# REGULATING GLOBAL FINANCIAL MARKETS

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## Summary

This paper discusses the role of regulation in the emergence of a global system of linked financial markets. It traces the origins of the internationalisation of financial markets to the emergence of new competitive pressures, rooted in changes in the social structures of savings and investment, breaking down both national systems of financial control and international arrangements for monetary and financial coordination. These changes have been accompanied and facilitated by a process of international reregulation, through informal specialist networks. Although these have facilitated the international diffusion of regulatory standards and practices, and attempted to coordinate them, they are greatly hampered by espousing the perspectives of the various markets and firms which it is their task to supervise. Together with their minimalist view of the aims of public legitimation and oversight of financial markets, they have proved inadequate to prevent the destabilising effects of the new global finance on the world economy.

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## INTRODUCTION

There can be few issues of greater public importance than the regulation of global financial markets. The international liberalisation of financial markets which gathered momentum in the 1980s has involved a qualitative jump in financial volatility and risk, as well as in the complexity and cost of the devices which are supposed to manage those risks. Consequently, the 1990s have been marked by a series of highly publicised financial disasters of various kinds. The 1994-5 Mexican peso crisis, due to a rapid inflow and even quicker outflow of short-term capital (mainly from US mutual funds), was responded to by a $50bn bailout. Yet within less than 18 months came the 1997 Asian crisis, triggered by the withdrawal of short-term loans channelled through an international chain of financial intermediaries, resulting in an IMF-led package of over $117bn. to Thailand, Indonesia and Korea (BIS 1998). In both these cases, financial disasters due to volatile, short-term, international capital flows have led to a more general economic crisis, requiring multilateral rescue measures to avert global repercussions as contagion threatened other countries: the Asian crisis also engulfed Russia and damaged Brazil. Both the Mexican and Asian crises resulted from inadequately monitored large-scale flows of private, short-term capital.[1] In addition to these major events, the opening up of national capital markets to global competition has also resulted in financial sector crises in many countries: research for the IMF has estimated the costs of such crises at between 3% and 25% of GDP.[2]

The inadequacy of efforts at public supervision leads some to argue that not only reform but a radical new approach is needed (Campbell and Picciotto, 1998b). Others argue that public intervention is merely counter-productive, and `the markets' should be left alone, self-regulation by the participants being the only desideratum. Yet many of the financial techniques devised over the past 20 years and justified as mechanisms for the management of financial risk, especially derivatives, have themselves led to enormous losses. Although in some of the highly-publicised cases, such as Barings and Sumitomo, the direct blame has been attached to an inexperienced ‘rogue trader’, the underlying factor has been the managerial problems of supervising esoteric financial practices, often involving distant and specialised markets. This is greatly exacerbated in the case of exchange-traded derivatives, since their highly-leveraged nature means that mishandled trading quickly runs up large losses.

Indeed, in a speech delivered some four months before the Barings collapse, Sir Andrew Large presciently drew attention to this danger:

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[1] Attention has mainly been focused on the inadequacy of monitoring by the capital-importing countries of the scale and uses made of foreign borrowing, and the inadequacy of their prudential supervision arrangements. However, already in mid-1996 the BIS noted the rapid growth of lending to ‘emerging markets’, especially in Asia and by European banks, with a predominance of short-term loans and a shift to lending to the non-bank private sector, partly to circumvent host country restrictions on bank borrowing. This should have alerted home country supervisors, although their fears may have been lulled by the apparently low exposures to particular country risk (Miles 1998). However, it seems that the inter-bank market was used to channel loans to other destinations: in particular, banks in Korea (which became classified as Zone A for the purposes of the Basle capital adequacy requirements once admitted to the OECD in 1996) apparently on-lent to other countries, such as Russia.

[2] The US Savings and Loan disasters of 1984-91 cost 3% of GDP, and the continuing Japanese bad loans crisis will have very high absolute costs, but the impact on smaller economies is even higher: recent cases include Venezuela 18%; Bulgaria, 14%; Mexico, 12-15%; Hungary, 10%; several cases (Argentina, Chile, Cote d'Ivoire) have cost over 25% of GDP: see Goldstein & Turner 1996, citing research by Caprio and Klingebiel.

> The fact is that over the past five years to ten years, the institutional deregulation initiatives in different countries have combined with huge advances in computing power and communications technology, to create a totally new breed of financial intermediary. You can call these firms international investment banks or global securities businesses or proprietary trading operations. The terminology is not important. What matters is that they have embraced the theory of financial risk management which applies portfolio theory to the range of risks associated with the securities business. I might term this the 'Greek Alphabet' or 'Derivatives' approach to financial markets. The key characteristic of this approach is that it seeks out the common elements of risk wherever they may lie in a portfolio and manages them centrally. These firms no longer respect the traditional boundaries between markets or the old institutional boundaries between banking, securities and insurance. They are in the risk management business pure and simple, and they operate on a large scale and on a truly global basis. (Large 1994).

He pointed out that one of this new breed of firms could run into difficulties 'in any market anywhere in the world' due to its trading rather than banking activities.

