TESTIMONY

Regulatory Fragmentation, the Balkanization of Financial Markets and the Competitiveness of the American Financial Services Sector

By: Louise C. Bennetts[1]

Subcommittee on Oversight and Investigations
Committee on Financial Services
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Introduction

Chairman McHenry, Ranking Member Green, and distinguished members of the Committee, I thank you for the opportunity to testify in today's important hearing.

I am Louise Bennetts, Associate Director of Financial Regulation Studies at the Cato Institute, a non-profit, non-partisan public policy research institute located here in Washington, D.C.

Before I begin, I would like to highlight that all comments I make and opinions expressed herein are my own and do not represent any official positions of the Cato Institute or any other organization. In addition, outside of my interest as a U.S. resident, consumer and taxpayer, I have no financial interest in the subject matter before the Committee today, nor do I currently represent any entities that do.

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Background

Since 2008, commentators, industry professionals, regulators, and elected officials have made numerous, often contradictory, suggestions about how to deal with, or avoid, banking crises. These suggestions range from "bailing in" creditors, to making banks smaller (whether through size caps or limitations on acquisitions), to limiting the activities that banks undertake (the "Volcker Rule" and similar initiatives), to imposing ever more stringent regulations, in particular, on larger organizations. In addition, increasingly regulators are looking inward, trying to insulate their domestic banking sectors from external shocks.[i]

In the United States since 2010 we have seen the rollout of one of the most comprehensive "reform" agendas targeting the financial services industry both in the United States and abroad. The centerpiece of the reform agenda – the Dodd-Frank Wall Street Reform and Consumer Protection Act – has **394** associated rulemaking requirements and already has spurred thousands of pages of related rules.

But this is just the tip of the iceberg. As of February 2014, only 52% of the rules required by the Act have been finalized.[ii] Around 20% have yet to be proposed. And Dodd-Frank is but one component of a far greater regulatory reform agenda that includes a complete overhaul of the capital and liquidity rules imposed on the U.S. banking sector (the "Basel III" regime); a radical revision of the regulation of nonbank financial companies such as insurance firms and asset managers; changes in the regulation of the U.S. operations of foreign banks; changes in the regulation of consumer credit; imposing new monitoring and enforcement obligations on banks on behalf of the Federal government. All of these new obligations are only magnified for banks and financial service companies that operate cross-border. In addition, barely a month passes without a new initiative aimed at the financial services sector being proposed either in Congress or through the regulatory agencies.[iii] While most of these proposals will never see the light of day, they nonetheless impose a

significant cost on the private sector in terms of the uncertainty they generate and the time and resources private firms must spend on evaluating the potential impact of such proposals.

The question before the Committee today is: how is this regulatory overhaul impacting the global competitiveness of the American financial services sector and, indeed, American consumers of financial services? To date, no assessment has been made and no studies have been undertaken to assess the cumulative impact or cost of all this regulation. To answer this question, in my view, we need to address two related issues:

- What are the costs associated with the individual impact and, more importantly, cumulative effect of all these regulations?
- And secondly, given the sheer volume, complexity and the unintended consequences of this massive undertaking, are we likely to achieve the desired outcome – that is: creating a financial system that is safer and more transparent without damaging credit provision and profitability?

Before I discuss these two key points with an analysis of some specific cases, I would like to make a few observations about the United States' position in the global economy. **The United States is a net importer of capital and a net exporter of financial services and products**. Despite, or possibly even because of, its inauspicious and crisis-prone banking history, the United States has the world's most vibrant capital markets and, currently, has the only well-developed debt market and short-term or overnight dollar funding market. Many foreign companies and banks raise a significant portion of their non-depositary short-term funding in the United States.

