

Stabilizing Global Financial Markets

The Case Against Global Standardization

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Outline

- Points of departure
- The Structure of Financial Markets
- Implications for Regulating Global Finance
- The Case for Flexible Coordination of Regulatory Diversity

Points of Departure

- Yes, incentives matter. However, the root causes of instability are not incentives, but
 - Imperfect Knowledge and
 - Volatility of Liquidity
 - In combination with the profit motive (incentive!), these factors lead endogenously to financial instability
- Yes, structures matter. Access to liquidity in times of crisis varies; this determines behavior and regulatory preferences
 - Reserve currency Y/N
 - FX reserves Y/N
 - Access swap lines or other forms of cross-border liquidity Y/N

The Structure of Financial Markets – Two Views

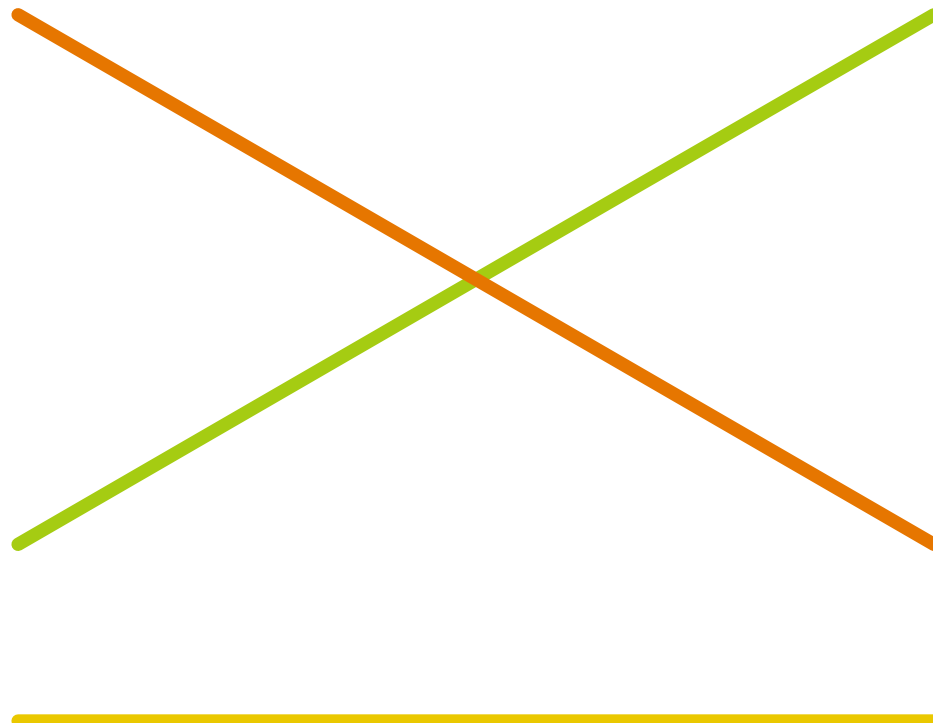
Equilibrium

- Deviations indicate distorted incentives and/or institutions
- Institutional fix
 - Disclosure
 - Transaction costs
 - Incentive alignment
- Regulators can fix it
 - All share same interests
 - Have perfect knowledge how market dynamics will shape incentives in the future

