Basel's Burst Bubble:

How Basel Has Broken Apart and

What Should Now Be Done to Fix Bank Regulation

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August 27, 2012

Executive Summary

With the European Union now far behind the Basel III implementation schedule and the U.S. pursuing a course that is in many respects dramatically different than the global accords, the prospects for harmonized international capital, liquidity and prudential standards have become considerably more uncertain. The recent controversy surrounding the decision by New York State's regulator to sanction a U.K. bank has also raised questions about the degree to which not just regulation, but also enforcement can be harmonized across national borders.

This paper analyzes the status of key rules that define financial-institution franchise value, seek to end "too big to fail," determine industry strategy and, regulators believe, are essential to reducing systemic risk. This leads to a finding that the Basel III framework and related Financial Stability Board (FSB) standards face one of two futures:

- they will become an "umbrella" set of goals by which national standards are judged even as home- and host-country rules become increasingly divergent; or

- there will be complete abandonment of even a largely-rhetorical global construct in favor of one-off national rules for banking organizations and other financial-services firms.

In either case, national rules will take on renewed importance, posing significant regulatory-arbitrage, competitiveness and systemic-risk concerns.

This realistic assessment of the prospects for the Basel III standards and related international rules leads to major strategic decisions for both regulators and financial institutions. The paper thus concludes with recommendations:

- Policy-makers at both the national and global levels must frankly recognize their own limitations, the increasing complexity and risk of pending rules and the structural differences between major banking regimes. They should craft global standards as transparent, measurable guides to best practice, not in hopes of setting top-down fiats.

- Where variations between national and global practice are deemed essential by national policy-makers, resulting risks should be described transparently as identified by global regulators to ensure that all stakeholders understand the degree to which national variations may pose macroeconomic or financial-stability risk.

- Global regulators and the International Monetary Fund (IMF) should also take as a matter of priority the responsibility for creating fair trade in sound financial services principles. These would identify risky practices and institutions to limit contagion risk, regulatory arbitrage and competitiveness concerns without the need – sure never to be met – of overriding national sovereignty. Financial practices in safe-haven regimes should be identified and sanctioned, as is now done for haven states for worker abuse or toxic production.

- Financial institutions should determine the degree to which the current reality of heterogeneous, not harmonized, banking regulation suits their long-term interests. Policy-makers must act now to ensure sound banking in the face of these realities, but industry groups can work to overcome them if desired. To do so, the most senior leadership of affected banks need frankly to recognize Basel's break-down and, if they prefer a harmonized framework, define its planks in sufficient detail to ensure harmony goes beyond rhetoric to meaningful regulation.

- The industry should consider the cross-border trade regime for financial services, identify barriers and needed protections and recommend these to global and home-country regulators. Firms active in cross-border banking should make this as much of a priority as regulators to ensure that Basel's break-down does not put them at undue disadvantage or result in systemic risk.

- Given the difficulty such negotiations face and the immediate need for an array of regulatory reforms, parallel efforts should commence to consider which rules are appropriate in home regimes to reflect national circumstances under the umbrella of the Basel and FSB standards.

The last decision-point is perhaps the most important given the macroeconomic and profit impact – all severely adverse – of a continued regulatory stalemate. Regulators have been caught up in countless "silos" in which complex rules are crafted in hopes of satisfying an array of expert and legal concerns. This has created a new over-arching risk which Federal Financial Analytics has called "complexity risk" and analyzed in depth in a prior report.[1]

One driving force in complexity risk is frequent efforts to capture the nuances of many divergent national banking structures, standards and accounting requirements in a single rule. For the reasons detailed in this paper, Federal Financial Analytics here finds that this effort is counter-productive – it is both failing to capture irreversible national structural differences that are fundamentally incompatible with many global rules and miring needed global best-practice standards in undue complexity and lengthy delays that pose new risk.

Policy-makers and financial institutions should thus quickly identify the most critical reforms with the lowest risk of unintended impact and work quickly to finalize these in their own regimes. Doing so would reduce uncertainty, lower risk and revitalize banking markets.

[1] Federal Financial Analytics, *A New Framework for Systemic Financial Regulation: Simple, Transparent, Enforceable and Accountable Rules to Reform Financial Markets* (Nov. 18, 2011), *available at*: http://fedfin.com/images/stories/client_reports/complexityriskpaper.pdf.

