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The global financial crisis that began in 2007 marked the failure of an ambitious experiment in financial diplomacy. Since the 1970s, officials from the world's leading economies have worked together to regulate financial institutions with the aim of making the international financial system safer. When the collapse of the U.S. subprime mortgage market triggered a cascade of events that put that new international regime to the test, the results were disastrous. International agreements on the regulation of banking and securities did little to protect against a financial meltdown that severely damaged the world economy.

Inevitably, painful experience has fueled a drive to get financial regulation right. The G-20 presidents and prime ministers who met in Pittsburgh last September found themselves discussing such arcane matters as bank leverage ratios and over-the-counter derivatives. A bevy of obscure multilateral organizations, from the Bank for International Settlements (BIS) to the International Accounting Standards Board, are now advancing proposals intended to prevent crises in the future. The G-20 finance ministers and central-bank governors are set to discuss international financial regulation in Berlin in May, and regulation will be on the agenda when the presidents and prime ministers convene again in Toronto in June. Meanwhile, some prominent bankers are proposing an international fund to insure against

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the collapse of any institution deemed "too big to fail." Regulatory cooperation is clearly a growth industry.

But that growth is not necessarily good for the global economy. Over three decades of experience have shown that international cooperation in financial regulation brings as many risks as benefits. The attempt to harmonize standards across borders has led many countries to make the same mistakes, adopting misguided rules in some areas and none at all in others. National governments have deferred important regulatory changes while waiting for multilateral agreements that may not be signed for years, if ever. Meanwhile, truly critical international issues, such as allocating responsibility for the oversight of banks operating across borders, have been addressed inadequately or not at all.

Financial diplomacy has its place, particularly when it comes to monetary policy, but on the regulatory side it is being tasked with a far heavier burden than it ought to bear. To rely on international organizations to protect the world economy against major financial disruptions is unrealistic. And expecting them to "level the playing field," the traditional justification for harmonizing financial regulation across borders, is neither reasonable nor desirable. Although international cooperation in regulating and supervising financial institutions is important, it should not be a substitute for tough regulation at the national level. Well-crafted regulations in individual countries matter far more than international accords. Most important, international agreements should not discourage a diversity of national regulatory approaches, which could make the financial system more resilient during the next worldwide crisis.

DISASTER RESPONSE

Cross-border cooperation in financial regulation came about due to two near disasters. Late one afternoon in June 1974, West German regulators closed Bankhaus Herstatt, an insolvent institution in Cologne. Herstatt was a very small bank, but it had foreign exchange dealings with banks in other countries. Due to time differences, Herstatt had already received payments related to some of these transactions at the moment it was shuttered, but its corresponding payments had not yet been sent. The precipitous closure blocked those payments, causing losses at many other banks around the world and roiling the foreign exchange markets for months. At the time of Herstatt's failure, U.S. regulators were trying to avoid the collapse of Franklin National Bank, a New York–based institution with a disproportionately large position in international currency markets. Fearful that Herstatt's abrupt demise could imperil other banks in the United States and Europe, U.S. regulators eventually averted a wider crisis through a government-assisted sale of Franklin National.

In late 1974, central bankers from Canada, Japan, the United States, and nine European countries responded to these crises by creating a new organization in Basel, Switzerland: the Committee on Banking Regulations and Supervisory Practices. Basel was already home to the BIS, which since 1930 has overseen the financial machinery for cross-border payments and provided a place for central bankers to talk shop. The new committee, subsequently renamed the Basel Committee on Banking Supervision, was more specialized and technocratic than the BIS: whereas in the BIS the heads of central banks met to discuss interest rates and inflation, the Basel Committee was mainly the province of bank regulators and senior central-bank staffers. The committee's initial efforts included searching for indicators that could provide early warnings of a banking crisis and compiling a list of regulators to contact in the event of a crisis.

