Border Problems

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Abstract

There are several generic problems connected with financial regulation. Among them, two perennial problems are associated with the existence of important, but porous, borders, or boundaries. The first such boundary is that between regulated and non-regulated (or less regulated) entities. The second, key, border is that between States, where the legal system and regulatory systems differ from state to state. In this paper, we explore these two boundaries.

I. Introduction

As with territorial waters and the exclusive economic zone in fishing disputes between countries, where you draw the line of regulation, protection and government assistance is contentious. Calls either to widen the net of regulation (and related protection) or to limit protection, for example to some set of 'narrow banks' have proliferated in response to the

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crisis.[1] The dichotomy between international (global) markets and institutions and national rules, exposing the limitations of the principle of national sovereignty, adds yet another layer of complexity to the design of effective financial regulation.

II. The first boundary problem

The first boundary problem was examined at some length in the National Institute Economic Review (2008)[2] and in the Appendix to the so-called Geneva Report (2009),[3] focusing on cases where the non-regulated can provide a (partial) substitute for the services of the regulated.[4] The unregulated frequently depend on services, e.g. payment services, and on

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[1] While in fisheries, it is a matter of defining jurisdiction – the basis of regulation – and the actual amount of regulation, including subsidies, is left to the particular jurisdiction, in finance the issues are more complex, for a number of reasons including the border problems analyzed in this paper.

[2] See Charles Goodhart, 'The Boundary Problem in Financial Regulation', 206 (1) National Institute Economic Review (2008), at 48-55.

[3] See Charles Goodhart, 'The Boundary Problem in Financial Regulation', Appendix A, in Markus K. Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash Persaud and Hyun Song Shin (eds), *The Fundamental Principles of Financial Regulation,* eleventh Geneva Report on the World Economy (Geneva: International Center for Monetary and Banking Studies, ICMB and Centre for Economic Policy Research, CEPR, 2009).

[4] The very definition of what constitutes financial regulation is contentious. While all companies are subject to some rules (general law concerning torts, contracts, property etc), some financial entities – notably commercial banks – are subject to more stringent 'financial rules' (concerning licensing, capital and liquidity requirements, lending limits, etc) than others. It is in this context that the dichotomy between the regulated and non-regulated becomes significant. There is always concern that financial activities will migrate from banks to other kinds of

back-up lines of credit from the regulated. In the build-up to the crisis, there are plenty of examples of unregulated entities which were structured as 'associates', or off-shoots, of the regulated ones.

If regulation is effective, it will constrain the regulated from achieving their preferred, unrestricted, position, often by lowering their profitability and their return on capital. So the returns achievable within the regulated sector are likely to fall relative to those available on substitutes outside. There will be a switch of business from the regulated to the non-regulated sector.[5] In order to protect their own businesses, those in the regulated sector will seek to open up connected operations in the non-regulated sector, in order to catch the better opportunities there. The example of commercial banks setting up associated conduits, SIVs (structured investment vehicles) and hedge funds in the last credit bubble is a case in point.

But this condition is quite general. One of the more common proposals, at least in the past, for dealing with the various problems of financial regulation has been to try to limit deposit insurance and the safety net to a set of 'narrow banks', which would be constrained to

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companies (non-regulated or less regulated) to avoid the crackdown of more stringent financial rules, such as those of the US Dodd-Frank Act 2010 [Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010)] and of the new Basel Committee proposals . 'Defining the perimeter of regulation will continue to be a challenge, given the growing number of tax and regulatory incentives for firms to establish businesses in the shadows outside the regulated sector'. See Report on Financial Regulation (by Francesco Guerrera, Tom Braithwaite and Justin Baer) in *Financial Times*, of 1 July 2010 quoting Charles Randell of law firm Slaughter and May.

[5] Though in some cases, legal security will be preferred over higher profits.

hold only liquid and 'safe' assets. The idea is that this would provide safe deposits for the orphans and widows. Moreover, these narrow banks would run a clearing-house and keep the payments' system in operation, whatever happened elsewhere. For all other financial institutions outside the narrow banking system, it would be a case of 'caveat emptor'. They should be allowed to fail, without official support or taxpayer recapitalisation.

