power was a way. Locking the US's creditors into America's recovery plan, made a less painful recovery possible for Americans. There is also the "cock-up" theory: President Bush was not aware that G20 was a group of central bank and finance officials when he asked G20 political leaders to meet him in Washington. Human evolution was driven by random mutations, so maybe there should be room for some randomness in the evolution of international governance too. However it happened; it happened. G20 Leaders met, signed up to common commitments and communiqués, repeated the refrain that we need global responses to global problems, established the Financial Stability Board to oversee new global rules on financial regulation and entrusted other global issues to other bodies[3]. The numbers and words of global governance have changed, but what does this really add up to in terms of substance? Is, for example, financial regulation under the 60-strong FSB going to be any different than under the more exclusive Basle Committee?

Stretching the span of global governance from its North Westerly corner is every internationalists' dream, but in financial regulation the process has quickly come across an issue that internationalists did not generally foresee. Global leaders now cover a more diverse group of countries, economies, financial systems and cultures with a broader set of perspectives and starting points than before. G7 was narrowly homogenous; G20 is widely heterogeneous. The instinct of G7 leaders was that a single regulatory pray book is achievable and what was right for them was right for everyone else. G20 leaders do not share that instinct. Agreeing to a common approach to regulation, far less a common set of rules, is proving elusive, especially now that financial regulation has become so politicized.

Moreover, national electorates are less willing to accept a process determined by "others". I recall one finance minister remarking one day that the financial sector is a global industry and so we need global regulation and the next, that nobody abroad was going to tell them how to regulate their banks. In their minds, the global regulation G20 leaders queued up to sign, was not about being one of twenty voices in the development of a single set of rules, but the global acceptance of their own sensible rules. The US Senate Banking Bill on US Financial Regulation makes no nods to what the EU, China, India, Brazil and Russia are up to. Across a wide set of issues, from financial regulation, bankers pay, bank taxes and competition policy, national regulators are going down different avenues from their international colleagues. The differences may appear to be subtle and nuanced but are quite fundamental.

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[2] Reinhart, C., and Rogoff, K., "This Time Is Different: A Panoramic View of Eight Centuries of Financial Crises", NBER Working Paper No. 13882, March 2008.

[3] In the April 2009 meeting issues of tax transparency were sent to the OECD and the multilateral development banks were entrusted to support a "green" recovery.

Regional perspectives

In the US the belief in markets remains strong. The prevailing view amongst policy makers and academics is that the real problem was that institutions had become too big to fail and that if they were smaller, they could have been allowed to fail without large tax payer bail outs. In the words of the mid-Atlantic Governor of the Bank of England, Mervyn King, if "a bank is too big to fail, it is too big". Too big to fail, or TBTF as it has become known in the United States is at the core of the recent bills proposed by the Senate Banking Committee. An aside to this prevailing view is that the banks grew too big as a result of their ability to capture the regulators into thinking that big is beautiful[4]. In response to this view the focus of bi-partisan regulatory initiatives from Congress is to limit the size of financial institutions, limit their activities and improve winding up rules. Large banks are likely to face additional capital adequacy requirements. The oft mentioned "Volcker Rule", named after the report chaired by former Chairman of the Federal Reserve, Paul Volcker[5], is a modern day version of the Glass Steagal Act and tries to segment riskier trading activities from deposit and loan issuance institutions. In a similar pro-market vein, US policy makers also want to make sure market institutions are more robust and so there is much discussion of banning instruments that do not trade on exchanges or are not centrally cleared or settled. The US approach is to save the market system.

As a ratio of bank assets to home country tax revenues, the truly big banks are in Europe not the US. The assets of America's largest bank, Bank of America, is around 50% of national tax revenues. It is not surprising that the assets of UBS or Fortis are many times home country tax revenues but the assets of Barclay's, not Britain's largest bank, is over 200%. In Europe, the belief in markets, always a little fragile, has been dealt a body blow, and the prevailing view is that there should be tighter, more centralized, rule-based regulation and a focus on market failures such as the boom-bust cycle[6].

