

EUR-IFRI 's TUESDAYS



Can globalised capital markets be regulated?

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Globalisation of investment

Nicolas Véron describes the actual situation of globalising capital markets as “investor-led globalization”: investors have always been looking for the best combination of risk and return and are now doing so on a global basis. Investment home bias is decreasing as investors buy an increasing proportion of non-domestic financial products in most jurisdictions. In a way this echoes very old trends (cf Fernand Braudel, *Civilization and Capitalism*) but is even more obvious nowadays vis-à-vis fast increasing markets of Asia (China and India), which affects the Transatlantic approach.

A multipolar financial world

On the one hand, financial hubs are fewer in number than before because of concentration at a regional level (Frankfurt and Paris are losing to London). But on the other hand, New York loses its former dominance, and other places are consolidating or emerging around the world especially in Asia (e.g. Hong Kong, Dubai). Competition between financial places will go on.

Regionalisation of banking

Banks remain the central backbone of the financial system. Data collected by Bruegel show that European banks are becoming markedly more European, i.e. they grow in Europe out of their domestic base. Ten years ago, listed European banks had in average 65% of their activity in their home country, 10% in other European countries and 25% outside Europe. Now, banks have in average 50% of their activity in the home country, 25% in the rest of Europe, 25% outside Europe. The “europeanisation” of banks’ activity is significant. Banks expanded in the rest of the world, notably in Asia, in the ten past years but not faster than they did inside Europe. There is therefore a combination of regional and global trends in most regions and especially in Europe where the regional level is paramount.

Regulation of globalising capital markets

The central question is whether globalising capital markets can be regulated. Historical experience suggests that regulation is an absolute requirement for the proper functioning

of capital markets. Unregulated capital markets cannot function well (cf. Russia in the 1990s).

A frontier experiment: International Financial Reporting Standards (IFRS)

IFRS (prior to 2001 also called "International Accounting Standards" – IAS) are very important for financial markets because of their influence on companies' behaviour. They represent an unprecedented attempt at enforcing global rules and are so far a "huge success". In 2003, 53% of the 500 largest companies of the world used the US GAAP standards ("Generally Accepted Accounting Principles" of the United States of America) as their primary financial reporting language. 42% used other national financial standards and 5% used IFRS. In 2006, US GAAP 'market share' had declined to 44% and IFRS had increased to 38%. An additional 15% (including Japan, Korea, Brazil, Canada, Israel) will converge to IFRS in the next five years, while 3% still use purely national standards other than US GAAP. A duopoly (IFRS / US GAAP) has clearly emerged in three years, at first thanks to the EU decision to adopt IFRS (2005 onwards) and to their acceptance by other national jurisdictions. This example demonstrates that global rules are "not utopia".

We can draw some lessons from the experience with IFRS so far. First, we need global financial rules. Second, they are possible. Three, they must be investor-driven as globalisation of financial markets means globalisation of investment strategies. This created a need to overcome national debates over loss of sovereignty. IFRS are up to now a real success but it is not sure that it will last. It depends on the future orientation of standard-setting towards investors, and on quality of implementation. For examples, the quality of application of IFRS in China is a concern. Also, there is tension between national and supranational levels. We have global rules, but rely on local enforcement.

Will the actual credit crisis change the situation?

According to Nicolas Véron, the dialogue between the European Central Bank (ECB) and the Federal Reserve of the USA (Fed) has been quite good, and arguably better than the relationship between the ECB and the Bank of England. Bank failures have been so far only at national level (Northern Rock in the UK, IKB and SachsenLB in Germany). However, if there were to be a big problem with a trans-national bank (for instance UniCredit, Santander or Deutsche Bank), there would be big difficulties because our framework to deal with these problems, based on national sovereignty, is inadequate. We

would need a change of regulatory framework. Other topical issues relate to how to live with the emerging market power of 'sovereign wealth funds', as well as disclosure by banks of the risks taken with the hedge funds.

Regulatory competition

Regulatory power is now distributed geographically and between different types of institutions, for example the Securities and Exchange Commission (SEC) in the USA and the members of the Committee of European Securities Regulators (CESR) as well as the European Commission in the EU. There is a big dissymmetry between the powerful SEC and European regulatory fragmentation. Simultaneously there is also competition between private and public regulatory options (cf. the debate on regulating rating agencies). Regulatory competition has become a dominant pattern. It raises again the traditional question whether highly regulated environments attract or repulse investors, whether it is a "race to the bottom" or "to the top" due to investors' quest for quality. In fact, it depends on the situation and there is no universal answer to this important question.