This was again dramatised by the collapse and rescue in September 1998 of the inaptly-named Long-Term Capital Management (LTCM), an arbitrage hedge fund run by Wall Street's top financial rocket-scientists whose advisers included Nobel laureates who had pioneered the 'science' of financial economics. Unlike Barings and other fiascos this could not be blamed on a 'rogue trader', but the fund's managers and their backers were nevertheless shielded from the consequences of their mistakes by a rescue facilitated by the New York Federal Reserve Bank, on the grounds that its failure could have had such serious repercussions on other market participants as to threaten the economies of major nations including the USA (Greenspan, 1998: 1). This rescue has two possible, and equally disturbing, implications (Hu, 1998). One possibility is that the Fed, the world's key financial watchdog, erred in helping to shield the world's most sophisticated financial market participants from the consequences of their activities in the markets they themselves had created. These included not only LTCM itself and its Nobel laureate advisers and financial rocket-scientists, but also the investment banks which knowingly advanced loans enabling LTCM to build up enormous potential losses from a relatively low capital base. LTCM's equity was some $5bn; which was leveraged through loans to over $125bn of balance-sheet assets; but these funds were being used, as the banks well knew, to take positions in derivatives for which only a small "margin" is required to be advanced, so that the total off-balance sheet exposure was later valued at over $1trillion (Treanor and Tran, 1998; BCBS, 1999). The alternative explanation is that a potentially deadly threat was created for the world's economy by activities the justification for which is that they help manage risk and smooth out turbulence. What is more, in justifying the action, Federal Reserve Chairman Alan Greenspan stated that such defaults are inevitable in 'dynamic markets', although the systemic threat posed by the collapse of LTCM was apparently exceptional (Greenspan, 1998).

The competitive pressures resulting from the shift to new forms of financial trading have also been identified as a major factor behind the rash expansion and stampeding contraction of credit which caused the Mexican and Asian crises. The liberalisation of controls over cross-border flows, and the ending of many restrictions which had segmented national capital markets, created competition among a wider range of financial institutions, and inter-connections between multiple financial markets. Even experienced financial regulators have found it hard to keep pace with the complexity and international ramifications of the activities they attempt to supervise, as shown by the difficulties of the Bank of England in relation to BCCI and Barings.

Although the techniques and procedures for the supervision of financial markets have undergone major changes in the past twenty years, and much of the impetus for these changes has come from international arenas and in reaction to dramatic crises, the arrangements for international regulatory coordination and cooperation still seem to lag well behind the dynamic of the transformations of finance.

## 1. THE COMPETITIVE TRANSFORMATION OF INTERNATIONAL FINANCE

What has been learned about the nature of these transformations, and what are their regulatory implications? First, it has become clear that far from dealing with a single global financial market, globalised finance consists of local markets, rooted in different socio-economic structures, patterns of savings and investment, and regulatory traditions. These have become linked internationally by a relatively small number of global firms which have the organisational and technical capacity to trade on a global basis. At the same time a far larger number of financial intermediaries of various kinds now participate in cross-border financial trading. Some aspire to become full-service global financial firms (not always successfully, as seen in the experience of the British commercial and merchant banks), but the vast majority are relatively small vessels whose once-tranquil domestic financial waters have now become vulnerable to the immense tides and potential storms of international financial flows.

Such cross-border flows followed from the relaxation of a wide variety of national controls on foreign currency transactions and regulations affecting investment. This has taken place in three main stages. The first was the introduction of convertibility for current account payments, which was the aim of the IMF under the Bretton Woods agreement, and was implemented from 1958. Current account convertibility ultimately led to the demise of the fixed exchange rate system in 1971-3, since it proved impossible for national central banks to defend currency parities, as was shown in the sterling crisis of 1967, against enormous hot money flows through the largely unregulated eurodollar market created by TNCs and their banks (Bank of England, 1973). The ability of such internationally-organised firms to manage their internal payments effectively undermined the distinction on which the Bretton Woods system was based, between current and capital accounts (Williamson, 1977: 3). Thus, currency floating led to the second stage, the ending of general exchange controls, with the UK leading the way in 1979. Nevertheless, many restrictions and obstacles have remained, both to the ability of residents to borrow from foreign capital markets, and conversely the right of foreign borrowers to tap domestic markets or of domestic savings to be invested abroad. In the third stage, which has been taking place since the mid-1980s, there has been a gradual removal of such restrictions. This is by no means complete, since it entails often substantial revision of regulatory requirements which act as effective obstacles, perhaps most importantly the stringent regulatory regime operated by the SEC and other US authorities governing access to US capital markets. Thus, regulatory coordination, or even harmonisation, is an important element in facilitating cross-border financial movements.