Federal Financial Analytics, Inc. has provided objective analytics and advice to major financial firms in the U.S. and around the world since 1985. Clients have also included major regulatory bodies in the U.S., U.K. and other nations, with a list of clients available on the firm's website (WWW.FEDFIN.COM). The firm provides advisory services that focus not only on transactions (e.g., mergers, new product offerings) with significant policy ramifications, but also on matters of legislative, regulatory and policy advocacy. Governmental clients seek guidance on the status of U.S. developments to inform their own decision-making on regulatory and supervisory matters. In general, the firm does not represent clients before regulators and it does not lobby the U.S. Congress or the executive branch.

The views expressed in this paper are purely those of the firm and its managing partner, Karen Shaw Petrou, and do not necessarily represent those of any of the clients it advises on matters discussed herein.

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Introduction

Like the United Nations or, less auspiciously, the League of Nations, the Basel Committee's efforts to craft a global bank-regulatory framework derive from a combination of idealism and self-interest. When its first major achievement – the "Basel I" capital rules – was finalized in 1988, it was the first meaningful cross-border standard applied to internationally-active banks. Efforts prior to that (i.e., the International Banking Act of 1978) were largely focused on removing barriers to fair trade in financial services so that foreign banks could operate in a jurisdiction on the same terms as home-country institutions. But, Basel I went farther to set a risk-based capital minimum ratio deemed necessary for prudent operations. The U.S. and U.K. launched Basel I over considerable objections from other nations due to fears at the time that astonishing growth in Japanese banks posed both systemic-risk and competitiveness concerns. Soon, however, the framework set in Basel I became not only a global norm, but also a platform for an array of additional global efforts to harmonize international banking standards.

Like both the UN and League of Nations, this global framework functioned reasonably well and issued many proclamations during the period of relative financial-market calm immediately after its establishment. Under stress, however, well-intentioned agreements quickly fell apart. Two decades later, in the global financial crisis of 2008, the least-common-denominator compromises that permitted global agreement and wide divergences in actual enforcement that masked differences were laid bare. The Basel II Accord (an effort to modernize Basel I finalized after more than a decade of negotiations) quickly gave way to Basel II.5 and Basel III, with the Committee also issuing numerous other prudential standards in an effort to remedy flaws that led to the crisis. At the same time, the Committee realized that, no matter how many global standards it issued, these would have little constructive effect if not actually implemented in comparable fashion. It thus joined other global financial-services regulators in coming under the jurisdiction of a new global agency, the Financial Stability Board.

The FSB sought to encourage common standards and practice but, finding this frustrating, appealed to global heads of state. In 2012, the Group of Twenty (G-20) summit agreed that the FSB could order other regulators around. It did not, however, allow the FSB to do the same for any nation. As a result, to track the UN analog, global regulators now have a Security Council as well as an international deliberative body, but its ability actually to tell anyone what to do or settle disputes is still, at best, uncertain.

Nevertheless, the Basel Committee and FSB remain committed to what they hope will turn out to be a global framework for banking organizations implemented in comparable fashion in home and host countries that is enforced to meaningful effect around the world. The same 2012 G-20 meeting that sought to empower the FSB also reiterated its commitment to all of these concepts. But, despite the hopeful rhetoric, the on-the-ground reality of global banking regulation is still fractious and incomplete.

This paper assesses the status of efforts to harmonize key global standards and, given the conclusion that a comparable regulatory regime is unlikely, addresses the strategic decisions that must now be made both by governmental decision-makers and financial-services firms.

Status of Basel III Standards

It is not the intent of this paper exhaustively to summarize or survey Basel III or FSB rules. Federal Financial Analytics has undertaken in-depth analyses of all of the rules discussed here, with summaries available on the firm's website. All documents discussed may be easily obtained from the Basel Committee on Banking Supervision (BCBS) or other referenced global and national regulators. The analysis below highlights the most significant planks of the Basel III capital and liquidity rules following their finalization in December 2010 and addresses other key global actions in areas that are fundamental to financial-institution operation and profitability.

