Regulatory Competition in Global Financial Markets — The Case for a Special Resolution Regime

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Abstract

Regulatory arbitrage in financial markets refers to a number of strategies that market participants use to avoid the reach of regulation, in particular by virtue of moving trading abroad or relocating activities or operations of financial institutions to other jurisdictions. Where this happens, such arbitrage can trigger regulatory competition between jurisdictions that may respond to the relocation of financial services (or threats to relocate) by moderating their regulatory standards.

This study develops a framework for the assessment of both phenomena in the context of financial regulation and the evaluation of their merits. I argue that regulatory competition has many advantages over alternative global approaches, notably international harmonization of regulation, by offering a dynamic process for the discovery of efficient regulatory standards. However, the risk is that countries lower their standards solely to attract business and thereby impose externalities on the worldwide financial market by undermining financial stability as a global public good.

Policymakers worldwide are experimenting with remedies to respond to the phenomenon. I introduce the importance of an effective special resolution regime for financial institutions to the discussion. I argue that, within limits, a credible, worldwide resolution scheme can effectively contribute to reducing the dilemma. Its main benefit would be to tackle the problem of financial stability caused by systemically important financial institutions' excessive risk-taking. If such risk-taking would be judged by market discipline instead of posing a risk to global financial stability, the main downside of regulatory competition could be restrained. Within the boundaries of such a system, competition could then operate and contribute to a market-led design of financial regulation.

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Introduction

Strategies to avoid regulation are as old as regulation itself. But avoiding regulation by way of relocating to escape from the territorial reach of a regulator is a more recent strategy, which has gained in importance in an ever more globalized world. In the context of financial regulation, the phenomenon has gained new interest since the global financial crisis of 2007–09, partly because regulatory standards have been tightened in many jurisdictions, and partly because the crisis dramatically demonstrated just how integrated international financial markets have become, and how modern technology and the global reach of large banking groups have reduced the costs to escape from the reach of legal rules by moving operations abroad.

For example, the New York Times reported in 2011 under the heading 'Could Barclays Move to New York?' that "Executives of large British banks, including HSBC, Standard Chartered and Barclays, had been threatening to move their headquarters abroad ever since a government-appointed banking commission [in the U.K.] hinted it would consider splitting investment and retail banking to make

Britain's financial sector more stable."[1] According to this story, market analysts had taken the view that there is "little option for Barclays but to reconsider domicile."[2] Such warnings are widely seen as a tactic by banks to scare their governments into abandoning plans for stricter financial regulation. Arguably it is the shareholders, pushing for higher returns, who pressure Barclays to consider such a move.[3] A relocation to Hong Kong is repeatedly being discussed at competitor HSBC, with reference to the increased U.K. bank levy and onerous regulatory reforms.[4,5]

For the most part, such relocation scenarios remain nothing more than an empty threat. For example, HSBC is reviewing the location of its headquarters every few years — they have repeatedly threatened

[1] Julia Werdigier, *Could Barclays Move to New York?*, N.Y. Times Dealbook, March 30, 2011, available at http://dealbook.nytimes.com/2011/03/30/could-barclays-move-to-new-york/?_r=0. The quote refers to U.K. plans to mandate an organizational separation of different banking activities, based on recommendations by the Independent Commission on Banking (ICB, chaired by Sir John Vickers), which produced its final report in September 2011.

[2] Werdigier, *ibid.*

[3] *ibid.*

[4] HSBC, originally founded in Hong Kong, has reviewed the location of its headquarters every few years since 1992. The most recent round was launched in 2015 and suggested relocation back to Hong Kong. The bank cited the high U.K. bank levy and its strict new regulation that was introduced over the past few years as undermining the rationale for staying in London. Martin Arnold, David Oakley & Jennifer Hughes, *Hong Kong's welcome adds force to HSBC's threat to quit Britain*, Fin. Times, April 25, 2015, p. 1. Already in 2011, HSBC had concrete plans around 2011 to quit London for Hong Kong: "HSBC explained to shareholders that the more relaxed capital requirements in Hong Kong would cost less and generate more profit by allowing it to make greater use of its balance sheet." Louise Armitstead, *HSBC plots London exit*, The Sunday Telegraph, March 6, 2011, p. 1. The 2011 decision round was particularly controversial due to the release of the ICB report on bank ring-fencing (*supra* note 1): see Richard Wachman, *HSBC 'must be sorely tempted' to make Hong Kong its HQ*, The Guardian, September 13, 2011.

