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American Enterprise Institute

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 321

Charles W. Calomiris
212.854.8748

Edward J. Kane
520.299.5066

Catherine M. Schrand
215.898.6798

Statement of the Shadow Financial Regulatory Committee on
Creating a More Flexible and Accountable Basel System

December 5, 2011

As cross-country contacts between financial markets and institutions became more numerous and more complex, so did efforts to create a coherent framework for coordinating the activities of central banks and supervisory authorities (“regulators”) in different countries. The most consequential efforts have taken place under the aegis of the Basel Committee on Banking Supervision (BCBS).

The ultimate goal of the BCBS is to promote global financial stability by means of global regulation of banking activities. Successive iterations of the original Basel Accord have resulted in a framework in which the role of the BCBS representatives is to negotiate common regulatory techniques, concepts, and rules (“rules”) for adoption in individual countries. Approaching financial stability in this way is premised on the erroneous belief that applying a common set of rules in selected areas of prudential regulation will produce uniform cross-country systems for regulating banking activities. This presumption neglects the fact that regulators and the institutions they supervise differ in many other respects and operate in environments that challenge them in different ways. Furthermore, the Accord fails to make regulators in individual countries accountable to one another for breaching the standards it promulgates.

A one-size-fits-all system of capital and liquidity requirements does not necessarily promote stability. Regulation consists of rules, applications of the rules, and enforcement. In principle, rules can be fashioned anywhere, but enforcement takes place in particular jurisdictions. Because no two countries’ legal systems and political

cultures are the same, identical rules can and will generate greater and lesser burdens according to where and how a bank operates. Multinational financial institutions are well aware of this and locate various offices and lines of business accordingly.

Substantial differences are bound to develop in the effectiveness of the rules for regulating banks' activities because of cross-country variation in regulatory incentives and enforcement. Realistically, cross-country bargaining over rules encourages compromises that threaten to prove counterproductive in some circumstances. Rules shaped by a vigorous centralized bargaining process have to accommodate (and often paper over) differences in the regulatory culture and economic structure of individual countries. The result is to open destabilizing gaps and loopholes in the supervisory system that innovative multinational institutions can arbitrage at little or no cost.

The Shadow Financial Regulatory Committee believes it is possible to improve the Basel process by dialing its goals back a step. What is needed is an honest and continuing conversation about best practices. Trying to hammer out common definitions on issues such as what kinds of hybrid liabilities might count as regulatory "capital" and how to assign specific risk weights to politically charged assets (such as mortgages and sovereign debt) has produced the regulatory equivalent of Swiss cheese. It would be far better for BCBS representatives to spend their time criticizing and defending short-run deviations from best practices that have developed in individual countries. The volume of regulatory arbitrage observed in recent years underscores the importance of making regulators in individual countries deal candidly with one another when they breach the standards the BCBS promulgates.

To address the inadequacy of the current BCBS framework for dealing with cross-country variation in application and enforcement of rules, the Shadow Financial Regulatory Committee proposes converting the BCBS into a global regulatory forum that would be directed to carry out two assignments. The first task would be to thrash out and articulate basic "principles" that delegates from participating countries believe would promote global financial stability. An example might be to require that every country monitor the risk-management and net-worth measurement systems of financial institutions that operate within its borders. But the Basel Committee would delegate to individual-country regulators the chore of making and enforcing a body of specific rules that apply these principles to banks that operate within its borders. The idea is that country-specific actions are needed to customize global principles and national authorities can adapt more flexibly to the ever-changing financial environment. Outsourcing the rule-making acknowledges that individual jurisdictions can deal with incentive conflicts and most other supervisory problems more effectively in customized but coordinated ways.

This conception is already embodied in one important regional regulatory body, the European Systemic Risk Board (ESRB), which issues statements but does not possess regulatory authority. Still, because membership in the ESRB includes central bankers and regulators with substantial authority in individual countries, the statements of the ESRB constitute authoritative endorsements of principles. These endorsements have important consequences, given the ESRB's membership. If the Basel Committee were to adopt that model, it would be able to discuss regulatory principles more effectively. Not having to fight for rules with which they can comply immediately would free members to speak more openly and honestly about the challenges faced in crafting meaningful rules, while providing members the latitude they need to adjust their standards to local, political and economic

circumstances. It is worth noting that Basel recognizes the need for enforcement and national regulators recognize the need for customization. However, these ideas are not formalized as part of the process, and attempts at incorporating customization into supervision have been uneven and incomplete.

The second task of the BCBS would be to coordinate individual-country rule-making and enforcement. It would set up and house a cross-country monitoring and compliance bureau charged with identifying, assessing, and (where appropriate) endorsing the manner in which incentive conflicts in implementing the principles are and are not successfully resolved in countries that make themselves members of the BCBS system. This second arm would act as a global overseer of national regulators. Its purpose would be to assess the alignment of regulatory incentives and to track and publicize deviations from the principles where they are observed.

Rule-making is an evolutionary process. Regular BCBS oversight of country adaptations would uncover incentive conflicts in the application of new rules and subject them to timely criticism and disciplinary pressure from fellow regulators. The ever-present threat of BCBS criticism should encourage individual countries to focus on incentive systems and to address loopholes opened by regulation-induced innovation more promptly than they have in the past.

When global rules fail as badly as Basel I and II did, national regulators cannot stand by. They must take action to pursue the goals of stability and liquidity at the national level. If national regulators do not plan adequately for this in what we might call Basel IV, the opportunity cost will be financial turmoil of the kind being suffered today.

Without accountability, global regulation has proved ineffective and distorting. Uniformity, *per se*, does not assure an acceptable balance between the costs and benefits of regulation. Indeed, uniformity in regulation and supervision, which requires accepting similar judgments about measuring risk, can contribute to herding behavior and make the system more vulnerable to common shocks and systemic breakdowns. In this way, some kinds of uniformity increase the costs of regulation and degrade the benefits experienced.

While a system combining national regulation with principles-based global supervision may exhibit gaps and redundancies, it is far from clear that the costs of tolerating the redundancies would exceed the costs of trying to implement nationally a uniform set of international rules.

The intended outcome of BCBS negotiations should not be merely to fashion a consistent set of rules. The goals whose achievement the public demands from financial regulators are stability and liquidity. Just as a consistent set of accounting standards need not by itself produce completely “comparable” financial reporting outcomes, a consistent set of banking rules will not necessarily achieve acceptable degrees of stability and liquidity.