New Rules of the Road

BY KLAUS C. ENGELEN

A behind-the-scenes look at the U.S.-European struggle over financial regulation.

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President Barack Obama gave some encouraging signals ahead of the second Group of Twenty financial summit in London on April 2. Ahead of this meeting to begin repairing the shattered global financial system, he said, "We can no longer sustain twenty-first century markets with twentieth-century regulation." Obama has pressed key lawmakers to overhaul the nation's financial regulatory system to restore "accountability, transparency, and trust in our financial markets." And he has used a term that is ringing especially loudly in some German ears: "Let me be clear: The choice we face is not between some oppressive government-run economy and a chaotic and unforgiving capitalism. Rather, strong financial markets require clear rules of the road, not to hinder financial institutions, but to protect consumers and investors, and ultimately to keep those financial institutions strong."

Clear rules of the road! The new U.S. president is using the semi-official German code words for a far-reaching new framework to reform the global financial system. But the "rules of the road" that Obama brought to the G20 London meeting edge much closer to what Wall Street's battered financial industry and its still-influential political allies in Congress consider acceptable than what the Europeans—especially the Germans and the French—have in mind when talking about new "rules of the road" on global financial markets.

Under the heading "Europe's New Rules of the Road," an expert group of Germany's Social Democratic Party put forward a fourteen-point agenda to fix global

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finance. (See "Barely Contained Outrage: What Europeans Really Think About America's Regulatory Blunders" in the Fall 2008 issue of *TIE*.) Using this repair list as a guidance, German finance minister Peer Steinbrück, who chaired the group, has been working hard to get broader backing for a set of rules reflecting the lessons learned from the financial crisis that has wreaked havoc on Germany. The proposals include increased liquidity and capital reserves for financial institutions, a ban on detrimental short selling, regulation of hedge funds and private equity funds, and more transparency from sovereign wealth funds.

This global finance reform list developed by the SPD grand coalition partners is not far apart from the proposals that German Chancellor Angela Merkel presented when she hosted the Group of Eight summit in Heiligendamm in the summer of 2007. So it doesn't come as a surprise that Merkel has been accusing both Britain and the United States of "failing … to heed her repeated warnings over the need to control hedge funds and other under-regulated sectors of the financial industry." Since then, stricter regulation for hedge funds and other pools of private capital, credit rating agencies, and offshore financial centers remains high on Merkel's repair list for global financial markets.

This became apparent at the gathering of European leaders that she hosted in Berlin on February 22 in order to hammer out a joint European position for the coming world financial summit in London. There was agreement on far-reaching reforms in core sectors of the Anglo-Saxon–dominated global financial industry. Perhaps as a *quid pro quo* for German support of a doubling of IMF financial resources, the British are now joining the French and Germans in a renewed effort to move against "uncooperative jurisdictions," meaning drying up tax havens and reining in offshore financial centers. With French President Nicolas Sarkozy on her side, Merkel has been able to get the G20's European heads of government and their finance ministers to agree on several points:

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- "[A]ll financial markets, products, and participants—including hedge funds and other private pools of capital which may pose a systematic risk—must be subjected to appropriate oversight or regulation." In Merkel's own words, "We want to make sure that in future there will be no blind spots on the world map when it comes to financial market products, market participants, and instruments."
- The year-long fight of some EU governments against under-regulated and non-transparent offshore financial centers and tax havens has to bring concrete results. As Merkel puts it, European leaders are now in agreement on "a list of uncooperative jurisdictions, and a toolbox of sanctions must be devised as soon as possible." Sanctions would cover "non-cooperation in exchanging information on tax evasion with other countries."
- The European Union will speed up providing the legal framework to regulate credit rating agencies.

Some of those high-priority reforms are already underway at the EU level. In November of last year, the EU Commission put forward a proposal for regulation of credit rating agencies. This proposal is part of a package of reforms dealing with the financial crisis that also includes proposals on solvency, capital

The proposal of a "global risk map" would in particular help to make the financial exposure of banks and other market participants transparent.

requirements, deposit guarantees, and accounting. "The new rules are designed to ensure high-quality credit ratings which are not tainted by the conflicts of interest inherent to the ratings business." Introducing the new regulation, Internal Markets Commissioner Charlie McCreevy said, "I want Europe to adopt a leading role in this area. Our proposal goes further than the rules which apply in other jurisdictions. These very exacting rules are necessary to restore the confidence of the market in the rating business in the European Union."