The U.S. Congress gave the Basel Committee its first serious assignment in 1983, after Mexico's debt default blew holes in the balance sheets of most big U.S. banks. When members of Congress demanded that U.S. regulators require the country's banks to boost their capitalization, bankers objected that higher capital requirements would put U.S. banks at a competitive disadvantage. Their particular competitive worry was Japanese banks, which were then the world's largest and could lend at low interest rates because regulators in Tokyo allowed them to lend while keeping little capital on hand. Congress reached a compromise with the bankers and directed the Reagan administration to seek common international financial standards. The Basel Committee was placed in charge.

Bringing about international convergence on financial policy was easier said than done. Each country had its own standards for how much capital a bank needed and how that capital should be measured, and no country was eager to impose heavier costs on its own financial sector. The impasse was resolved only when the United Kingdom and the United States took matters into their own hands, striking a bilateral accord on bank capital rules in 1986. That was the first-ever international agreement designed to reduce the risk of a banking crisis. Japan, fearing that a plan shaped by London and Washington would harm its undercapitalized banks, soon joined in, and the three countries adopted a single negotiating position in Basel. Confronted with this deal among the major financial powers, the other members of the Basel Committee abandoned their parochialism and signed on to common standards that, although weaker than those accepted by London and Washington, at least represented a multilateral approach to financial regulation. Each country pledged to follow the agreed principles in its own domestic regulation. The 1988 agreement became known as the Basel Accord.

International cooperation in financial regulation brings as many risks as benefits.

Over time, the Basel Committee acquired numerous siblings. The International Organization of Securities Commissions, established in 1983, brought together the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission, and their foreign counterparts to coordinate securities and futures regulation. The International Association of Insurance Supervisors arrived on the scene in 1994; the Financial Stability Forum—now called the Financial Stability Board—was created in 1999 to bring political leaders, namely, finance ministers, together with regulators and central bankers; an existing international accounting committee was reconstituted in 2001 as the International Accounting Standards Board, a private body with strong government support, to standardize corporate accounting rules around the world; and the International Association of Deposit Insurers followed in 2002.

Thirty-five years of negotiations over financial regulation have produced some substantial achievements. Banks uniformly have more capital than they did in the 1970s. The basic plumbing of the financial system, the channels through which securities and money change hands, is far more robust than it used to be, in large part because bank and securities regulators have collaborated to push banks to settle transactions quickly rather than letting paperwork languish for days or weeks. Supervisory "colleges" comprising regulators from several countries are beginning to oversee a handful of the largest financial institutions. Regulators now routinely collaborate on investigations of money laundering and terrorist financing. Perhaps most important of all, financial supervisors around the world know one another and see one another frequently. If there is a cross-border problem, they can readily pick up the phone and call their foreign counterparts—although they do not always do so, as was the case in January 2008, when French regulators failed to notify the U.S. Federal Reserve after learning of a five billion euro fraud at Société Générale, one of France's largest financial institutions.

TAKE TWO

The 1988 Basel Accord was the culmination of years of bargaining. Its provisions were relatively simple, and its flaws were widely criticized. Throughout the 1990s, the Basel Committee, gradually expanding in size, tried to fix these problems. In 1998, it began work on an entirely new agreement on the safety and soundness of banks, which was approved in 2004. Known as Basel II, this framework now forms the basis for the regulation of almost all the banks in Europe, large U.S. banks, and many banks elsewhere. All 27 members of the Basel Committee are now bringing the Basel II principles into effect. Bank supervisors in many emerging economies, determined to prove that they can oversee financial institutions as effectively as their rich-country brethren, see Basel II as the regulatory standard to which they should aspire. In some ways, Basel II has succeeded admirably. In other ways, however, it worsened the problems that became apparent in the summer of 2007 and arguably made the financial system less stable.

Conceptually, Basel II divides bank regulation into three different areas, known as pillars. The first addresses the amounts and types of capital that financial institutions are required to have, the second concerns regulatory supervision and risk management, and the third deals with using market forces to encourage bankers to behave prudently. Each pillar includes a large number of highly technical provisions that are meant to provide guidance to national banking authorities. The Basel Committee itself has no bank examiners and no enforcement power; its purpose is to encourage national regulators around the world to move in the same direction.

Unfortunately, financial regulation is far from a scientific enterprise. New regulations often respond to the last crisis rather than forestalling the next one. Some regulations prove unworkable or simply irrelevant. In some instances, the Basel Committee's attempts to harmonize the activities of national bank regulators have resulted in regulators everywhere making the same mistakes.