However, while the United States may have had a head start, one cannot assume a permanent state of dominance. Steps are being taken to develop high yield and other short-term funding markets in South East Asia, particularly in Hong Kong and

Singapore as well as in Europe (although the European funding markets remain weak).[iv] In addition to the large European banks, several emerging markets, most notably China, are taking noteworthy steps towards the creation of worldwide banking conglomerates, by acquiring significant stakes in banks and financial companies in the developing, and to a lesser extent, the developed world.

The Costs of Regulatory Fragmentation within the United States

The United States' financial services sector has long been subject to a fragmented regulatory regime, in part due to the structural spilt that historically characterized the market (between activities such as loan-making and underwriting) and the deep-seated American aversion to the "universal" banking model.[v] In most countries, banks and financial services companies report to a single regulatory authority. In the United States, even monoline financial firms such as commercial or investment banks must report to more than one regulatory agency and these agencies frequently have overlapping jurisdiction. This creates a competitive disadvantage for U.S. financial institutions as it increases the costs associated with regulatory compliance, decreases the efficiency of both the regulators and the regulated, opens the door for regulatory arbitrage and creates a lack of transparency as to who bears ultimate responsibility for regulatory oversight.

It could also result in the release of rules and regulations that are contradictory in nature, making it impossible for a regulated entity to be compliant with all rules at all times. The Dodd-Frank Act made this problem worse not better. Instead of streamlining the regulatory agencies responsible for the oversight of the financial system, the Dodd-Frank Act adds several new regulatory bodies – the Consumer Financial Protection Bureau, the Office of Financial Research and the Financial Stability Oversight Counsel. It also gives overlapping jurisdiction to multiple regulators and carves up the regulatory "turf" in arbitrary ways.[vi] This has led to the situation where, for example, multiple versions of rules on the same topic have been

released by more than one agency (such as was the case with the first release of the Volcker Rule proposal).

The Dangers of Financial Sector "Balkanization"

Several commentators and industry experts have drawn a parallel between the current climate in global financial regulation and the relations that characterized trade politics among the world's largest economies in the early 1930s following the passage of the "Smoot-Hawley" Tariff Act, a situation known as "balkanization."[vii] In this regard, particular attention has been paid to current measures that have protectionist implications or serve to encourage the further balkanization of financial services or the isolation of American banks, companies and individuals, (such as the Federal Reserve's recent Foreign Banking Organization proposal or the FATCA legislation). I believe the comparison is well made.[viii]

In the two years following the passage of Smoot-Hawley, the volume of U.S. imports fell 40 percent. This was due, in part, to a decline in domestic demand, but scholars estimate that at least a quarter of this decline can be directly attributable to the act itself.[ix] In addition, retaliatory actions against the United States resulted in a decline of 60 percent in U.S. exports in the 1930s, and this discrimination against U.S. products persisted for decades. In addition, Smoot-Hawley encouraged other countries—most notably Germany—to institute retaliatory measures, leading to a worldwide trade freeze that exacerbated hardships for local consumers and almost certainly contributed to the increasingly Balkanized international environment in the period leading up to World War II.

Following a crisis, the natural inclination for any regional authority is to attempt to erect walls around local industries and operations to make it easier—at least, theoretically—to address problems at a local level. Usually this also serves to meet the demands of local interest groups harmed by the crisis. But for U.S. regulators, the lesson from the Smoot-Hawley experience should be clear: this approach may

yield positive results in the immediate term only, if at all, and any positive outcomes are far outweighed by the negative effects of retaliation. As the world's leading financial services economy, the actions of U.S. policymakers have a disproportionate effect on the global financial sector and are likely to spur retaliatory actions elsewhere in the world. When it comes to the regulatory "marketplace," the United States is a "price-setter" and ought to lead by example.

Indeed, my great fear is that the response to the 2007–08 Financial Crisis in the United States may be a classic example of policymakers throwing the baby out with the bathwater. In this case it is global capital flows—as with global trade flows in the 1930s—that could potentially suffer a steep decline in the wake of the measures adopted to address the perceived problems in the financial services industry.