The notion of counter-cyclical capital charges has its greatest proponents in Europe - even though it is former Fed Governor Martin's words are most often used to describe it: "remove the punch bowl before the party gets going". At the heart of the notion of counter-cyclical capital charges is that crashes happen because markets get it wrong[7]. Similarly, Europe is concerned about banning speculation in certain economically sensitive products such as commodities, credits and limiting short-selling. The European approach at its most gentle is to reform the market and at its most brutal is to "turn off" the market in certain areas.

Asia is a more diverse region, but if there is a central view it is that it would be wrong to tinker too much with regulation. Under this view new global bank rules (Basle II) were only just

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[4] See, "Restraining Regulatory Capture? Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance", Andrew Baker, in this volume.

[5] Volcker, P., et al., "The Structure of Financial Supervision", Group of Thirty, 2009.

[6] Borio, C., and White, W., "Whither Monetary and Financial Stability: The Implications of Evolving Policy Regimes", BIS Working Paper, No. 147, February 2004, and, Borio, C., "Monetary and Financial Stability: So Close and Yet So Far", National Institute Economic Review, Vol. 192, No. 1, 84-101 (2005).

[7] Goodhart, C. A. E and Persaud, A. D., (2008, I) "How to avoid the next crash" Financial Times, January 30, 2008. Goodhart, C. A. E and Persaud, A. D., (2008, II) "A Party Poopers Guide to Financial Stability", Financial Times, June 5, 2008.

enforced and hardly implemented and as the crisis did not extend to Asia it suggests the blame rests less with new regulatory rules and more with US and European supervision.

It would be wrong to suggest that these fundamentally different perspectives did not also have some important areas of agreement. There is widespread agreement that leverage was too high and that as one of the few banking systems that did not collapse was the Canadian system where a leverage ratio was comprehensively applied, a leverage ratio would be a good idea. A leverage ratio of close to 20, to limit bank asset growth would likely get global buy-in today. Initiatives to strengthen market plumbing such as centralized clearing and settlement would have cross-regional support as will pressure to force more of the over-the counter derivatives market to exchange. But Europe will be reluctant to adopt the US emphasis on too big to fail, given the size of European banks, the US would be reluctant to adopt counter-cyclical capital charges, arguing that regulators are not there to second guess the market. Asia would be reluctant to adopt changes to Basle II after their painstaking adoption of the new rules.

A New Internationalism

These differences occur behind the scenes in the arcane world of technical advisors and regulators. However, differences have already surfaced in the politically charged area of bankers pay and competition policy. Despite a stronger convergence of belief, principle and intention, than exists in other areas, US, British, French and German politicians still decided to go their own way in dealing with limits to bankers pay and bonuses. This lays the ground for an increasingly national approach to regulation. The surface veneer is of global agreement and action, but underneath there is a shift towards more nationally derived decisions. This can be seen in the important debate on whether the lead regulator of an international bank should be its "Home" country regulator or its "Host" country regulator in each jurisdiction.

In the years running up to the crisis the locus of regulation shifted to the home country regulator, following global rules. Finance is sometimes described as "unfettered", but while there were significant gaps, the paradox is that it was also heavily regulated and was one of our most significant experiments in global regulation. More national decision-making as described above would arrest the trend of the past ten years and a return to the host country regulator being in the driving seat following national rules. "Internationalists" are dismayed at this prospect. But it is important to see this issue through other prisms than whether regulations are based around global or local rules. In the sections that follow we look at the role of regulatory capture in the evolution of home country regulation and we suggest that a better goal of internationalism would be to foster institutions that help integrate diversity, not impose a one-size-fits all.

Home versus Host: Why Home?

When the idea of home country regulation is questioned, the initial response from bankers and regulators is that "banking is global, so banking regulation must be global". But this is mostly poetry. Many industries with systemically important supply chains like food, copper, and oil are global, yet they are not regulated globally. When a more detailed response is forthcoming, the following issues tend to be raised.