Capital Standards

Basel largely confined itself to capital regulation for much of its existence due to the still-prevalent view that capital is the cornerstone of safety and soundness. As a result, while other Basel actions (e.g., the liquidity standards) are consequential, the global framework remains premised on international capital standards. These were most recently finalized in the Basel II.5 standard in 2009 for bank trading books (thus addressing market risk) and the 2010 Basel III standards for credit and operational risk. Although the trading-book rules have been finalized, the BCBS has still proposed a "fundamental" review of them that could dramatically restructure these global standards in coming years.

Key developments that undermine harmonized implementation of the Basel II.5 and III standards include:

- **Leverage**: In part because of wide disparities in the calculation of risk weightings for assets (RWAs), the Basel III rules now include a 3% minimum (i.e., leverage) capital charge for on- and off-balance sheet assets, calculated generally without regard to actual risk. This leverage charge was strongly opposed by major Eurozone nations and only grudgingly included in Basel III. It is now among the most contentious provisions holding up action in the EU to implement Basel III. In sharp contrast, the U.S. already has a higher on-balance sheet leverage requirement and plans to impose a stringent version of the Basel III off-balance sheet requirement for the largest banks. The U.S. also sanctions banks based on the degree to which they meet these leverage requirements. Disparities in the leverage rule permit wide divergence in actual capital if RWA differences are not effectively resolved since there will be no cross-border floor on regulatory capital.

- **Additional Floors**: In general, the Basel III rules have no minimum requirement other than the leverage charge. In sharp contrast, U.S. law (the "Collins Amendment" to the Dodd-Frank Act) requires that banks doing business in the U.S. never hold less capital than would apply to them under the Basel I rules. U.S. regulators have interpreted this to mean that RWAs cannot reduce capital below Basel I minimums, even though capital is to be held against these RWAs judged by higher Basel III quality-and-quantity standards. The "standardized" notice of proposed rulemaking (NPR) now pending in the U.S. imposes this requirement, which could make the U.S. Basel III standards far higher than those applicable elsewhere.

- **Credit-Risk Measurement**: RWAs are determined based on credit risk, making the manner in which this is measured a fundamental building block for the global capital accord. Historically, RWAs have been set based on asset categories (i.e., mortgages, commercial loans, etc.), ratings provided by credit rating agencies (CRAs) and, for users of the advanced-internal ratings based (A-IRB) approach, internal models. Internal models have come under critical scrutiny since the crisis, leading Basel III to impose limits on them and the U.S. to mandate the floors noted above. However, the Dodd-Frank Act now bars reliance on CRAs in bank regulation. As a result, the U.S. final version of the Basel II.5 rules require, and the NPRs for Basel III propose, U.S.-specific credit-risk criteria, many of which result in considerably higher capital charges than expressly mandated in Basel III.

- **Risk Weightings**: In addition to differing measures of credit risk, the U.S. has proposed different capital charges for certain asset classes. These are of particular concern with regard to residential mortgages and asset securitizations. Differences between U.S. and global rules in the latter asset category are exacerbated by the Dodd-Frank requirement that asset-backed securities (ABSs) issuers hold at least a 5% risk position in ABSs they sell into the secondary market, a proposal with so many differences from EU risk-retention requirements that the International Organization of Securities Commissions (IOSCO) has launched an inquiry into the degree to which these differences threaten global capital markets.

- **Surcharges**: In 2011, the Basel Committee decided to impose a capital surcharge on banks deemed to be global systemically-important ones (G-SIBs). The G-SIB surcharge is premised on the underlying Basel III requirements, meaning that it will be placed atop rules that are, as noted above, increasingly dissimilar. This will exacerbate disparities in capital requirements for designated G-SIBs, with the uncertain state of systemic-capital surcharges adding an additional level of concern for banks doing business in the U.S. A pending Basel proposal for domestic systemically-important banks (D-SIBs) increases the scope of potentially different capital standards.

