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AICGS POLICY REPORT

FINANCIAL REGULATION IN THE UNITED STATES AND GERMANY: FROM NATIONAL AUTARKY TO INTERNATIONAL COORDINATION?

Sigurt Vitols

AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES THE JOHNS HOPKINS UNIVERSITY

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FOREWORD

Financial services play a vital role in the transatlantic economy, serving as a major employer, factor of production, and a provider of services. Changes in financial services have been driven by financial globalization and innovation—to the point where experts are beginning to ask whether continued efforts by national governments to regulate their own service sectors must now give way to broader EU and transatlantic arrangements. The challenge facing policymakers in Washington, Berlin, and Brussels is how their joint efforts to obtain higher productivity and efficiency in this vital sector can be reconciled with still formidable, at times clashing, national approaches to regulation.

This publication is part of a series, sponsored by the DaimlerChrysler Fonds im Stifterverband für die Deutsche Wissenschaft, examining the political, social, and economic causes of U.S.-European key regulatory disputes and assessing the prospects for reconciliation of transatlantic differences. In this report, Sigurt Vitols illuminates the historical, political, and cultural factors that have shaped the U.S. and German approaches to financial services regulation. To move beyond "autarkic" national regulatory systems, the United States and Germany/Europe have two alternatives: the "international regulator" system, where standards are enforced at the supra-national level; and the "international coordination" system, where minimum standards are agreed upon, but are adapted to local conditions and enforced at the national level. Vitols argues that the autarkic model is no longer feasible due to the increasing international mobility of capital and that the international regulator model would be difficult to implement for political reasons. He contends that although the international coordination model may have some disadvantages, it is viewed by many as the best solution to financial instability and indeed is the model for integration of financial services within the European Union.

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EXECUTIVE SUMMARY

Why is this issue important?

Financial services are important, not only as one of the largest employing sectors in the United States and Germany, but also as a "factor of production" supplying capital to industry and government, and as a provider of key services to households (asset management, insurance, consumer credit, mortgage debt, etc.).

Financial innovation is important in meeting the evolving needs of customers, and a healthy degree of competition can help encourage innovation and keep prices down. But innovation and the internationalization of finance have also led to more financial instability, and thus a greater need to regulate financial services at the international level. Agreement at the international level, however, is difficult, since financial services are organized very differently in various countries. Germany has a bank-based system dominated by universal banks offering a wide range of financial services. The United States has a more market-based financial system with a plurality of specialized financial services providers. Different types of financial systems have varying strengths and weaknesses, and it is instructive to learn about these comparative advantages. However, international conflicts arising from different national models of financial service provision have been a source of tension in international relations and impede progress in finding viable regulatory solutions at the supra-national level.

Alternative Models of Financial Regulation

This chapter outlines three different ideal types of financial regulation. The first is the "autarkic" national regulatory system, where standards are set and enforced within one country. This type of system was established universally in the 1930s and 1940s in response to the worldwide financial crisis and World War II. Since the 1970s, however, the increasing international mobility of capital has made it more and more difficult to maintain this type of system. As a result, interest in regulatory solutions at the supra-national level has increased.

One supra-national alternative is the "international regulator" system, where standards are set and enforced at the supra-national level. A second alternative is "international coordination," where minimum standards are agreed upon by a number of countries, but are adapted to local conditions and enforced at the national level. It is argued here that although the international regulator model may offer some advantages from an efficiency point of view, it is politically unfeasible. Thus the international coordination model of regulation, though subject to a number of shortcomings, has emerged as the leading supra-national solution to financial instability.

The Rise and Decline of Autarkic National Financial Regulatory Systems

This chapter traces the origins of differences in the German and U.S. financial systems to different policies developed in the 1930s in response to the depression and financial crisis. The United States developed a regulatory system that 1) separated actors concerned with the stock market (brokers, investment banks) from the banking and insurance sectors; and 2) established competing bank regulatory regimes at the national and state level. The key problem in the United States has been dealing with financial instability due to financial innovation and competition between these regulatory regimes.

Germany, in contrast, reflecting a much more skeptical attitude towards financial markets, developed a regulatory system in the 1930s and 1940s that 1) disadvantaged the stock market; 2) imposed universal quantitative prudential standards on banks; and 3) granted a prominent role to banking associations in return for "responsible" self-regulation. Public policy in Germany also encouraged the development of the public savings bank sector (*Sparkassen/Landesbanken*), serving public infrastructure needs and the encouraging "thrift" among the working class, and credit cooperatives (*Genossenschaftsbanken*), serving small businesses and farmers. The pace of financial innovation has been more of a problem in Germany than banking stability.

Financial Services Regulation: Domestic and International Conflicts

This chapter analyzes the main issues and conflicts arising from attempts to reform domestic regulatory systems and create supra-national regulation. In the United States the debate has been centered on the removal of barriers between banking, the stock market, and insurance, as well as improving protection for small shareholders and financial consumers. In Germany, the debate has focused more on increasing the importance of the stock market and encouraging financial innovation.

Both Germany and United States are important political actors, and differences in models of financial service provision have been reflected in conflicts over international regulation. Significantly, the most significant developments in supra-national financial regulation have been based on the international coordination model, particularly in the area bank capital adequacy standards (Basel I and Basel II) agreed through the Bank for International Settlement (BIS).

The Way Ahead: An International Financial Regulator or Improved International Coordination?

This chapter discusses the difficulties of the "international regulator" model and possible ways to improve the functioning of the international coordination alternative. Most of the scientific literature has unfortunately argued that there is a "one-best" financial system, thus suggesting that countries with suboptimal financial systems should imitate superior systems. Further research should explore the comparative advantages of these systems in more detail. Furthermore, a better understanding of the features of different financial systems among policymakers, and improved international relations, could better foster international coordination in financial regulation.

01

CHAPTER ONE

WHY IS FINANCIAL REGULATORY REFORM IMPORTANT?

The regulation of the financial system has emerged as one of the key economic problems and political challenges of our time. The S&L crisis of the 1980s, the "Asian crisis" of the late 1990s, and the stock market crash of 2000-2002 have made clear the shortcomings of financial regulatory systems around the world and the need for new solutions.

The financial services industry is a key sector in the United States and Germany, as in all industrialized economies:

- It is one of the largest sectors, accounting for about 5 percent of employment and value added in both countries;
- It is a major "factor of production," supplying credit and key services (account services, asset management, insurance, etc.) to industry, government, and households;
- It plays a significant role in corporate governance, M&A (mergers and acquisitions) activity and the IPO (initial public offering) market;
- It already accounts for much of retirement savings in the United States, and will play a more important role in this area in Germany in the future.

Change in regulation therefore has an impact on employment, profitability, and tax revenues created by this sector; on the cost of and ease of access to capital; on the decision-making of management and the reorganization of the corporate sector; on the availability of financing for start-ups; and on the accumulation, risk profile, and payout structure of retirement savings.

