Conference Proceedings

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This year's annual conference of the University Research Priority Program (URPP) Financial Market Regulation[1] – the third in the history of the URPP – was devoted to "International Aspects of Financial Regulation: Competition vs. Coordination" and took place at the University of Zurich on June 1 and 2, 2015. In line with the URPP's interdisciplinary approach, the conference program blended economic and legal approaches to international regulatory competition and coordination.

After a few opening remarks by the organizers, *Mathias Hofmann* and *Rolf H. Weber*, the conference started with a first session on "Regulatory competition and regulatory arbitrage". *Richard S. Grossman*'s presentation "A historical perspective on regulatory competition versus cooperation: the view from economics" began with an overview of the motives for regulation in general and banking regulation in particular. *Grossmann* pointed out that contagion, while very much in the news, was not new and had provided ample scope for regulatory cooperation in the past. Still, barriers to cooperation usually prevailed, even in the U.S. To the extent they could be overcome, this led to very complex supervisory structures at the national level. *Grossmann* argued that the dual State-federal banking system in the U.S. in the late 18th and 19th century was a key feature of U.S. banking throughout its history. After the number of State banks had declined sharply due to creation of "national banks" through the National Banking Acts in 1863-64, growth in deposit taking as well as the easing of State bank branching restrictions and capital requirements can be seen as reactions by State regulators to increase competitiveness of State-chartered banks. *Grossmann* then moved to discussing regulatory cooperation based on the experience with deposit insurance in the U.S. What started with private and voluntary clearing houses and 14 mandatory State deposit insurance systems was transformed into a compulsory federal deposit insurance for member banks of the Federal Reserve System with the Federal Deposit Insurance Corporation in 1933. *Grossmann* concluded that regulatory cooperation in U.S. banking history was limited and most successful when compulsory, whereas regulatory competition, especially at the State-federal level, was more common.

Andreas Thier provided a complementary legal perspective with his presentation "A historical perspective on regulatory competition vs. cooperation: the view from law". At the outset, he presented the following basic assumptions: Regulatory convergence tends to appear where essential governmental interests are involved, whereas differences (and therefore potential competition) in regulation are more likely if the government has no distinct interest in the particular policy area (the only exception being crisis situations). In the latter case, legal philosophies and cultures will have a stronger influence on regulation.

[1] The URPP Financial Market Regulation is a joint and interdisciplinary research program by members of the law faculty and faculty of economics at the University of Zurich. For more information, please visit: <http://www.finreg.uzh.ch/index_en.html>.

Thier used the historical examples of railroad regulation (strong governmental interest) and the antitrust and cartel laws (less immediate governmental interest) in the U.S. and Germany to illustrate his points. He concluded that the different approaches of the U.S. and German governments towards public goods reflect to some extent the distinction of the civil/common law traditions. However, we also observe a trend towards regulatory convergence as far as natural monopolies are concerned as well as (not unproblematic) legal transfers from the U.S. to Germany regarding institutional settings.

In the Q&A following the first session, moderated by *Iryna Stewen*, the speakers and audience discussed parallels and differences of railroads vs. financial regulation. Other topics included whether a race to the bottom actually did take place prior to the adoption of international financial standards and whether deregulation was a product of such lack of international coordination. Further questions raised by the audience were directed at whether there were any notable exceptions to banking crises acting as a driver of regulation and whether the rigidity of banking regulation in the U.S. lead to the growth and today's importance of capital markets in the country.

Rolf H. Weber introduced the second session on "Regulatory competition vs. coordination – challenges in times of globalization" with his presentation "Regulatory competition as policy and legal instrument". He reflected on Charles Tiebout's model of regulatory competition, which remained constrained in its practical application but may serve as a model for regulatory federalism. *Weber* discussed a typology of regulatory interactions: (1) competition, including yardstick competition, trade competition, production factor competition and free choice by regulates; (2) coordination, leading to more convergence in international financial regulation; and (3) so-called "co-opetition" as a concept that merges both competition and coordination, which *Weber* illustrated based on the example of OTC derivatives regulation. He contrasted the theoretical advantages of regulatory competition – discovery of best rules, satisfaction of diverse preferences and restraint of the Leviathan state – with its practical limitations (e.g., the lacking mobility of indirect regulatees). *Weber* criticized that findings of behavioral research and cost-benefit analysis have still not found their way into the regulatory process in most cases. Discussing the actors involved in regulatory competition, *Weber* examined not only the role of legislators/governments and independent regulatory agencies, but also of courts (using the example of the UBS emergency tax information delivery by Switzerland to the U.S.) and private regulators. In terms of outlook, he concluded that while standardization has diminished the room for regulatory competition in the field of finance, competitive interventionist elements might be possible and necessary when it comes to consumer protection (consumers as indirect regulatees are not mobile) and dispute resolution in particular.