Liquidity Standards

Although capital is, as noted, considered the cornerstone of global prudential rules, liquidity standards are a major part of the 2010 Basel III agreement. These reflect hard experience during the financial crisis, when funding problems toppled otherwise-solvent institutions. The failures of Bear Stearns and Lehman Brothers are often cited to demonstrate the vital importance of liquidity requirements. The 2010 standards are to be implemented following an ongoing observation period, but the rules have been determined to require such significant revision that implementation remains uncertain. The BCBS plans by year-end 2012 to issue revised standards which are likely, among other things, to revise the types of unencumbered highly-liquid assets that are considered offsets for liquidity risk under both the thirty-day liquidity-coverage ratio (LCR) and one-year net-stable-funding ratio (NSFR). The Basel liquidity standards remain in limbo due not just to the observation period's findings and pending changes, but also to significant differences of opinion in key markets. These may well threaten implementation of a comparable international liquidity regime regardless of what Basel is able to finalize. Key concerns include:

- **Implementation Variances**: So far, the U.S. has taken no action on the Basel III standards, but it has other liquidity standards. These include inter-agency guidance that is more general than Basel III, but includes a broader range of time horizons, stress tests and other factors than addressed to date by Basel. The FRB's proposal for systemic standards for designated firms and bank holding companies with assets over $50 billion is very specific with regard to liquidity risk and differs in many respects from the Basel III rules. For example, the NPR takes a very different approach to liquid assets (see below), a far more specific stand on board responsibilities and a very detailed approach to stress tests and liquidity buffers. The latter is a critical unresolved issue, as it is uncertain if banks will be required to hold more capital than clearly required by a buffer above minimum standards or if the buffer suffices to ensure resilience under stress. The EU has yet to act on the liquidity standards, although it is signaling that it will take a very different approach – by for example not including anything like the NSFR. Other nations are generally withholding decisions on the liquidity rules until the Basel Committee finalizes them.

- **Funding Sources**: The new standards pending in Basel may help to resolve this issue, but significant differences are likely to remain and, thus, complicate global implementation. Some of these differences pertain to underlying structural variations in national banking systems – for example, the U.S. has the most developed deposit-insurance system that permits even very large banks to rely on core deposits, as well as on the wholesale unsecured funding sources that generally characterize global banking. However, EU banks also rely on secured funding – e.g., covered bonds – liquidity sources with significantly different characteristics than either core deposits or wholesale unsecured funding. Possible reforms to money-market funds (MMFs) in the U.S. also drive potential funding differences with structural impact.

- **Liquid Assets**: Structural differences in national finance also affect the types of assets available to meet the LCR and NSFR. For example, the U.S. has giant government-sponsored enterprises (GSEs) that provide "advance" funding and issue consolidated obligations, debt instruments and mortgage-backed securities (MBS) on which many U.S. banks rely. Under the global rules, these assets and funding sources have limited value, making the rules particularly problematic in the U.S. and especially so for regional banks with large mortgage operations and/or limited investment portfolios.

Resolution

Despite the emphasis to date on capital and liquidity, perhaps the most fundamental question in bank-prudential regulation is what happens when a banking organization fails. Who bears the cost and how systemic the impact of failure proves drives critical decisions such as whether banks are too big to fail (TBTF) and, thus, require compensatory or even punitive regulation to cushion taxpayers from any TBTF safety net and/or to insulate markets from undue risk. However, as with other prudential standards, the resolution framework for global banks remains a wide variance, creating a conflicting premise underpinning rules that, even if harmonized, may make little sense when a key goal – dealing with TBTF – is considered differently in each applicable national regime.

Of particular importance here are the following national practices that significantly affect the prospects for harmonized prudential regulation:

- **Orderly Resolution**: Title II in the Dodd-Frank Act includes a new "orderly liquidation authority" (OLA) under the Federal Deposit Insurance Corporation (FDIC). OLA is set in law specifically to bar TBTF when a stringent process finds that a financial institution's failure could create systemic risk. To promote OLA, designated nonbanks and BHCs over $50 billion must file "living wills." The FRB and FDIC can break up a systemic firm or otherwise sanction it if they find the resolution plan not to be credible. Although OLA rules remain incomplete and it has not yet been tested by a systemic failure, the process is seen by many as a robust one. If perhaps imperfect, the U.S. process is the only established one expressly barring TBTF with sanctions and other powers in law to reinforce the end to the taxpayer safety net. CRAs and other market participants have recognized the force of OLA and altered behavior in response.