In presenting new legislation for credit rating agencies, the EU Commission is putting up high hurdles for those seven credit rating agencies—among them Standard & Poor's, Moody's, and Fitch—that are registered as Nationally Recognized Statistical Rating Organizations by the U.S. Securities and Exchange Commission.

The proposed new European rules for credit rating agencies include banning the agencies from providing advisory services, requiring sufficient quality information on financial instruments before releasing any rating, and publishing annual transparency reports.

A long-time proponent of free markets, McCreevy wants credit rating agencies to register to operate in the 27-nation European Union and undergo day-to-day supervision and regular inspections. He has blamed the agencies for failing to "sniff out the rot" in securitized products—in particular subprime mortgage securities in the United States that collapsed in value amid home loan defaults despite triple-A ratings. Under the terms of McCreevy's proposal, registration and supervision would be done jointly by national regulators and the Committee of European Securities Regulators—all national regulators of securities markets in the European Union. The European parliament and EU governments are still in the process of making up their minds. So far, the issue of whether the Committee of European Securities Regulators should oversee credit rating agencies or whether national authorities should also be involved is not yet resolved. Some EU member countries fear a loss of influence if the regulation is only on the EU level. The proposal also raises, for the United States, crucial issues of "extraterritorial" impact.

Also, by April of this year, McCreevy will bring forward "an appropriate legislative initiative for closer direct regulation and supervisory oversight of hedge funds and private equity." In troubled times, argues McCreevy, "hedge fund trading has not always been the stabilizing force that we expected … investor redemptions and tighter leverage have led to forced selling of assets."

But addressing an EC conference on February 26, McCreevy reminded European politicians not to use hedge funds and private equity as easy scapegoats. "Before we rush out to point the finger of blame, we should not forget that hedge funds and private equity have not been central to the crisis, and it is not just me that says so."

McCreevy then quotes from the report of the High-Level Group on Financial Supervision in the European Union, commissioned by EC President José Manuel

Peer Steinbrück's Proposed New "Rules of the Road"

- Increase liquidity and capital reserves for financial institutions.
- Tighten accounting obligations for financial institutions.
- Establish a minimum 20 percent retention for securitizations.
- Ban detrimental short selling.
- Change incentive and remuneration schemes.
- Make those responsible personally liable.
- Strengthen European supervision.
- Improve ratings.
- Give the IMF a new core role.
- Strictly regulate hedge funds and private equity funds.
- Demand more transparency from sovereign-wealth funds.
- Strengthen participation rights for employees.
- Plug the tax haven gap.
- Preserve Germany's three-pillar banking model, consolidate the Landesbanken sector.

Barroso in October of last year and released the day before the conference. Chaired by Jacques de Larosière, former head of the International Monetary Fund and governor of the Bank of France, the report states with respect to hedge funds that "they did not play a major role in the emergence of the crisis. Their role has largely been limited to a transmission function, notably through massive selling of shares and short-selling transactions. We should also recognize that in the European Union, unlike the United States, the bulk of hedge fund managers are registered and subject to information requirements. This is the case in particular in the United Kingdom, where the largest thirty hedge funds are subject to direct information requirements often obtained on a global basis as well as to indirect monitoring via the prime brokers."

Leaving aside such targets for more regulation and oversight as hedge funds, tax havens, and credit rating agencies, there were two other specifically German proposals coming out of the preparatory Berlin meeting for consideration at the London G20 summit.

First, the German side repackaged older proposals for an "international credit register" into the much broader new concept of improving the collection of data on financial markets by creating a "global risk map" on financial assets. This would very much improve market transparency and thus could mitigate future risks. (See "A New Financial Architecture" in this issue.)

Put forward by an expert group commissioned by Chancellor Merkel and chaired by Otmar Issing, the former ECB chief economist who is now an advisor to Goldman Sachs, the proposal of a "global risk map" would in particular help to make the financial exposure of banks and other market participants transparent.