Although the increased size, depth, liquidity, and complexity of financial markets has received widespread criticism, including being labeled as a "cause" of the crisis, in my view this criticism is misplaced. It overlooks the significant global benefits that fluid and highly developed capital markets have accrued—benefits that have not come close to being wiped out even in the wake of the financial crisis.[x]

In the only detailed study released to date on the effect of post-crisis reforms on global capital flows, the McKinsey Global Institute (the research arm of the consulting firm McKinsey and Co.) found that since 2008, cross-border capital flows have fallen dramatically as banks and borrowers deleverage.[xi] **The firm estimates that cross-border capital flows have declined 60 percent since 2007.**[xii] Financial assets had been increasing by close to 8 percent per annum since the early 1990s, but they are now growing at under 2 percent.[xiii] At the same time, **government debt securities have increased by more than $15.4 trillion worldwide**. The authors note that "for three decades, capital markets and banking systems rapidly expanded and diversified, but now that process—called financial deepening— has largely ground to a halt. . . . Today, global financial markets are at an inflection point. One path leads to a more balkanized structure that relies

primarily on domestic capital formation and concentrates risks within local banking systems."[xiv]

The study also notes: "facing new regulations on capital and liquidity as well as pressures from shareholders and regulators to reduce risk, **many banks in advanced economies are winnowing down the geographies and business lines in which they operate. Since early 2007, commercial banks have sold off more than $722 billion in assets and operations, with foreign operations accounting for almost half of this total.** Regulators in many countries are moving to exert more control over the foreign banks that remain active in their jurisdictions, in some cases requesting that banks operate as subsidiaries rather than branches."[xv]

Although the "Foreign Banking Organization" rule release last month by the Federal Reserve (discussed below) may stop short of requiring the full subsidiarization of foreign banks' U.S. operations, the likely chilling effect on global capital is the same. The McKinsey Global Institute study concludes with the warning that regional differences in the availability of capital could emerge and that regions with high savings rates could find themselves with surplus capital and a shortage of good investment opportunities, while other countries could find themselves short of capital and facing lower growth.[xvi]

Undoubtedly, there are many factors contributing to the collapse of global capital flows post-2008, not least the European public debt crisis, the weaknesses in the Chinese financial sector, and a general lack of investor confidence worldwide. Nonetheless, any measures on the part of U.S. regulators that have the effect—whether intentional or incidental—of hastening the decline of such flows should be approached with extreme caution. This is especially true when it is unclear whether the measures will deliver their promised benefits.[xvii]

U.S. Regulatory Overreach and Potential Retaliatory Actions against American Banks and Financial Services Firms: The Case of the Federal Reserve's "Foreign Banking Organization" Proposal[xviii]

The Federal Reserve's FBO proposal represents a seismic shift in the regulation of U.S.-based subsidiaries and operations of foreign banks. Since the passage of the International Banking Act of 1978, foreign banks seeking to operate in the United States have been afforded considerable flexibility in the structuring of their U.S. operations.[xix] The Federal Reserve would now change this approach for important market players. This would require foreign banks to transfer their U.S.-based operations to an existing holding company or to a newly created one.[xx] Once this transfer is complete, the subsidiary would be required to comply with U.S. capital and liquidity standards as well as U.S.-specific requirements such as single counterparty credit limits, enhanced risk management practices, and early remediation requirements *in addition* to meeting all home country requirements.[xxi]

At the macro level, the proposal interferes with the ability of global banks to allocate capital and liquidity in the manner they determine to be most efficient. The proposal would trap a material amount of capital and liquidity inside the U.S. subsidiary, rendering it unusable for the rest of the institution. Ironically, the Federal Reserve itself noted the benefits of its traditional approach to foreign bank supervision in the preamble to the FBO proposal: "[T]he structural diversity and consolidated management of capital and liquidity permitted under th[is] approach has facilitated cross-border banking and increased global flows of capital and liquidity."[xxii] But the corollary is also true. If such flows stimulate economic growth, any reduction in those flows is likely to inhibit growth and prolong recessionary or sluggish tendencies. This seems a major drawback to a proposal introduced at a time when the Federal Reserve is engaged in unprecedented expansionary monetary policies to stimulate growth.