In fact, in the UK something akin to a narrow banking system was put in place in the19th century with the Post Office Savings Bank and the Trustee Savings Bank. But the idea that the official safety net should have been restricted to POSB and TSB was never seriously entertained. Nor could it have been. When a 'narrow bank' is constrained to holding liquid, safe assets, it is simultaneously prevented from earning higher returns, and thus from offering as high interest rates, or other valuable services, (such as overdrafts), to its depositors. Nor could the authorities in good conscience prevent the broader banks from setting up their own clearing house. Thus the banking system outside the narrow banks would grow much faster under normal circumstances; it would provide most of the credit to the private sector, and participate in the key clearing and settlement processes in the economy.

This might be prevented by law, taking legal steps to prohibit broader banks from providing means of payment or establishing clearing and settlement systems of their own. There are, at least, four problems with such a move. First, it runs afoul of political economy considerations. As soon as a significant body of voters has an interest in the preservation of a class of financial intermediaries, they will demand, and receive, protection. Witness money market funds and 'breaking the buck' in the USA. Second, it is intrinsically illiberal. Third, it is often possible to get around such legal constraints, e.g. by having the broad bank pass all payment orders through an associated narrow bank. Fourth, the reasons for the authorities' concern with financial intermediaries, for better or worse, go well beyond insuring the maintenance of the basic payment system and the protection of small depositors. Neither Bear Stearns nor Fannie Mae had small depositors, or played an integral role in the basic payment system.

When a financial crisis does occur, it, usually, first attacks the unprotected sector, as occurred with SIVs and conduits in 2007. But the existence of the differential between the protected and unprotected sector then has the capacity to make the crisis worse. When panic and extreme risk aversion take hold, the depositors in, and creditors to, the unprotected, or weaker, sector seek to withdraw their funds, and place these in the protected, or stronger, sector, thereby redoubling the pressures on the weak and unprotected sectors, who are then forced into fire sales of assets, etc. The combination of a boundary between the protected and the unprotected, with greater constraints on the business of the regulated sector, almost guarantees a cycle of flows into the unregulated part of the system during cyclical expansions with sudden and dislocating reversals during crises.

The institutional criterion that typically governs financial regulation, divides firms into banks, securities firms and insurance firms, among others, and then generally applies a separate set of rules for each type of institution (with banks bearing the heaviest regulatory cost), while leaving entities that perform similar services (e.g., the shadow banking system) outside the regulatory loop; and this approach has proven deficient during the crisis. The example of the 'shadow banking system', which played a key role in the growth of the securitization market, and is considered by many as one of the causes of the crisis, is an example of this boundary problem.[6] While we mostly know what a bank is, the very expression 'shadow banking system' is imprecise and its contours are not clearly defined. According to Roubini, broker-dealers, hedge funds, private equity groups, structured investment vehicles and conduits, money market funds and non-bank mortgage lenders are all part of this shadow system.[7] Gary Gorton and Andrew Metrick believe that it was the (wholesale) run on the repo market during 2008, a run not so much on depository institutions as on the shadow banking system, that caused the crisis, and suggest that new regulation could improve the functioning of the shadow banking system by making it less vulnerable to panics and crises of confidence.[8]

Today's financial markets are characterized by the proliferation of financial conglomerates and complex financial groups and by the blurring of the frontiers between the types of business that financial firms undertake, thus rendering institutional classifications less meaningful. Supervision has traditionally been organized by institution, irrespective of the business function or range of functions that the institution undertakes. Inter-industry

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[6] See Rosa M. Lastra and Geoffrey Wood, 'The Crisis of 2007-2009: Nature, Causes and Reactions' in this issue.