In the following presentation "Banking flows and international regulatory arbitrage", *Joel Houston* discussed a joint paper (Houston, Lin and Ma [2012]) studying whether cross-country differences in regulations have affected international bank flows. The authors found strong empirical evidence, based on a sample of 26 source countries and 120 recipient countries from 1996-2007,

that banks have transferred funds to markets with fewer regulations. The more stringent the regulation was in the source country the bigger were the outflows. *Houston* suggested that this form of regulatory arbitrage might point to a destructive "race to the bottom" in global regulations, which restricts domestic regulators' ability to limit banks' risk-taking. However, the authors also found that the links between regulatory gaps and bank flows were significantly stronger in developed recipient countries (compared to developing/emerging countries) and in recipient countries with stronger creditor and property rights and greater information sharing. *Houston* thus concluded that lenient regulatory requirements are insufficient to encourage massive capital flows in the absence of a strong judicial and institutional environment. Research on cross-border M&A activities conducted subsequently to their paper seems to come to similar conclusions.

The second session continued with *Markus A. Schmidt*'s presentation "Competition versus cooperation – striving for the best of two worlds within the EU institutional framework for macroprudential policy". *Schmidt* analyzed the EU's framework for macroprudential policy in light of the model developed by Parisi, Schulz and Klick (2006). According to the model, there are two important dimensions of regulatory competition: (1) whether regulatory action grants rights (positive action) or restricts rights (negative action) and (2) whether regulatory bodies have concurrent or alternative competences. Each of these regulatory combinations has different implications in terms of welfare. *Schmidt*'s analysis was based on three examples. The ESRB, albeit mainly having a coordinating role, possesses a concurrent power to that of the EBA to issue an opinion in favor of national measures to the European Commission. Counter-cyclical capital buffers are based on alternative competences outside the Single Supervisory Mechanism (SSM). Within the SSM framework, the ECB can only top-up national measures and act instead of national authority, i.e., has alternative powers. Concluding his presentation, *Schmidt* suggested that the current framework assumes varying but not necessarily benevolent behavior of responsible agencies, and that further research is needed to study how to achieve benevolent behavior.

Franca Contratto concluded the first conference day with her presentation "The future of regulatory competition: Challenges and opportunities for substantive law and enforcement". She began with an outline of four potential scenarios for the future of financial regulation: (1) abandonment of regulatory coordination altogether, (2) total harmonization and complete centralization, (3) perpetuation of the current complex system of transnationally coordinated regulation, (4) decentralized rule making coupled with procedural cooperation. In the following, *Contratto* looked into three levels of regulatory interaction: At the EU level, substantive securities regulation leaves little room for regulatory competition, but some remaining institutional diversity of national supervisory and enforcement systems allows for "reflexive regulatory co-opetition". Two mechanisms are at the center of the transatlantic regulatory dialogue U.S.-EU today: extraterritoriality and equivalence. *Contratto* suggested that partial convergence is the likely outcome of the bilateral dimension U.S.-EU, and that third countries are going to experience "upward pressure" towards convergence

as well. Regarding the international level (G-20), she identified a certain diffusion of the regulatory preferences of the dominating global players (U.S./EU), albeit without true multilateral coordination. The resulting weak convergence and mock compliance by the periphery leaves room for regulatory competition, which may lead to a weakening of global standard setting in the longer run. *Contratto* concluded by identifying scenario (4) as the most favorable scenario for the future, which she envisages as a system of cooperative decentralization that allows for a "healthy diversity of rules" and includes strong cooperation mechanisms.

The discussion in the following Q&A-session, moderated by *Claire Célérier*, centered around the question of whether regulatory competition still plays in an environment of limited mobility of financial firms and limited possibilities for cross-border services provision. Other points of discussion included whether there is room for open competition in core areas of financial regulatory standards given the tight implementation framework imposed by international standard-setting bodies.