Jan Pieter Krahnen, a professor of finance at Goethe University in Frankfurt and a member of the Issing group, warns, "Experts agree that a lack of data is at the heart of the problem. We need this to improve future macroeconomic risk management." As Krahnen sees it, "We entered into this crisis so blindly because there was no information on huge sections of the financial system. Take the sums involved in credit default swaps, for example—they totally escaped oversight. Nobody really knows where the counterparties are and how these assets are distributed. Only where there's trouble as in the case of Lehman does the blind spot suddenly become apparent." But Merkel's expert advisers were not optimistic about the acceptability of their crucial and practical proposal at the G20 summit level. "Creating a basis for shared information on complex financial instruments was imperative, but this was likely to be viewed with skepticism by countries with traditionally strong financial sectors as Britain and the United States," predicted Krahnen.

Second, the German government used the Berlin gathering to call for coordination of debt issuance to insure that governments do not drive up borrowing costs by competing against each other, maybe even on the same day. Chancellor Merkel is worried that the volume of new government bonds issued—estimated at US$3,000 billion (€2,350 billion)—will probably be three times that of 2008. Coordination of government debt issuance would not only be needed within the Eurozone but also globally. Even Germany, with the biggest and most liquid bond market in Europe, is feeling the impact of the huge government debt placements. As governments must refinance ever larger rescue operations in the financial and corporate sectors, private investors and bankers are increasingly alarmed about the prospect of being crowded out in capital markets.

Europeans didn't need rogue U.S. capital markets to help them pile up intolerable risks.

THE PITFALLS OF HIGH EXPECTATIONS AND LOW DELIVERY

So European leaders—with Merkel and Sarkozy in front—arrived at the G20 London financial reform summit with a long and ambitious repair list for fixing global finance. Whether any of those European proposals will be accepted by the United States remains highly uncertain.

Key German supervisors, regulators, and other experts advise low expectations. Their rather pessimistic view can be read in the protocol of the Finance Committee of the German Parliament when, on December 17, 2008, they testified on the role the International Monetary Fund could play in the so-called "G20 Process to Strengthen the International Financial Architecture."

Jochen Sanio, president of Germany's financial market watchdog BaFin, and Hermann Remsperger, a member of the Bundesbank's board, argued that "There will be only a short time window when the United States will get its act together for meaningful reforms." And Remsperger, who represents the Bundesbank at the Basel Financial Stability Forum, warns: "If we [Europeans] try to pass too many reform proposals—not only regulatory but also institutional—through the window, that might not work."

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According to Sanio, who has been dealing with U.S. and British regulators for decades, "This time window will certainly stay open as long as the crisis lingers on. But remember, just before the crisis broke out, the U.S. government published a report analyzing the competitive disadvantages the U.S. finance industry was suffering because business was lost to London due to its 'light touch' regulatory environment. As the report stated, huge market shares had migrated to London. It concluded that the United States should go on with further deregulation, in order to recover that lost business."

Looking beyond the present financial turmoil, Sanio sees even fiercer competition between financial centers. "There always will be the risk that someone will try to gain competitive advantages by regulatory arbitrage." And Sanio asks, "Will the hedge funds that are under heavy pressure be put under regulatory control? Would the United States and London, where the management companies are located, lose a major competitive advantage? This would be a real test."

Gerd Häusler, who headed the International Monetary Fund's capital market department, recounted how G7 industrial countries under pressure from the United States for some years waged a "name and shame" campaign against offshore centers, then stopped when this effort ran afoul of powerful interests. At the time German finance officials named several reasons. The United States wanted to have a free hand in their fight to dry up the financial sources of terrorists. Hedge funds and banks needed the Cayman Islands and other "un-cooperative jurisdictions" for their huge refinancing operations. And, while chairing the IMF constituency for important Caribbean islands, Canada started blocking the IMF/EBRD program to strengthen regulation and transparency in offshore centers.

EUROPEAN LEADERS SHOULD STOP BLAMING OTHERS, AND THE UNITED STATES SHOULD BE MORE SINCERE

Experts such as World Bank veteran Achim Dübel, a Berlin financial consultant, endorse the skeptical view of Sanio and Remsperger with respect to how far the new U.S. administration will go on meaningful repairs of global finance.

Working on both sides of the Atlantic, Dübel sees politically induced deficiencies in the analysis of the causes of the crisis on both sides.