[7] See Nouriel Roubini, 'The Shadow Banking System is Unravelling: Roubini Column in the Financial Times. Such demise confirmed by Morgan and Goldman now being converted into banks', http://www.roubini.com/roubini-monitor/253696/the_shadow_banking_system_is_unravelling_roubini_column_in_the_financial_times_such_demise_confirmed_by_morgan_and_goldman_now_being_converted_into_banks (visited 4 August 2010).

[8] See Gary Gorton and Andrew Metrick, 'Securitized Banking and the Run on the Repo', NBER Working Paper No. w15223, August 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1454939 (visited 4 August 2010).

affiliation and inter-industry competition in the financial sector have suggested the need for enhanced consolidated supervision, and increased reliance on regulation by business function rather than by institution. Under a system of supervision by business function, supervisors focus on the type of business undertaken, regardless of which institutions are involved in that particular business. The Dutch supervisory model, introduced in the second half of 2002, provides an example of a functional model based on the objectives of supervision. The Dutch central bank (De Nederlandsche Bank, DNB) is the institution responsible for prudential supervision in the pursuit of financial stability. The Authority for Financial Markets (AFM) is the authority responsible for conduct of business supervision. Both supervisory authorities cover the full cross-sector width of financial markets (all institutions in banking, securities, insurance and pensions).[9] Notwithstanding this functional–institutional boundary problem, whether we need to circumscribe government protection to a specified set of regulated institutions remains an issue of great importance. If regulation is to differ in intensity between the systemically important and the less so, then there is a need for (legal) clarity as to which falls into each camp. But the systemic importance of any financial intermediary may vary depending on circumstances. The definition of 'systemic importance' is fuzzy.

However, the recent crisis has shown that we must make a much greater effort to understand the emergence and existence of such systemic risks. We need greater transparency to be able to identify systemic risk in the first place. It is clear that some non-banks are

[9] See Rosa M. Lastra, *Legal Foundations of International Monetary Stability,* (Oxford: Oxford University Press, 2006) chapter 3.

systemically significant and that the potential provision of government assistance justifies the widening of the regulatory net. The problem is how to do it.

The issue of drawing boundaries for regulation-protection is not new. For instance, the Glass–Steagall Act of 1933 (named after its legislative sponsors, Carter Glass and Henry B. Steagall), established a clear boundary between commercial banks and investment banks in the USA, with government assistance typically confined to the former (even though there were some emergency provisions, such as section 13(3) of the Federal Reserve Act, which permitted the Fed to act as Lender of Last Resort to non-depository financial institutions, a provision that became handy since it was activated in the rescues of Bear Stearns in March 2008 and of AIG in September 2008). Many provisions of Glass–Steagall were repealed by the passage of the Financial Modernization Act of 1999 (Gramm–Leach–Bliley Act).[10] Interestingly, this repeal, though hailed at the time as a major achievement, has been blamed for some of the problems that led the financial crisis by a few politicians and commentators.[11]

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[10] Pub.L. 106-102, 113 Stat. 1338, enacted November 12, 1999.

[11] Ten years ago, the revocation of Glass–Steagall drew few critics. One of the leading voices of dissent was Senator Byron L. Dorgan, Democrat of North Dakota. He warned that reversing Glass–Steagall and implementing the Republican-backed Gramm–Leach–Bliley Act was a mistake whose repercussions would be felt in the future. 'I think we will look back in 10 years' time and say we should not have done this, but we did because we forgot the lessons of the past, and that that which is true in the 1930s is true in 2010', Mr Dorgan said 10 years ago. 'We have now decided in the name of modernization to forget the lessons of the past, of safety and of soundness.' Senator Richard Shelby of Alabama, now the ranking Republican on the Senate Banking Committee, voted against the Gramm–Leach–Bliley Act because of his concern that repealing Glass–Steagall would threaten the safety and soundness of the banking system. Mr Dorgan's views were echoed by then-Senator

Indeed, among the structural reforms suggested to deal with crises, some have proposed a return to Glass–Steagall, while narrow banking or mutual fund banking has been advocated by others.[12]

Given the link between regulation and government protection, financial institutions are somewhat reluctant to accept more intensive regulation as the price for protection. This explains why Goldman Sachs and Morgan Stanley did not apply to become bank holding companies until after the collapse of Lehman Brothers in September 2008. But regulation is costly and banks and other regulated financial institutions often try to game or circumvent the regulatory system, so as to reduce this cost. There often appears to be a trade-off between safety and profitability, with financial institutions willing to sacrifice safety in good times in order to enhance their profitability.[13]

Barack Obama in 2008 as he campaigned for presidency. See http://dealbook.blogs.nytimes.com/2009/11/12/10-years-later-looking-at-repeal-of-glass-steagall of 12 November 2009 (visited 10 May 2010).

[12]The narrow banking proposals have been again endorsed by John Kay, 'Narrow Banking. The Reform of Banking Regulation', Centre for the Study of Financial Innovation, 15 September 2009, available at http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf (visited 4 August 2010) while Lawrence Kotlikoff has made a case for the mutualization of the financial industry in his book *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking* (Chichester: John Wiley & Sons, 2010).

[13] See Charles Goodhart, 'How Should We Regulate the Financial Sector', Chapter 5 in 'The Future of Finance: The LSE Report', (London: The London School of Economics and Political Science, 2010), pp 153-176; also available at futureoffinance.org.uk

How in a regulatory system can we combine the need to protect safety and soundness with the need to make a profit, and therefore to take risks? What is the difference between normal risk and excessive risk, and who defines it? These are perennial questions in financial regulation. While regulators – in a free market economy – should not be unduly concerned about profits (unless the lack of profits should threaten a desirable function) they should, however, worry about risks. As acknowledged, a regulator can always claim: 'If I am going to assist you on a rainy day, I need to oversee you on sunny day'.

Safe and sound banking and finance rests firstly upon good risk management and secondly on good risk control (by both the regulated and the regulators). In principle, only if management fails to control risks adequately should regulators intervene. However, it is difficult for regulators to know whether the institution has been or is being irresponsible unless they monitor on a regular basis. Any risk can grow to systemic proportions when its negative impact extends beyond an individual institution, affecting or threatening to affect by contagion many other institutions, often creating a disruption in the monetary system and an associated economic paralysis. Systemic risks seldom occur alone; they usually spread to other risks like wildfire and undermine confidence. Confidence and trust play an essential role in the financial system. Henry Thornton wrote in 1802:

> Commercial credit may be defined to be that confidence which subsists among commercial men in respect to their mercantile affairs. ... In a society in which law and

the sense of moral duty are weak, and property is consequently insecure, there will, of course be little confidence or credit, and there will also be little commerce.

Historical experience suggests that regulation, and more specifically governmental banking regulation, was often a by-product or reaction to crises or conflicts. In the United Kingdom, for instance, the shift from self-regulation to legal regulation in the field of financial services was prompted by a series of crises: the enactment of the 1979 Banking Act[14]followed the secondary banking crisis, and the 1987 Banking Act[15] was enacted following the Johnson Matthey Bankers' failure. This is also the case in the United States, where both the creation in 1913 of the Federal Reserve System (acting as lender of last resort) and the Federal Deposit Insurance Corporation in 1933 were responses to financial crises. Similarly, in Spain the creation of the guarantee insurance funds (Fondos de Garantía de Depósitos) for banks and thrifts in 1977 was motivated by a banking crisis. At an international level, regulation has also been prompted by financial failure and crises. Regulation after crisis is a constant in the history of finance.[16]

In some instances there are regulated and unregulated entities performing similar types of business. This is the case for instance with investment companies (pools of funds), where the legislation in the USA (and other jurisdictions) separates between the 'ins', i.e., mutual

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[14] http://www.opsi.gov.uk/acts/acts1979/pdf/ukpga_19790037_en.pdf (visited 30 August 2010).

[15] http://www.opsi.gov.uk/acts/acts1987/pdf/ukpga_19870022_en.pdf (visited 30 August 2010).

[16] See Rosa M. Lastra, *Central Banking and Banking Regulation*, (London: Financial Markets Group, London School of Economics and Political Science, 1996) chapters 2 and 3.

funds falling in the US under the Investment Company Act of 1940 from the 'outs', such as hedge funds, which are not subject to the stricter requirements of the Act and other securities laws. In the EU, Alternative Investment Funds (AIFs) are defined as funds that are not harmonized under the UCITS Directive.[17]

Another twist in the boundary problem is the interaction that some unregulated (or lightly regulated) institutions have with regulated ones. For instance, rating agencies exert an extraordinary influence and power upon financial institutions and their regulators (not to mention politicians in countries where sovereign debt is downgraded, with the example of Greece in 2010 providing ample evidence on this point).

The boundary problem has particular implications with regard to capital requirements. Why should capital requirements be strictly imposed upon commercial banks (credit or depositary institutions) when the shadow banking system is engaged in similar types of risky activities? Moreover, emphasis on capital, important as it is as an indicator of soundness, should not be the sole tool in the regulators' armoury. As Robert Litan insightfully stated in the 1980s, regulators focus so much upon capital requirements because it is difficult to assess and control the quality of the asset portfolio, and, of course, potential mismatches between the

[17] See proposed Directive on Alternative Investment Funds, 21 April 2009, http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf (visited 4 August 2010).

duration of liabilities and assets provides a cause for concern about liquidity management and controls.[18]

The boundary problem is also present with regard to lending limits, a traditional tool in banking regulation. We need to devise effective leverage limits that fulfil the same function that traditional lending limits have fulfilled in the past with regard to banks' overall exposures (including lending limits to insiders, to subsidiaries, to shareholders, and limits on large credit exposures).

In so far as regulation is effective in forcing the regulated to shift from a preferred to a less desired position, it is likely to set up a boundary problem. It is, therefore, a common occurrence, or response, to almost *any* regulatory imposition. A current (2010) example is the proposal to introduce additional regulatory controls on systemically important financial intermediaries (SIFIs). If SIFIs are to be penalized, there needs, on grounds of equity and fairness, to be some definition of and some criteria for what constitutes an SIFI – a complex exercise. But once such a definition is established and a clear boundary established, there will be an incentive for institutions to position themselves on one side or another of that boundary, whichever may seem more advantageous. Suppose that we started, say in a small country, with three banks, each with a third of deposits, and each regarded as too big to fail (TBTF), and the definition of an SIFI was a bank with over 20% of total deposits. If each bank then

[18] See Robert E Litan, 'Taking the Dangers Out of Bank Deregulation', 4 (4) The Brookings Review 3-12 (1986): 'Examinations are costly and time-consuming and the most important aspect of a bank's balance sheet, the quality of its asset portfolio, is difficult to assess at any given time. Perhaps in recognition of those limitations, federal regulators are increasing capital requirements.'

split itself into two identical clones to avoid the tougher regulation, with similar portfolios and interbank linkages, would there have been much progress? Similarity can easily generate contagion. Indeed, regulation tends to encourage and to foster similarity in behaviour. Does it follow then that regulation thereby enhances the dangers of systemic collapse that its purpose should be to prevent? Does the desire to encourage all the regulated to adopt, and to harmonize with, the behaviour of the 'best' actually endanger the resilience of the system as a whole?

One extreme solution to the first boundary problem is either to regulate all financial entities alike or none at all.[19] Laissez-faire proponents of free banking have long advocated this system, suggesting a minimalist approach in which the only acceptable rules are those that promote competition (entry or licensing, bankruptcy rules to govern exit and others) or anti-fraud provisions. Such a laissez faire system however is unrealistic, while the alternative – regulate all alike – is not feasible. This means that the boundary problem is likely to remain, and that any new rule will bring with it new boundary problems.

What should the regulators and supervisors then do? Again we quote from the Geneva Report:

> They should start by trying to list the key financial markets and systems in their own country. Having done so, they should review whether and which financial institutions are so important to the functioning of that market, or system, that their

[19]See Goodhart, above n 3.

> downfall, whether in the form of bankruptcy or major deleveraging, would seriously disrupt the operations of that market or system. ... In essence the financial supervisors have got to ask themselves, which financial institutions can be allowed to fail, and which cannot. Those that they claim cannot be allowed to fail, should be specifically regulated. ... Besides occasions of institutional downfall, regulators need to be concerned with such market failures as may lead to resource misallocations, e.g. in the guise of asset bubbles and busts.[20]

A criterion that divides institutions into those that can be allowed to fail and those that cannot (a criterion that draws on the too-big-to-fail doctrine and its variants, such as too interconnected to fail), needs to be well known and publicized *ex ante*, since only those institutions that cannot be allowed to fail (because of the need to protect essential functions such as the smooth functioning of the payment system) are to be protected and regulated. And since licensing is the first stage in the supervisory process, which acts as a filter in subsequent stages, the licensing requirements would be a relatively straightforward way to deal with this problem.[21] Of course, if enacted, any such rule dividing institutions into those that are allowed to fail and those that are not, is likely to lead a legion of lawyers to look at it in microscopic detail so as to find loopholes.

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[20] Ibid.

[21]With regard to the four stages of the supervisory process: licensing, supervision stricto sensu, sanctioning and crisis management, as well as the difference between supervision and regulation, see Lastra, chapter 2, above n 16.

> The more effective regulation is, the greater the incentive to find ways around it. With time and considerable money at stake, those within the regulatory boundary will find ways around any new regulation. The obvious danger is that the resultant dialectic between the regulator and the regulated will lead to increasing complexity, as the regulated find loop-holes which the regulators then move (slowly) to close. Basel I metamorphosed into Basel II [and now into Basel III]. So the process becomes ever more complex, almost certainly without becoming less porous.[22]

The above consideration suggests that any prescriptive rule-based approach needs to be complemented with more generic principles that respect the spirit of the law. Furthermore, national regulation alone will not suffice. Global problems require global solutions, which leads us into the next section.

III. The second boundary problem

The second boundary of critical importance to the conduct of regulation is the border between states or jurisdictions (such as the EU), each with their own legal and regulatory structures, i.e., the cross-border problem, which is rooted in the limitations of the principle of national sovereignty. Sovereignty as a supreme power is typically exerted over the territory of the state: the principle of territoriality.[23] So, the ongoing process of globalization and the

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[22] See Goodhart, above n 3.

[23] See Rosa M. Lastra, *Legal Foundations of International Monetary Stability*, (Oxford: Oxford University Press, 2006) chapter 1. Sovereignty is the supreme authority within a territory. The state is the political institution in

frequency of cross-border movement of persons, capital, goods or services has major implications for the scope of unfettered sovereignty, which continues to shrink.[24]

Financial markets and institutions have grown international in recent years. However, supervision and crisis management generally remains nationally based, constrained by the domain of domestic jurisdictions. The cross-border expansion of banks (via mergers and acquisitions, joint ventures or the establishment of branches and subsidiaries) and the effective supervision of institutions operating in various jurisdictions present numerous challenges for financial regulators and supervisors. Though progress has been made with regard to the regulation and supervision of cross-border banks, notably via soft law rules (Basel Committee of Banking Supervision and others) and regional rules (EC rules), the cross-border resolution of banking crises remains a matter of intense policy and legal debate.

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which sovereignty is embodied. Sovereignty in the sense of contemporary public international law denotes the basic international legal status of a state that is not subject, within its territorial jurisdiction, to the governmental (executive, legislative or judicial) jurisdiction of a foreign state or to foreign law other than public international law. It forms part of the fundamental principles of general international law and it is considered to be one of the principal organizing concepts of international relations. Monetary sovereignty is a particular attribute of the general sovereignty of the state under international law. Some authors argue that the concept of monetary sovereignty predates by thousands of year the concept of political sovereignty that was developed in the Renaissance, since the authority to create money had been proclaimed by the rulers or priesthood of ancient civilizations (Sumer, India, Babylon, Persia, Egypt, Rome and others). However, the modern understanding of the attributes of sovereignty is rooted in the political thought that was developed in the Renaissance. Politics operated without this organizing principle in the Middle Ages.

[24] See Helen Stacey, 'Relational Sovereignty', 55 Stanford Law Review 2029 (2003), at 2040-51.

Despite the many difficulties involved, efforts to develop international standards on cross border bank resolution are currently under way.[25]

In a global financial system with (relatively) free movement of capital across borders, most financial transactions that are originated in one country can be executed in another. This means that any constraint, or tax, that is imposed on a financial transaction in a country can often be (easily) avoided by arranging for that same transaction to take place under the legal, tax and accounting jurisdiction of another country, sometimes, indeed often, under the aegis of a subsidiary, or branch, of exactly the same bank or intermediary as was involved in the initial country.

This tends to generate a race to the bottom, though not always since the parties to a contract will prize legal certainty and contract reliability. (In this latter regard, Howell Jackson, drawing on the 'race to the bottom' versus 'race to the top' debate that has been a feature of corporate law scholarship in the United States – through the work of Roberta Romano and others – over the last twenty-five years, discusses the merits of regulatory

[25] The Basel Cross Border Resolution Group issued a report and recommendations in March 2010, http://www.bis.org/publ/bcbs169.htm (visited 4 August 2010). The International Monetary Fund issued a paper 'Resolution of Cross Border Banks – a Proposed Framework for Enhanced Coordination' (to which one of us contributed) on 11 June 2010. See http://www.imf.org/external/np/pp/eng/2010/061110.pdf (visited 22 July 2010). See generally Rosa M. Lastra (ed), *Cross Border Bank Insolvency*, to be published by Oxford University Press (2011).

competition in securities markets.)[26] Another aspect of this same syndrome is the call for 'a level playing field'. Any state which seeks to impose, unilaterally, tougher regulation than that in operation in some other country will face the accusation that the effect of the regulation will just be to benefit foreign competition with little, or no, restraining effect on the underlying transactions.

Moreover the cross-border concern may constrain the application of counter-cyclical regulation. Financial cycles, booms and busts, differ in their intensity from country to country. Housing prices rose much more in Australia, Ireland, Spain, the UK and the USA than in Canada, Germany and Japan in the years 2002–2007. Bank credit expansion also differed considerably between countries. But if regulation becomes counter-cyclically tightened in the boom countries, will that not, in a global financial system, just lead to a transfer of such transactions off-shore; and London has been at the centre of arranging such cross-border financial operations.

More generally, financial globalization in general, and the cross-border activities of SIFIs (systemically important financial intermediaries) in particular, mean that the level-playing-field argument is advanced to oppose almost any unilateral regulatory initiative. The main response to this, of course, is to try to reach international agreement, and a whole structure of institutions and procedures has been established to try to take this forward, with

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[26]Howell Jackson has advocated the advantages of legal certainty and reliability and the role of securities laws in creating strong capital markets. See, inter alia, Howell E. Jackson, 'Centralization, Competition, and Privatization in Financial Regulation', 2 (2) Theoretical Inquiries in Law, article 4 (2001), http://www.bepress.com/til/default/vol2/iss2/art4 (visited 3July2010).

varying degrees of success. Inevitably, and perhaps properly, this is a slow process.[27] Those who claimed that we were losing the potential momentum of the crisis for reforming financial regulation simply had no feel for the mechanics of the process. Moreover, any of the major financial countries, perhaps some three or four countries, can effectively veto any proposal that they do not like, so again the agreements will tend to represent the lowest common denominator, again perhaps desirably so.

Finally, there can be circumstances and instances when a regulator can take on the level-playing-field argument and still be effective. An example can be enforcing a margin for housing LTV (loan to value) ratios by making lending for the required down-payment unsecured in a court of law. Another example is when the purpose of the additional constraint is to prevent excessive leverage and risk-taking by domestic banks, rather than trying to control credit expansion more widely (as financed by foreign banks).

There is no easy solution to the second boundary problem. The doctrine of multilayered governance, which discusses the allocation of regulatory powers at the national, regional (European) and international level, provides a template to address some of these issues.[28] We need an inter-jurisdictional approach to financial regulation. Some rules and

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[27] The problem is a general one and in EU law outside of finance, eg in goods, is has been a matter of harmonizing only key points, but not entire areas. A level playing field in international finance calls for some international rules. Given the difficulties inherent in the regulation and harmonisation of asset quality, the focus so far has been on capital, though in the aftermath of the crisis attention has also turned to other areas, such as liquidity and resolution.

[28] For a more extensive discussion of this doctrine see article by Rolf Weber in this issue.

supervisory decisions must remain at the national level, while rules for a regional area, such as the European Union, ought to be regional. Yet, a global banking and financial system requires some binding international rules and an international system for the resolution of conflicts and crises. An analogy with football could be instructive in this regard. There are domestic leagues, ruled by national football associations, there is in Europe a Champions League of the best football clubs governed by UEFA, and finally – though this is a competition among countries not clubs – there is FIFA and the World Cup. The challenge is to identify the criteria under which financial regulatory powers should be allocated and the different layers (including private mechanisms) that are needed. Effective enforcement remains the greatest challenge at the international level, since enforcement mechanisms have traditionally been nationally based. The conditioning of market access on the basis of compliance with some international rules could be an effective way of tackling some of these difficult cross-border issues.

Globalization and regionalization (in particular in the EU) have challenged the traditional law-making process, a development which is particularly relevant for the future of financial regulation.

> International financial soft-law is often a 'top-down' phenomenon with a two-layer implementation scheme. The rules are agreed by international financial standard setters and national authorities must implement them in their regulation of the financial industry. The financial intermediaries are the 'final' addresses of those rules. Standards and uniform rules, however, can also be designed by the financial industry itself. Self-regulation, by definition, has a 'bottom-up' character.

> International lawmaking relies upon a variety of sources. It is in the confluence of 'hard law' (legally enforceable rules), soft law of a 'public law' nature (which can complement, co-exist or turn into hard law) and soft law of a 'private law' nature (comprising rules of practice, standards, usages and other forms of self-regulation as well as rules and principles agreed or proposed by scholars and experts) where the future of international financial and monetary law lies.[29]

IV. Concluding Observations

To conclude, border problems are pervasive, and complicate the application of regulatory measures both within and between countries. The prospective regulator will always need to be alert to the likely effect of shifts of business across such borders, and seek to mitigate them. But to some extent such cross-border business transfers are generic and the regulator or supervisor will just have to monitor and, up to a point, to live with them. The perimeter issue remains a major challenge for regulators and supervisors, one that resurfaces again and again in the debate about derivatives, hedge funds, rating agencies and others. Progress towards an effective framework for cross-border crisis management and resolution is hampered by the two boundaries that we have discussed in this paper. Regulation is most needed in good times, when rapid credit expansion and exuberant optimism cloud the sound exercise of judgment in risk management, yet regulation is typically designed in bad times, in response to a crisis. We need appropriate counter-cyclical regulation, bearing in mind the biblical story of Joseph in

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[29] See Rosa M. Lastra, *Legal Foundations of International Monetary Stability,* (Oxford: Oxford University Press, 2006) 500-01.

which provisions were gathered in good times to be used in bad times. Regulation and supervision should aim at protecting the interests of society (by identifying, preventing and containing systemic risk as well as by guaranteeing the functioning and access to critical banking and financial functions), rather than the interests of individuals or institutions. Notwithstanding the porous borders of financial regulation, we have to continue to make progress in redesigning finance so as to restore the faith in the financial market as an instrument for the wealth and development of nations.