One such misstep was a heavy emphasis on capital levels to the exclusion of other financial concerns. Capital is critical to banks' health; it represents the resources available to repay depositors and trading partners in the event of losses. It can take several forms, such as equity (money raised when a firm issues shares), retained earnings (past profits that a firm set aside rather than using them for dividends or expansion), or loan-loss reserves (money held in expectation of future losses). Past crises, most notably the Japanese banking crisis of the early 1990s, found banks holding far too little capital to cover their losses, so Basel II told national regulators to impose higher capital requirements. Almost every country followed the same plan.

Regulations often respond to the last crisis rather than forestalling the next.

But inadequate capital is only one of the problems that can beset a financial institution during a crisis. Some institutions that seemed well positioned when the recent crisis struck suffered not from a lack of capital but from a lack of ready cash—what bankers refer to as "liquidity." As the credit market froze up, they could not issue the short-term paper or obtain the overnight loans that they had always depended on to meet immediate cash needs. Insufficient liquidity left banks in various countries too cash-strapped to open their doors. One reason was that strong liquidity rules were virtually nonexistent, because Basel II did not mandate them.

The Basel Accords also failed the system by basing capital requirements on mistaken risk assessments. Basel instructed national regulators to determine the amount of capital a bank must hold based on the riskiness of its business. Since holding capital is costly for a bank's shareholders, as capital represents money that cannot be lent at a profit, a requirement to hold more capital for some activities than for others inevitably encourages banks to aggressively pursue activities for which little capital is required. Around the world, regulators adhering to the Basel II rules required banks to hold less capital against home mortgages than against loans to big companies, which were deemed riskier. As a result, banks in many countries had too little capital to cover losses on mortgages when local housing prices collapsed and borrowers began walking away. Similarly, under Basel II, loans by foreign banks to Icelandic banks required less capital than loans to highly rated multinational corporations simply because the Icelandic government had a strong credit rating. But as the crisis developed, all three of Iceland's major banks failed. In the end, Basel's capital requirements destabilized the financial system by giving banks an incentive to get loans off their books by securitizing them rather than setting aside more capital to back them.

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Even less comforting, the Basel rules allow the biggest banks to calculate their own capital requirements based on their own internal risk models. By and large, these proprietary mathematical models performed disastrously in 2007 and 2008, failing to shield banks from large losses due to national housing-market collapses and the international economic downturn. That sorry record brings into question the wisdom of letting banks model their own capital requirements. At the same time, it is not clear that regulators have the time or the expertise to evaluate individual institutions' highly complex risk models properly and to demand changes.

Basel's creation of a uniform international definition of "capital" has also made the banking system less safe. Before Basel, some countries had stringent definitions, requiring banks to have large amounts of equity, whereas other countries' definitions meant far more lenient capital requirements. Basel II made leniency the international standard. Although banks everywhere must have a certain amount of common equity, they are allowed to meet part of their capital requirements with special bondlike securities. The idea is that if a bank becomes distressed, it can stop paying interest on these so-called Tier 2 securities or convert them into equity even as the bank operates normally and services its other bonds. In all but a handful of recent bank bailouts, however, regulators treated the owners of Tier 2 securities, mostly institutional investors, no differently than other creditors, protecting them against default—which meant that the Tier 2 securities never played their intended role as a cushion against the banks' losses. What seemed a brilliant financial idea was a political nonstarter, because in many countries, the bank regulators and their political overseers were unwilling to force the fixed-income investors who held these Tier 2 securities to bear large losses. As a result, many banks were less able to cope with losses than their published financial statements indicated.

Finally, Basel II's emphasis on the ability of market forces to help keep banks in line proved fundamentally misguided. The agreement lays out in detail the disclosures a big bank must make about its capital position and its risks, asserting that "market discipline can contribute to a safe and sound banking environment." This premise, however, may be incorrect. Over the past year, studies have shown that the big banks that produced the best returns for shareholders in the years prior to 2007 were those hit hardest by the crisis. Because equity investors favored riskier banks, not more conservative ones, the market provided an incentive for bankers to take greater risks, not to be prudent. Nor did market discipline make credit investors wary of the bonds issued by institutions that took excessive risk and ended up in trouble. The markets bet that governments would make good on the big banks' debts, and with very few exceptions, the markets were right.