First, it is argued that it would be a backward step to force banks to "subsidiaries": set up separately in each country with separate capital and assets. It would reduce capital flows. Capital-short countries would starve and capital rich countries would overheat. Investment would be constrained by national savings. Secondly, it is argued in a modest contradiction to the above, there would be regulatory arbitrage. Capital would flow to where regulations were permissive and away from where they were strict. Thirdly, it is argued that the “balkanization” of bank supervision would mean no one would have a good idea of the overall risk of the bank. Fourth, host country regulations are often an excuse for financial protectionsim. Countries clinging to host country regulation over the last decade like India tend to have very limited penentration by international banks. Fifth, often said sotto voce, it is arguably better for everyone to have Citigroup’s activities, say, in a small, developing country regulated by sophisticated and knowing (sic) regulators in New York than in where regulatory capacity is limited.

Examples of home country regulation are in emerging markets. The Baltic and Eastern European banking sectors that are regulated in large part by foreign regulators, in particular, Swedish and Austrian.

The experience of home country regulation

At first glance these arguments for home country regulation are persuasive and succeeded in persuading regulators over the past. However, the recent crisis has shed a different light on the workings of home country regulation. Having a single, minimum, capital adequacy requirement across countries with different stages of boom or bust creates perverse pressure on capital flows. In boom countries, capital adequacy levels are low relative to the apparent profit opportunities and increasing lending appears more profitable when it should appear more risky. In recession countries the single capital adequacy requirement makes lending unprofitable relative to other countries and so there is less lending where it is likely to be safe in the long-run. Single and fixed capital adequacy requirements are pro-cyclical[8]. Most lending mistakes are made in the boom. Where there is too much lending chasing a boom, who is best placed to see that and respond? If Swiss banks, for instance, are financing a property bubble in Hungary, is the Hungarian regulator better placed to respond, or the Swiss regulator who has better able to weigh up what the right amount of aggregate lending should be in Hungary. Bear in mind that the lending to Hungary carried out by our archetypical Swiss bank, may be important to Hungary, but not to the bank.

Different regulations in different countries or regions could lead to regulatory arbitrage, but this is not really a home-host issue, but one of control and enforcement. If all lending and borrowing activity that takes place in the country has to be carried out by nationally regulated entities, then excessive lending or borrowing, whether it is driven by regulatory arbitrage, profit opportunities or something else, could be controlled by the local regulator. Could regulators really stop cross-border lending and borrowing? Bankers and home country regulators like to portray the image that finance is immune from the laws of gravity and all other laws. But the law is not impotent, the problem with regulation is not that the regulations were flouted. If any activities were to take place outside nationally regulated entities, contracts could be made unenforceable. Back to our example, no Swiss lender would lend to a Hungarian borrower, if the borrower could ignore his obligations and have a Hungarian court declare it unenforceable.

One of the unintended consequences of home country regulation is what might be termed, regulatory arbitrage by regulators. When Lehman Brothers was on the verge of going bust, the US-based investment bank, watched by its home country regulator, pulled its capital back home, leaving its foreign branches and subsidiaries considerably short. This led the UK regulator and others to question whether we do not need a return to the ring fencing of capital and assets, or

[8] See, Brunnermeier, M., Crockett, A., Goodhart, C. A. E., Persaud, A. D., “The Fundamental Principles of Financial Regulation”, Geneva Report 11, ICMB/NBER, 2009.

mechanisms to achieve this, such as requiring international branches to become nationally regulated subsidiaries[9].

Far from being concerned about overseas over-reach undermining a bank back home, it appears that national regulators acted as global champions for the institutions in their jurisdictions and their jurisdictions as a whole[10]. Iceland is frequently fingered in this regard, with reason, but the most flagrant example must be the UK, which not only practiced “light touch” application of global rules, but shouted about it from the roof tops as a means to attract more financial sector business from other jurisdiction, notably the US. London’s role as the world’s pre-eminent financial centres owes much to its luring away businesses from existing centres, like hedge funds and Eurobond trading from the US.