Secondly, a key element of this transformation, indeed its driving force, has been the shift from relational to market-based financial intermediation, sometimes described as the ‘financial services revolution’ (Moran, 1991). The roots of this process also lie in the economic boom of the 1950s and 1960s in the developed capitalist countries, based on sharply rising labour productivity and growing world markets, which generated vast sums of financial-capital in new forms of private and corporate savings. The struggles to control and direct these new forms of social savings and investment have shaped the changes in financial structures over the past quarter-century. The three major factors behind the changes in the patterns of financial intermediation have been:

(i) the financial strength of giant firms especially TNCs, enabling them to fund their activities internally, or by accessing global financial markets directly, rather than borrowing from banks;

(ii) the growth of private savings and the increasingly important role of institutional investors in channelling them; and

(iii) the growing role of social expenditures (e.g. for health-care, education, social security), coupled with the increasing political difficulty of funding them through the state from taxation. This has further augmented the role of private savings by the affluent middle classes, as well as turning the state (in its many institutional forms) into a supplicant in the financial markets, a borrower to be assessed by the lending institutions and specialised agencies which evaluate creditworthiness.

In the capital markets, the financial strength of large industrial firms and of the new investment institutions gave them great power vis-a-vis the various types of intermediaries (banks and brokers) who acted as the gatekeepers to these markets, and the ability to by-pass them or play one off against the other.[3] This challenged the restrictions which gave protected positions in the financial markets to these traditional financial intermediaries: the commercial and investment banks, and the stock exchange brokers and market-makers. Competitive pressures created challenges to existing market structures, which were embedded in various legal, administrative, and institutional forms, and generated pressures to change these forms. Thus, it was the interaction of internal shifts in patterns of savings and investment, with international presures due to exploitation of the increased opportunities for capital mobility, that undermined the existing institutional structures of finance. These shifts took place first and most strongly in the US and the UK, spreading more slowly to other developed countries.

The main dynamic in this process has been the interaction between changes in the US, the epicentre of money and finance, and London, which was reinvented as the key global financial marketplace (Moran, 1991). The key element in this interaction was the creation of the system of 'offshore' finance, centering on the development of the Eurodollar market, which exploited the opportunities for avoidance of tax as well as banking and financial regulatory requirements, to provide a low-cost source of finance (Hampton 1996). This received its main impetus with the setting up in London and other centres such as Nassau of branches of US commercial banks, escaping from the Federal Reserve's interest rate controls. They were followed by the investment banks, who began to tap this market for dollar bond issues, especially after 1968 when new rules required US TNCs to raise funds abroad for foreign direct investment.[4] The

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[3] For example, in 1982 the SEC introduced Rule 415, allowing corporations to register in advance all the securities they planned to issue over a 2-year period, ending the need for individual filings for each underwriting, and thus relaxing their ties to individual underwriters. This facilitated off-the-shelf issues, which allowed borrowers to make the banks bid against each other for the business: Ferris 1984, 83.

[4] The eurobond market began in 1963 when the Interest Equalisation Tax blocked access by non-US issuers to the domestic dollar-bond market, and US investment banks (many of whom already had London offices for selling US equities) started trading dollar bonds and issuing them for non-US borrowers. When US firms began also to tap this market, issues could be prepared in the US and merely completed offshore (Scott-Quinn 1990, 280). The

growth of the Euromarkets increased the competitive pressures on domestic financial markets, since investors and issuers could arbitrage between the two, based on the effects on yields of interacting fluctuations in rates of interest and of foreign exchange (Scott-Quinn, 1990: 281). At the same time, the offshore financial centres, especially London, also became marketplaces for new financial products and techniques. Firms acquiring this know-how through a base in such centres would seek to deploy it in their own domestic markets.

The patterns and timing of changes in each country also owed much to the specificities of its institutional structures, and of the social and political roles of the key groups and factions involved. These included not only the corporate and institutional managers, state officials, and various kinds of financial specialists, but also the professionals who began to play an increasing role in mediating these institutional changes, especially lawyers and accountants. These professionals operate at the interface between the public sphere of the state and the private sphere of market relations, and derive their authority from the major academic disciplines of economics and law, which underpin the major forms of mediation of the public-private interaction, money and the law. The new competitive environment also stimulated, and was further enhanced by, competition amongst various professional groups and fractions emerging within and between the law and economics: accountants, actuaries, financial analysts, tax specialists, etc.

The new competitive pressures led to a shift from traditional forms of relationship-based financial intermediation to transaction-based or marketplace finance. This meant that banking became more like trading, and trading became transformed from a relatively sedate to an increasingly frenetic process. For example, commercial banks, finding themselves competing for funds with other deposit-takers, and being by-passed by large borrowers in search of cheaper funds, invented CDs (Certificates of Deposit) and other tradeable money-market instruments. Brokerage firms hit by loss of income due to the ending of fixed commissions on share trading turned their attention to the bond markets, which began to boom as monetary policy allowed interest rates to fluctuate, and they invented new instruments such as mortgage bonds.

