Intersections in Financial Regulation After The Crisis?

Caroline Bradley[*]

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The financial crisis required some rethinking of financial regulation, and the Dodd-Frank Act is one very complex product of such re-thinking. The rethinking of financial regulation has been occurring in countries around the world and in transnational organizations. It is an ongoing project: many commentators suggest that the ways in which domestic legislatures and transnational organizations have reacted to the crisis are the first, but not the final, steps in the development of appropriate regulation.[1] Others, provocatively, suggest the need for a radical rethinking of financial regulation. For example, Andrew Haldane of the Bank of England recently said:

> As a thought experiment, imagine .. we were designing a regulatory framework from scratch. Finance is a classic complex, adaptive system. What properties would a complex, adaptive system such as finance ideally exhibit to best insure about future crises? Simplicity is one. There is a key lesson, here, from the literature on complex systems. Faced with complexity, the temptation is to seek complex control devices. In fact, complex systems typically call for simple control rules. [2]

Haldane is clearly right about the first part: finance is a complex system, and the regulations that are meant to control finance are also complex. Financial regulation was complex before the financial crisis and it is no less so today (and part of the complexity is that we do not yet know the details of the arrangements that will be put into place under the Dodd-Frank Act in the US and in other jurisdictions). We are not moving in the direction of Haldane's proposed solution, but perhaps we should be.

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[*] Professor of Law, University of Miami School of Law, PO Box 248087, Coral Gables, FL, 33124, cbradley@law.miami.edu ; http://blenderlaw.umlaw.net/ . © Caroline Bradley 2011. All rights reserved.

[1] *See, e.g.*, Governor Daniel K. Tarullo, Regulating Systemic Risk, Speech at the 2011 Credit Markets Symposium, Charlotte, North Carolina (Mar. 31, 2011) at http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm (discussing "the relative lack of reform directed at the shadow banking system").

[2] Andrew G Haldane, Capital Discipline, based on a speech given at the American Economic Association, Denver (Jan. 9, 2011) at http://www.bankofengland.co.uk/publications/speeches/2011/speech484.pdf ("

I characterize financial regulation[3] as a series of intersecting spheres: between governmental and non-governmental or private spheres; between the spheres of expertise and of politics; and between the domestic and foreign or international spheres. These spheres are interconnected: governmental authorities work together across territorial borders, there is some overlap between the private sphere and the sphere of expertise, and the market-based sphere of expertise is transnational, rather than being entirely domestic. These different sets of interconnections make achieving simpler financial regulation more difficult.

The following sections of the presentation will examine these three sets of intersection in the context of the financial crisis

Domestic and Foreign or Transnational Regulation

The financial crisis prompted governments of the G20 to commit to increased co-ordination of financial market regulation,[4] to developing new structures to control systemic risks,[5] to reviewing existing harmonized standards,[6] and to introducing new harmonized

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[3] Although financial regulation in the US and at the transnational level makes functional distinctions between the regulation of securities, banking and insurance business .

[4] *See, e.g.*, G20, Declaration on Strengthening the Financial System, London (Apr. 2, 2009) at http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf. *Cf.* Elliott Posner, Making Rules for Global Finance: Transatlantic Regulatory Cooperation at the Turn of the Millennium, 63 Int'l Org. 665, 669 (2009) (describing an institutionalization of transnational co-operation in financial regulation after 2002).

[5] G20, Declaration on Strengthening the Financial System, *supra* note 4, at 1 ("We have agreed that the Financial Stability Forum should be expanded, given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity as the Financial Stability Board (FSB).")

[6] *See, e.g.*, BIS, Basel Committee on Banking Supervision, Consultative Document, Proposed Enhancements to the Basel II Framework, 1 (Jan. 2009) *available at* http://www.bis.org/publ/bcbs150.pdf ("The Basel Committee has finalised its proposals for enhancing the Basel II framework in the area of securitisation and more specifically for dealing with resecuritisations. These enhancements are intended to strengthen the framework and respond to lessons learned from the financial crisis.")

regulatory standards.[7] The new structures for the control of systemic risks involved the transformation of the Financial Stability Forum, which was established during the Asian Financial Crisis in 1999, into the Financial Stability Board ("FSB"),[8] and the European Union established a European Systemic Risk Board..[9]

The members of the G20 agreed to submit to peer reviews of their implementation of transnational standards of financial regulation,[10] and the FSB has already published some of these reviews.[11] The FSB has recently also published a more general review of progress in implementing the G20 recommendations, noting that:

> Despite significant progress to date on global policy developments, there is much to be done before a more resilient financial system has been secured. The policies that have been agreed need to be implemented consistently across jurisdictions. Recognising that regulations must be nationally appropriate, they also will need to be internationally consistent. As experience shows, in a financially globalised world, uneven regulations across borders will inevitably lead to regulatory

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[7] *See, e.g.*, *id.* at 2 ("once recovery is assured, prudential regulatory standards should be strengthened. Buffers above regulatory minima should be increased and the quality of capital should be enhanced. Guidelines for harmonisation of the definition of capital should be produced by end 2009. The BCBS should review minimum levels of capital and develop recommendations in 2010")

[8] *See* http://www.financialstabilityboard.org/about/history.htm. In addition to these transnational initiatives to manage financial stability states established bodies with responsibilities for ensuring financial stability. For example the US set up the Financial Stability Oversight Council. *See* http://www.treasury.gov/initiatives/Pages/FSOC-index.aspx .

[9] *See* Regulation (EU) No 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board OJ No. L 331/1 (Dec. 15, 2010), and see generally http://www.esrb.europa.eu ..

[10] *See* Financial Stability Board, FSB Framework for Strengthening Adherence to International Standards (Jan. 9, 2010) at http://www.financialstabilityboard.org/publications/r_100109a.pdf.

[11] *See, e.g.*, Financial Stability Board, Country Review of Mexico: Peer Review Report (Sep. 23, 2010) at http://www.financialstabilityboard.org/publications/r_100927.pdf; Financial Stability Board, Peer Review of Italy: Review Report (Jan. 27, 2011) at http://www.financialstabilityboard.org/publications/r_110207b.pdf.

arbitrage and defeat of our common regulatory objectives.[12]

These peer reviews under the auspices of the FSB are an intensification of the reviews the IMF and World Bank have carried out under their ROSC and FSAP programs.[13] Generally the crisis has led to a more intense co-operation between domestic regulators through the transnational networks, such as the Basel Committee on Banking Supervision and IOSCO, that co-ordinate financial regulation.

The IMF responded to the G20 declarations with an assessment of how it could help with the peer review (or mutual assessment) process.[14] As a formal matter, the IMF stated that its role would constitute "technical advice" rather than "surveillance", but that:

> Even though the envisaged G-20 assessment process constitutes technical advice, it could be used to inform surveillance, in that the information obtained and the analysis undertaken could be used as inputs for bilateral and multilateral surveillance. [15]

The Basel Committee published new standards for capital adequacy, known as Basel III, in December 2010.[16] The new standards attempt to patch the weaknesses of the prior capital adequacy accords, insisting, for example, that banks must have a high quality capital base,[17] and

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[12] Financial Stability Board, Progress since the Washington Summit in the Implementation of the G20 Recommendations for Strengthening Financial Stability, p.2, Report of the Financial Stability Board to G20 Leaders (Nov. 8, 2010) at http://www.financialstabilityboard.org/publications/r_101111b.pdf.

[13] *See, e.g.*, The World Bank, Reports on the Observance of Standards and Codes (ROSC), Overview of the ROSC Accounting and Auditing Program (Jan. 2004) at http://www.worldbank.org/ifa/rosc_aa_overview.pdf , IMF, Financial Sector Assessment, A Handbook (Sept. 29, 2005) at http://www.imf.org/external/pubs/ft/fsa/eng/index.htm.

[14] IMF, The G-20 Mutual Assessment Process and the Role of the Fund (Dec. 2, 2009) at http://www.imf.org/external/np/pp/eng/2009/120209a.pdf .

[15] *Id.*

[16] Basel Committee on Banking Supervision, Basel III: a Global Regulatory Framework for More Resilient Banks and Banking Systems (Dec. 2010) at http://www.bis.org/publ/bcbs189.pdf .

[17] *Id.* at 2 ("The crisis demonstrated that credit losses and writedowns come out of retained earnings, which is part of banks' tangible common equity base. It also revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would

introducing a new leverage requirement. Basel III's requirements as to banks' capital base are designed to be more restrictive than the earlier capital accords, and these new restrictive standards are reinforced as far as the G20 nations are concerned by their public commitments to submit to peer review. This combination of more restrictive rules and more coercive (although still soft) procedures for encouraging conformity is a significant change in the transnational financial standards regime.