A key driver of the return to greater host country regulation is the realization from this crisis that while “banks may be global in life; they are national in death[11]”. The bail outs have cost tax payers billions nationally and trillions globally. Perhaps the real cost is that domestic policy, social and welfare agendas have been derailed. Public deficits have risen to unseen levels in living memory and public debt levels have doubled.
Given that they bear the cost, national tax payers do not want to leave it up to someone else to do the regulation. As long as bail-outs are national, regulation will have a national character.

Regulatory capture

Given the logic of host country regulation, the question has to be asked, why did we move to home country regulation from host in the first place? Set against the problems of home country regulation for host countries, are the benefits to the banks. Setting up local subsidiaries with locally ring fenced capital and assets is considerably more expensive and inefficient than having a single regulator with single reporting and accounting and passing capital around the branches wherever it is needed most. Large international banks campaigned for home country regulation and within the general context of liberalization and globalization, were able to persuade bank Basle regulators that this was a good idea[12]. The spread of the first, financial part of the financial crisis was largely defined by those countries with home country regulation. Emerging markets with their largely host country regulation had been viewed as backward, but they proved largely immune from this part of the crisis.

Wouldn’t host country regulation with different capital adequacy regimes and ring-fenced capital lead to a sharp curtailment of global capital flows? Two responses to this come to mind. First this is likely. The height of globalization and global capital flows coincided with the lowering of regulatory borders and the aspiration of level playing fields. It would be natural to assume that cross border capital flows would fall in response to a rise in these regulatory boundaries. That said, while global capital flows to those countries that already have host country regulation – large emerging markets – are much smaller relative to developed countries with less regulatory barriers, they have grown at a strong pace.

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[9] Turner, Adair, “The Turner Review: A regulatory response to the banking crisis”, FSA, 2009.

[10] I first heard this point from Charles Goodhart
[11] Mervyn King, 2008.
[12] See, “Restraining Regulatory Capture? Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance”, Andrew Baker, in this volume.

Second, the China and India model where trade barriers have fallen more rapidly than capital barriers, and where capital flows are not banking flows, but FDI or private equity, appears to be a successful one for economic growth. Economists are certainly far less certain of the benefits of the free movement of capital compared to the free movement of trade[13]. This may be a big country story. There will be bigger challenges for smaller, countries less able to rely on local savings. These countries could well make a different choice than larger countries, looking to converge their regulatory regime more rapidly with other countries in order to promote more capital and banking flows. Small open economies already make different choices on exchange rate and trade regimes and so it should not be surprising if they make a different choice about capital regimes too.

The new internationalism and the FSB

Host country regulation does not mean an end to global co-operation and co-ordination. Different levels of intensity of global co-ordination would be possible across different areas under a host-country regulatory regime. There are a number of critical roles the Financial Stability Board can play, the G20's hand maiden in the field of financial regulation, and roles that it would find easier to play than the original Basle Committee of bank supervisors and regulators could play. Below, I set out four such roles of increasing intensity[14].

(1) Facilitating the free flow of information to support the national monitoring of internationally systemic developments, analyzing this information to provide lessons of good and bad practice, and potentially assessing performance versus certain international standards.

In this regard the FSB would be acting more like IOSCO - the international organization of security regulators - than the Committee of Bank Supervisors who meet at Basle.

(2) Policing financial protectionism through peer review.

The FSB with its greater democratic legitimacy could facilitate peer review of host country regulation to ensure that the regulation was not serving to discriminate against financial institutions by origin as opposed to activity. This function could be modeled on peer review in the WTO.

(3) Regulating market infrastructure whose reach goes beyond national boundaries such as commodity, foreign exchange and derivative markets.