The Federal Reserve's FBO proposal also contains a potential serious drawback for American banks and financial services firms, particularly those with significant cross-border operations. If foreign regulators use the same reasoning as the Federal Reserve, the FBO proposal would likely further encourage additional protectionist measures to be taken by foreign regulators. These measures could include retaliatory actions against U.S. banking organizations with significant international operations.

Many foreign supervisors have raised concerns about the Federal Reserve's proposal during the public comment process, and they may well take more drastic actions if the FBO proposal is retained.[xxiii] Indeed, if the United States' principal "systemic" regulator takes the position that ex ante ring-fencing of the U.S. operations of foreign banks is necessary to safeguard the U.S. financial system, why would other home country regulators not follow suit? And if they do, we will see a domino effect where host countries impose inefficient individual capital and liquidity requirements or move to requiring full subsidiarization.[xxiv] Moreover, the Federal Reserve's FBO proposal *explicitly* questions the principle of international cooperation that has been at the heart of cross-border bank supervision and regulation for decades

"Optimal" Levels of Capital and American Competitiveness

It is an article of faith that "well-capitalized" banks are safer banks. There can be no doubt that despite meeting existing regulatory capital requirements, many banks were under-capitalized and over-leveraged going into the Financial Crisis in 07/08. This increased the need for these institutions to rely on volatile short-term funding. While it is easy to suggest banks need to be "well-capitalized," no-one seems able to agree on exactly what this term means, hence the difficulties associated with structuring global capital standards and the resulting complexity of the Basel III regime and related initiatives. In addition, there is a clear trade-off here: imposing very stringent capital requirements unavoidably reduces the funds available to

banks to lend out or otherwise put to use in the broader economy. But there is also a more fundamental question: are high levels of capital and low leverage really a cure-all for financial crises?

Many commentators have noted – correctly – that smaller commercial banks, particularly those with assets of less than a billion dollars - operate with much higher equity capital reserves and far lower leverage than their larger and more diversified peers. Yet, in the United States, these smaller banks have a significantly higher rate of failure than larger banks. If capital were the only measure of stability, why should this be so? As we learn during every financial crisis, banks fail for one reason – undiversified risk.

We cannot eliminate risk from the banking system. Banking is nothing more than the pooling and management of risk. But if we view undiversified risk as the key cause of bank failure, then initiatives such as the Basel III risk-weighting system can potentially heighten the riskiness of banks even though the intention is to make banks better capitalized. This is because the regime uses advanced modeling techniques to determine which classes of assets are "safer" than others. It then incentivizes banks to hold assets in those "safer "classes, resulting in the assets held by banks becoming more concentrated not less – at both the firm and the industry-level.

I support the use of risk weighting models at the individual firm level. But, the industry-wide reliance on the same financial models is a recipe for a future crisis because all financial models, regardless of the complexity or sophistication, will contain some errors and when adopted by all industry participants, these errors can lead to a system-wide problem. The same concerns can be raised about the C-CAR/stress-testing process run by the Federal Reserve in which all major U.S. banks participate. While the models the Federal Reserve uses to determine whether banks are adequately capitalized are extremely sophisticated, they are nonetheless just that – models. And early indications are that

U.S. banks have become increasingly focused on aligning their models with that of the Federal Reserve instead of focusing on their own concerns about market risk.