[5] According to neutral observers, HSBC's plans are more credible than Barclay's, since HSBC's structure means that they have already sufficient operations abroad; they are therefore in a position to threaten with a realistic exit option if government intervention becomes too constraining. Cornelia Woll, The Power of Inaction: Banks Bailouts in Comparison 172 (Ithaca, NY: Cornell University Press, 2014); see also Pepper D. Culpepper & Raphael Reinke, *Structural Power and Bank Bailouts in the United Kingdom and the United States*, 42 Politics & Society 427, 437 ff. (2014).

to relocate the banking group abroad, but never done so.[6] There is, however, a more refined, indirect way of moving banking business abroad: by shifting financial transactions to other entities within the same banking group. For example, in the reports about HSBC's most recent plans, observers explain that the more likely option is to move the bank's repo trading abroad. As Anthony Browne, chief executive of the British Bankers' Association, argued, repurchase transactions can inflate banks' balance sheet, which is unfortunate for the bank's exposure to the U.K. bank levy.[7] Instead, such transactions that have formerly been booked in London are now being moved abroad and executed by foreign subsidiaries.[8] That would be an easier and more elegant way of avoiding the U.K. bank levy.

Another example for a more sophisticated arbitrage strategy concerns the U.S. rules on derivatives trading. When U.S. regulators recently toughened these rules, American banking groups were quick to respond by changing their trading behavior to avoid them. According to media reports, "U.S. banks [...] are shifting some trading operations overseas to avoid tough CFTC rules."[9] Again, this illustrates that banks do not have to physically move any assets or places of business abroad, but rather structure their trading operations in a way that escapes from the reach of domestic regulation. Subsidiaries or affiliates abroad then execute these trades instead of the corporate parent.

The question is whether all of these scenarios described are of importance to policy makers. In other words: are regulators impressed by the global relocation market, or, as the case may be, by a threat to relocate? From a moral point of view, they certainly should not.

[6] For the most recent decision to stay in the U.K., see Martin Arnold, *Gift to UK as HSBC decides to keep headquarters in London*, FIN. TIMES, February 20, 2016, p. 14.

[7] The U.K. bank levy is a post-crisis annual tax on U.K. banks, charged depending on the size of the balance sheet. When the bank levy was introduced in 2011, the rate was set at 0.05%. Since then, the rate has been increased many times, up to 0.21% as of April 2015.

[8] Patrick Jenkins, *Banks plot repo retreat from London*, FIN. TIMES, May 6, 2015, p. 19.

[9] Andrew Ackerman & Scott Patterson, *CFTC to Examine Swaps Loophole*, WALL ST. J., Sept. 6, 2014, p. B1. See on this in more detail in Section 3.1.

After a global financial crisis that came close to a financial meltdown, lawmakers worldwide have understood that they need to overhaul regulatory standards. As the Financial Times put it, "After a crisis in which the taxpayer bailed out the banks to the tune of many billions, the authorities cannot allow financial regulation to be guided by considerations of trade promotion. The public interest, not private profit, is what the rules should protect."[10] But the comment goes on, revealingly, to observe that "[i]t is true that the UK proposals[11] are more stringent than those elsewhere. The most mobile parts of banking might look for more forgiving regimes."[12] These two statements nicely encapsulate the dilemma that regulators are faced with. They simply cannot ignore that they do not operate in a vacuum — but that they make choices in a world where competition lures elsewhere. So the reality is that they *do* care.[13]

Consider politicians' seemingly benign arguments during the rule-making process on various recent financial laws. During the European discussion around the strengthening of banks' capital requirements, "(...) the EU's [then] internal market commissioner, Michel Barnier, stepped into the debate by warning of the potential downside from adopting rigid rules based on Basel III. Barnier fears European banks could become uncompetitive if they are forced to adopt higher capital rules than rival banks in the US or Asia."[14] Furthermore, the dramatic

[10] Financial Times, Comment, *Hold Britain's banks to higher standards: New rules on personal accountability are tough but necessary*, FIN. TIMES, October 9, 2014, p. 12.

[11] Here: on personal accountability of senior bankers. See *infra* Section 4.4.

[12] Financial Times, *supra* note 10.

[13] See also the description made by *The Economist*, "A chance of showers", July 18, 2015, p. 55: "Though bits of the regulatory set-up are stern, the British government has recently sent some conciliatory signals. It has tried to mollify big multinational lenders based in London with changes to the bank levy, an expensive and ill-conceived tax on their global balance-sheets. It will be halved, and applied only to local operations. The unspoken aim is to stop HSBC and Standard Chartered from moving to Asia, as they have threatened."