Thus, the decade 1975-85 was marked by a spate of innovation, involving the devising of a wide range of new types of financial instrument. Many of the innovative financial formats aimed to take advantage of the low-cost funds available by routing transactions through 'offshore' centres, due ultimately to avoidance of tax and other costs such as bank reserve requirements. New ways were devised for high-rated borrowers to tap into the offshore Euromarkets, such as Note Issuance Facilities and convertible Eurobonds. Improved liquidity and reduced financing costs could also result from securitisation (the transformation of an illiquid asset such as a mortgage into a tradeable security with a secondary market). A major feature has been the emergence of 'derivatives', contracts involving a transfer of an element of the risk in an underlying cash asset (for example, agreeing a present price for the delivery at a future date of a block of foreign currency or government bonds). These aimed to deal with fluctuations in inflation, interest rates, and foreign exchange rates, and their interaction. Interest rate and

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euromarkets offered low-cost funds to borrowers as well as attractive returns to investors mainly because of the tax advantages: eurobonds can be bearer bonds and the interest can be paid free of withholding tax to nonresidents, thus offering opportunities for tax avoidance or evasion. Initially, freedom from withholding tax on interest payments was available only in tax havens, but in 1984 the US and UK introduced the same exemption, subject to some controls, aiming to reduce tax evasion by their own residents, although effectively conniving in avoidance/evasion of other countries' taxes (Picciotto 1992, 123-5, 168-9).

currency risks were managed by new types of swaps and options, as well as Forward Rate Agreements (BIS, 1986). The trading of many of these instruments in a more public form has become institutionalised, as a result of initiatives by the old commodity futures exchanges, and some stock exchanges, to facilitate trading in financial futures. Thus, the derivatives markets are broadly divided between OTC (over-the-counter) transactions in tailor-made contracts (although often standardised and subject to industry-agreed rules), and exchange-traded futures and options. The institutional arrangements established by the exchanges offer greater transparency and security and attract speculative finance, which provides liquidity but may also generate destabilising volatility.

The emergence of this market-based international financial system undermined the postwar institutional framework agreed at Bretton Woods. This attempted to facilitate the liberalisation of international trade and long-term investment, while leaving macro-economic management, and the political compromises it entailed, to national state authorities and political processes (Ruggie, 1982). However, the very process of liberalisation, interacting with new competitive forces generated by the patterns of capital accumulation, fatally weakened state-based monetary management and finance. Under the previous system of national, segmented capital markets and restrictions on short-term capital flows, the fixed exchange rates imposed strict limits on the destabilising effects of short-run changes in sentiment, isolated disturbances, and curbed the tendency of financial markets to exhibit lemming-like panic behaviour (Padoa-Schioppa and Saccomanni, 1994).

The new market-based system now puts a heavy premium on the ability of dispersed market agents to process information efficiently, and take decisions based on dispassionate evaluation of long-run economic fundamentals. The markets in which they operate do not exist in a vacuum, but require an institutional and regulatory underpinning. Indeed, the analysis in the next section will show that the construction of the market-based system has been in many ways encouraged and facilitated by a process of international diffusion of institutional and regulatory models and practices.

However, the disintegration of the arrangements for monetary and macroeconomic management based on national states and coordinated by the IMF has left institutional disorder. A variety of international bodies perform diverse public functions in a fragmented way, and they are undermined both in the performance of those functions, and in their horizontal and vertical coordination, by the inadequate understanding of the nature of the state-market relation and the role of regulation shown by economic theory based on neo-classical assumptions (Campbell and Picciotto, 1998a).

## 2. The New Forms of Global Regulation

The construction of the new international financial system, as the account in the previous section has shown, has been a process of international interaction between locally-based national financial markets, as their institutional and regulatory structures have responded to and attempted to control the changes in the social structures of savings and investment. The interaction of national and international political and economic processes has fundamentally transformed monetary regulation and financial intermediation. The breaking-down of relatively closed national systems of credit and finance has been accompanied and facilitated by often elaborate new regulatory arrangements, developed through complex international political processes. This has introduced formalised rules and professionalised supervision in place of cosy clubs and informal oversight by central banks and finance ministries (Moran, 1991; Porter, 1993;

Kapstein, 1994; Goldstein et al., 1992). Thus, although there has been national deregulation, in the sense of a dismantling of structural controls and informal oversight, there has also been an international process of re-regulation. This has involved a shift to more formalism and legalisation, based both on state law and state-authorised self-regulation.

Regulatory internationalisation has operated through international networks of officials, professionals and managers, attempting to coordinate the performance of specific public functions essential to the management of money and finance. This is part of a more general process of restructuring of state-market relations on a global scale, in which increasingly fragmented public functions are now formally legitimised far less through the political processes of national states (Picciotto 1997a). Instead, there has been a growing role for the professional practices of various kinds of specialists: economists, accountants, scientists, and lawyers. The emergence generally of such 'epistemic communities' (Haas 1992) may be identified as a characteristic feature of the emerging new forms of global governance. However, the term is misleading if it suggests that they are depoliticised, global, homogenous formations. Rather, these professional and ideological fields are themselves the sites of conflict and contestation,[5] involving the renegotiation and redefinition of the boundaries between, and indeed the nature and forms, of the state, the market, and the firm. However, to the extent that their role entails the displacement of the focus of contestation from political concepts of 'national interests' to issues expressed and debated within technicist paradigms, they represent a qualitatively new approach to the management of international affairs, as represented by the frequently-used term 'global governance'.

