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European Financial Centres: How to deal with Regulatory Competition?

Malta Financial Services Authority, 16 January 2017

(1) The Story

“HSBC threatens to move headquarters from UK”:

“HSBC threw down the gauntlet to the British government on Friday as Britain’s biggest bank threatened to move its headquarters from the UK, citing the tougher regulation imposed on the City since the financial crisis. […]
The Hong Kong Monetary Authority said in a statement that HSBC was the largest bank in Hong Kong and had deep historical links to the territory. It would take “a positive attitude should HSBC consider relocating its headquarters back to Hong Kong,” it said.”

(Source: Martin Arnold, David Oakley and Jennifer Hughes, ‘HSBC threatens to move headquarters from UK’ Financial Times, April 25, 2015, http://www.ft.com/cms/s/0/265619ccea5911e496ec00144feab7de.html?siteedition=intl#slide0)

(1) The Story

David Davis and Brexit:

‘Davis said they [might] need to switch to his “alternative strategy” that the UK Government will have to take a position of competing with other EU Member States for business — lower tax, softer regulation and other strong business incentives.
[…] EU Member States, such as France have “no faith” in their economic models and ability to compete with an “AngloSaxon approach”.’

(Source: memo taken by a City of London Corporation representative after meeting David Davis, the minister for Brexit, on 15 November 2016)

(1) The Story

Regulatory arbitrage and competition in Financial Markets Law

- Arbitrage by market actors
- Competition as a reaction by lawmakers

- Is it happening?
- What are the consequences for Financial Regulation, on a national and a global level?

(2) Competition & Arbitrage in Financial Markets

Arbitrage and competition in financial markets

- Arbitrage: money is intangible and can be easily moved (no need to move physical headquarters)
- Financial institutions have strong incentive to make use of jurisdictional discrepancies (& threaten to do this)
- Global financial services as a "comparable product" -> strong competitive forces
- Regulators under pressure to accommodate them, as financial sector vital for economy
  (can be sovereigns and private actors, e.g. stock exchanges)
- Worldwide market: no global government

(2) Competition & Arbitrage in Financial Markets

Problems of Regulatory Competition in financial markets

- Banking is a fragile business: arbitrage is risky
- Financial stability as a common good, high likelihood of externalities
- Fear of race to the bottom: Acharya et al. 2009
- Recent example of Financial Crisis

Recognized? The example of financial institutions within the EU, an exception to *Centros*

(2) Competition & Arbitrage in Financial Markets

Evidence?

Trend towards lightly regulated markets

- Dong et al., 2011: cross-border bank M&As
- Houston et al., 2012: international bank flows, ‘race to the bottom’ likely
- Karolyi and Taboada 2015: international bank acquisitions

- Concrete examples:
  - savings and loan associations in the US moved from OTS to OCC supervision (Dodd-Frank Act)
  - Escape from CFTC oversight by moving OTC derivatives trading abroad

(2) Competition & Arbitrage in Financial Markets

Benefits?

- Dong et al., 2011: promotes more independent supervision
- Houston et al 2012: strong legal institutions selling point (e.g. rule of law, independent judiciary)
- Maier & Haufler 2013: ‘a race to the top in capital regulations is an equally plausible scenario as a race to the bottom’ (Switzerland & UK resort to capital adequacy rules that exceed the Basel III standards)

So: a race to the top after all?

(2) Competition & Arbitrage in Financial Markets

Assessment: ambiguous

- Regulatory Competition is generally **beneficial**
  - “discovery process” for new and dynamic lawmaking
  - Strong legal institutions seem to matter
- Risk is threat to **financial stability** – global public good
- Regulatory responses need to balance these two sides

(3) Solutions?

How might the law respond – on the national and the international levels

Obvious solution: worldwide harmonisation / unification

- Examples: Basel III, G20
- De Larosière Report 2009:
  "Over the medium term, thought might be given to establishing a full international standard-setting authority […]. The objective should be to put in place an international standard setting process which would be binding on jurisdictions and which would ensure implementation and enforcement of international standards. This would have to be supplemented by providing the IMF with the tasks of surveying the enforcement of these standards."

(3) Solutions?

But:

- Politically feasible?
- Dong et al: countries with large financial markets agree on a broad set of principles

The challenges of harmonisation

- Lack of mutual learning, experimentation, creativity
- Harmonisation is source of instability (Romano 2014, Gordon & Mayer 2012, Whitehead 2011): encourages parallel behaviour and creates systemic risk
- harmonisation is extremely contentious, a difficult process and largely ineffective (Riles 2013)

(3) Solutions?

Extraterritorial reach of laws (Coffee 2013, Griffith 2014)

- A natural reaction by lawmakers – in the absence of worldwide consensus, go the unilateral way
- Current examples: OTC derivatives trading; bank structural regulation; financial transaction tax
- A “first mover advantage”?
- Downsides
    - International comity, fairness
    - Duplicating rules, frictions btw systems

(3) Solutions?

The role of bank resolution

- Resolution regimes key to introducing discipline into banking
- Resolution as opposed to bankruptcy: a special framework to address systemic risk and "too big to fail"

Once worldwide credible resolution mechanism is in place, competition may be permissible within these borders

- Global level playing field: reintroduces responsibility into the market
- Financial institutions can "fail": home jurisdiction responsible for winding down – fits to the precise problem of banking groups shifting trading abroad
- Within these limits, financial centres can flourish

(4) Conclusion

Regulatory competition and arbitrage in financial markets

- Problems are the fragility of banking, the ease of arbitrage, and likely externalities on financial stability
- International coordination and harmonisation difficult to achieve and maybe undesirable
- “Double dilemma” of competition
- Globally effective resolution regime may lead to more market discipline and curb externalities