One of the main justifications for regulation in this sector is that the financial services industry is fundamentally different from other industries. As described by the Minsky instability hypothesis, specifically, an unfettered financial system has a tendency to crisis due to strong speculative motives among investors and financial institutions.[1] The need to constrain these speculative tendencies and to maintain investor confidence in the system has justified a strong governmental role in this area. At the same time, too much regulation is considered undesirable, insofar as it raises costs for customers and inhibits financial innovation. There is a broad consensus that good policy in this area should therefore seek to tread the thin line between over- and under-regulation. In practice, however, it is difficult to define what over-regulation and under-regulation are.

In the past few decades, the increased pace of financial innovation and the internationalization of finance have created especially great challenges for policymaking in this area. The recent experiences with the stock market crash of 2000-2002, acts of large-scale terrorism (particularly September 11), and natural disasters have also highlighted the potential fragility of the financial system and demands on regulation. Among the greatest risks:

- Innovation is desirable to better meet existing needs and to respond to new needs. However, the risks of new financial products may not be well understood by customers or properly monitored by regulators. Examples of products that are new or increasingly used to hedge risk or to seek above-average returns, and have caused regulatory concern, include: financial derivatives (options and futures), the complex transfer of risks through swaps, and increased leverage through the so-called carry-trade (i.e. financing of long-term assets with higher interest rates through incurring short-term debt at lower interest rates);

- The internationalization of finance, including cross-border lending and the increasing activity of multinational financial conglomerates, makes it difficult for national regulatory authorities to monitor and control risk and to deal with crises when they arise. Examples of this are the Latin American debt crisis of the 1980s, the Mexican peso crisis of 1994-95, and the Asian/LTCM crisis of 1997-1998;

- The stock market crash of 2000-2002, and the effects on the solvency of insurance companies and unfunded liabilities for defined-benefit pension funds, raises the issues of systemic stability. Although there has been a recovery in the second half of 2003 and 2004, the potential for sub-par returns for the next decade or two raises a host of issues for financial services providers who have future liabilities independent from financial market performance (e.g. defined-benefit pensions, annuity products, and in Germany "guaranteed minimum return" insurance products);

- Large-scale acts of terrorism (particularly September 11) and recent natural disasters have highlighted the vulnerability of the financial system to shocks caused by the sudden immobilization of a number of key financial institutions, as well as the exposure of insurers to unlikely events; and

- The increasing importance of corporate governance has put pressure on financial service providers both in terms of their need to comply with new standards, and in their roles as investors (both on their own account, and as trustees or custodians for customers).

One important response to these risks has been regulatory reform on the national level. However, due to the perceived limits of purely national responses to the growing internationalization of financial markets, there has been increasing pressure for international cooperation and the definition of minimum standards.

The process of international cooperation, however, has at times been difficult. Perhaps the key difficulty has arisen from the very different organization of financial systems and the different regulatory philosophies in different countries. Germany, for example, has much more of a universal bank-based financial system, whereas in the United States, financial markets are more important and the specialization of financial services providers is more developed.

This report offers an analysis of these differences, focusing on the case of the regulation of bank capital, since this is the area where most international progress has been made. First, different types of financial systems have different strengths and weaknesses, and it is instructive to learn from different systems. Second, the internationalization of finance has led to a need to regulate financial services at the international level and/or to encourage national regulatory systems to converge. This is because financial institutions are exposed to risks from all of their international operations. Both these financial institutions and regulators need to understand the extent of these global risks. The extent of this global risk is easier to understand if there are common global standards for defining and monitoring these risks, or if national standards are similar. Finally, different national models of financial service provision have been an important source of tension in international relations. Although this has been less true for the case of U.S.-German relations, the resolution of conflicts in this area can contribute to a better bilateral relationship overall.

02 CHAPTER TWO

ALTERNATIVE MODELS OF FINANCIAL REGULATION

In order to help understand current developments and alternatives in regulatory reform, this chapter explores three different approaches to financial regulation. The first is the "autarkic" national model, which was dominant from the 1930s until the recent past, but has been facing increasing problems. The two alternatives currently under discussion focus on the international level: the international regulator, and international regulatory coordination. The third model, although not perfect, appears to be the best model for dealing with current financial regulatory problems.

These models, although different in structure, are designed to achieve similar goals. The first goal of financial regulatory systems is to limit the amount of risk taken on by financial institutions, through restrictions on both the types and the amount of investments these institutions can make. The second is to make sure that financial systems have a "cushion" in the form of adequate capital to prevent financial institutions such as banks from going bankrupt, even when shocks cause a large number of their investments to go bad. When a loan or another type of investment goes bad, this loss must be absorbed by the capital base.

The "Autarkic" National Regulatory System

Prior to the 1930s, most financial systems were subject only to a minimal amount of regulation.[2] The instability of these "laissez-faire" financial systems culminated in the stock market crash of 1929 and a series of bank crises in the early 1930s. The failure of many or even most of their banks forced many countries to implement large-scale rescue plans and to establish serious regulatory systems in the attempt to prevent a recurrence of crisis. The mobilization for World War II and the subsequent reconstruction efforts in many countries was a further motive for strengthening regulation, since the financial system was frequently used as a tool for financing war or reconstruction needs.

These regulatory systems were for the most part "autarkic" regulatory systems, in the sense that standards were set and enforced within one country. Although some financial institutions had been quite active internationally before the 1930s, the financial crisis and the dampening of global commerce by the war severely constricted the international activities of banks. This tendency was reinforced by the establishment of capital controls in most countries limiting cross-border financial flows.

Notwithstanding John Maynard Keynes' argument that the establishment of an international financial regulator would be a necessary part of the postwar international financial system, in fact most countries confirmed the autarkic regulatory model in the late 1940s and 1950s. The dollar became the "de facto" world currency, and was given some stability through re-establishing the gold standard. Most currencies were pegged at a fixed rate to the dollar. Limited cross-border financial flows were allowed.

However, the increasing international mobility of capital in the 1970s made it more and more difficult to maintain this type of system based on national controls. The buildup of a large unregulated offshore "Euromarket", in which U.S. and British banks were key players, made it more difficult for national regulators to monitor and control risk. In the early 1970s the United States took the dollar off of the gold standard, and the search for a new international financial regulatory structure began in earnest. Although some countries such as Malaysia have tried to defend the independence of their national systems by imposing capital controls during the 1997-98 Asian crisis, most countries have acknowledged that it is difficult if not impossible to separate themselves from the international financial system, and have abandoned capital controls and fixed exchange rates.

International Financial Regulator

An alternative to autarky is the "international regulator" system, where standards are set and enforced at the supra-national level. This regulator would have the authority to override specific national interests. As mentioned above, Keynes argued that such a regulator would be needed to avoid the international financial crises of the past and make the new international system work properly.