These networks have in many ways facilitated the international diffusion of regulatory practices, and their coordination. The changes that have been introduced in national arrangements for the supervision and regulation of financial markets, institutions and firms have, to a great extent, resulted from international debates and discussion. There have been emulation and transplantation of regulatory models, as well as movements to establish common approaches and standards, and to ensure cooperation. Nevertheless, this has been in a context of competition between financial centres and national economies to maintain or develop the depth of their capital markets. Thus, the form and degree of regulation has itself become a factor in the competition between markets and the agents active in them.

The new global financial system, based on competing centres and a wide variety of institutions, generates multiple layers of regulation, which are nevertheless loosely coordinated through horizontal and vertical networks, to form a regulatory web. Although US policies and practices have been in the forefront, and the dollar has been the dominant currency, the central paradox has been that the US authorities by themselves could control only its formal and not its substantive validity as money (Ingham, 1994), since the financial markets were increasingly

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[5] Thus, although Ethan Kapstein contributed an essay analysing the emergence of the Basle Committee and its capital adequacy standards to the Special Issue of *International Organization* on Epistemic Communities and International Policy Coordination edited by Peter Haas (1992), he took the view that it was not the product of an 'epistemic community', although it remained possible that central bankers could become such. The capital adequacy standard, he argued, did not originate from a common technical approach, but from judgments by central bankers of what was desirable and possible in the international and domestic politics of the debt crisis of the early 1980s. Thus, they were not acting from pure technical considerations, but making political calculation in 'attempting to serve several conflicting public and private sector interests in an effort to maintain if not enhance their positional power in their domestic political structures' (Kapstein 1992, 267).

based in London and other 'offshore' centres.[6] In contrast, during the period of sterling's dominance up to 1914, the bulk of the world's money-capital actually flowed through London. Hence, although the Bank of England was an insular institution (its directors rarely travelled abroad and foreign visitors were received out of courtesy) nevertheless:

> 'The outside world did matter greatly and indeed it was the world outside Britain that seemed to matter most. The tides that operated on the Bank operated on it through various parts of the City, but they did in the main come from outside Britain and were recognised as such' (Sayers, 1976: 9).

Thus, by managing sterling through control of the Bank Rate, the Bank was also effectively maintaining the Gold Standard, on which global trade and investment relied.[7] The situation with the dollar after 1960 was radically different: the US Federal Reserve was neither able to manage it as a global currency, nor was it equipped to do so (Ingham, 1994).

In this new context, national officials attempting to perform their 'public' roles of monetary management and financial supervision were pulled into closer interaction with each other by the shifting forces operating through the financial markets. At the same time, these forces altered the balance of power between the different bodies, groups, and sectors structured around and legitimised by national state institutions. Thus, central banks, and later bank supervisors and financial market regulators, acquired a new importance. Within the Keynesian system of macro-economic controls, the central bankers had played the important but secondary role of managing the public debt, while the national finance ministries used macro-economic tools to control the domestic economy. The new focus on monetary management placed the central bankers closer to centre stage. While they may have appreciated the new weight given to their concerns, they did not relish either the new responsibilities this entailed, or their exposure to the public spotlight. Their assumption and development of new functions have therefore tended to be reactive, and it has generally been only following scandal, controversy, and the politicisation of issues, that even a minimal level of formalisation and institutionalisation has emerged.

An immediate and continuing concern has been the prudential regulation of banking. However, while this task rapidly became one of central importance, it has also been extremely difficult to define, as banking was transformed by the shift to market-based finance and the internationalisation of financial markets. These combined factors affected London earliest and most acutely, so it is not surprising that the Bank of England has played a key role in the development of supervisory arrangements for international banking, and financial markets more

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[6] The Eurodollar market was estimated by the BIS at $7bn in 1963, and had grown to about $91bn by the end of 1972. By that stage, net Eurocurrency deposits were estimated at 35% of the US narrow money supply, and 17% of its broad money supply (Padoa-Schioppa and Tommasso 1992: 239). London was attractive since the Bank of England applied its informal but strict monetary controls only to the clearing banks (which were subject to a 28% liquid asset and an 8% cash ratio), but not to the secondary banks or finance houses, which it regarded as outside its supervisory responsibilities. Foreign-owned banks were treated even more lightly and exempt from all credit and interest rate requirements, except in sterling transactions with residents. The Competition and Credit Control reforms of 1971 introduced a common reserve assets ratio for all banks, but only on sterling liabilities.