Hierarchy

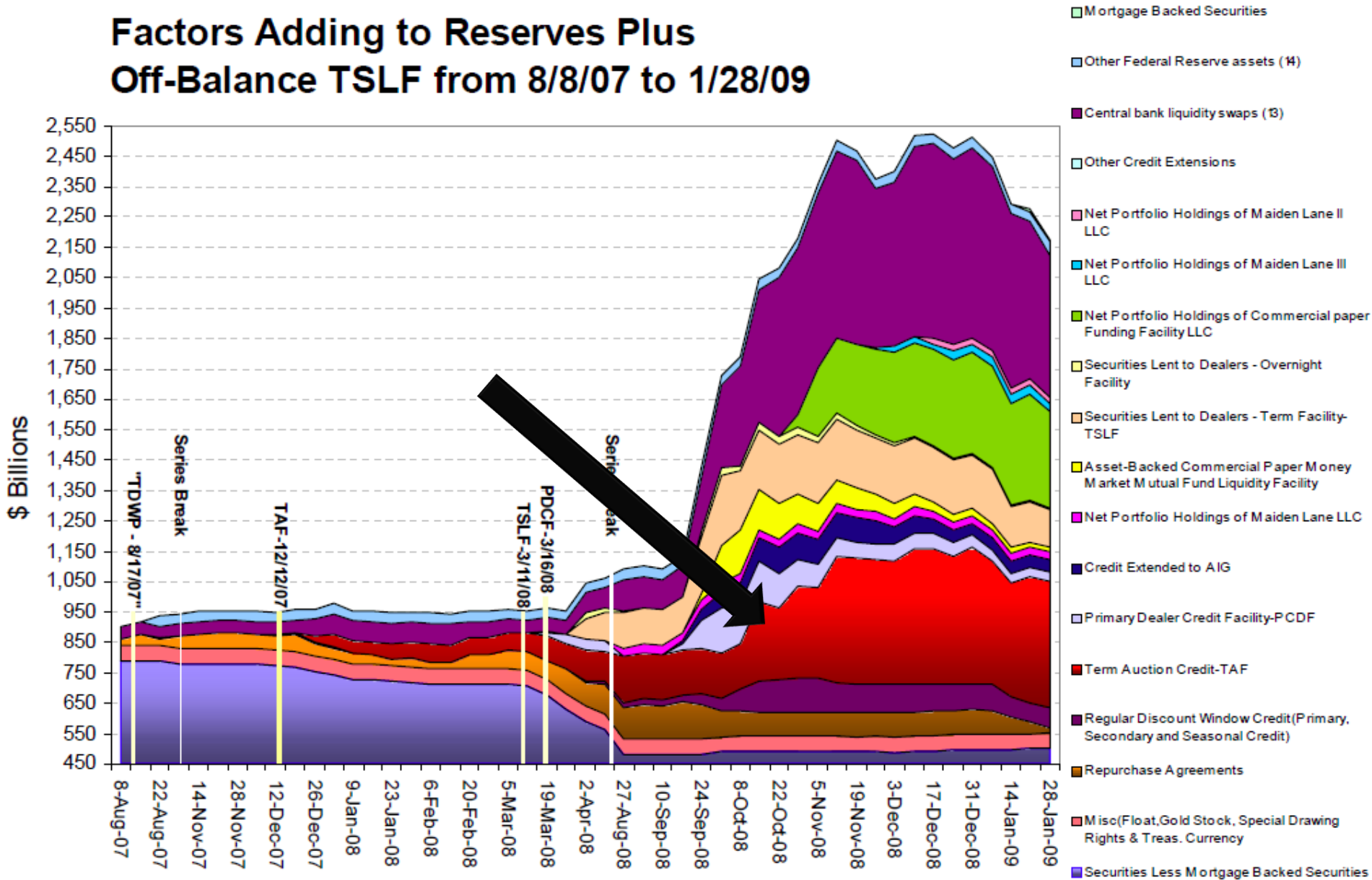
- Ability to convert claims into cash (liquidity) on demand establishes survival constraint for countries and private actors
- Determinants
 - Institutions
 - Financial engineering
 - Relation to LLR
 - Gap between expectations and actual outcomes
- Access to liquidity is uneven