Some policymakers have proposed including a simple leverage ratio be used as a "backstop". I should note that the proposed leverage ratio is an **additional** measure, *not* a replacement. It is also an idea that has far greater traction in the United States – while regulators in Europe and Asia will adopt some leverage measure, it is unlikely to be especially stringent. Therefore, a proposal such as the one contemplated by some senior officials at the FDIC is an added burden on U.S. financial institutions and creates a competitive disadvantage because it is one that their foreign peers will not be subject to. Although a leverage ratio has the benefit of simplicity as a standalone measure and can be easily monitored and understood, it nonetheless does not cure the fundamental flaw in the risk weighting system - the tendency for concentration in certain asset pools. Therefore as an addition to the Basel III regime it is not especially helpful, in my view. It is clear that many of the proponents of the initiative view it not as a means to create safer institutions, but rather as a means to downsize large institutions (by forcing them to include derivative and other off-balance sheet activities in their liability calculations). The effect of this is to drive those activities into the unregulated sector or into single-activity shops, which may not be the most desirable outcome and may further segment the market.

But this begs the question: if we are so concerned about leverage, why do we continue to incentivize banks and individuals to become over-leveraged in the first place? We have a system that heavily penalizes equity holders, while rewarding holders of debt with tax breaks and the like. Instead of imposing blunt tools that require expensive monitoring and enforcement on these institutions, we could begin by reforming the incentive structure that they operate under.

Differing Approaches to Regulation: Europe v. the United States

It may be worth highlighting that the United States and the European parliament have taken very different approaches to imposing the financial reform agenda and that this may further place U.S. institutions at a disadvantage. The recent passage of the final "Volcker Rule" in the United States (in particular the ban on proprietary trading) and its equivalent proposal before the European parliament is a useful case in point. While I should note that I disagree with the imposition of a ban on proprietary trading in any form as I consider it to be unnecessary, it nonetheless illustrates the differences in approaches taken by the United States and Europe. I should also note that the proposal before the EEC is in its very early stages and may never be enacted in its current form or at all).

The Europeans favor a "principle-based" approach, by outlining a simple prohibition. They do not impose extensive or costly compliance and monitoring obligations. They do not attempt to guess the intention of the trader or list and carve out every scenario that may conceivably lead to or indicate the presence of proprietary trading. If a bank can demonstrate that its trading activities are nominally in the client interest, it should fall comfortably within the rule. In contrast, the final Volcker Rule in the United States is an extremely poorly-drafted and highly-technical document that spans hundreds of pages and imposes an extremely complex and costly regime on banks and industry participants.

Conclusion

The time has come to acknowledge that we are at a crossroads – globally and domestically. One path leads to a system where American banks and financial services firms, buckling under the weight of excessive and contradictory regulations, become less diversified, less competitive globally, more inward looking and, in my view, potentially more unstable. This path leads to a sub-optimal outcome – one in which financial firms are less focused on market drivers and

meeting the needs of consumers and more on pleasing local regulatory authorities. Another path begins with the recognition that we already may have gone a step too far. The time has come to ask ourselves, "what was the purpose of this all?" If the purpose is to make the United States banking sector less crisis-prone, safer and more competitive, we need a comprehensive and realistic assessment of whether all these regulations – given their significant costs – are achieving that outcome. I thank-you for the opportunity to testify today.

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[i] For a recent discussion of this phenomenon in Europe, see Sonia Sirletti and Yalman Onaran, "Banking Balkanization Prevails in Europe on Eve of Review," *Bloomberg*, October 23, 2013, http://mobile.bloomberg.com/news/2013-10-22/banking-balkanization-prevails-in-europe-on-eve-of-review.html.

[ii] Available at: http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/

[iii] These include proposals such as the Brown-Vitter bill, tabled in April 2013, the Federal Deposit Insurance Corporation's soon-to-be proposed leverage ratio, and most recently, the proposed tax levied on banking institutions with over $500 billion dollars in assets.

[iv] See e.g.: http://www.mckinsey.com/app_media/reports/financial_services/between_deluge_and_drought.pdf

[v] See e.g. Charles W. Calomiris & Stephen H. Haber, *Fragile by Design The Political Origins of Banking Crises and Scarce Credit* (Princeton; Princeton University Press, 2014).