The London Metal Exchange (LME) and Chicago Mercantile Exchange (CME) for example are regulated domestically, but they are global markets and if regulation of these markets contributes to misalignment and distortions in prices, it will have global impact. Wherever domestic consumer protection or local systemic risk is not the major issue, it may make sense for domestic regulators to pass on the regulation of, and cost of regulating these markets, to the FSB. This role would also facilitate the establishment of centralized clearing and settlement houses that are

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[13] Reinhart, C., and Rogoff, K., "This Time Is Different: A Panoramic View of Eight Centuries of Financial Crises", NBER Working Paper No. 13882, March 2008.

[14] For a more indepth study of alternative roles, see "What role for the new kid in town?", The Financial Stability Board and international standards". Eric Helleiner, Draft memo prepared for workshop "New Foundations for Global Governance", Princeton University, January 8-9, 2010.

critical to the plumbing of the global financial system, could be anywhere physically[15]. Having global markets regulated locally creates a social externality as local regulators would be incentivized to underinvest in global stability if that investment is being made in national "tax dollars".

(4) Promoting a convergence of principles and a consolidation of instruments that would maintain local control, but promote a transparency and predictability in regulation that would support more cross-border activity, entry and more competitive markets.

Host country regulation could end up like a close jungle of obtuse, local regulations where visibility is low and passage tough. In such an environment, entry would be slight, markets uncompetitive and comparisons hard. But it need not be so. At one extreme, host country regulation could mean the adoption of a single set of rules with national discretion on the value of key parameters. For example, minimum capital adequacy requirements could be estimated in a single, agreed, way, but different countries would be allowed to apply different, time varying multiples to that minimum. Or countries may apply different data standards on the principle of greater applicability. Under Basle II, one of the data standards is a minimum of seven years of data on defaults, but this data is both hard to get hold of and of far less relevance in a rapidly growing and transitioning economy than a moderately growing mature economy, some countries could specify a shorter or longer period.

While these four roles for the FSB are not slight, they do preclude the kind of level playing field that international banks want[16].

Europe is a special case

Europe is a special case. Tax payers remain national, but European politicians wants to enshrine a single financial space. Europe will try to behave like one single host country regulator, with a single systemic risk council and collective body of regulations with a stronger convergence of principle and instruments across Member States than otherwise[17]. The battle lines are drawn between those who want more Europe and those who want less. Perversely, in this situation, the "less Europe" option would actually do more to underpin the single European currency than the "more Europe option.

The challenge for European policy makers is that a single currency brings benefits but also the costs arising out of the rate that is set for the average economic conditions, but is too low or too high for some and there is not a sufficiently large and flexible central fiscal authority that could make the necessary offsetting adjustments. In the case of Ireland, Spain, Greece and Eastern Europe, euro-area interest rates were too low, helping to pump up local housing market bubbles. In this context, an additional policy instrument that operates at the national level will strengthen the integrity of the euro. But this greater national independence is automatically seen as implying less regionalism.

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[15] See, Clearing and Settlement in the EU, Alexander, Eatwell, Persaud and Reoch, DG INTERNAL POLICIES OF THE UNION, Policy Department Economic and Scientific Policy, (IP/A/ECON/IC/2009-001).

[16] See, "In Priase of the Unlevel Playing Field: The Warwick Commission of Financial Reform, 2009."

[17] See, The Jacques de Larosiere Report: The High Level Group on Financial Supervision in the EU, February 2009.

Conclusion

Broadening global governance to include the 20 largest economies or thereabouts has deepened the democratic legitimacy of the Gs. However, it has also been associated with a shift from a group of countries with common experiences and problems to a group with diverse experiences, challenges and starting points where there is less common ground. In these waters the previous trend of the adherence of globally agreed rules by single, "home" country regulators has run aground. Despite the language of global regulation, the action in financial regulation action is increasingly local. This has dismayed internationalists hoping for the crisis to lead to a strong set of comprehensive rules, applied and enforced globally. They already view the crisis as a "missed opportunity".