Financial Markets





Factors Adding to Reserves Plus Off-Balance TSLF from 8/8/07 to 1/28/09

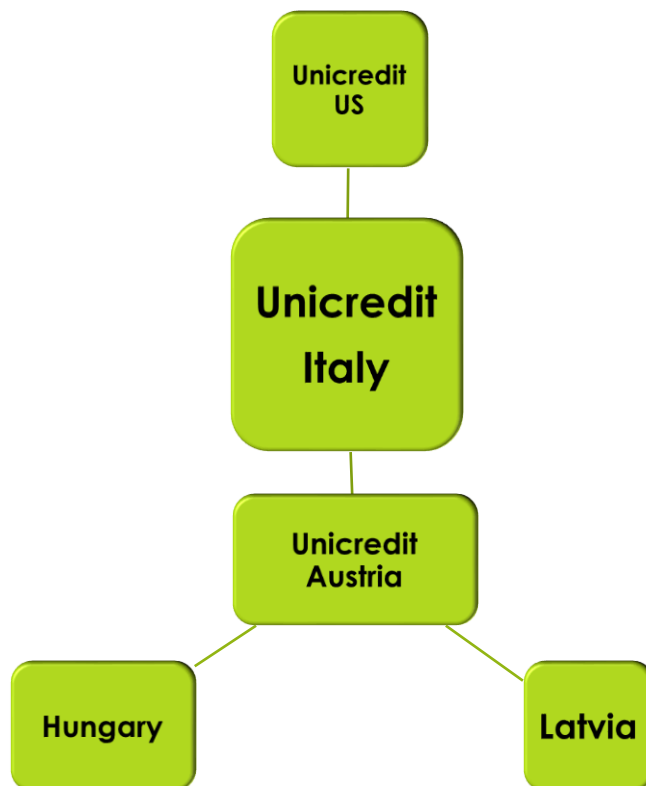


Getting a Seat at the Fed's TAF

DZ BK Deutsche	Dresdner	Mizhuo	Standard Chartered
Bayerische HV	Depfra	Bk Tokyo- Mitsub	BK of Scotland
HSH Nordbank	Credit Indus & Comm	Sumitomo	RBS
West LB	Dexia	Norinchukin	Barclays
Commerzbank	BNP Paribas	Arab BKG Corp	
Bayerische LB	Natixis	Allied Irish	
Unicredit	Societe Gen.	BK of Nova Scot	
Deutsche BK	UBS	Toronto Dom	
Deutsche BK	Fortis	Royal Bk Ca	



Funding Liquidity and Debt Shifting in Global Markets



Financial Interdependencies and Risk Allocation

- Banks source in global wholesale markets and shift debt to markets where they maintain lending vehicles (banks and non-banks) to earn higher returns
- Distribution of Risk is Uneven Across Countries
 - Funding market
 - If collapse of funded (foreign) markets can adversely affect home market (Fed's TAF)
 - Parent company markets
 - If collapse of target market affects parent banks in home market
 - Target markets
 - Exposure to collapse of global wholesale funding markets without knowledge of local regulators

Hierarchy of Global Finance

- Access to liquidity varies for different actors and countries
- Current regulatory structures re-enforce structural hierarchy
 - Basel Concordat
 - Home-Host division of regulation and liquidity provisioning
 - Limited liability of parent bank regulators in target markets
 - Source market regulators no responsibility in principle
 - Free capital mobility & strengthening of creditor rights
 - Supports cross-border debt-shifting
 - Crisis management
 - Protection of core, not periphery, of global markets
 - “Where is my swap line?” (Sester)

Towards Flexible Coordination of Regulatory Diversity

- Management of country & actors specific liquidity risk
- Coordination of countries with weak bargaining power
- Coordination of policies in source, home country, and target markets
- Global monitoring of excess liquidity & its sources
- Global information repository for effective liquidity management strategies
- Sanctioning mechanisms

Designing the Coordinator

- Credibility/Legitimacy
 - Effective representation of source, home and target markets
- Convening power
 - Ability to convene regulators, central banks, and private sector representatives
- Responsiveness
 - Learning by Monitoring
 - Organizational structures to ensure detection of non-routine events

Thank you