[7] It can also be said that these internal and international aspects were contradictory, and the tensions they created eventually led to the breakdown of the gold standard, once Britain lost its position as the centre of world trade and finance (Ingham, 1984: 165, 187-8).

generally. The 1970s saw a dual process of reform of the UK framework, and its international coordination, especially through the Basle Committee on Banking Supervision (BCBS) set up on the initiative of the Bank of England in 1974. The emergence of new financial intermediaries and the growth of the Euromarkets in the 1960s undermined the City's banking oligarchies, leading to liberalisation and then (after the secondary banking crisis of 1974) to a more formalised regulatory structure.[8] However, although the 1974 crisis revealed the limitations of the insularity and informalism of the Bank of England's approach to regulation, it continued to see its role as one of protecting the British clearing banks and boosting the City, and to prefer to operate through informal networks. Thus, it was a hesitant participant in the shift to formalised regulation, as reflected in its ambivalent roles in the development of the British banking and financial services legislation,[9] as well as its influence in shaping the nature and work of the Basle Committee.[10]

Although the BCBS has been hailed as a central institution in the new framework of global economic governance (Kapstein, 1994), it has seen its role as a minimalist one, and has developed only reactively, every initiative being a response to the latest crisis. While it has been clear since the 1960s that the major cause of financial instability has been the existence of a vast pool of finance exploiting the 'offshore' system, and thus beyond the reach of national regulators, the BCBS has shown no inclination to tackle the problem at its root, concentrating instead on trying to curb its effects. It began by attempting to reinforce national systems of supervision, establishing jurisdictional principles based on parental home country responsibility in the Concordat of 1975.[11] Although this was reinforced by the addition of the requirement of

[8] The informal and extra-legal methods of 'moral suasion' used by the Bank of England to control credit depended essentially on cartels and old-boy networks (more recently described in relation to the Asian crisis as 'crony capitalism'), which broke down under the pressure of competition from new intermediaries and foreign banks. With the shift to a cost-based allocation of credit in the Competition and Credit Control reforms of 1971 the inadequacies of the supervisory arrangements were quickly revealed by the secondary bank crisis of 1974, caused by the fuelling of a property boom by an over-expansion of credit, based on exploitation of innovative wholesale financing devices and the creative avoidance of reserve assets requirements (Moran 1984, 70-71). This episode has some significant similarities to the financial crises in emergent market economies in 1997, not least in the way financial liberalisation exposed the inadequacies of the British regulatory arrangements of the time.

[9] The Bank responded quickly to the 1974 crisis, by replacing the Discount Office with a new Banking Supervision Division, but the capital and liquidity requirements which it was to apply were agreed with the clearing banks, who were to be subject only to annual 'discussions' (Bank of England 1975). The Bank reluctantly accepted the need to put its powers on a more comprehensive legal basis in the 1979 Banking Act, at the price of having the Deposit Protection Scheme included in the statute, against the stiff opposition of the clearing banks (Moran 1984, 118-24). However, by the early 1980s it was showing greater independence and professionalism, and played a key role in forcing the Stock Exchange to accept the changes leading to the Financial Services Act (Moran 1991, 73ff).

[10] This new phase of central bank multilateralism built on the links forged in the late 1920s, when Montagu Norman took the lead in developing cooperation among the leading central bankers, culminating in the setting up of the Bank for International Settlements (BIS) in Basle: Sayers 1976, ch. 15.

[11] This basic principle was urged by the Bank of England and agreed at the regular G10 central bankers' meeting at the BIS in July 1974 (Moran 1984, 135), following the Herstatt bank crisis and the rescue of the Franklin National Bank. However, the failure to agree a commitment to provide lender of last resort support for Euromarket operations resulted in difficulties for some banks in accessing these interbank markets, which was only resolved by the issuing of an ambiguously supportive statement at the September meeting (Kapstein 1994, 43).

consolidated reporting in 1978, a parallel attempt by the US authorities for multilaterally agreed reserve requirements for offshore banking failed to overcome British objections, and paradoxically led to deregulation in the US.[12] The failure of the Ambrosiano Bank due to imprudent Euromarket operations, and the developing country debt crisis triggered by Mexico's announcement of default, both taking place in 1982, forced the BCBS to consider more directly the substantive standards of capital and liquidity adequacy to be applied to internationally-operating banks.[13] However, the Accord of July 1988 was achieved only following political manoeuvres outside the Committee, involving a direct approach by the US authorities to the Bank of England, later extended to Japan (Kapstein, 1992).

In taking on the task of defining substantive supervisory requirements, in the form of capital requirements, the BCBS ventured into a complex area, since the formulation and enforcement of such standards pose jurisdictional problems, both between countries and between different types of supervisors. The early approach of relying on home country supervision has been greatly modified although not abandoned, culminating in the issuing of the Core Principles for Effective Banking Supervision in April 1997, prepared after involvement of and consultation with banking supervisors from a number of countries outside the G10. These now seek to establish minimum procedural standards of supervision, which are also linked to the substantive capital adequacy standards by the requirement that supervisors must set appropriate minimum capital requirements, which for internationally active banks must not be less than those established in the Basle Capital Accord. Nevertheless, although as a matter of procedure the Basle standards require consolidated supervision, the Basle capital requirements do not explicitly state that they must be applied to all branches and subsidiaries in a group on a consolidated basis.[14] This is not a minor technical point but a crucial one, since the application of capital

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[12] The US Treasury and Federal Reserve (the Fed.) had been concerned at the need to increase domestic US interest rates in response to the dollar crisis in the autumn of 1978, and opened multilateral discussions on reserve requirements on offshore banking. In order to overcome objections from London and pressurise the UK, the Fed. in 1981 finally yielded to pressures from US transnational banks to allow the creation of an International Banking Facility (IBF) in New York City. The Fed. and the Treasury still hoped that they could insulate domestic banking from this new zone of 'onshore Euro-banking', and use it as a means of pressuring 'offshore' centres; but instead of facilitating tighter controls on Euro-banking, it accelerated the move towards national deregulation (Hawley 1984).