But the old dichotomy of global or local may be out-moded. Is "internationalism" about a one-size-fits-all approach to regulation, or about how to integrate diverse systems? Host country regulation may prove a safer way to regulate financial systems, in large part by allowing regulation to be more responsive to national economic conditions and cycles[18]. It will also prove more politically sustainable as long as the tax payers financing the bail outs are national.

Host country regulation does not mean no role for international institutions, but a more nuanced and diverse role. Certain part of the financial infrastructure such as some exchanges or central clearing and settlement institutions are global rather than local, and the Financial Stability Board could play an important and new role of global policeman for markets that do not have a national character. Host country regulation is vulnerable to abuse by local institutions wanting to be protected by obtuse local regulations that work against foreign The FSB could facilitate and discuss peer reviews of jurisdictions to reduce financial protectionism. Converging regulatory principles and consolidating regulatory instruments would help to make local markets more competitive and lower barriers to entry. At the extreme, countries could express their differences through different capital adequacy requirements rather than a raft of different instruments. The FSB should also be a source of great knowledge about financial sector developments, nationally and internationally. Information sharing does not sound very glamaorous, but it is important to note that the most frequent defence of regulators and bankers in this and every crisis is that "we did not know". Information and analysis will not stop financial crises, but it may help to arm those who are trying to do so.

An informed, and collegiate process of integrating different financial systems will be a more resilient system than a system with single rules being applied across different countries. In finance, systemic resilience requires a foundation of heterogeneity[19]. Sellers can only sell if there are buyers and vice versa. This heterogeneity will generate a richer set of examples and experiences to help inform policy makers around the world. The new international order may be more local than proponents hoped for, but that may not make it any worse, and may even make it a little better.

The benefit of more liberal capital flows were best extolled by international bank who benefitted from the notion of a level playing field for themselves, one that allowed them to hold small amounts of capital and move it around wherever it could be most profitably applied. It is highly

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[18] UN Commission of Experts on International Monetary, Financial Reform, Recommendations, UN, March 2009.
[19] Persaud, A., "Sending the herd off the cliff edge: the disturbing interaction between herding and market-sensitive risk management systems", First Prize, Jacques de Larosiere Award in Global Finance, IIF, 2000, Reprinted in BIS Papers, 2002.

likely that a shift back to host country regulation will act as a drag on international capital flows. The economic repercussions of this have to be examined in the cold light of day and set alongside the economic repercussions of highly contagious financial crashes. The evidence is far from conclusive. The instinct of economists is that we are more certain – rightly or wrongly – of the long-term economic benefits of openness in the goods sector, while the benefits of openness in the capital markets sector is more conditional, complex and suspect.

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The Empire Strikes Back

There are two remarkable aspects of the consensus around international financial regulation emerging in the run up to the November G20 meeting in Seoul. The first is that there is a consensus. International regulators are agreed that banks must set aside much more capital for risky assets; be less dependent on the whims of money markets; constrain the maturity mis-matches between their assets and liabilities and set aside capital for holding complex derivatives where there may be settlement and clearing risks. They also agree that capital adequacy should move counter to the economic cycle and that banks should not be "too big to fail". Getting an international consensus around action that is sensible - save for the emphasis on "too big to fail"- is no mean achievement.

The second is that despite appearing to be down and out, the banking lobby has struck back, successfully making the case that all of these initiatives should be postponed or phased-in between 2015 and 2019. By then the pressure for regulatory reform could be a distant memory. Financial regulation veterans will be experiencing déjà vu. In each of the last seven international financial crises, plans for a radical shake up of international regulatory or monetary arrangements made surprising progress, only to be tidied way and stuffed in the bottom drawer once the economy recovered. Many of the new initiatives being proposed today have been pulled out of that same drawer, dusted down and updated.