European leaders, he says, should stop blaming others but rather acknowledge that the present financial catastrophe was caused in strictly regulated banks under the eyes of supervisors and governments. In dozens of cases, European supervisors turned a blind eye to the risks undertaken by their fast-expanding local champion banks. In many smaller jurisdictions, one might even speak of a coalition of governments and banks to promote their regional financial markets at all costs, and as a result speculate with taxpayer money. The case of massive lending to Eastern Europe from Lisbon, Brussels, Milan, Vienna, and Stockholm shows that Europeans didn't need rogue U.S. capital markets to help them pile up intolerable risks. And with a few surprises in between—it was more or less the usual suspects—wholesale banks with defunct business models such as the German public Landesbanken—that amassed the biggest piles of U.S. toxic assets.

Therefore, while criticism from European capital markets has a point, blaming hedge funds and offshore financial centers would be misleading the public about the real causes of the financial meltdown. If, for example, Angela Merkel and Peer Steinbrück propose that conduits and special purpose vehicles be considered risky "under-regulated" sectors, why then did the German public owners of banks or the banking supervisors did not move much earlier against the huge shadow banking structures that German banks were piling up, operating through offshore financial centers such as Ireland?

A similar lack of sincere analysis can be observed on the American side, where capital markets need urgent reform. U.S. Treasury Secretary Timothy Geithner needs the hedge funds and private equity funds for the ambitious public-private partnership segment of his overall rescue operation for U.S. banks and other parts of the financial industry.

This is obviously not the time to get into big fights with the credit rating agencies. Debtor countries around the world realize how powerful the rating agencies still are—able to downgrade sovereign debt and thereby increase borrowing costs at a most unsuitable time.

According to Dübel, rating agencies not only stand accused of having colluded with the producers of what turned out to be toxic financial products. It was also the resulting inflationary supply of AAA bonds that turned a painful but potentially short-lived housing bubble into a global financial catastrophe with long-term economic consequences. Despite the much larger crime, however, the death penalty, as suffered by accounting firm Arthur Andersen after the Enron scandal, seems to be out of question for the rating agencies.

Also, says Dübel, the United States has painfully avoided a debate over the role of Fannie Mae and Freddie Mac and how their constant lobbying for political favors helped fuel the housing bubble. Conservative Asian investors would never have invested triple-digit billions into the U.S. housing market without U.S. government credit protection, implicit though it was. The adventures of U.S. investment banks and insurers in the mortgage market can be seen as an offshoot of the Fannie/Freddie bubble. The tallies of housing markets globally that went rogue at peak price levels and produced their homegrown versions of the subprime crisis go into the dozens.

When it comes to repairing the global financial system, Americans and Europeans thus only seem to be on a collision course, argues Dübel. The reality is that structural reforms are not really on the agenda for either party as long as a serious analysis of the causes of the crisis is absent and conflicts of interest of policymakers abound.

Also on both sides of the Atlantic, crisis management is the order of the day. Policymakers have not had much time to think about the architecture of a new house while the old one is burning and all hands are needed to put out the fire.

Looking at the bank rescue operations in most countries, says Dübel, taxpayer money and guarantees have been provided in vast amounts while the badly needed restructuring of the banking system—including trimming down overcapacities and curtailing risky wholesale business models—is postponed into the future, especially in Europe. With a few exceptions—Lehman Brothers being the most prominent—bondholders, including in the riskiest bond classes, can now expect to be made whole by taxpayers for their failed investments. Implemented as a short-term measure to preempt a financial panic, the expansion of public deposit insurance will likely stick around, including now-full coverage in important economies such as Australia and Germany.

This *de facto* nationalization of the entire liability side of much of the Western banking system, except for voting shares where for not entirely clear reasons there is a political blockade, promises to lay the seeds for a future crisis, warns Dübel. "In the past there have already been competitive distortions in the financial sectors of staggering dimensions through public subsidies and regulation arbitrage between jurisdictions, but the future promises worse: international banking sector competition will become a function of sovereign credit. Sovereign credit without the sovereign, that is, as the experiences with Fannie Mae and Freddie Mac or the German Landesbanken strongly suggest. Financial firms endowed so lavishly with public guarantees tend to control government rather than be controlled."