[vi] The swap market is a good example of this. The CFTC has jurisdiction over ordinary swaps; the SEC has jurisdiction over security-based swaps. These agencies have taken different approaches to regulating the swap market, particularly in the agencies' respective approaches to the cross-border application of the rules, creating much confusion for the market participants who are tasked with implementing the rules.

[vii] See, e.g., Davis Polk & Wardwell, "Governor Tarullo Foreshadows Proposal to Ring-Fence Large U.S. Operations of Foreign Banks;" Client Memorandum (New York, December 2, 2012); H. Rodgin Cohen of Sullivan & Cromwell LLP and Hal Scott of Harvard Law School have also made this point. See also Alex Barker and Tom Braithwaite, "EU Warns US on Financial Protectionism," *Financial Times*, April 22, 2013, http://www.ft.com/cms/s/0/6d599a10-ab59-11e2-ac7100144feabdc0.html.

[viii] In June 1930, Congress passed the Tariff Act, colloquially known as "Smoot-Hawley" after its two Republican sponsors. Smoot-Hawley raised tariffs on approximately 20,000 imported products to unprecedentedly high levels. Ostensibly, the act's purpose was to protect U.S. industries, workers, and prices in the wake of the stock market crash of 1929, but its medium- and long-term effects were dire. Although imports accounted for only 4 percent of U.S. gross domestic product at the time, Smoot-Hawley had significant, if concentrated, regional effects and in particular served to further weaken the United States' already-struggling banking system. (The Tariff Act of 1930 (19 U.S.C. ch. 4). See also: Thomas Rustici, *Lessons from the Great Depression* (Washington: Capitalism Works Publishing, January 2012).

[ix] Douglas Irwin, "The Smoot-Hawley Tariff: A Quantitative Assessment," National Bureau of Economic Research Working Paper 5509, March 1996, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=4916.

[x] The significant gains in wealth across the globe, including the vast numbers of people lifted out of poverty in the three preceding decades, have been well documented and are attributable in no small part to the fluidity of global capital. See, e.g., Shaohua Chen and Martin Ravallion, "An Update to the World Bank's Estimates of Consumption Poverty in the Developing World," *Briefing Note*, Development Research Group, World Bank, January, 3, 2012, http://siteresources.worldbank.org/INTPOVCALNET/Resources/Global_Poverty_Update_2012_02-29-12.pdf.)

[xi] McKinsey Global Institute, *Financial Globalization: Reset or Retreat*? March 2013, www.mckinsey.com/mgi.

[xii] Ibid.

[xiii] Ibid.
[xiv] Ibid.
[xv] Ibid.
[xvi] Ibid.
[xvii] Former U.S. treasury secretary Henry Paulson has made this point as well, warning that such post-crisis reforms could lead to "walling off markets, constricting cross-border access to capital, and conflicting requirements for global firms." See Tom Braithwaite, "Hank Paulson Warns of Regulatory Conflict," *Financial Times*, September 19, 2013.
[xviii] For a more detailed discussion of this important topic, please see my Cato discussion paper, co-authored with Arthur Long and available at: http://www.cato.org/publications/policy-analysis/new-autarky-how-us-uk-domestic-foreign-banking-proposals-threaten
[xix] 12 U.S.C. § 3102(a), 3105(d).
[xx] 12 C.F.R. Part 252 (proposed).
[xxi] Ibid.
[xxii] *Federal Register* 77, no. 249, p. 76629.
[xxiii] Letter from Michel Barnier, Commissioner for Internal Market and Services, European Commission, to Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, April 18, 2013.
[xxiv] It is worth noting this trend is already underway in some European countries (e.g., Spain). See Jonathan Fiechter et al., "Subsidiaries or Branches: Does One Size Fit All?" IMF Staff Discussion Note, Washington, March 2011, http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf