Viewpoint: Global Regulations Can Be Lost in Translation

Published in American Banker, Friday, February 6, 2009

By Philippa Girling

There is much talk about whether the regulatory environment in the financial services industry was partly to blame for the recent downward spiral in the markets. Was there too little regulation, or too much regulation of the wrong kind?

As these discussions rage, financial services firms have to grapple with increased global regulatory complexities as a result of the rush of foreign investments and rescue attempts.

While members of the Group of 20 consider the merits of a global regulatory framework, the current reality must be managed by financial firms worldwide, and the group's meeting in April should look at these practical challenges.

There are important lessons to be learned from the global adoption of Basel II rules. Basel II, the common name for the European Union's Revised Capital Framework, requires all financial firms wanting to remain in Europe to implement global risk management and capital standards according to a selected regulator's interpretation of the rules.

Different regulators have interpreted Basel II in different ways, as the recent rush of foreign acquisitions has underscored. Firms that are subject to more than one interpretation struggle with pleasing all of the regulators all of the time, and there are challenges for firms having to manage a transition from one lead regulator to another.

Consider the purchase of Lehman Brothers operations by Barclays Capital in the United States and by Nomura Securities International Inc. in Asia and Europe.

Lehman was in the process of implementing Basel II under the Securities and Exchange Commission's interpretation. Barclays Capital is subject to the U.K. Financial Services Authority's interpretation. Therefore, Lehman's U.S. operations need to move to an FSA approach from an SEC approach. Nomura is subject to the Japanese Financial Services Authority's interpretation. Therefore, Lehman's European and Asian operations need to move to that approach.

The interpretations by the three regulators contain some significant differences, and all the firms involved need to navigate new regulatory waters.

Sovereign Bancorp provides another example. It was subject to Federal Reserve Board rules when it was acquired by Banco Santander SA, which is subject to Spanish rules. Now Sovereign will need to look to the Spanish interpretation of Basel II.

Clearly, when a regulator interprets Basel II its own way, the interpretation can impact foreign as well as local firms. This suggests that financial regulators are already engaged in informal foreign policy activities and must be especially sensitive to them.

Regulators already drive the behavior of their institutions abroad by imposing global standards for risk management under their own interpretation of Basel II, and these standards can extend to foreign subsidiaries. Many regulators have recognized the impact of their rules and have been meeting privately to resolve "home-host" conflicts, where a bank faces different rules for its headquarters and for its branches.

The Group of 20 is considering the possibility of global regulatory standards. Basel II has been quietly imposing minimum global risk standards behind the scenes, but the local interpretations of those standards differ enough to cause serious headaches for global banks.

This may be a cautionary tale. While debating the merits of a global regulatory framework for financial services, Group of 20 members should look at the informal current framework and recognize that any standard will suffer from differences in local interpretation.

There is no regulatory body to adjudicate on the different interpretations of Basel II, so the challenges persist when a firm moves from one regulatory environment to another.

This suggests the enforcement of global standards is likely to be at least as difficult as reaching agreement on the content of those standards. We need only look at the challenges faced by the United Nations and international courts to see that without enforcement, rules are of little value.

Overall, the current drive for a global regulatory framework that could prevent an economic crisis may be laudable, but enforcement may be the Achilles heel.

The informal, bilateral Basel II conversations among regulators may have already produced fledgling global standards, and further development and enforcement of these standards may be the most effective way forward. However, if foreign regulatory policy is going to be owned by regulators, they will need to work closely with their legislative bodies to ensure a position reflecting the global agreements their countries enter.

Whoever owns the development and interpretation of global standards for financial services, local and global enforcement needs careful and practical consideration.

This was clearly acknowledged at the recent World Economic Forum in Davos, Switzerland. Prime Minister Gordon Brown of Great Britain and President Angela Merkel of Germany called for a global regulatory framework, and George Soros, the chairman of Soros Fund Management LLC, emphasized the enforcement challenge by calling for "a new sheriff."

As difficult as this task might be, the Group of 20 regulators need to address these issues head on at their coming meeting. Who will make the rules, who will interpret the rules, and who will enforce the rules?

The global financial services industry, like the markets, needs clarity.

Ms. Girling, of counsel in the New York office of Garrity, Graham, Murphy, Garofalo & Flinn PC, runs the firm's banking and financial services group.