[13] The problem illustrated by the Ambrosiano bank débacle of the use of holding companies located in jurisdictions with inadequate supervisory facilities was partly tackled by revisions to the Concordat issued in 1983, especially by introducing the 'dual key' principle. A host country should 'discourage and, if legally possible, prevent' the entry of banks with a parent institution established in a country where supervsiory arrangements are non-existent or inadequate, or where it has been granted exemption: BCBS, 'Authorisation Procedures for Banks' Foreign Establishments', March 1983. (A convenient collection of BCBS documents was issued in 1997 (BCBS 1997)). However, groups could still evade effective supervision, as was shown by the BCCI collapse in 1991 (Alford 1992, Bingham 1992), which led to a new set of Minimum Standards in 1992, stressing the need to identify a clear home-country authority capable of supervising groups on a consolidated basis. This still left open the question of groups engaged in both banking and financial market operations, exemplified by the Barings collapse in 1995.

[14] Although within Europe, the EC's Capital Adequacy Directive does require this, it does not specify how such consolidation should be done, and has been interpreted differently by the BoE and the SFA. The latter took the view that, in relation to investment business, the CAD did not require consolidation of non-EU affiliates, which has been described as 'an open invitation for UK investment firms to escape ... any or all UK rules that are found to be onerous, simply by routing business offshore' (Dale, 1996: 214). The difference in the practices of the BoE and SFA have not been resolved by the amalgamation of their supervisory functions within the new Financial

requirements to all financial groups on a consolidated basis is essential in combatting the use of "offshore" facilities for regulatory avoidance.

These 'horizontal' jurisdictional issues (between the authorities in various countries) are exacerbated by the 'vertical' jurisdictional problems between different kinds of supervisors. These have increasingly come to the fore as the shift to market-based finance has broken down structural barriers, and created competition between different types of financial intermediary (retail and investment banks, brokers, insurance companies, etc.) as well as a process of concentration to form large financial conglomerates. This creates 'turf battles' between different regulators at the national level, which interact with parallel conflicts at the international level. This has been most clearly seen in the disputes over capital requirements, which arose when the BCBS sought to extend its capital standards to cover not only credit (or counterparty) risks, but also market risks. This both created problems among bank supervisors, and took the committee into the territory of the securities market regulators. Its adjustments to capital requirements for market risks, aiming to make them suitable both for banks and securities firms, met with opposition from some bank supervisors (Dale, 1994: 176). Yet, the extension to the trading book of its 'building block' approach to capital provisioning failed to gain approval from IOSCO, the International Organisation of Securities Commissions, whose members were themselves divided (Steil, 1994: 203-4; Dimson and Marsh, 1995: 832-33). Following the Barings collapse, a Tripartite Group of banking, insurance, and securities regulators was established, which has been reporting to the G7 on its progress in coordinating standards, including capital requirements and procedures for effective supervision of international financial conglomerates (BCBS, 1997-III: 59, 64).

At the same time, the new focus on market rather than counterparty risk led to a shift from attempting to define requirements internationally-agreed by supervisors, towards establishing criteria for the approval of the risk-management systems of firms themselves, or the so-called Internal Models approach.[15] Reliance on such internal models may help to deal with the problems of rigidity of formal requirements, which are unresponsive to innovation and result in discretion and potential variability of application by supervisors. However, the use of such models run the danger of creating self-reinforcing practices among firms and practitioners, so their validity greatly depends on systems of backtesting.[16] The establishment of detailed parameters for backtesting has taken international regulators into even more difficult and arcane regions (BCBS 1997-II, 144).

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Services Authority (FSA), which has so far merely continued to administer their different rulebooks (BoE, "Consolidated Supervision", issued 30.9.98; SFA Rulebook Release 22 & 24, section 10-200).

[15] These are based on Value at Risk (VAR) models, which became publicised in October 1994 when J.P. Morgan made available, over the Internet, its RiskMetrics system and the data needed to apply it. They are argued by financial economists to be more consonant with portfolio theory (Dimson and Marsh 1995; Dowd 1998), although these are the subject of some controversy among theorists as well as practitioners : see e.g. the debate between Nassim Taleb and Philippe Jorion in *Derivatives Strategy* (1997) vol. 2 No. 4, available through http://www http://www.derivatives.com/archives/1997/0497fea2.html. We are grateful to Kevin Dowd for helping us with insights into the arcana of VAR, and other aspects of financial economics.

[16] The indeterminacy of valuation models appears to account, for example, for the £100m losses from options trading identified at Natwest Markets in March 1997.