However, after World War II this suggestion received little support because governments were not willing to give up national sovereignty over the financial systems, and international institutions such as the IMF and World Bank were limited to financial "firefighting" and project development. The United States, through its role as the world's strongest economy and the supplier of the de facto world currency, played the role of international stabilizer throughout the 1950s and 1960s. The termination of the gold standard for the dollar in the early 1970s signaled the end of the willingness of the United States to bear the costs of this arrangement. Since then international financial crises have been dealt with mainly by coordinated action by the countries with the most important financial systems (mainly the United States, UK, Japan and Germany). However, dissatisfaction with the ad hoc nature of this action has led to calls for a more sustained effort at international regulation, particularly after the Asian crisis of 1997-98.

For the most part, suggestions for an international regulator have focused on the Bank for International Settlements (BIS) based in Switzerland. The Basel Committee on Banking Supervision is composed of representatives of the central banks of the G-10 (i.e. economically strongest) countries plus Switzerland. Through the BIS two international agreements on capital adequacy (Basel I and Basel II) and a number of smaller recommendations for bank regulation have been reached. The success of the BIS as the platform for these agreements has led some to argue in favor of granting the BIS regulatory powers.

Another suggestion for supra-national regulation, albeit at the regional level, has focused on the European Commission. The efforts to establish a Single European Market, including the passage of a number of financial services directives, have started to break down national barriers and encourage European financial services firms to expand their cross-border activities. The European Commission has claimed that one of the largest benefits of the Single Market should be the achievement of greater efficiencies and economies of scale through a European financial market. Some have argued that, given the deepening of this financial market in Europe, it would make sense to establish a European regulator with the authority to develop and enforce regulatory standards.

International Regulatory Coordination

The third approach is "international regulatory coordination." This involves negotiation between countries on common regulatory standards. Due to the differences between countries, these are typically minimum standards, which may in fact be exceeded at the national level, or may only apply to part of the financial system in question. Furthermore, these standards also typically have to be adapted to local conditions. Unlike the case of the international regulator, these standards are enforced at the local level by the national regulatory authorities.

The most extensive implementation of this model has been made in the European Union. This involves negotiation between countries over Directives defining minimum standards applicable throughout the European Union. However, the Directive itself is not legally binding. Rather, national legislation is passed in each country adapting the standards to local conditions. Furthermore, countries are generally free to have stricter standards, if they wish.

The main disadvantages of the international coordination model are:

- Negotiations can be quite protracted;

- The success of negotiations can be subject to the prevailing international relations climate, since some countries involved may hold negotiations "hostage" due to disputes in other areas;

- Implementation and enforcement at the national level may be uneven, and thus open to accusations of competitive unfairness.

Nevertheless, the international coordination model offers a number of important advantages:

- This approach does not require the establishment of an extensive and expensive regulatory apparatus at the supra-national level. Instead, just a platform for negotiations, and perhaps minimal monitoring of implementation, are needed;

- The political issue of delegation of national authority to a body that may only be indirectly accountable to the electorate is avoided;

- National regulators may have superior access to information and better knowledge of local conditions and actors, and thus be more effective than a supra-national regulator; and

- Experimentation with different regulatory solutions simultaneously in a number of countries may be more useful for learning and innovation than imposing one (possibly suboptimal) solution on all countries.

03 CHAPTER THREE

THE RISE AND DECLINE OF AUTARKIC NATIONAL FINANCIAL REGULATORY SYSTEMS

This chapter explores the roots of the present differences in the German and U.S. financial systems and regulatory philosophies. These systems were built up in the 1930s in response to the Depression and financial crisis and in the 1940s as a response to World War II. The United States developed a regulatory system which controlled risk by separating actors concerned with the stock market (brokers, investment banks) from the banking and insurance sectors. The main drawback was the existence of competing bank regulatory regimes at the national and state level. The key problem in the United States has been dealing with financial instability due to financial innovation and competition between these national and state regulatory regimes.

Germany, in contrast, reflects a much more skeptical attitude towards financial markets. It developed a regulatory system in the 1930s and 1940s that allowed banks to be active in both commercial banking (i.e. deposit-taking and loan-making activities) and investment banking (i.e. stock-market related transactions). Financial risk was controlled mainly by discouraging the development of the stock market and by imposing universal quantitative prudential standards on banks. Public policy in Germany also encouraged the development of the public savings bank sector (*Sparkassen/Landesbanken*), serving public infrastructure needs and encouraging "thrift" among the working class, and credit cooperatives (*Genossenschaftsbanken*), serving small businesses and farmers. The slow pace of financial innovation has been more of a problem in Germany than banking stability .

The U.S. "New Deal" Financial Regulatory System

The emergence of a financial regulatory system in the United States has been a long-term process starting with the authorization of the first banks in the late eighteenth century. From the beginning the political debate over this regulatory system has been concerned with the division of powers between the individual states and the federal government. As a result bank regulators exist both at the state and national levels. On the whole, however, it is fair to say that before the 1930s regulatory standards and enforcement were not very strict, despite the many bank crises that occurred.

During the 1930s, federal regulation of the financial system increased substantially as a response to financial crisis and the Great Depression. This increase in regulation has been permanent, due to the widespread acceptance of the belief that the financial system needs to be strictly controlled in order to avoid further crises of this magnitude. The Depression was triggered by a collapse in the stock market on October 29, 1929, when a speculative boom on securities markets that lasted for much of the past half decade burst. While the collapse of the stock market by itself constituted a serious disruption of the financial system, the problem was complicated by the spread of the financial crisis from securities markets to the commercial banking system. Banks were heavily involved in the speculative boom of the 1920s through the provision of loans to brokers selling securities to customers "on margin," i.e. for a fraction of their market value. These broker loans, which were secured by the securities they were financing, became uncollectible when the stock market collapsed. Banks were unable to recall these loans in response to depositor withdrawals and became insolvent. Though prohibited from involvement in investment banking or brokerage activities, national banks also were heavily involved in the speculative boom through state-chartered affiliates, which purchased securities for the banks' own accounts.

The banking crisis was compounded by the Federal Reserve System's adherence to the "real bills" doctrine. Based on the theory of self-liquidating commercial finance, the Fed failed to provide the necessary refinancing to the commercial banking system in response to the withdrawal of funds.[3]

As a result of loss of confidence in the banking system, increasingly serious bank panics were triggered. By 1933 over 10,000 of the almost 25,000 commercial banks in operation in 1929 had been closed. The closure of these banks disrupted the payments system and wiped out the financial assets of many companies and households; in 1933 unemployment had reached 25 percent of the labor force and gross national product was at half of its 1929 level.[4]

Finding a solution to the banking crisis was one of the top legislative priorities of the newly elected Franklin D. Roosevelt and New Deal Democrats in Congress. Roosevelt's first official act upon taking office in March 1933 was to declare a national "banking holiday," and steps were quickly taken to examine the financial health of banks and revive the banking system through the Reconstruction Finance Corporation.