[14] Phillip Inman, *UBS may move investment bank to UK to avoid Swiss capital regime*, THE GUARDIAN, May 26, 2011, available at http://www.theguardian.com/business/2011/may/26/ubs-may-move-investment-bank-to-uk-to-avoid-swiss-capital-regime.

fight for capping bankers' bonuses in the EU has led many British policy makers to protest.[15] The reason is obvious: "British officials and bankers have warned that the limits [on bonus payments] could make it harder to keep London, Europe's main financial hub, competitive with financial centers like New York, Singapore and Hong Kong."[16]

What counts here is the *perception* by policy makers, and the *alleged* threat of business exodus. At the moment of policy making, they can only make assumptions on whether the arbitrage threats are genuine or not, and on whether the perceived loss in competitiveness later really materializes.[17] Just recently, a year after the EU bonus cap for financial executives came into force, commentators observed that "[s]o far, at least, new European restrictions on bonuses have not undermined London dramatically, with no wholesale shift of financial services jobs away from the UK, either to New York, or Asia."[18] But psychology matters. There is anecdotal evidence that the impact of the new bonus rules and other regulatory pressures have yet to feed through fully. Ninety percent of senior staff in the U.K. financial sector say that they are considering or willing to move abroad.[19]

To be sure, the list of examples provided here could be continued indefinitely. What this introduction seeks to describe has now become clear: the dialogue between regulators and regulatees does impact on

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[15] The 'Capital Requirements Directive IV' (CRD IV) implemented the Basel III capital standards in the E.U. and also introduced a cap on bankers' bonuses. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, [2013] OJ L176/338.

[16] James Kanter, *Europe's Finance Chiefs Reject British Move to Ease Caps on Bank Bonuses*, N.Y. Times, March 5, 2013, available at http://www.nytimes.com/2013/03/06/business/global/britain-isolated-as-european-colleagues-support-bonus-caps.html.

[17] For example, there is widespread agreement amongst commentators that HSBC's 2015/16 headquarter manoeuver paid off, as U.K. regulators made concessions to the bank. See George Parker, *Threat to move appears to have paid off handsomely*, Fin. Times, February 16, 2016, p. 16.

[18] Michael Pooler, *New York and London vie for crown of world's top financial centre*, Fin. Times, October 2, 2014, p. 19.

[19] *ibid.*

the way financial rules are written.[20] This applies to a broad range of norms that we describe as 'financial regulation' and which encompass genuine banking regulation, such as capital requirements, but also rules governing other financial institutions, products, and market or trading practices. Financial institutions frequently seek to avoid them: we speak of 'regulatory arbitrage'. Policy makers may bow to (perceived) market pressure and change their rules: that is 'regulatory competition'. Business can easily shift to jurisdictions where the legal and regulatory environment is more attractive. And in an ever more globalized world, regulators find themselves among an increasing number of rivals.[21]

This study evaluates the power of market pressure on the way financial regulation is made. I will argue that — unlike in many other regulatory contexts—the phenomena of arbitrage and competition in financial rulemaking are potentially more problematic than elsewhere. This is linked to the ease of arbitrage on the one hand, and to the risks of deregulation for global financial stability on the other. This study demonstrates that regulatory competition in financial markets is a reality, and it evaluates its merits. As a response to market behavior, it has many positive effects for the lawmaking process, but may at the same time pose a risk for and undermine global financial stability as a public good. The resulting dynamics may require regulatory intervention: the traditional response has been to promote international harmonization of legal rules, with extraterritorial reach as a comparable unilateral response. In contrast to these traditional concepts, this paper introduces the benefits that a special resolution regime for financial institutions can bring to the debate. I argue that resolution regimes can help introduce market discipline, and that threats to market stability can be eliminated where an effective and credible global framework is in place.

The study is structured as follows. Section 2 gives an introduction to the notions of regulatory arbitrage and regulatory competition, and

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[20]See Harvey L. Pitt, *Bringing Financial Services Regulation into the Twenty-First Century*, 25 Yale J. Reg. 315, 320 (2008).

[21]Traditionally, the competition for the leading financial center in the world was mainly between New York and London. More recently both cities have reason to be wary of their Asian rivals. See Pooler, *supra* note 18.

provides an analytical framework to analyze the subject matter of this paper. Section 3 then takes the debate into the specific field of financial markets regulation and identifies the problems that it creates in this context. This allows Section 4 to discuss the various regulatory answers that regulators traditionally subscribe to. Section 5 then introduces the benefits that a resolution regime for financial institutions can produce if it is designed in the right way. Section 6 concludes.