

## **Don't bank on global reform**

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### **When Lehman crashed, world leaders vowed to change the system. Why haven't they?**

Two years ago, in the wake of the Lehman collapse, world leaders huddled together for warmth as they stared into the abyss of a financial market meltdown. A G20 summit was quickly convened in Washington, in the dog days of the Bush presidency. That was hastily followed by another in London hosted by—what was that fellow's name, the one who saved the world?

International agreement on a host of financial reforms seemed likely. The G20, which includes China, was deemed the best forum. Leaders realised it was no longer possible to take a global view of market developments without China. Part of the reason for the crisis involved the emergence of massive global imbalances, with Chinese capital exports creating easy financial conditions in the west, which in turn led to the mispricing of risky assets.

The London summit was, as these things go, rich in outcomes. There was unusual consensus on the causes of the crisis. Fine words were spoken about the need for a co-ordinated response, both in fiscal and regulatory terms. Stimuli were agreed and, in some cases, even implemented. On the regulatory front, the Financial Stability Board, sitting at the centre of a web of international committees, was born out of the ashes of the Financial Stability Forum. US agreement to a new forum to co-ordinate regulatory reform, even one with no new formal powers, was something of a concession—and a recognition that a global problem needed global solutions.

Two years on, things look different. The last G20, in Canada, cost a huge amount to stage but achieved little. The communique was blancmange after the red meat of London. Expectations of the next gathering, in Seoul in November, are low.

Countries have retreated back into their national agendas. The Fed launched its bank stress test exercise alone, with Europe forced to follow some months later. During the marathon passage through congress of the huge, unreadable Dodd-Frank Act there was almost no mention of the international aspect of the crisis.

In Brussels, the European parliament popped up with new compensation rules that showed no awareness of the other approaches being adopted around the world. London embarked on another regulatory reform which, whatever its merits, interfaces awkwardly with other regimes.

The Basel Committee on Banking Supervision, which represents the central banks of 27 member states, has been working on new capital rules, but even here there are divisions, with Germany reserving its position on the latest proposals.

So why has the initial enthusiasm for global solutions run into the sand? Part of the answer no doubt lies in the removal of the fear factor. In late 2008 world leaders were worried they might be powerless to stem the tide of panic which overcame the markets after the Lehman disaster. Although many economies are not yet out of the woods, there is not the same sense of imminent collapse. And while almost all countries went into the crisis together, they are emerging at different times, and in different conditions. China scarcely missed a beat while some southern European countries are still in recession, with banks in jeopardy. Britain and the US are in between, but both have major fiscal problems and convalescent financial systems.

There is also no longer a common understanding of the causes of the crisis. Usually, when disaster strikes, whether natural or man-made, we begin with a range of potential explanations, some more plausible than others. Then, as we learn more, opinion tends to settle on a narrower range of explanations. The opposite is true of this crisis. Three years ago there was broad agreement that the core of the problem lay in the US sub-prime market. Now that is not so clear.

In my new book, *The Financial Crisis: Who Is to Blame (Polity)* I have identified 38 distinct narratives, ranging from the impact of growing income inequality, through weak monetary policy to an excess of testosterone on trading floors. Even in the regulatory arena, there are big differences of view between the leaders of the major economies. Nicolas Sarkozy speaks of the iniquities of offshore centres, or 'fiscal paradises' as they are known in French. Angela Merkel is preoccupied by hedge funds. By contrast, much US debate centres on the Volcker rule, which would ban proprietary trading—using a bank's own money to play the markets—by investment banks. George Osborne and Vince Cable would like to go further, separating investment, commercial and retail banking, while in France, Germany and Switzerland there is no interest in breaking up their universal banks. (The German government, under pressure from Deutsche Bank, even rejected a proposal to make it harder for banks to 'hoard' their liquid cash around the globe, a practice which left the London branch of Lehman Brothers short of assets when the bank went bust.)

At a more detailed level, there are important differences over the quality of bank capital, where practices in the US and Europe differ, partly for tax reasons. Decades of debate in Basel have failed to reconcile these strongly held conflicting views.

The underlying problem, however, is that nation states are more reluctant to cede sovereignty over their financial institutions and markets than they are over other aspects of their economies. The contrast between financial regulation and the resolution of trade disputes is instructive. The World Trade Organisation can

arbitrate disputes between states on anti-dumping measures and other trade issues but there is no comparable power that can be used to reconcile differences on international financial regulation. Agreements at Basel and elsewhere are reached on a "best endeavours" basis between regulators that in many cases are not empowered to commit their governments. In theory, countries should not allow banks to operate in their jurisdictions if they do not meet international standards. But this can easily be overridden by political imperatives.

There is still little willingness—on both sides of the Atlantic—to empower an international body to oversee the core principles of financial regulation. The financial crisis has changed nothing in that respect. So we will have to rely on the usual informal agreements, which have been tried, tested, and found wanting in the past.