In order to deal with the underlying problems of the banking system and improve the long-term stability of the banking system, New Deal legislators under the leadership of Senator Glass and Congressman Steagall passed two major pieces of legislation reforming the banking system and banking regulation, the Banking Acts of 1933 and 1935. The first of these, the Banking Act of 1933, has become more popularly known as the "Glass-Steagall Act." These legislators were guided by the view that the banking crisis was ultimately caused by inadequate controls on risk-taking by the banking regulatory system and thus substantial risk mismatch between bank assets and liabilities. The first problem was the extensive use of short-term low-risk deposits to finance speculative investments in long-term assets by banks, both directly, through securities holdings, and indirectly, through broker loans. The second problem was excessive interest rate risk; destructive competition between banks was pushing up the level and volatility of interest rates on deposits and pushing down interest rates on loans. The third problem was inadequate levels of capital due to lax supervision of banks

Table 1 "New Deal" System for Commercial Bank Regulation

Type of Risk Exposure Controlled	Regulatory Constraints
Default Risk	Prohibition from involvement in the securities business (Glass-Steagall Act)
Interest Rate Risk	Prohibition of interest rates on demand deposits and ceilings on savings deposit interest rates (Regulation Q) Encouragement of local and regional bank cartels Low interest rate monetary policy
Liquidity Risk	Federal Deposit Insurance Extension of assets discountable by Federal Reserve
Capital Risk	More frequent and rigorous bank examination and moral suasion for compliance with informal capital ratios

Source: compiled from Klebaner (1974)[5] and less stringent capital standards for state-chartered banks.[6]

In order to reduce the mismatch between the risk levels of bank assets and liabilities, the Glass-Steagall Act included major restrictions on commercial bank involvement in the essentially "speculative" securities business (see Table 1). Banks were prohibited from owning state-chartered banks involved in investment banking activities; thus banks were forced to choose between dealing with the emission and trading of securities (investment banking) or the acceptance of deposits and the making of short-term loans (commercial banking).

In order to reduce the level of interest rate risk, the Glass-Steagall Act authorized the Federal Reserve Board to set legally-binding ceilings on commercial bank deposit interest rates. The Fed used this authority to prohibit the payment of interest on demand deposits and to set low interest rate ceilings on savings deposits (Regulation Q). Furthermore, the Fed and other banking regulators encouraged the formation of local and regional banking cartels for determining interest rates and fees for standardized financial services.

In order to reduce the level of liquidity risk, the Banking Act of 1933 established a new federal regulatory authority, the Federal Deposit Insurance Corporation (FDIC). The FDIC was set up to administer a new system of insurance on commercial bank deposits up to specified amounts. Deposit insurance was meant to reduce liquidity risk by reducing the risk of bank runs set off by fear of safety of bank deposits. The Fed also tried to reduce liquidity risk by increasing the type of assets eligible for discount loans (short-term loans to cover liquidity shortfalls) at its regional Federal Reserve Banks.

Finally, in order to control the level of capital risk, federal bank regulators were given increased examination powers and staffing capacity to carry through more frequent banking examinations. Regulatory powers were enhanced beyond national banks, which the Office of the Comptroller of the Currency or (OCC) was entitled to examine, to state-chartered banks participating in either the Federal Reserve System or the Federal Deposit Insurance program; the FDIC was given the right to monitor and examine all commercial banks participating in the insurance program and the powers of the Federal Reserve Board were considerably enhanced.

While New Deal legislators wanted to make participation in and regulation by the Federal Reserve System and federal deposit insurance program compulsory for all commercial banks, states rights activists forced them to compromise. As a result, membership in the national system has been voluntary and a state level banking system has co-existed with this national system (the so-called "dual" banking system). This coexistence means that banks in effect have a menu of choices between regulatory regimes. In addition to the choice between a national or state-level charter, state-chartered banks also exercise a degree of choice over which national programs they would like to participate in. Thus the New Deal regulatory regime was forced to reflect the fundamental federalist nature of the U.S. political system.

Throughout the 1960s and 1970s banking regulators were increasingly concerned by the problem of adequate banking capital but were hampered from addressing this problem by fragmented bank regulation and regulatory arbitrage. With the passage of New Deal reform legislation, banks had at least four choices available to them regarding the regulatory regime they belonged to: (1) they could hold a charter at the state level and participate in none of the federal programs, in which case they were subject to the regulatory authority of the state legislature and state banking commissioner; (2) they could hold a state charter but elect to participate in the federal deposit insurance program; in this case they were subject to regulation by both state authorities and by the Federal Deposit Insurance Corporation (FDIC); (3) they could hold a state charter but participate in both the federal deposit insurance program and the Federal Reserve System; in this case they would be subject to regulation by state regulators and, at the federal level, by both the FDIC and the Federal Reserve Board; or (4) they could hold a national charter, which would require them to participate in both the federal deposit insurance program and the Federal Reserve System; in this case they would be subject to regulation at the federal level by the Office of the Comptroller of the Currency (OCC), the FDIC and the Federal Reserve Board.[7]

Federal level regulators attempted to reduce the confusion of this fragmented system by dividing responsibilities among themselves and designating a "lead regulator" for each of the categories of banks; thus the FDIC, the Fed, and the OCC have primary responsibility for banks in categories (2), (3), and (4), respectively; in addition, the Fed is the lead regulator of bank holding companies. However, this did not completely solve problems in which there were differences of opinion among the federal regulators. Also, federal regulators have little means other than the power of persuasion to try to influence state regulators regarding regulatory standards under their jurisdiction. In effect banks had an "exit option" to the state level if they feel that the costs of belonging to the national systems offset the benefits of membership. This exit option created a "membership problem" in which the threat of exit by banks constrained national regulatory decisions on issues like minimum capital requirements, minimum reserve levels, and qualitative standards for the minimum quality of loans and risk diversification:

> Almost 60 percent of all banking organizations have two or more federal regulators and close to half of all bank and thrift assets are held by banking organizations with three or four regulators. The existence of multiple regulatory agencies in the U.S. financial system creates institutional overlap among the regulators at the federal level, leading to the emergence of different regulatory regimes. This forces regulators to compete with each other in a market for regulation, reversing the traditional role of public policy.[8]

This problem of regulatory fragmentation between the state and federal level and among federal regulators has been a major constraint upon the development of minimum capital standards for banks. Since national banking law until the late 1980s only defined a minimum absolute level of required capital (rather than capital ratios), the individual federal regulatory authorities were dependent upon informal pressure to influence banks to maintain adequate capital levels:

> ... none of the regulators had formally stated minimum requirements for the ratio of total capital to total assets. Instead, each regulator typically compared capital ratios for banks grouped together by common characteristics, including asset size, and attempted to persuade those banks that had relatively low capital ratios to raise them.[9]

In the 1960s, the federal bank regulators developed substantially different conceptions of "adequate capital." This appears to be in part due to the types of banks they were mainly concerned with, as well as the degree of risk aversion of the staff at the different regulatory agencies. The OCC relied on a subjective evaluation of national banks based on "the quality of management; the liquidity of assets; the history of earnings (including the proportion retained); the quality and character of ownership; the burden of meeting occupancy expenses; the potential volatility of deposits; the quality of operating procedures; and the bank's ability to meet the financial needs of its trade area."[10] The Federal Reserve System developed a Form for Analyzing Bank Capital (FABC), which classified the asset structure of the bank into six categories of credit and interest rate risk. The FDIC, which as a deposit insurer was the most risk-adverse, in practice was the strictest regulator. As a result, different categories of banks under the supervision of federal regulators (banks chartered at the national level, state banks participating in federal deposit insurance, and state banks participating in federal deposit insurance and the Federal Reserve System) were subject to different conceptions of adequate capital and different levels of vulnerability to regulators' pressure if they fell below these standards.[11]