Americans and Europeans thus only seem to be on a collision course. The reality is that structural reforms are not really on the agenda for either party.

Says Dübel, "One of the first prominent victims of the new government-sponsored banking systems is transparency. There is an irony here: at the center of the G20 Action Plan to reform the international financial architecture, there is the call for more transparency and accountability to regain the confidence of investors and customers. But in most countries, the taxpayer-financed bank rescue operations have had the exact opposite effect: they weaken relatively transparent capital markets, such as securitizations and covered bonds, and strengthen the information black box universal bank."

To make matters worse, the operations themselves are shrouded in secrecy. For instance, in Germany taxpayers did not receive information about the identities of creditors in the case of Industriebank AG or Hypo Real Estate, creditors that they were forced to bail out with billions of their money. Most government rescue operations are structured in a way to protect powerful groups of bondholders not just from being forced to take a haircut, but also from being identified as beneficiaries of subsidies.

For the United States, the mantra of a full bondholder bailout has powerful implications for crisis resolution strategy. For example, proposals such as that of George

Soros to allow borrowers to repurchase their debt at levels below par in a quasi-Brady Bond mechanism will be balked at by investors, who bet on receiving full payment from government. The TARP mechanism already failed for similar reasons. Such strategies can only work for the unfortunate few in the investor universe who fall between the cracks, such as non-bank, non-institutional holders of alt-A or subprime securitizations.

The biggest irony of all, however, is that the deeply destructive policy to shift the burden of the financial crisis resolution from current creditors to future generations of taxpayers works. It works because the globalizing capital markets have created the conditions for socializing credit losses. Absent coordination—and who would credibly represent a transnational taxpayer?—governments that can afford to bail out bondholders and depositors will simply do so. Apart from a few small jurisdictions where matters are impossible to hide, they have nothing to fear from voters, who through a constant state of fear and panic are coerced to open their purses.

Absent coordination—and who would credibly represent a transnational taxpayer?—governments that can afford to bail out bondholders and depositors will simply do so.

And despite high expectations for the newly elected U.S. president, both sides of the Atlantic have one thing in common: The same people in key positions in the public and private sector who let financial institutions, their managements, and the markets destroy large parts of the wealth of nations are now acting as the powerful saviors of the financial system and the larger economy by doling out taxpayers billions in amounts nobody in his wildest dreams thought possible. And those so-called "wise men" who were working as advisors to the "Masters of the Universe" of global finance are now in the limelight on both sides of the Atlantic, telling the world how to get out of the worst financial crisis in generations.

LONDON G20 SUMMIT PREPARATION FRENZY

In many respects, the November 2008 financial summit of the G20 heads of state in Washington could be considered a defining moment for those in the business of supervising ever-more-globally integrated and no-longer-functioning financial markets.

This gathering took place against the backdrop of a widely held perception: that the crisis was not only caused by massive failures in risk management and greed among major institutions and investors, but also by massive failures in the supervision and regulation of banks and other market players by national authorities.

In its regular format the G20 is made up of the finance ministers and central bank governors of nineteen nations, including the major industrial countries and also emerging economies such as Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, and Turkey. It represents around 90 percent of global gross national product and 80 percent of world trade as well as two-thirds of the world's population.

In much greater detail than expected, the summit's "Declaration on Financial Markets and the World Economy" spells out what policymakers have to do under the 47-point "Action Plan" adopted there. At the international level, regulatory and supervisory initiatives are being coordinated by the Financial Stability Forum.

Separately, the G20 finance ministers set up four groups to work on the following five areas: strengthening transparency and accountability; enhancing sound regulation; promoting integrity in financial markets; reinforcing international cooperation; and reforming the international financial institutions.

The framework for policy responses to the financial turmoil was set up in April 2008, when the Financial Stability Forum published its "Report on Enhancing Market and Institutional Resilience." This report was endorsed by the G7 finance ministers and central bank governors and can be considered the blueprint for repairing the broken-down global financial system. It comprises a comprehensive set of recommendations for regulatory and supervisory authorities, as well as central banks.

Its main reform principles are strengthening capital, liquidity, and risk management in the financial system; enhancing transparency and valuation; changing the role and use of credit ratings; strengthening the authorities' responsiveness to risk; and putting in place robust arrangements for dealing with stress in the financial system.