BANKERS WITHOUT BORDERS

International negotiations also failed to adequately assign responsibility for supervising those institutions whose activities cross borders. As a general rule, the lead regulator of such institutions is their home government: U.S. regulators have primary responsibility for Goldman Sachs and Citigroup, German authorities take the lead in overseeing Deutsche Bank, and so on. This approach, known as home-country regulation, is problematic, because the countries responsible for regulation are not necessarily those whose citizens and economies would be crippled by regulatory failure. The most glaring example of the failure of home-country regulation is Iceland. That country's regulators permitted their rapidly expanding banks to take deposits in the Netherlands and the United Kingdom, but when the banks hit trouble and their foreign operations abruptly closed, the Icelandic government refused to repay Dutch and British depositors. On March 6, Iceland's citizens rejected a plan to make the depositors whole.

A more serious case, from the standpoint of systemic stability, arose with the failure of the New York–based investment bank Lehman Brothers in September 2008. Lehman had major operations in both New York and London. While it teetered, U.S. and British regulators each sought to avoid having their country's taxpayers take responsibility for the losses in Lehman's portfolio. Although an orderly sale of Lehman might have been good for both countries' economies and the world financial system as a whole, allowing the credit markets to continue functioning and averting the steepest recession since the 1930s, neither country was willing to take actions that might have been domestically costly. In addition to this classic free-rider problem, the Lehman collapse exposed other glaring deficiencies in the regulation of cross-border activities. Hedge funds and other customers of the investment bank's London office found that Lehman had transferred $8 billion from London to New York just before its bankruptcy filing, protecting the interests of money managers in the United States at the expense of those in Europe. Moreover, some U.S. money managers discovered to their surprise that their accounts were legally based in London and therefore subject to British, rather than U.S., bankruptcy rules. None of the accords worked out by the international bodies of banking or securities regulators addressed such situations.

Only national governments can be held politically accountable for regulatory failures.

The banking sector is not the only area of the economy in which international financial diplomacy has failed to confront major systemic risks. It was not until June 2009 that the International Organization of Securities Commissions—the securities-sector counterpart to the Basel Committee—launched a task force on cooperation on the oversight of cross-border securities. Moreover, the U.S. Commodity Futures Trading Commission, which probably oversees more trading of futures contracts than any other regulator in the world, is not even involved in overseeing cross-border transactions, even though futures trading has the potential to create systemic risk if a major market participant is not properly supervised. Finally, there is the insurance industry, where inadequate regulation contributed greatly to the global crisis.

Major bond insurance companies in the United States and Europe had provided guarantees to protect investors holding securities created from subprime mortgages. As increasing numbers of U.S. homeowners stopped making their mortgage payments, some of these insured securities went into default, passing losses on to the bond insurers. Investors in the $2.6 trillion municipal bond market quickly sniffed trouble. Municipal bonds had nothing in common with subprime mortgages, save the fact that some bonds issued by local governments carried insurance from the same companies that insured subprime securities. The municipal bond market seized up as investors struggled to sort out the good risks from the bad, and some bondholders who had steered clear of subprime mortgages ended up facing losses on some of the most conservative investments available. This was a development the International Association of Insurance Supervisors had not foreseen.

In an increasingly multipolar world, such gaps in the international financial regulatory framework will become more difficult to address. The membership of the Basel Committee has grown from 12 in the 1970s to 27 today, the International Association of Insurance Supervisors includes representatives from 140 countries, and more than 100 national governments and several lesser jurisdictions are represented in the International Organization of Securities Commissions. All of these organizations operate by consensus. Having more countries at the table, each concerned with protecting the interests of its own domestic firms, makes consensus difficult and effective action even harder.