At the same time, the new Basel rules are not perfect: the process for developing them was a slow one, and they will take a long time to implement. The standards are not as ambitious as they might have been, nut at the same time financial firms use them as an example of excessive interference with the business of banking. Capital adequacy regulation is difficult: concrete rules (Basel I) invite gaming and may limit the provision of credit in undesirable ways and a more flexible self-regulatory approach (for example aspects of Basel II) risk encouraging excessively risky behavior. Andrew Haldane predicts that Basel II will prove to be inadequate.[18]

As the role of the transnational standard-setters is changing, so that the standards leave less discretion in implementation to domestic policy-makers and peer review processes reinforce the constraints of the standards, the bodies seek to enhance their perceived legitimacy by expanding membership,[19] and by emphasizing consultation as a component of their work.[20] Nevertheless, the development of meaningful supranational standards for financial regulation has been dominated by the developed economies. The processes for developing supranational standards of financial regulation are not inclusive, and tend to privilege the wealthiest countries. Although the Basel Committee's recent expansion of its membership shows some sensitivity to this issue, it is still a very select group. From its inception in 1974 until very recently the

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have enabled the market to fully assess and compare the quality of capital between institutions.")

[18] Haldane, *supra* note 2.

[19] See BIS, Press Release, The Basel Committee Broadens its Membership (Jun. 10, 2009) available at http://www.bis.org/press/p090610.htm (announcing invitation to join the Committee to Argentina, Indonesia, Saudi Arabia, South Africa, Turkey, Hong Kong and Singapore); BIS, Press Release, Expansion of Membership Announced by the Basel Committee (Mar. 13, 2009) available at http://www.bis.org/press/p090313.htm (announcing invitation to join the Committee to Australia, Brazil, China, India, Korea, Mexico and Russia).

[20] *See, e.g.*, Caroline Bradley, *Consultation and Legitimacy in Transnational Standard-Setting* (forthcoming MINN. J. INT'L L (2011)).

membership of the Basel Committee on Banking Supervision included only the G10 countries:[21] Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden the United Kingdom, and the United States. The 2009 membership expansion was significant, and occurred as the IMF was recognizing a need to be more inclusive,[22] but it is still too early to tell whether the wealthiest countries will be less privileged as a result.

In addition to the development of new transnational standards and procedures for ensuring compliance with these standards it is also necessary to note that financial regulation develops through the interaction of different domestic and regional regimes. The EU and the US host significant financial activity and the US Congress and regulators and the EU and its new financial regulatory bodies have been engaged in separate processes for changing financial regulation since the onset of the crisis. But because market participants operate across borders they encourage policy-makers to pay attention to the how other jurisdictions are regulating financial activity. Before the financial crisis commentators on EU proposals for new rules of financial regulation frequently urged the EU not to regulate more harshly than the US,[23] and these arguments have survived the financial crisis. Indeed, in the aftermath of the financial crisis, some trade associations seem to believe that the risk of independent and different regulation of financial activity in different jurisdictions has increased.[24]

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[21]*See* http://www.bis.org/bcbs/history.htm .

[22] *See, e.g.*, IMF Executive Board Discusses Governance Reform, Public Information Notice (PIN) No. 09/98 (Aug. 4, 2009) at http://www.imf.org/external/np/sec/pn/2009/pn0998.htm .

[23] With respect to consultation on financial regulation before the crisis I discussed this idea in Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., MULTILEVEL REGULATION AND THE EU: THE INTERPLAY BETWEEN GLOBAL, EUROPEAN AND NATIONAL NORMATIVE PROCESSES (2008).

[24] *See, e.g.*, AFME & SIFMA, Reinvigorating Open Trade in Financial Services (Mar. 31, 2011) at http://www.afme.eu/AFME/Home/Trade%20in%20Financial%20Services.pdf ("some regulatory reform efforts and trade policy discussions suggest that a need for "de-globalization" or "dis-integration" of financial markets is the right conclusion to draw from the financial crisis. This is sometimes driven by the perception that open markets in financial services were a contributor to the crisis.")

Expertise and Politics in Regulation

For much of the time financial regulation seems to be a matter for technocrats rather than for citizen involvement. Some issues in financial regulation, especially those which clearly affect the interests of consumers of financial services, attract attention from citizens,[25] but others do not. Scandals and crises tend to shift issues of financial regulation into the realm of politics. During the financial crisis politicians, regulators and private sector groups recognized that citizen-voters were offended by the fact that bankers, who were seen as having caused the crisis and whose institutions were bailed out by taxpayers, nevertheless had contractual rights to large bonuses while non-bankers suffered increased rates of mortgage foreclosure and unemployment.[26] Market and regulatory failures in the financial markets[27] were acknowledged to

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[25] *See, e.g.*, Debit Interchange Rule Delayed (Mar. 31, 2011) at http://financialreform.wolterskluwerlb.com/2011/03/debit-interchange-rule-delayed.html (Noting more than 11,000 comments on .a proposed rule).