The argument that the banking system is too broken and the world economy too fragile, to support more onerous regulations, is seductive for politicians desperately trying to boost consumer demand. But it is suspect. It highlights that attempts to make banking regulation more counter-cyclical have not gone far enough. The point of counter-cyclicality is to loosen the constraints to lending in times of recession like today and to tighten them when growth and optimism have returned and the worse credit mistakes are being made. Counter-cyclicality needs to be at the heart of the new regulatory regime and not an optional extra. As Professor Charles Goodhart of the LSE and I have said before, crashes will not be avoided if we continue to feed the booms. The methodology of counter-cyclicality is complex and given that economic cycles are more national or regional than global, it makes for greater host country regulation and national ring fencing of bankers' operations. International banks do not like that. To counter they appeal to the right-sounding notion of level–playing fields.

The other problem of kicking regulatory initiatives into the long grass is that as long as the prospect of new profit-squeezing regulation is out there, uncertainty will limit the one thing everyone is agreed the banking system needs more of - capital from investors. It is one of those delicious fallacies of composition that what banks want individually is often not in their collective interests. I recall writing in October 2002, what the FT headline writers presciently captured as "Banks put themselves at risk in Basle".

Competitive finance is critical to the development of a robust and dynamic economy - locally and globally. But the lesson currently being repeated is that regulatory capture - subtle, sophisticated and seductive – has the power to stops us from developing a financial industry that serves the economy rather than the other way around.

Tackling regulatory capture head on is the better argument for limiting bank size. The notion that smaller institutions will make the financial system safer ignores history. The UK Secondary Banking Crisis of 1973-75, for example, had a bigger impact on property prices and the stock market than the current one. The principal avenue of financial contagion is the panic-stricken search for institutions that look similar to the one that has just failed. Moreover, a large number of small institutions doing the same dangerous thing is as toxic, if not more so, than a small number of large institutions engaged in the same activity. But smaller institutions invest less in political lobbying. A politically less powerful financial system has a better chance of being reassuringly boring.

The way to make the financial system safer is to break up institutions not by the porous boundaries of “narrow” and “wholesale” banking, but by the more fundamental boundaries of risk capacity. To create systemic resilience we need a systemic approach to capital adequacy requirements across the entire financial system, one that pushes different financial risks to wherever across the entire financial there is greater capacity for those different risks.

This is simpler than it sounds. There are three major types of risk, credit risk, market risk and liquidity risk. Their differences can be found by the different ways in which these risks can be hedged or absorbed. The capacity to absorb liquidity risk comes from having time to sell an asset because, liabilities, like promises to pay a pension in twenty years, are long-term. The capacity to absorb credit risk comes from having access to a wide rage of uncorrelated credit risks to pool together, like a loan to an international oil company and another to a local wind farm. A financial system in which liquidity risks were held by young pension funds because of the capital required to set aside maturity mismatches, and credit risks by large consumer banks, because of the capital required to set aside for concentrated credit risks, would be far safer than one with twice the amount of capital but where the banks fund illiquid private equity investments and pension funds hold credit derivatives because regulators and accountants treated risk as if all that mattered was price volatility not risk capacity. Limiting risk taking to risk capacity would limit the size of banking institutions. It would create opportunities for new players with different risk capacities. But the odds of a systemic approach to systemic risk appear slim. Its politics stupid!

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Avinash Persaud, Biography

Avinash Persaud’s career spans finance, policy and academia. He was formerly a senior executive at investment banks J. P. Morgan, UBS, State Street and the alternative asset managers, GAM. He was a top ranked analyst for ten years and is known for the development of risk appetite indices and EMU Calculators. He was elected, director of the Global Association of Risk Professionals. He is chair of the regulatory committee of the UN High Level Task Force on the financial crisis, Co-Chair of the OECD EmNet, a Member of the Pew, US Congressional Task Force, a Non-Executive Director of the UK Treasury’s Audit Committee and an External Member of the FSA’s Policy Board. He is Emeritus Professor of Gresham College, a senior Fellow of CaPRI, a visiting fellow of CFAP, University of Cambridge. He is a Governor of the London School of Economics and a Member of Council, Royal Economics Society. He is the 2010, President of the British Academy, Section F (Economics).