The second conference day was devoted to the developments in the EU, with the third session on "Competition vs. coordination – lessons for Europe from banking regulation in the US and Japan". *Mathias Hoffmann* started with his presentation "Lessons from the US and Japan for banking union in Europe". Based on two of his recent co-authored papers, *Hoffmann* discussed State level integration in the U.S. during the 70s-90s and Japan's banking crises in the 90s as historical experiences of financial and banking integration at the intranational level to draw lessons for the EU. While banking integration in the U.S. benefited small firms and consumers, deregulation may have also contributed to imbalances and hence to the recent financial crisis by allowing banks to become geographically diversified. Geographically diversified banks may have more easily attracted international capital flows by offering theoretically safer as more diversified "country wide" assets. This, in turn, allowed these banks to expand mortgage lending and lower interest rates, driving up housing prices. The lesson *Hoffmann* drew from Japan is that a common regulatory framework may not be enough for genuine banking integration, as segmentation can be very persistent. The silk reeling industry in Japan lead to the development of regional banks, which continued to account for above average shares in lending in the formerly silk-exporting prefectures long after the decline of the silk industry. The post-1990 financial decline was worse in prefectures with low levels of banking integration. *Hoffmann* concluded from these findings that different pathways to financial development could lead to long-term differences in de facto financial integration, even if there are no formal barriers to capital mobility between regions, as is the case in modern Japan.

Kern Alexander continued with his presentation "Scope for regulatory competition in the EU banking union". At the outset, he identified regulatory competition between Member States as one of the benefits of the EU's internal market, a framework that cracked in the financial crisis. *Alexander* examined the remaining room for such competition in four areas financial regulation. Both micro- and macroprudential regulation were institutionally reorganized during

the crisis at the EU level. The recent refocusing of policy-makers on macro-issues, according to *Alexander*, comes with the challenge that macroprudential regulation is not amenable to the international environment but largely depends on national authorities, which deploy different approaches (price- vs. quantity-based approach). *Alexander* further highlighted that we observe a trend towards maximum harmonization in microprudential regulation, in particular with CRD IV/CRR that removed most options and discretions. The U.K. and other Member States, however, insisted on certain discretions in capital requirements at the national level (e.g., capital buffers, macro-prudential tools etc.). Very different approaches were developed in Europe regarding structural banking regulation. Both the German and French structural reforms, for example, deviate from the EU Commission's proposed Regulation, which would prohibit proprietary trading for the 30 biggest banking groups. *Alexander* identified competition as an important area here, as the applied doctrine of equivalence allows for derogation of equivalent structural regimes from the EU Regulation. The new supervisory and resolution frameworks within banking union, in contrast, distort the EU's framework of national discretions, stifling regulatory competition. Overall, *Alexander* concluded that significant room for discretion of national authorities to adapt to local circumstances remains as far as EU-wide regulation is concerned, while the developments surrounding banking union lead to a splitting of the internal market.

Bent E. Sørensen's presentation "Integration (and regulation) gone wrong: The big problem of small business finance in the European banking union" concluded the session. *Sørensen* showed based on an empirical study of Europe's Great Recession that countries and regions with many SMEs are more vulnerable to contractions in bank lending. In countries with many small firms, high domestic banking dependence further amplifies the negative impact. *Sørensen* further presented evidence that low risk sharing in the same areas exacerbate the impact of financial contractions. As a main policy conclusion, *Sørensen* pointed out the importance of further encouraging consolidation of banks in Europe.

The Q&A following session three, chaired by *Seraina Grünewald*, centered around the extent to which and the ways in which bank lending has evolved throughout the past years and decades (in particular through IT and financial innovation). Discussants also addressed whether bank consolidation is desirable in all circumstances and whether there remains room for regulatory differentiation within banking union.

The keynote speech, held by *Douglas Arner*, addressed "Regulatory competition between financial market places in East Asia". *Arner* pointed out that East Asia's financial markets are very fragmented, while with ASEAN 2020 some integration processes (e.g., capital markets development plan, ASEAN banking integration framework, APEC) are under way. A significant number of Asian countries are now members of the G-20 and/or FSB, a difficulty being that they have undergone varying stages of economic development. The more developed countries increasingly seek to influence the direction of international standards going forward (and not only implement them), including through regional coalition building. Competition between jurisdictions in East Asia, according to

Arner, takes place through countries seeking to attract headquarters of international and regional firms (HSBC, Standard Chartered). Developments are also under way to implement passporting-systems for asset management in the region. Regarding the fast-growing FinTech market, countries are taking differing approaches to regulation, but the industry is pressuring for convergence. *Arner* further argued that there are good reasons for internationalizing the RMB and identified developments towards connecting China with the rest of Asia and the world (BRICS development bank, inclusion of RMB in the SDR basket of the IMF). Overall, according to *Arner*, China has moved to increasingly building Chinese-centered systems with respect to trade, investment, development financing and monetary affairs, but is still giving the lead to the U.S. and EU in finance. As this may change in the future, the international community might want to find ways to more accurately include China in existing systems of international finance.