- **TBTF**: In sharp contrast to OLA, most other large financial centers are premised on TBTF. The FSB has finalized key attributes of orderly resolution for big banks, but only the U.K. is in the process of finalizing them. In the rest of the EU, an array of sovereign backstops and EU supports are propping up troubled banks. In most other nations (e.g., China, Japan), banks are seen as "arms of the state" and are thus TBTF. To be sure, the EU is seeking to reduce or even eliminate TBTF, doing so in concert with establishing a pan-Eurozone banking union that would include better deposit insurance and clearer cross-border lines of liquidity support. But, unless or until this new framework is established in a robust way as a meaningful end to TBTF, this fundamental premise of financial regulation – as noted, a core foundation of the Basel standards – is not harmonized across national borders.

- **Bail-In Capital**: Various regimes are considering bail-in capital or contingent instruments designed to put a layer of investor support ahead of taxpayers to discipline systemic institutions. However, major regimes (e.g., the U.S.) have significant reservations about the value of these instruments which, if used as an interim step before TBTF rescue, would reinforce TBTF and, perhaps, result in moral hazard. Some versions of these capital instruments would deploy them prior to failure to recapitalize a bank while others would do so upon failure, making their impact very different from both a market and policy perspective.

Other Prudential Standards

The discussion above addresses the wide disparities in national implementation of the key planks of the Basel III standards and the FSB's work to end TBTF. Importantly, many other aspects of home- and host-country bank regulation vary dramatically and directly affect the degree to which global standards can create a harmonized cross-border regulatory framework for banking organizations. Additional differences include:

- **Size**: The U.S. has thousands of insured depositories despite the sharp increase in concentration of assets at the largest banks in recent years. Even so, however, U.S. banks hold a considerably smaller percentage of assets to gross-domestic-product (GDP) than in most other countries, where banks are often considered not just TBTF, but even "too big to save" because their size threatens the stability of their sovereign domicile.

- **Regulatory Structure**: This varies widely across national regimes. In some countries, central banks govern; in others, this responsibility is either shared with a banking regulator or solely granted to it. In some jurisdictions (e.g., the U.S.), there is a "dual" system of state/provincial regulation and national standards, with responsibility either shared between state and federal agencies or housed solely in one or the other. These federal agencies need not be bank regulators, with nations varying in the degree to which "functional" regulators (e.g., for securities firms) may govern activities housed in banking organizations. In some nations (including the U.S.), there are various choices among federal agencies for a bank charter and a separate holding-company regulator. At the very least, all of these jurisdictional differences complicate harmonized regulation and enforcement. Often, they make it impossible since rules are created to meet local, not global, objectives.

- **Ring-Fencing**: To enhance safety and soundness, some regimes have erected barriers between traditional banking and non-traditional activities (e.g., investment banking). In the U.S., examples include the inter-affiliate transaction limits of Sections 23A and 23B of the Federal Reserve Act and the holding-company structure required for non-traditional activities. In the U.K. the "Vickers" reforms mandate ring-fence separation between commercial- and investment-banking operations. The EU has a committee considering ring-fencing, but its banks now generally operate in a fully integrated fashion consistent with decades of preference for the "universal" banking model.

- **Activity Limits**: The universal-banking model not only does not include intra-group transaction limits, but also generally eschews specific activity ones (for example, allowing banks to have significant stakes in manufacturing firms). The U.S. model is a far narrower one, despite liberalization in the 1999 Gramm-Leach-Bliley Act. This

> narrow focus was further constrained in the Dodd-Frank Act, where the "Volcker Rule" stipulates a ban on proprietary trading and certain investments and the "Lincoln Amendment" pushes out certain derivatives activities from insured depositories, with neither of these rules comparable to other major financial markets. Differences in permitted activities affect not just the structure of national banking organizations, but also the degree to which global rules can be applied (e.g., the French strongly oppose Basel standards related to subsidiary investments due to integrated banking/insurance activities not generally found elsewhere).

These differences and many others have created increasing disputes between home and host countries over the degree to which regulators can impose their standards on an extraterritorial basis. This has most recently flared in contentious disagreements over an extraterritoriality proposal by the Commodity Futures Trading Commission (CFTC), but it has been a longstanding concern among the U.S., U.K. and EU. Several EU rules (e.g., regarding asset management and investment-bank regulation) have limited entry rights based in part on the degree to which home-country standards comply with host-country ones. Because of these disputes, many nations are contemplating or have erected barriers to entry, an issue addressed below.