An additional barrier to the development of clear capital standards was the divergence of state-level regulation from (the already diffuse) federal standards. Many states had considerably looser capital standards or lax enforcement, creating an attractive alternative for banks that wished to rapidly expand their loan base without issuing additional (and relatively expensive) equity capital. Lower minimum capital ratios meant that banks could make more loans with a given capital base, and thus earn more income from interest. Laxer standards meant that banks could also make more income, since riskier loans generally charge higher interest rates. Studies commissioned in the 1960s and 1970s comparing the costs and benefits of membership in state versus national level regulatory regimes indicated that the costs of national regulation were considerably greater than the benefits in many states, which in addition to less rigorous capital standards often had lower minimum reserve requirements, cheaper deposit insurance programs, and laxer risk diversification standards. The possibility of "exit" to state-level systems to avoid the costs of federal regulation became known as the "membership problem" for the Federal Reserve System.[12]

As a result of these pressures, the capital ratios of banks fell precipitously over the postwar period; between 1962 and the early 1980s, the capital ratio for the banking system overall had fallen from eight percent to under six percent relative to total banking assets.[13] Ironically, although the danger of exit was least among the largest banks due to their reliance on the Fed's discount window as insurance against liquidity crises, their overall capital ratios were the lowest when comparing commercial banks by broad group sizes; the ratios of the so-called money center banks, the nine largest banks, had declined to four percent by the early 1980s.[14]

In response to the concern about the further weakening of bank capital and an increasing number of nonperforming loans in the early 1980s, the three federal bank regulators attempted to define common standards to use for banks subject to national regulation. The first attempt, in 1981, involved an agreement among federal regulators to require a capital ratio of six percent for smaller banks and five percent for other banks. Since the money center banks were struggling with so-called "less developed country" (LDC) loans and had no chance of meeting these standards, federal regulators exempted the seventeen largest banks from these requirements.[15] The capital levels of a number of these larger banks continued to deteriorate during the 1980s. The two most aggressive expanders, Citibank and Bank of America, in all likelihood became technically insolvent but were allowed to continue operations by the regulators due to the fear of the panic that would be set off due to the bankruptcy of major U.S. banks.[16]

This problem of deteriorating capital levels was to trigger a bank solvency crisis and the credit crunch of 1982. In July 1982 the Penn Square National Bank collapsed. While Penn Square was a relatively small bank (with $500 million in assets) located outside the major banking centers (Oklahoma City), the failure spread panic because of the Penn Square's role in selling billions of loan participations to large commercial banks. More than $1 billion alone in loan participations were sold to Continental Illinois, the largest bank in the Midwest and the seventh largest in the country. Many of these loans were high-risk investments in states with oil production; with the collapse of the economy in 1981/82, many of these loans went bad. As a result of the fear of a spread of bank failures throughout the banking system, all but the soundest banks found it difficult or impossible to renew their short-term borrowing, triggering a credit crunch for their business customers.[17] This problem of widespread concern about the health of the banking system leading to a runoff of funds and credit crunches was to be repeated in the wake of the 1987 stock market crash and the rash of bank failures in 1989.[18]

Although these financial crises led to calls for the development of clear quantitative prudential standards which were universally applicable, many internationally-active U.S. banks were concerned with the possible negative impact of stricter standards on their competitiveness relative to banks from other countries, particularly Japan. This concern was the driving force for internationally-applicable regulatory standards, discussed in greater detail in chapter 4.

The German Corporatist Bank-Based Financial System

In contrast with the segmented U.S. financial system, the German financial system is characterized by a bank-based system in which banks have a monopoly of access to short-term funds and in which competitors for longer-term "patient" savings are severely circumscribed in their deposit-taking and investment activity. As a result of the ability to attract an increasing proportion of patient savings, German banks have been able to expand their long-term fixed-rate lending activity over the postwar period—including the 1970s and 1980s—with little interest rate and liquidity risk despite an increasingly unstable international financial environment. Furthermore, the encompassing nature of regulation in the banking sector has allowed regulators to tighten up regulations in response to growing instability and financial innovation with relatively little danger of regulatory arbitrage. As a result, the German financial system has been relatively free of the frequent banking crises which have led to "credit crunches" in the United States.

While most financial regulatory systems involve some kind of prudential banking standards in their inventory of regulatory mechanisms, the German regulatory system in the postwar years has been distinguished by its emphasis on quantitative, universally applicable prudential standards. One reason for this is the number of and extreme severity of financial crises Germany has experienced: the hyperinflation of the 1920s, the stock market crash of 1929, the banking crisis of 1931 (which rendered most of the for-profit banks bankrupt), and the complete breakdown of the financial system at the end of World War II. Another is the strong tradition of corporatism in Germany; corporatism involves mandatory membership of companies in associations which negotiate universally-binding standards with regulatory agencies. The tradition of corporatism made it easier for the state to

Table 2 German Banking Regulations

Type of Requirement	Description of Regulations
Capital Requirements	Principle I – Risky Assets (Loans and Investments) not to exceed 18 times own capital. Principle Ia – risk adjusted standards (revised in 1990).
Liquidity Requirements	Reserves to be held with the *Bundesbank*. Principle II – Long term investments (4 years or more) must be fully covered by long-term funds (own capital, long term deposits, long term bonds, 60% of medium-term deposits and bonds, 10% of other funds). Principle III – Medium- and short-term investments must be fully covered by other suitable funds.
Diversification of Risk	Investment in Property and Shares not greater than own capital. Individual Large Credit (i.e. credit exceeding 15% of own capital) not to exceed 50% of own capital. All large credits together not to exceed eight times own capital. Large credits must be unanimously approved by bank's top managers and must be registered with the *Bundesaufsichtsamt* (Federal Banking Supervisory Office).
Default Risk	Insider credits require unanimous approval of top managers and majority approval of supervisory board. Large insider credits (over €125,000) to be registered with the *Bundesaufsichtsamt.* Loans over €500,000 to be registered with the *Bundesaufsichtsamt.* Mortgage loans not to exceed 60% of the worth of collateral property (45% for insurance company loans) (special regulations for *Hypothekenbanken*).

develop and enforce quantitative, universally applicable prudential standards in the financial system in Germany.

The German banking regulatory authorities were first authorized to develop and enforce these standards in the wake of the Banking Crisis of 1931 in order to constrain the kind of imprudent lending practices and excess competition that were widely held to be responsible for precipitating the crisis. During postwar reconstruction, bank regulators developed a number of quantitative standards for exposure to different kinds of risk. These standards control liquidity risk (through requirements that long term loans be covered by long-term deposits), risk through exposure to large loans, and "insider" loan risk; in addition they require an adequate cushion for absorbing risk through minimum adequate capital regulations (see Table 2).

This system of prudential regulation has been protected from the eroding effects of "regulatory arbitrage" (i.e. the tendency of capital to flow to less regulated financial sectors) through the uniform regulation of banks and the privileging of banks within the financial system. Unlike the banking regulation in the United States, where regulation is fragmented between the national and state levels and between different authorities on both levels, the essential banking regulations in Germany are set at the national level and are applicable to all sectors of the banking system.[19]

Furthermore, strict German banking regulation has been protected from "regulatory arbitrage" through the stricter regulation or outright prohibition of potentially competing financial institutions. Life insurance companies, the second most important financial intermediaries, and building and loan societies are even more strictly regulated than banks. Until the recent past, commercial paper programs and money market funds were also prohibited, thus constraining the growth of an open money market, which in other countries represents an alternative (and less regulated) channel for funding.

Thus, there are substantial regulatory constraints in Germany on the kind of destabilizing price competition that characterized the speculative boom of the 1980s in most advanced industrialized countries. A level regulatory playing field within the banking system limits the degree of price competition between the groups; thus, while there is competition between the different banking groups, this tends to follow an "unwritten rule" that competition should focus less on price and more on the quality of services provided.[20]

This strict prudential regulatory system has supported a strong banking system and contrasts strongly with other countries, which relied mainly upon market segmentation and interest rate controls to suppress destabilizing competition well into the 1980s. Other countries in Europe, which for the most part lacked Germany's tradition of universal banking and corporatism, had more fragmented regulatory systems with less strict prudential standards. When these regulations were removed or circumvented in the 1980s, destabilizing price competition further weakened an already relatively weak banking structure. The strong underlying banking structure has also given a freer hand to German monetary policy than in other countries, e.g. the United States, where monetary policy has been constrained by the underlying weakness of the banking system and the resulting danger of bank failures if the monetary brakes were pulled too hard.[21]

A second major characteristic of German banking regulation is the role that associations play in banking system governance, particularly in the public savings bank and credit cooperative sectors. These alternative banking sectors, which are dominated by banks relatively small in comparison with the joint-stock banks, have been able to not only survive but also thrive despite the strong concentration tendencies inherent in banking systems in part due to a supportive regulatory framework, which can be characterized as "federalist corporatism."

Each of these alternative groups has a *federalist* structure involving a division of labor between local, regional, and national institutes within the group (vertical cooperation) and the recognition of territorial exclusivity to units at the same level (horizontal cooperation). They also have a *corporatist* structure in which banking associations play a key role not only in exercising delegated powers of regulation (admitting new members and auditing their members' books) but also in supporting horizontal and vertical cooperation needed to provide their member banks with the specialized services normally only provided by larger banks due to economies of scale.

The credit cooperative and public savings bank associations and jointly-owned financial institutions on the regional and federal levels have provided three services that have been particularly important in helping the small banks modernize: liquidity management, long-term refinancing, and training. In terms of *liquidity management*, institutions on the regional and federal levels of these sectors, which were originally founded to handle regional and national payments transfer, have developed into managers of the short-term needs of local banks; while much of this short-term need can be balanced out within the sector (through balancing out the short-term surpluses of some local banks with the deficits of others), these regional and national institutions have also developed the capacity for short-term money management on both the German and international money markets. As discussed above, regional and national institutions have also become important sources for the *refinancing of long-term loans* through the issuance of long-term bonds and pass-through of these funds to local banks. Finally, the banking associations in these sectors have also played a key role in *creating a highly-skilled workforce* in the banking sector through the negotiation of upgraded standards for the training of the bank clerk (*Bankkaufmann*) and loan officer (*Firmenkundenbetreuer*); these associations also run Bank Academies, which train loan officers.[22]

These member banks alone generally are too small to have access to wholesale money markets and long-term capital markets and to develop sophisticated training programs and thus would have a competitive disadvantage relative to larger banks without the assistance of the associations. This in general has allowed them to offer services on a par with the large banks while at the same time retaining the advantages of decentralized service provision, i.e. accumulated local knowledge and speedy decision-making. The structure of the German banking system thus differs significantly from the British system, in which a handful of joint-stock banks account for almost all bank assets, or in the United States, where the removal of geographical limits on service provision has lead to a rapid acquisition wave of smaller "community banks" by the regional and money-center banks. The German regulatory system has thus exposed smaller banks to pressures to modernize while at the same time providing them with the means to do so.

To summarize, the German banking system can be characterized as a strictly regulated oligopoly. Banks are granted a privileged position but at the same time subject to strict prudential regulation; this strict regulation discourages excessive price competition and contributes to financial stability, which in turn encourages long term investment. In contrast with the United States, Germany has had only one major banking crisis, the bankruptcy of the Herstatt bank in 1974. The contribution of strict prudential regulation to banking system stability is being increasingly recognized by regulators; for example, the advanced industrialized countries through the Basel Agreement have agreed to implement one of the most important of these standards, minimum risk-adjusted capital standards, in their countries.

Although the German banking system has been considerably more stable than the U.S. system, nevertheless some policymakers and Germany banks have not been entirely happy with the system. In particular, the desire to improve the rate of financial innovation in the system, to strengthen other parts of the financial system (particularly the stock exchange and venture capital), and to attract foreign capital have spurred attempts to reform the regulatory system.

04

CHAPTER FOUR

FINANCIAL SERVICES REGULATION: DOMESTIC AND INTERNATIONAL CONFLICTS

This chapter analyzes the main issues and conflicts arising from attempts to reform domestic regulatory systems and create European/international regulation. In the United States the debate has centered on the removal of barriers between banking, the stock market, and insurance, as well as improving protection for small shareholders and financial consumers. A key concern has been improving the stability of the banking system without overly impeding international competitiveness.

In Germany, in contrast, the debate has focused more on increasing the importance of financial markets (the large banks have pushed for this) versus protecting the savings bank and cooperative bank sectors (state guarantee, privatization, etc.) and on shifting from a public to a private pension system without aggravating social inequality.

Since both Germany and the United States are important political actors, and financial services providers have major clout in both countries, these differences have been reflected in conflicts over international regulation (Basel capital requirements, international accounting standards, etc.) as well as within the EU (Financial Services Plans, competition policy towards state-owned banks, etc.).

Basel Capital Adequacy Agreements (Basel I and Basel II)

Only after the experience with mass default on LDC loans and the numerous bank insolvencies in the second half of the 1980s was there sufficient political pressure within the United States to impose universal capital ratios on commercial banks. The UK had also experienced similar problems, with the rise of the so-called "secondary banks" not under the supervision of the Bank of England. These secondary banks made much riskier loans, with less capital coverage, and thus were undercutting the main "clearing banks" in London. The United States and the UK therefore had similar interests with regard to regulatory reform in the late 1980s.