Undoubtedly, the difficulty of the task of establishing acceptable and workable substantive standards for financial firms and market transactions has been greatly exacerbated by the need for them to be both agreed and implemented by a wide diversity of nationally-based regulatory authorities. The provisions in the mounting stacks of documents and standards agreed by bodies such as the BCBS and IOSCO must be integrated into the layers of national legislation, rule-books, and codes. Arrangements for their enforcement depend on even more complex networks of cooperation arrangements established between state regulators as well as self-regulatory bodies such as exchanges.[17] It is hard to avoid the conclusion that these ramshackle cooperation arrangements are far from adequate to maintain oversight over financial markets which, even if they remain substantially local in their roots, are globally interlinked by the ability of a substantial number of financial agents to engage in many types of transactions in and across all markets.

## C. CONCLUSIONS

In a prescient comment issued in July 1997, as the Asian crisis began to break, Henry Kaufman, a senior Wall Street figure, described the global financial system as 'an incubator of risk', and dismissed the initiatives for improved cooperation arrangements given impetus by the G7 meetings at that time as 'modest step ... [not] remotely adequate to the task of assuring a safe and sound global financial system'. Kaufman specifically pointed to the rapid growth and complexity of derivatives, which 'has multiplied the potential for a shock to careen through the financial system. It has increased the capacity of market participants to take speculative positions in financial markets, to trade those positions at a moment's notice, and to use considerable amounts of leverage in the process'. He argued that a global Board of Overseers is needed, not only to avoid 'market meltdown', but also as 'essential for achieving competitive equality among market participants'.[18] Although this might be considered a utopian proposal, it could at least be used as a template against which to evaluate both of the network of cooperation arrangements sketched out above, as well as the rather modest plans to improve the 'architecture' of the global financial system put forward following the Asian crises (G7, 1998).

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[17] Notably, in response to the Barings crash, a grouping of regulatory authorities from 16 countries responsible for the supervision of the world's main futures exchanges has held meetings and issued a series of documents, beginning with the Windsor Declaration in May 1995, agreeing to promote various measures of enhanced disclosure, and to improve cooperation and measures for protecting customer assets. This was followed by a London Communiqué on supervision of commodity futures markets of July 1997, and a Tokyo Communiqué of October of the same year, which included two annexed sets of guidelines, covering standards of best practice for the design of commodity contracts, and guidance for the components of market surveillance and information sharing. In March 1996 representatives of 49 futures and options exchanges worldwide signed a multilateral Information Sharing Memorandum of Understanding (MOU) at Boca Raton, Florida; it was also open for signature by other market authorities, and within a few months a further five had signed. Although it establishes quite detailed administrative arrangements for information sharing between the exchanges and clearing houses, like all MOUs its legal status is ambiguous, and it may be read primarily as a statement of intention rather than a legally binding document. Indeed, many of the signatories may not yet have the power under national law to provide information to foreign authorities: in Germany, for example, the exchanges did not have such powers, while the new federal authority established partly for the specific purpose of international cooperation (the BAWe) was initially given specific powers only in respect of insider dealing.

[18] Personal View column in *The Financial Times*, 7th July 1997, London edition p.20.

The central problem is the ambivalence about the justification for and aims of public oversight. As we hope to have shown, the new dominance of international finance has not been created by independent and irresistible economic forces, and it does not constitute a unitary global financial market. The underlying dynamic of changes in the social structure of finance (the social patterns of saving and investment), has generated new competitive pressures mediated through institutional and regulatory forms, which have played a major part in shaping the new financial system. Far from being a lawless new frontier, financial markets are riddled with regulation at every level, of varying degrees of formalisation: the unwritten norms of traders, the often elaborate rulebooks of exchanges and standardised contracts of associations, the laws which authorise exchanges and trading systems and providing for the enforcement of contracts of speculation, the provisions on the treatment of margin advances and set-off in bankruptcy, as well as the prudential rules for financial institutions discussed above. Markets do not and cannot exist independently of rules - they are created and shaped by rules, and the more impersonal the exchange relations involved the more formalised the rules will be.

Market participants understand this very well, and are generally at the forefront of demands for better regulation. The question of course is, who should regulate, and to what end. Not surprisingly, the view of market participants generally favours a maximum of "self"-regulation, and a minimum of "external intervention". However, this still begs the question of which "self" should regulate, and what is the role of the external intervenor (at every level). The emergence of complex global networks of financial intermediation has, as we have sketched out, resulted from the competitive interactions of regulators as much as traders, taking place within an increasingly multi-layered institutional kaleidoscope. The absence of any external reference-point makes it difficult, if not impossible, for regulators to establish what "public interest" they should be defending. Consequently, they see their dual role as (i) to facilitate the market, and (ii) to prevent systemic collapse. This goes a long way towards explaining the essentially reactive character of regulatory changes, which routinely have resulted from the latest crisis or scandal. However, it is clearly an inadequate perspective on which to base the desirable public framework for this very central activity. We should recall that money is not just any commodity, but the repository and channel for social value as a whole. The time is over-due for a strong reassertion of the crucial importance of a positive public role in regulating financial markets, not simply to prevent economic collapse, but to ensure that they operate in the broader public interest.

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