Recognizing the increasing economic and financial weight of emerging economies, the Washington G20 summit also decided, "The Financial Stability Forum must expand urgently to a broader membership of emerging economies, and other major standard-setting bodies should promptly review their membership. The International Monetary Fund, in collaboration with the expanded Financial Stability Forum and other bodies, should work to better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response."

The Financial Stability Forum comprises national financial authorities (central banks, supervisory authorities, and finance ministries) from the major financial centers. Represented are also international financial institutions such as the International Monetary Fund and international regulatory and supervisory groupings. The forum was established in 1999 by G7 finance ministers and central bank governors. The FSF Secretariat is based at the Bank for International Settlements in Basel, Switzerland.

Following an agreement of shared work and responsibility, the International Monetary Fund and the Financial Stability Forum are given the task of monitoring and promoting the implementation of the Action Plan with a deadline of March 31, 2009. (See "Letter from the G20 Summit" in the Fall 2008 issue of *TIE*.)

For much of the bottom-up work since the G20 summit in Washington, the Financial Stability Forum is able to draw on its April 2008 report. "The work underway in the Financial Stability Forum and member bodies on the G20 Action Plan is on schedule for the London summit," is the positive message coming out of Basel.

"On our level we are making progress on a wide range of agenda items," says a financial market supervisor.

THE EC'S GROWING ROLE

The global financial meltdown that originated from the contamination of financial institutions and markets by toxic financial products made in United States and exported heavily to Europe is shifting global regulation more than ever also towards the European Commission. Although European regulators and supervisors admit that putting in place needed major reforms for cooperation and integration of supervision and regulation in the second largest financial market will take years, not months, they can point to important reform initiatives.

The high-level group headed by Jacques de Larosière in late February 2009 presented a reform outline for cross-border financial supervision in the European Union to repair the flaws in the bloc's patchwork of nation-based supervision. Their report calls for stronger coordinated supervision and effective crisis management procedures, and also new bodies through which the European Union will be assuming a stronger role in efforts to repair global finance. Keeping in mind the reluctance of the EU member states to give up national sovereignty, the group of experts stipulated a two-level approach to reform—new oversight of broad, system-wide risks, and a beefing-up of coordination among national supervisors in day-to-day oversight.

They propose a "European Systemic Risk Council." Its role would be to gather information on all macro prudential risks in the European Union. It would be chaired by the ECB president and composed of members of the general council of the European Central Bank, a member of the European Commission, and chairs of the three existing pan-EU committees of banking, insurance, and securities supervisors. By establishing an effective risk warning system under the auspices of the ESRC working closely with the existing EU Economic and Finance Committee, the Larosière group thinks that this way Europe could better weather a future financial crisis.

Second, a European System of Financial Supervisors is proposed, transforming the present three supervisory committees—the Committee of European Banking Supervisors in London, the Committee of European Insurance and Occupational Pension Supervisors in Frankfurt, and the Committee of European Securities Regulators—into EU authorities. The ESFS would cover micro-prudential supervision with expanded regulatory and legal powers but with day-to-day supervision remaining in the hands of the network of national supervisors.

As the Larosière group envisions, the new ESRC in particular should work closely with important global bodies such as the Bank for International Settlements, the Financial Stability Forum, and the International Monetary Fund.

Gerhard Hofmann, a former top banking supervisor of the Bundesbank and now member of the managing board of the BVR, Germany's central organization of the cooperative banking group, sees a more important role for Brussels and the European Commission in oversight and regulation of European and global financial markets.

"For the first time, the European Commission is taking part in the G20 process as an important player in the global effort to repair and strengthen the international financial architecture. And in time for the G20 London financial summit, the European Union is putting forward new procedural and institutional reforms, like the concept of a European Systemic Risk Council and European System of Financial Supervisors, through which Europe in the not-so-distant future can improve its negotiating position in the highly competitive global regulatory arena, and at the same time could strengthen international cooperation in financial market regulation and supervision. The real challenge for both the EU Commission and international standard setters will be not just the issue of new common regulation, but to come up with better regulation which represents intelligent answers to address the crisis." ◆