The main concern of the U.S. and UK banks, however, were that if stricter capital standards were imposed unilaterally in the two countries or even through bilateral agreement, then their competitive position internationally would be undercut. At the time there was a massive international expansion of Japanese banks in particular, who had grown to be the largest banks in the world. These banks, however, were subject to a much laxer regulatory regime, and thus had a much lower capital ratio than other internationally active banks. They were therefore able to make a greater volume of loans, at a lower interest rate, than other banks with the same amount of capital.

Thus it appeared that the only feasible way to achieve stricter regulation in the United States and UK was through the international applicability of new standards, i.e. to the competitors of U.S. and UK banks as well. The United States and UK thus submitted a proposal to the Basel Committee of the Bank for International Settlements (BIS). This committee includes representatives of the central banks and bank regulators from the G-10 countries plus Switzerland. This proposal defined a minimum capital ratio, to be set aside by all internationally active banks.

After a prolonged period of negotiation, a commitment to clear minimum capital ratios for all banks was made for the first time in the 1988 Basel Accord (now popularly referred to as "Basel I"). In practice two types of capital were defined: Tier I and Tier II. Capital had to be set aside in set minimum ratios for different types of liabilities, e.g. loans, securities, etc.

Although some have argued that the Basel I accord was reached because of clear joint gains among all of the signatory countries, it appears that there was a loss for Japanese banks due to the reduction in relative competitiveness caused by these standards. Japan went along with the accord, despite this loss, because of diplomatic pressure from the United States and UK. Germany reportedly had few problems with the Basel I accord because 1) the German system was already roughly in line with the Basel I proposals; and thus 2) German banks would enjoy a relative increase in international competitiveness due to the application of the new standards to competitors.

TABLE 3 BASEL II TIMETABLE

- Original Proposal (1999)
- 2nd Proposal (2001)
- 3rd Proposal (2003)
- Final Version (2004)
- Compromise result: both internal and external rating systems allowed
- Implementation through national law by 2006

More problematic for German-U.S. relations was the debate over the revision of the 1988 Basel agreement, popularly referred to as the "Basel II" process. This process started in the late 1990s, as U.S. and UK banks were reportedly increasingly unhappy with the simplicity of the Basel I standards. According to this, for example, the same amount of capital had to be set aside for corporate loans, regardless of the risk level (probability of default) of these loans. U.S. and UK banks felt that they would therefore be at a competitive disadvantage relative to banks making much more risky loans, which in principle should be setting aside more capital.

The main proposal of the United States and UK in 1999 (see Table 3) was therefore to modify the Basel I capital standard by including a risk-weighted measure for capital set-aside. Banks would have to set aside more capital (i.e. a higher capital ratio) for riskier loans than for less risky loans.

Although there were disputes over a number of aspects of the proposal, the most controversial part for U.S.-German relations was the mechanism proposed for determining the risk level of the loans. Being a much more market-oriented financial system, most U.S. banks already had well-developed systems of risk management based on external credit ratings (i.e. ratings through credit rating agencies like Moody's). Most corporations in the United States already had such ratings, which were relatively expensive, but could result in a reduction of interest rates that companies had to pay if their credit rating was good. U.S. corporations are relatively large in comparative context, and thus the fixed cost of credit ratings could be spread over a larger volume of credit.

German companies, in contrast, tend to be smaller, and small and medium-sized enterprises (SMEs) thus account for a much larger proportion of economic activity than is the case in the United States. For example, two thirds of manufacturing activity in Germany is accounted for by SMEs, versus only one third in the United States.[23] German companies and banks depend on a much more informal system of credit analysis, through long-term relations with a specific lending officer (or "relationship manager" in modern terminology). German accounting standards (HGB – *Handelsgesetzbuch*) are known for being less transparent than U.S.-GAAP or IAS accounting standards, due to dozens of options for company accountants, and therefore not considered as suitable for the type of ratio analysis that quantitative rating systems require.[24] Thus lending officers tend to focus on more qualitative criteria in their lending decisions, e.g. reliability of repayment of loans in the past.

The concern of German banks was therefore that the imposition of the external credit rating requirement, as contained in the Basel II original proposal, would force them to set aside much more capital for many of their SME customers. In the absence of an external rating, banks would have to set aside the maximum amount of capital, for the riskiest category of loans. This would require them to charge higher interest rates, or even cut off credit to their *Mittelstand* (small business) customers, resulting in a "credit crunch."

After an extended period of negotiation, involving three modifications to the original proposal, a final version of the Basel II agreement was reached. The final version contains the option for banks of either using an external credit rating, or an approved internal credit rating system, for risk-weighting their loans. The final version was approved in 2004, and signatory countries are expected to implement the accord in national law or in regulatory directives in 2006. In all, the process of Basel II, from discussions over the first proposal to implementation at the national level, stretched over roughly a decade.

EU Directives on Financial Regulation

Although not involving the United States as a negotiating partner, it is nevertheless instructive to examine the experience of the European Union in supranational regulatory coordination. The European Union could be considered a "best candidate" for the establishment of an international regulator, due to the decades of close cooperation between EU member states, and relatively less pronounced cultural differences in Europe. In fact, there have been calls for the establishment of an EU level financial services regulator.

Financial services have been identified by the European Commission as one of the areas where the greatest benefits of European integration should be realized, through economies of scale and greater competition. As a result the Commission has been especially keen to encourage integration in this area. Although there are arguments from an efficiency point of view for establishing a European regulator, nevertheless the EU has chosen the "international coordination" model to pursue its goal of a Single European Market. Fundamental governance principles that have evolved in the EU include a preference for minimum standards which respect national differences, rather than harmonization of standards (i.e. the same standards). The arguments in favor of a European regulator have not been compelling enough to justify overriding this basic principle to date.

TABLE 4
PROCEDURAL STEPS FOR FINANCIAL SERVICES ACTION PLAN (FSAP)

- 1999 Approval of FSAP by Commission, European Parliament, Member States
- Individual Directives Agreed by Commission, EP, Member States
- Directives must be implemented through national law or regulatory decrees in each member state
- Main results: prospectus, takeover, and securities sales directives

As a result European initiatives on financial regulation and reform have for the most part taken the form of EU directives. The first step is the drafting of a proposed directive by the European Commission, followed by a (typically extensive) period of negotiation with member states, as represented by the relevant Council of Ministers. The European Parliament is involved in the approval process as well. Once agreement is reached, the directive can be approved. After directives are approved at European level, however, they are not in and of themselves binding. Rather, they must be implemented at the national level through national law and/or through regulatory decrees by the responsible regulatory agency. Although this process of negotiation is quite time-consuming, it nevertheless has evolved as the preferred mechanism for policymaking in the EU.[25]

For the banking system the most significant directives have been the Capital Adequacy Directive (which implemented the Basel I agreement), and the 2nd Banking Directive, which allows banks licensed to do business in one of the member states to do business in all EU countries. The most recent initiative in this area was the Financial Services Action Plan (FSAP), approved in 1999 by the European Commission, which contained over fifty individual measures for improved integration. The procedure followed in the EU for the implementation of FSAP, as is the case for most other major initiatives, is outlined in Table 4. European directives have had a major impact on the regulation of financial systems in the different EU countries.