THE FIRE NEXT TIME

WITH THESE shortcomings now laid bare, the various international bodies are busy refining their approaches to regulatory harmonization, and there is much talk of a possible Basel III. Proposals include requiring banks to maintain additional capital, limiting bankers' pay, supervising big transnational insurance groups, and recommending that the purveyors of subprime mortgage securities be required to hold some of those securities on their own books rather than selling them all to investors. Had all of these regulations been in force five years ago, the crisis might have been forestalled.

Yet although the last systemic crisis could have been averted, the next one might not be. No one can say with any certainty what the best rules are, and whatever rules are imposed, it is a sure bet that smart bankers and insurers will do their best to circumvent them. The closer the world comes to having a single set of rules for financial institutions, the greater the likelihood that some gap in those rules will lead to global instability. Diversity can be a source of strength.

Spain's weathering of the recent financial crisis highlights the positive effects of regulatory diversity. The large Spanish banks withstood the crisis better than most of their European counterparts, despite the collapse of Spain's property market. Many scholars attribute Spain's success to its decision to depart from the Basel II norms in setting capital requirements. Alone among the large economies, Spain required its banks to set aside extra reserves for potential future loan losses during the boom years. In a world of regulatory diversity, if some countries make poor regulatory choices, the effects will likely be limited because other countries may have chosen to regulate differently.

Along with encouraging regulatory diversity, political leaders need to cultivate greater realism about what the international regulatory organizations can deliver. Realism must prevail when it comes to global governance, too: it cannot be expected to improve the stability of the global financial system. That must be the task of national governments, not multilateral committees.

There is simply no way to provide meaningful global regulation of far-flung international entities, no matter how well meaning the effort.

Only national governments have the ability to establish and enforce regulations on companies operating in their territory. And only national governments can be held politically accountable for regulatory failures. This implies a step back from financial globalization in the interest of safety. Prudence dictates a much greater role for host-country regulation, with each country taking responsibility for regulating the financial institutions that operate within its borders, no matter where they are based. This is undoubtedly an inconvenient solution for the financial industry: it may force large financial companies to establish separate subsidiaries in each country in which they do business, with each subsidiary having to meet local standards concerning capital, liquidity, and risk management. Yet even if the annual costs to these companies will be higher than they are today, it is hard to imagine that they will be greater than the costs of a massive regulatory failure such as the one the world just experienced. Weak regulation can be the most expensive regulation of all.

Shifting toward greater host-country regulation will not trigger a "race to the bottom" in which business flows to companies based in countries with lax regulation.

There is little evidence to suggest that the risk of a race to the bottom is real. Regulation and reputation matter hugely in finance: banks' and insurers' big customers, lenders, and trading partners care greatly about the strength of the institutions they deal with and the legal environment surrounding them. Were regulatory laxity an important competitive advantage, the giants of finance would long since have moved their key operations to places where oversight is weaker than in London and New York. It is worth noting that when the United Kingdom's Financial Services Authority put forth new rules on bank liquidity in October 2009, it argued that "strengthened liquidity requirements can bring substantial long-term benefits to the competitiveness of the UK financial services sector"—in other words, it argued that the rules would stimulate a race to the top. Similarly, Washington needs to focus on stronger oversight of the operations of both foreign and domestic institutions within the United States.

The need for clear lines of responsibility should also doom the idea of an international bailout fund for the biggest banks. It would be extremely unwise to place hundreds of billions of dollars at the discretion of a multilateral committee with no direct responsibility for regulating the insured institutions. As the Icelandic saga should make clear, divorcing financial responsibility from regulatory responsibility is an invitation to supervisory neglect: if it is some international body's money that will be lost in the event of failure, and not domestic funds, no national supervisor will have the proper incentives for close oversight.

That does not mean regulators should walk away from the international bargaining table: cross-border cooperation and supervision in financial regulation are well worth pursuing. But asking international organizations to develop global standards for the financial sector will not preclude the next crisis. At some point, another crisis will come, and the precise mixture of problems that caused the last one will surely not cause the next. The best way to limit the fallout is to assign national supervisors clear responsibilities to regulate and police the financial institutions operating within their countries' borders, using a diversity of approaches. The lesson of 35 years of experience is that when it comes to financial regulation, less international diplomacy might be better than more.