[26] *See, e.g.*, Productivity Commission, Executive Remuneration in Australia, Productivity Commission Inquiry Report No. 49, xv (Dec. 19, 2009) *available at* http://www.pc.gov.au/__data/assets/pdf_file/0008/93590/executive-remuneration-report.pdf ("A catalyst for this inquiry was concern that executive pay had got out of hand. This perception was fuelled by practices in financial institutions abroad that were seen as a key contributor to the global financial crisis (GFC). Further, while local shareholder value plummeted in 2008 as a result of that imported crisis — with some companies and sectors being propped up by taxpayers — executive pay seemed to emerge unscathed, crystallising a view that executives were being rewarded for failure (after having been rewarded for success)."); FSA, Reforming Remuneration Practices in Financial Services, CP 09/10 (Mar. 2009) at http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf ; The Conference Board, The Conference Board Task Forceon Executive Compensation (Sep. 2009) at http://www.conference-board.org/pdf_free/ExecCompensation2009.pdf.

[27] *See, e.g.*, Financial Services Authority, The Turner Review: a Regulatory Response to the Global Banking Crisis, 22 (Mar. 2009) *at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf (identifying excessive reliance on particular risk management techniques as a factor contributing to the crisis :"Central to many of the techniques was the concept of Value-at-Risk (VAR), enabling inferences about forward-looking risk to be drawn from the observation of past patterns of price movement. This technique, developed in the early 1990s, was not only accepted as standard across the industry, but adopted by regulators as the basis for calculating trading risk and required capital, (being incorporated for instance within the European Capital Adequacy Directive)").

have imposed externalities on those outside the financial markets.[28] These developments led to some debates about the extent to which the financial markets provide value to the real economy.[29]

Debates about financial regulation were largely channeled into discussions of the technical details of how to go about implementing reforms. The large number of rule-making and reporting projects initiated by statutes like the Dodd-Frank Act means that the discussions are not merely technical, but overwhelmingly numerous. Moreover, as the financial crisis required bailouts of financial institutions and turned into recession governments began to limit their spending and to introduce austerity measures.[30] Although weaknesses in financial regulation contributed to the financial crisis and thus played a role in the implementation of public sector cuts, public discussions, and even protests, focused on the immediate need to challenge (or

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[28] *See, e.g.*, Financial Crisis Inquiry Commission, Preliminary Staff Report, Shadow Banking and the Financial Crisis, 41 (May 4, 2010) ("..many financial firms were crippled, and some only survived with substantial government assistance. Their capital was depleted and many of their revenue channels were extinguished or impaired by the decline in financial activity. This condition severely restricted their capacity to provide funding to consumers, businesses, and governments, reinforcing reductions in real economic activity around the world and magnifying the ensuing recession.")

[29] *See, e.g.*, Adair Turner, What Do Banks Do, What Should They Do and What Public Policies Are Needed to Ensure Best Results for the Real Economy? Speech, CASS Business School (Mar. 17, 2010) at http://www.fsa.gov.uk/pubs/speeches/at_17mar10.pdf . *Cf.* SOMO, EU Financial Reforms Newsletter (April 2010) at http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/april_2010/view ("The financial sector has the potential to serve the real economy, to improve sustainability and to help people in need, for instance, through credit and investments. However, recent financial crises have shown that the financial industry primarily serves itself. The financial sector has become so powerful that some say we "live in financial times". It is therefore important to seize the momentum of the ongoing financial reforms to truly transform the financial sector so it serves the real economy, the environment and the interests of the most vulnerable within Europe and especially within developing countries. ")

[30] *See, e.g.*, Public sector cuts: where they will hit, The Guardian (Mar. 25, 2011) at http://www.guardian.co.uk/society/2011/mar/25/public-sector-cuts-where-will-they-hit?intcmp=239.

support) the cuts, rather than on financial regulation.[31]

Governmental and Non-Governmental Involvement in Regulation

Before the crisis financial firms had considerable success in persuading governments and the networks of regulators to defer to a large extent to the expertise of the private sector. When the crisis hit, the idea of self-regulation seemed suddenly less attractive. For example, in late 2008 Christopher Cox, then Chairman of the SEC, said that it had become "abundantly clear that voluntary regulation does not work".[32]

Basel II allowed regulators to permit sophisticated banks to use their own models for credit risk.. Adair Turner has argued forcefully that everyone put too much faith in these models:

> Mathematical sophistication ended up not containing risk, but providing false assurance that other prima facie indicators of increasing risk (e.g. rapid credit extension and balance sheet growth) could be safely ignored. [33]

The crisis disturbed the complacency with which policy-makers viewed self-regulation in the financial markets. But the private sector reacted by developing new self-regulatory principles and practices. Industry groups have focused on the securitization process, for example by

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[31] *See, e.g.*, TUC, Moving from austerity to prosperity, the TUC's case for an economic alternative to spending cuts (Apr. 6, 2011) at http://www.tuc.org.uk/mediacentre/tuc-19453-f0.cfm. See also the list of campaigns against the cuts at http://falseeconomy.org.uk/campaigns/uk/all/t1.