Decision Points for Policy-Makers

The analysis above demonstrates two key findings:

- the Basel rules are being implemented in ways that are often radically different across regimes that have committed to homogeneous regulation; and

- national bank regulation and law is often so different that these disparities are inevitable regardless of the best wishes of regulators or financial-industry best practice.

Given this sorry, but necessary conclusion, we turn now to what needs to be done in light of it to ensure that bank regulatory practice does not become so slipshod as to create systemic risk and macroeconomic damage.

Policy makers should:

1. **Abandon Hope for Binding Global Rules**

Because of all the differences in law, rule, banking-industry structure and national practice summarized above, the Basel Committee and FSB are chasing a chimera if they hope going forward that final rules in all the detail mandated in Basel III and anticipated in global resolution standards will be adopted in full and enforced as anticipated in key banking markets. If global regulators fail to recognize this hard reality, they could well become the financial-market equivalent of all the United Nations agencies that issue lengthy protocols and proclamations ignored in form and substance around the world even as signatories dutifully pen their names.

If all of the hard work dedicated to Basel III and its many constructive provisions are to guide financial reform, then it and the other global dictates detailed above should be codified not as hoped-for rules, but rather as industry and regulatory best practice.

This approach is meaningful because it differs from the many "high-level principles" issued by Basel and other global regulators. These include best practices often phrased in such generality – i.e., supervisors should ensure that bankers act with integrity – that no one can be held accountable for compliance with global edict. The specificity of Basel III and other standards is valuable in that it provides clear qualitative standards and quantitative criteria to ensure that both national and institution performance can be objectively evaluated.

Based on this, the Basel Committee, FSB and IMF should continue recent efforts at peer review, detailing in advance how nations will be judged and reporting on findings on specific reviews without diplomatic niceties. These peer-review findings should be used not to attempt top-down pressure on recalcitrant countries – this simply won't work – but rather to guide national supervisors as to where home-country regulation creates concerns about the degree to which parent-organization capital, liquidity or other supervisory standards are of concern. In such cases, host-country regulators should take steps to protect their financial systems from disorderly resolutions and/or other problematic regulatory issues. National rules that are more stringent than global standards should not be viewed as violations of global standards as long as they are not applied in a discriminatory fashion.

2. Set Trade-in-Financial-Services Standards That Recognize the Need for Cross-Border Barriers

Trade in financial services is not conceptually different from trade in other services or in manufactured goods. Protectionism is inefficient for both importers and exporters, but customs inspections to ensure that imported products meet national safety standards are a longstanding feature of global trade that can and should be reflected in expectations for trade in financial services.

Where home-country regulation of a banking organization or product seeking entry into a host country does not meet host-country standards, safeguards should be imposed. These could include simple barriers to entry, conditional entry granted on use in the host country of a subsidiary form that subjects host-country operations to host-country standards or branch operation through memoranda of understanding (MOU) or similar accords with home-country regulators that ensure transparent compliance with key host-country conditions. As with manufactured-good or agricultural-product trade, trade in financial services can be suspended if a product or institution seeking to enter a market is deemed toxic in an importing regime.

To be sure, this trade-in-financial-services approach can quickly become the equivalent of the Smoot-Hawley Act – virulently protectionist U.S. trade legislation enacted in 1930 to disastrous effect – if not governed by global principles and, if possible, fair-trade enforcement. The Basel Committee, FSB and IMF should quickly turn from promulgating detailed rule after detailed rule to identify key criteria for fair and prudent trade in banking and, then, in other financial services. These should be articulated first as measurable standards to judge home/host banking operations that are made clear in peer reviews and other documents that inform global negotiations. These international bodies should also consider ways to improve or replace World Trade Organization (WTO) trade-in-financial-services provisions to make them clearly focused on prudential factors, transparent and enforceable.

