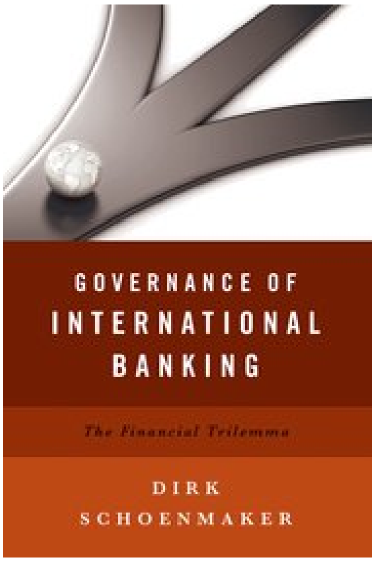
Book Review: Governance of International Banking: The Financial Trilemma

Blog Admin

In the aftermath of the financial crisis, the business model of international banks is under pressure. Regulators across the world are retrenching to national lines by applying restrictions on cross-border banking. Applying game theory, this book develops a model of the financial trilemma to understand the co-ordination failure among regulators. ***Roger McCormick*** *finds that the book contains some excellent, succinct case studies of bank collapses in the crisis.*

Governance of International Banking: The Financial Trilemma. Dirk Schoenmaker. Oxford University Press. April 2013.



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Dilemmas, "trilemmas"…… they can impact at various levels. European holidays, for example, are great but, for many of us, it's always good to get back home to the UK. Are we behind the times, thinking of the UK (as opposed to Europe) as "home"? Does it matter any more?

It's a wonderful thing, this "Europe" that we on our offshore island kingdom seem to belong to. Such wonderful roads! Great culture! Delicious food and wine! And it's all so much easier to appreciate and experience than it was a few decades ago. You almost feel a part of it, a citizen of Europe! You have freedom of movement, of capital, of employment…….Why all the fuss about "in/out" referenda and bailing out those parts of it that have borrowed more than they can repay? If we are so happy about the benefits of being in the EU why don't we play fair, take the rough with the smooth and throw in our lot with our EU "partners" on the difficult issues? Accept joint responsibility with them for the problems the eurozone faces and settle those Greek, Cypriot, Portuguese, Spanish, Italian (French? any more?) debt problems once and for all. Have a whip round. There's enough money there if we all pull together. As if we were one country (sharing the same "home"). Should be easy enough. We can set up the regulatory architecture, improve democratic accountability (don't worry about the detail) and hire clever technocratic leaders (former investment bankers seem to fit the bill) to tell us how much and when we have to pay (it will be our money that is tapped, you understand).

This book explores the dilemmas (nay, "trilemma") that face us as we seek to enjoy the benefits of both increased globalisation and the comforts of the old-fashioned nation state at the same time. The financial crisis has forced us to see the dilemmas more clearly. Mervyn King's famous aphorism, "Global banks are global in life but national in death", says it all, and, justifiably, starts off Chapter 1. However international a bank's operations may be, if it goes bust, it will be the taxpayers of individual jurisdictions that must choose either to bail it out or face up to creditor losses on its insolvency. The rules of the game at this point are national, not international. In the UK, we saw this with the fall of Lehman Brothers, the collapse of Icelandic banks and the near-collapse of major (and some smaller) UK banks. Different solutions were found for those different situations, but in all cases the potential impact on us was serious, wherever the "global" (or not so global) bank originated. There was not too much international co-operation from other governments in helping us address the problems. It was every nation for itself.

The

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eurozone crisis shows another facet of the problem. Member countries A, B, C, etc. have serious financial problems at both sovereign level and (it can be assumed) at the level of their banks. There is no mechanism (and certainly no obligation) for eurozone countries F, G, H etc. to either assist them in any conventional way or to participate in a eurozone-wide “resolution” of their banks. The treasuries of the UK and other Northern EU members have no democratic mandate for the transfer (on a non-returnable basis) of tax revenues to other countries (or their banks) to “help them out”. And we cannot “resolve” any EU bank in trouble by employing an EU-based procedure that has no “root” in a national law. We want an effective, efficient and “safe” banking system in the EU as well as elsewhere, but can that be achieved if the only relevant laws that “count” are national, not “global”?

The answer is probably "no". We all (including the eurozone) may be muddling through right now, but confidence in the system is low. So, this book argues, we must face up to the "trilemma". This is, traditionally stated, that it is impossible for a country to have effective policies for (1)a fixed exchange rate, (2) international capital mobility, and (3) national independence in monetary policy, all at the same time. Thus, if a country, wanting to tighten the money supply, causes its domestic interest rates to increase, that will result in capital inflows, which will cause its currency to appreciate and that will in turn force it to sell its currency on the FX markets (reversing the initial tightening) if it wants to keep its currency competitive. The author suggests a restatement of the problem: that (a) a stable financial system, (b) international banking, and (c) national policies for supervision and resolution are incompatible. The financial crisis has given many examples of why our desire for (a) and (b) forces us to recognise the need for compromise on (c). At the height of the crisis, much lip service was paid to the need for international co-operation as a modifier of (c) – and many architectural changes have been implemented (detailed at some length in the book). But, as the author Dirk Schoenmaker, time and time again notes, from an EU -based perspective (Schoenmaker has positions in academia in Holland and with the European Systemic Risk Board and has worked at or with the Bank of England, the IMF and the OECD) the "politics" gets in the way of really substantive changes that would result in countries handing over real power to international agencies in order to regulate international banks and handle their insolvencies. "Soft law" mechanisms abound, he observes, but, when push comes to shove, we need something legally binding…like treaty obligations. (Although the author is perhaps too optimistic about countries' inclination to comply with such obligations (which are hard to enforce) when the going gets rough).

Chapter 4 contains some excellent, succinct case studies of bank collapses in the crisis and suggests the lessons that can be learned from them, and also provides a wealth of statistical information on the activities of international banks as well as the international regulatory architecture (which, despite its title, is the book's focus: it is not concerned with the corporate governance of banks). And, of course, it makes a strong case for a supranational approach to bank regulation. This is particularly pressing in the eurozone, where the adoption of the single currency has put participant states in a virtually impossible position as each state pretends to cling on to financial independence even though it has lost control of its currency. The fashionable call for "banking union" is repeated but no definition is offered. A pity, given the EU's historically casual usage of the word "union".

But, as the author seems to recognise, banking union (whatever that is) surely has to lead on to (perhaps be accompanied by) political union. Disappointingly, this only receives about a page of coverage towards the end of the book, in Chapter 7. Unconvincingly, the author indicates that the solution to the reluctance of individual states' taxpayers to fund economic problems (and, in some cases, gross irresponsibility) in other states is to go for "joint sovereignty" since "the construction of the EU as a democratic polity in international law allows for a different, post-Westphalian approach to the concept of sovereignty." EU states have to "share sovereignty". But surely, this only restates the problem: how much are we prepared to "share"? The current trend of EU, and other international, politics suggests "not very much". Many are saying (not just from the UK) that we have already shared too much. As the author observes on several occasions, "he who pays the piper, calls the tune". Crude but apt. If we are to call the tune, we need to know that someone (with power) is listening. We may not hold our national politicians in very high regard, but, they are at least accountable to us, albeit imperfectly. In the UK, we rather like the idea of the House of Commons keeping the executive in check occasionally. This is not the case with international institutions, who, all too often, seem to behave in a manner that suggests they feel they are above the concerns and hurly-burly of mere "domestic politics", being focused on some higher purpose. Maybe, one day, we might just put it all to a vote?

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