[32] Sec. & Exch. Comm'n, Press Release, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008) *available at* http://www.sec.gov/news/press/2008/2008-230.htm . See also, e.g., Sec. & Exch. Comm'n, Office of Inspector General, SEC's Oversight of Bear Stearns and Related Entities: Consolidated-Supervised Entity Program, Report No. 446-A (Sept 25, 2008) *available at* http://www.sec.gov/about/oig/audit/2008/446-a.pdf . Contrast Chairman Cox' statement with the SEC's July 2008 New Guidance Release on SRO rule filings, expanding the range of SRO rule changes which would become immediately effective and stating that "Self-regulation, with oversight by the Commission, is a basic premise of the Exchange Act." Sec. & Exch. Comm'n, Commission Guidance and Amendment to the Rules Relating to Organization and Program Management Concerning Proposed Rule Changes Filed by Self-Regulatory Organizations, 73 Fed. Reg. 40144, 40144 (Jul. 11, 2008).

[33] Financial Services Authority, The Turner Review, supra note 27, at 22.

developing guidelines for limiting reliance on credit ratings,[34] and addressing issues of transparency.[35] ISDA, the International Swaps and Derivatives Association, has developed protocols for novations of credit derivatives and interest rate transactions to address backlogs.[36]

Industry groups have actively negotiated and lobbied over changes to the financial regulatory structure and rules. They have done so with the knowledge that circumstances have changed, and earlier habits of deference to industry views have been disrupted. For example, SIFMA - the Securities Industry and Financial Markets Association - a trade group formed after the merger of the Securities Industry Association and the Bond Market Association, submitted a 71 page response to the SEC's proposals for new regulations on issues of asset backed securities.[37] The response included this passage:

> SIFMA's members have directly experienced the pain of the recent financial crisis and the collapse of the structured finance markets, and are acutely sensitive to what is at stake as both government and the private sector work to rebuild these vital markets. There is a long way to go.

Trade associations like SIFMA and ISDA lobby and negotiate not just with US based regulators and politicians but also with regulators and legislators in other jurisdictions and with the European Commission and the Basel Committee. That they do so is important, because they are in a position to exert influence on the development of rules of financial regulation at all levels: they negotiate about the development of high level principles at the supranational level and again when the principles are implemented within domestic legal systems either during the legislative process or in the administrative rule-making process or sometimes both.

There are other illustrations of the complex relationship between government and non-governmental interests that relate to regulation. The IMF has focused on capital inflows into

[34] European Fund and Asset Management Association, European Securitisation Forum & Investment Management Association, Asset Management Industry Guidelines to Address Over-Reliance upon Ratings (Dec. 11, 2008).

[35] *See, e.g.*, Industry Initiatives to Increase Transparency: Issuer and Investor Transparency Initiatives (June 2008) at http://www.europeansecuritisation.com/Communications/Archive/Current/Issuer%20and%20Investor%20Transparency%20Initiatives.pdf.

[36] *See* http://www.isda.org/isdanovationprotII/isdanovationprotII.html.

[37] SIFMA, Re: Asset-Backed Securities, Release Nos. 33-9117; 34-61858; File No. S7-08-10 (Aug. 2, 2010).

emerging markets as a source of potential future instability.[38] In the middle of a sovereign debt crisis the European Commission proposed additional regulation of credit rating agencies whose re-ratings of sovereigns are seen by some as partly responsible for the sovereigns' problems. But reactions to these new proposals have been mixed.[39]

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[38] International Monetary Fund, Recent Experiences in Managing Capital Inflows — Cross-Cutting Themes and Possible Policy Framework (Feb. 14, 2011) at http://www.imf.org/external/np/pp/eng/2011/021411a.pdf .

[39] Commission Warned on Credit Rating Agencies Shake-up, Eur-Activ (Apr. 6, 2011) at http://www.euractiv.com/en/euro-finance/commission-warned-credit-rating-agencies-shake-news-503833.