However, as all of these considerations advance, the FSB can and should become an arbiter of trade-in-financial-services disputes, using its prestige and cross-border knowledge to recommend remedies to trade barriers deemed protectionist or otherwise risky. The FSB could become a mandatory arbiter of fair trade in financial services should this be deemed advisable due to the inability or unwillingness of other bodies to assume this role, but at the least it should work with the Basel Committee and other sector regulators to promulgate what we will call a Fair Trade in Prudent Financial Services Protocol.

3. Govern Cross-Border Banking Where Needed to Ensure Orderly Cross-Border Resolution

As with global trade in other activities, trade in financial services can only be constructively addressed at national borders for certain purposes, principally the need to prevent the import of risky products or entry by risky institutions. However, the international nature of financial services means that, even with better bulwarks to cross-border risk, international operations will still pose problems in multiple jurisdictions, especially under highly-stressed conditions that do not permit lengthy negotiations. Reflecting this, one of the most pragmatic actions global regulators have taken since the crisis is recent work to establish "crisis management groups" and clear protocols to handle the failure of a systemic cross-border bank. Based in part on the "living wills" recently filed by some of the largest cross-border banks, these plans seek to avoid the chaos following the Lehman collapse resulting from lack of knowledge in the U.S. and U.K. of which operations were under what law with what risk.

Nothing in these resolution plans overrides national differences even as they proceed under efforts to harmonize them wherever possible. They are thus a very effective model for cross-border regulatory standards that prevent contagion risk based on a clear understanding of irreconcilable differences in national banking regimes.

Decision Points for Financial Institutions

To summarize the decisions presented below, the critical ones facing financial institutions are:

- Do they want to permit the break-down in Basel to continue unchecked or seek to reverse it? If the latter, is this politically viable and practical given the array of structural and statutory differences discussed above?

- Is a more robust trade-in-financial-services regime a critical factor to prevent regulatory arbitrage and competitive harm due to the Basel break-down? If so, how should these agreements be structured and what advocacy strategies are needed to advance them to rapid implementation and enforcement?

- Which home- and host-country standards require revision to reflect both global norms and national needs? What advocacy strategy should be deployed to ensure rapid implementation to reduce market uncertainty and advance economic recovery?

The first key decision point for financial institutions is whether or not they want a harmonized or heterogeneous regulatory framework. This paper has demonstrated that current forces are disintegrating the Basel and related standards into widely divergent actual home- and host-country rules. Regulators can decry this, but they are unlikely to be able to change it without active support from home-country and global banking organizations. To date, banks have largely advocated global standards in very broad terms while opposing key provisions in them deemed adverse to profit or competitive interests. It is unlikely that banking interests can go beyond rhetoric to actual, active support of sweeping homogeneous cross-border banking rules that would then lead to the statutory revision necessary to execute them. Those in the industry who believe it to be in their interest in fact to see such an outcome must decide not only if industry agreement is viable, but also if sufficient momentum for it can quickly be amassed to reverse the ongoing, increasingly rapid disintegration of global rules.

Secondly, like regulators, financial-services firms should assess the degree to which fair-trade-in-financial-services agreements would permit modification of global rules to meet their desired objectives without exposing them or markets in which they operate to undue risk of regulatory arbitrage. To date, industry attention to this has been very limited and focused principally on specific standards (e.g., EU rules that could limit branch entry and offerings of certain products), not on the degree to which the overall global regime promotes non-discriminatory access on sound terms. Most immediately, the industry should consider the degree to which current trade-in-financial-services agreements (e.g., those in the WTO) can be made more effective, as doing so within an existing treaty regime would be the most effective way to enhance cross-border trade rules. Only if existing organizations lack sufficient authority or proved disinterested in financial services should consideration be given to new bodies.

Finally, financial institutions should take as a matter of priority an inventory of rules they think are warranted in home and host countries for effective reform and orderly resolution, considering extraterritorial ramifications as a key part of this prioritized strategic assessment.

Due to the deluge of new rules, the industry has all too often taken on what some see as a just-say-no posture despite studies and comments intended to take a constructive stand on contentious regulations. In part, this perception difference derives from the complexity of many proposals and the procedural focus that has preoccupied some industry advocacy. Stepping back to design a regulatory-reform advocacy agenda in which some policies are actively advocated would dispel at least some of the political differences that lead regulators to go their own way and guide policy-makers to a more meaningful, near-term reform agenda.