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CHAPTER FIVE

THE WAY AHEAD: AN INTERNATIONAL FINANCIAL REGULATOR OR IMPROVED INTERNATIONAL COORDINATION?

The United States, Germany, and other countries have long-standing regulatory regimes deeply embedded in national traditions and cultures. These countries are struggling to adapt to change and have acknowledged the need for a supra-national solution. However, national traditions and the interests of powerful actors within each country make it difficult to give up authority. Furthermore, although governments may see problems in their own regulatory systems, the tendency to feel that one's own system is "better" than other national systems and should be the model for supra-national solutions is inevitable.

For these reasons the United States and Europe have favored international coordination, even though this approach has many shortcomings, as the case of coordination on capital adequacy standards through the BIS demonstrates. The obvious difficulties are:

- Negotiations can be quite drawn out. The Basel II process, for example, stretched over roughly a decade from the first discussions over the initial proposal to final implementation by individual countries. The financial innovation process in contrast is considerably faster than this;

- The speed and success of negotiations can be subject to the prevailing international relations climate. In particular strained relations between the United States and Germany may have slowed down agreement on the final version of Basel II; and

- Implementation and enforcement at the national level may be uneven, and thus open to accusations of competitive unfairness. There already were complaints by U.S. banks, for example, that the internal rating systems that German and other non-U.S. banks will most likely use are not as rigorous as external rating models. Non-U.S. banks might thus allocate less capital to their risky loans, lowering their financing costs and thus giving them a competitive advantage.

Nevertheless, the "international regulator" model also has a number of important drawbacks, which renders it politically unfeasible:

- The establishment of a regulatory apparatus at the supra-national level could be time-consuming and expensive. Financial service providers may also be reluctant to exchange the "known quantity" of a national regulator for the unknown risks and inevitable trial-and-error period of a supra-national regulator (even if it might look superior on paper);

- It is not clear that a supra-national regulator is necessarily more efficient than the national alternative. National regulators may have superior access to information and better knowledge of local conditions and actors, and thus be more effective in enforcement and recognizing crisis developments at an early stage; and

- Probably most decisively, the delegation of national authority to a body only indirectly accountable to the electorate is very difficult politically. This process has taken many decades with EU institutions, and is still not considered legitimate by many voters. On the international level, where cultural differences are even greater and the number of key actors may be even larger, such a delegation of authority would be very difficult if not impossible.

Thus, it would appear that the "international coordination" alternative, although difficult, is the best one. Policy efforts should therefore focus on improving the functioning of international coordination in financial regulation. Policy recommendations for improving the functioning of this model are as follows:

1) Future research on financial regulation should be more sensitive to the possible comparative advantages of different types of financial systems.

Most of the scientific literature has unfortunately argued that there is a "one-best" financial system, thus suggesting that countries with sub-optimal financial systems should imitate superior systems. In the 1980s the German and Japanese bank-based financial systems were considered superior and "could do no wrong" in the eyes of many academics. The U.S. market-based financial system, in contrast, was seen as focusing too much on short-term results, and thus neglecting long-term investments.[26] Since the early 1990s the tables have turned, and the U.S. is considered to have developed the superior financial regulatory and corporate governance regime.[27]

However, a closer look at financial systems suggests that the bank-based financial systems may be better at providing the kinds of finance needed by traditional, capital-intensive manufacturing, while market-based systems may be better at providing the high risk finance needed by startups and high tech industry.[28]

When comparing the United States and Germany, for example, it appears that the United States has a comparative advantage in market based financial services, including investment banking and the mutual fund industry. This can be seen in part in the increasing market share that U.S. investment banks and mutual fund groups are gaining in Germany. Germany in contrast seems to do better in serving the needs of small businesses and local economies (tradition of *Sparkassen* and *Genossenschaftsbanken*). Small businesses in many U.S. communities are dissatisfied with the large banks and there is a move back to founding new community banks. Germany also seems to have an advantage in insurance and reinsurance and possibly in municipal infrastructure finance: Allianz and Depfa (originally *Deutsche Pfandbriefanstalt*) have gained international market share in these segments.

2) Policymakers should focus more the possibility of comparative advantages of different systems, and on the possibility of how to take advantage of these comparative advantages at the international level.

Following on the first point, it is a misleading policy to argue that there is "one best system" serving all financial services needs. Globalization, when combined with a greater international division of labor, may lead to mutual benefits between countries with different types of financial systems.

It would be helpful if further research exploring the comparative advantages of these systems would be diffused among policymakers. A better understanding of the features of different financial systems among policymakers could help improve international coordination in financial regulation. Organizations like AICGS can play a key role in promoting such "mutual learning."

3) In general, efforts to improve international relations between the United States, Germany and other countries should help prevent (or at least

decrease the possibility of) disturbances to international coordination in financial regulation.

Germany and the United States are key players in the emerging international regulatory regime. The importance of the United States stems from its role as the strongest economic power in the world, and from the role of the dollar as the world's leading currency. Germany is also important as Europe's leading economy and due to the dominant influence of the conservative *Deutsche Bundesbank* on monetary policy.[29] It has thus been impossible to move ahead in financial matters at the international level without agreement between these two countries.

However, tensions between these two countries, as well as between other important countries, can threaten the speed and efficacy of international regulatory coordination. Even though these tensions may arise from disagreement over unrelated issues, nevertheless they can have a tendency of "spilling over" into other areas. Progress on agreement on financial regulatory issues can thus fall victim to disputes over these unrelated issues.

Measures that improve the international relations climate between the United States, Germany, and other countries can thus be expected to help support international coordination in financial regulation. Again this is an area where organizations like AICGS can play an important role.

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24 The reason for the lack of transparency in German accounting standards—or for that matter most national accounting standards—relative to U.S.-GAAP and IAS principles is that the needs of institutional investors have played a much larger role in the development of the latter.

25 The recent rejection of a proposed EU constitution by French and Dutch voters reinforces the point that regulatory coordination is more politically feasible than creating a supra-national regulator. Voters rejecting the constitutional proposal were, at least in part, reacting to what they see as too much centralization of power in Brussels and a correspon-ding loss of decision-making authority at the national level.

26 Michael E. Porter, “Capital Disadvantage: America’s Failing Capital Investment System,” *Harvard Business Review*, September-October (1992); Michael Jacobs, *Short-Term America: The Causes and Cures of Our Business Myopia* (Boston: Harvard Business School Press, 1991).

27 Rafael La Porta et al., “Legal Determinants of External Finance,” *Journal of Finance* 52, no. 3 (1997); Rafael La Porta et al., “Law and Finance,” *Journal of Political Economy* 101 (1998); Rafael et al. La Porta, “What Works in Securities Laws?,” in Working Paper Series (Tuck School of Business at Dartmouth: 2003).

28 Peter A. Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001).

29 This conservative influence has arguably continued after the introduction of the Euro, since the *Bundesbank* was used as the role model for the European Central Bank.

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