Globalization, Regulatory Arbitrage and Efficient Oversight

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Globalization's Ripple Effect

The systemic contagion from the US housing market collapse has not simply passed from one region to another, but, has spread across industries – from mortgages, to consumer credit, to corporate finance, to deposit insurance and now to global growth. As we now know, global portfolio managers buoyed by highly levered portfolios provided liquidity to deals that otherwise would not have qualified for funding. Margin calls, and other significant portfolio obligations lead to the indiscriminate selling of global assets which, in turn, spread the crisis to the four corners of the earth. Whether a Kenyan mother depending on ever-rising local stock markets to finance household expenses; or whether a Trinidadian small business owner expanding operations guaranteed by global capital; or better yet, whether a Mexican grandmother depending on remittances from her US homebuilder son to pay for much needed medicines – each has felt, in a uniquely devastating way, the impact of this crisis. The victims are no longer institutional and local – they are retail and global.

Given the above illustrated global devastation, can a multilateral approach to regulatory oversight, as suggested by the G20, effectively eliminate arbitrage as we know it?

Global regulatory arbitrage – Preventable or an Unfortunate Reality?

In a strident speech in defense of "Capitalism" out-going President George W. Bush suggested that "[Free markets] offer the surest path to lasting prosperity." Absent context, Bush's comment would have seemed innocuous. But, they were uttered a few days before the beginning of the G20 Summit on Financial Markets. The speech is instructive in that it informs us, ahead of time, of the outcome of attempts at a harmonized global regulatory framework – at least as far as the US is concerned.

The US legislative process is known to be heavily deliberative and "inclusive" of special interests priorities. France and Germany have, for instance, long expressed a strong desire to have the US Congress regulate hedge funds – viewed by some as key players in this global financial meltdown. That desire, imbedded in the G20 statement, will unfortunately, fall victim to the powerful hedge fund lobby on Capitol Hill. This is nothing new. The US Security and Exchange Commission (SEC) itself has had to lick its wounds following several unsuccessful clashes with the hedge fund industry in US courts. As a result, the prospect of a harmonious global regulatory framework that eliminates global regulatory arbitrage is quite dim.

So, while France, Germany and the European Union as a whole, may pass sweeping laws limiting financial activities, the US' versions of the same laws may be watered down leaving room for cross-border arbitrage.

The wholesale adoption of G20's proposed framework may not happen in the US. However, there is hope to be found in a regulatory reform blueprint put out by the US Treasury earlier this year.

Hope in the form of US regulatory consolidation – a US Treasury Blueprint

The reform blueprint put out by the US Treasury earlier this year essentially addresses the myriad of conflicting and overlapping authorities and bodies overseeing US financial markets. Two salient points can be extracted from the report:

a. The US regulatory framework is a patchwork of redundant authorities which came about in response to successive crises dating back to the early 18th century. This patchwork is at the source of regulatory arbitrage in the US.

b. US regulations, contrary to Europe and other frameworks, are focused on regulatory function (i.e.: banking, insurance, brokerage…) as opposed to focusing on outcomes, or results-based (i.e.: consumer protection and financial markets oversight.) This focus on regulating market functions lead to significant pockets of inefficiencies as technology and congressional oversight laws changed over time.

In response to the above, the US Treasury proposes a drastic streamlining of agencies. Some key highlights are:

a. Absorb the Commodities Futures Trade Commission (CFTC) into the SEC which will merge oversight of both securities and derivatives (commodity and financial futures and options);

b. Eliminate the Office of Thrift Supervision (OTS) which was solely in charge of mortgage origination in 1933, and, in its most recent incarnation, took over the authority of the Resolution Trust Corporation that, itself, was created to deal with the Savings and Loans crisis in the mid 80s.

c. Strengthen the Federal Reserve's authority by unifying oversight of all financial institutions under the Fed.

Confusingly, however, the US Treasury also recommended the creation of a Mortgage Origination Commission (MOC) to oversee transparency of mortgage origination. That's puzzling. Granted, outstanding mortgages amount to about US$10 Trillion – But what about credit card and other forms of consumer credit origination? Should they not be subject to oversight?

Finally, and more importantly, the US Treasury recommends an objective-based approach to regulation (away from the inadequate and incoherent functions-based approach) in which two key objectives will be fulfilled: consumer protection and financial markets oversight – both in a unified fashion. The report goes on to outline key agencies and their roles under a coherent framework – emphasizing that the Presidential Commission on Financial Markets coordinate all resulting agencies.

In the final analysis, this consolidation of regulatory bodies will make it easier to coordinate with foreign counterparts and therefore, despite the influence of powerful lobbies, will mitigate the impact of inevitable global regulatory arbitrage.