Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

February 10, 2015

Introduction to Financial Services: International Supervision

Overview

The financial crisis of 2007-2008 and subsequent global economic turmoil underscored the interconnectedness of the global financial system as well as its weaknesses. In the wake of the crisis, leaders from the United States and other countries have pursued a wide range of reforms to the international financial regulatory system.

At a basic level, the goal of international financial regulation is to maximize economic gains from integrating global financial markets while minimizing losses from instability and financial crises. Over the past several decades, global capital flows have grown rapidly, driven by deregulation of national financial sectors, advances in technology, and innovation of financial products and instruments. While financial markets have become more global, financial regulation remains territorial, exercised by national governments over financial transactions occurring within their geographic borders.

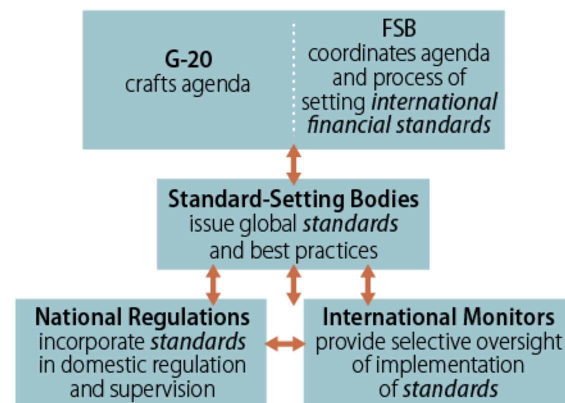
International financial stability is a policy objective that transcends national boundaries. In the absence of an international financial supervisory or regulatory body, countries, for the past several decades, have negotiated voluntary international financial standards and best practices. However, despite decades of efforts among national regulators to agree on and coordinate international standards on accounting, securities, and bank capital adequacy among the major economies, substantial regulatory differences exist among national regulations. Furthermore, the absence of an institution with the authority to conduct prudential supervision of transnational financial institutions may have contributed to the failure to prevent the 2007-2008 crisis and hampered efforts to contain the spread of financial instability throughout the global economy in the years following the crisis.

Current Institutional Landscape

In contrast to the rules-based system for governing international trade, centered on the World Trade Organization (WTO), international financial regulation is fragmented, with regulatory and supervisory authority dispersed among a range of international and national institutions **(Figure 1)**.

The overall agenda-setting for international financial cooperation and coordination is most associated with the Group of 20 (G-20) and the Financial Stability Board (FSB). National financial authorities are the primary actors, responsible for devising rules and providing oversight and supervision of financial institutions operating under their jurisdiction. National financial authorities are also responsible for participating in the international standard-setting bodies. The international agenda and standard-setting bodies operate on a consensual basis and have no legally binding authority. Since national regulators (or other authorities) cannot enter into treaties with other countries, agreements made at international fora or by regulators at standard-setting bodies require domestic legislative and/or regulatory changes before they are implemented. International financial institutions, primarily the International Monetary Fund (IMF) provide overall surveillance of national compliance with the agreed upon international financial standards, among its other functions.

Figure 1. International Financial Architecture



Source: CRS.

- **Group of 20 (G-20).** The G-20 is an informal grouping of nineteen countries (including the United States) and the European Union, which since 2009, has been the primary political steering forum for international economic cooperation. G-20 leaders meet at annual summits. Finance ministry officials meet more regularly. The G-20 has no authority to impose rules on its member countries. Rather, finance ministers and central bank officials work through the G-20 to agree on a global international financial regulatory agenda.
- **The Financial Stability Board (FSB).** The FSB is a technical body, which was established by the G-20 to coordinate the G-20 agenda and set the priorities for the international financial standard-setting process. FSB members include the regulators from the G-20 countries (and others), several international financial institutions and the most important standard setting bodies (e.g., accounting, banking, insurance). The FSB has no supervisory authority or regulatory power to compel compliance with internationally agreed standards. The primary U.S. representatives to the FSB are the Federal Reserve, the Securities and Exchange Commission (SEC), and the Treasury Department. However other U.S. agencies participate in FSB working groups and activities.

> "We are committed to take action at the national and international level to raise standards, and ensure that our national authorities implement global standards… that ensures a level playing field, a race to the top and avoids fragmentation of markets, protectionism and regulatory arbitrage." *G-20 Seoul Summit Document, November 11-12, 2010.*

Standard-setting bodies include international financial institutions such as the IMF, as well as many other private and public bodies. These include the following.

- **Basel Committee on Banking Supervision (BCBS).** The BCBS, which is based at the Bank for International Settlements (BIS), in Basel, Switzerland, formulates standards, guidelines, and best practices in banking. Basel members are the national banking regulators. The United States is represented by the Federal Deposit Insurance Company (FDIC), the Federal Reserve, and the Office of the Comptroller of the Currency (OCC).
- **Committee on Payments and Market Infrastructure (CPMI). T**he CPMI sets standards for payment, clearing, and securities settlement systems. The Federal Reserve and Federal Reserve Bank of New York are members of CPMI.
- **Financial Action Task Force (FATF).** FATF develops standards and policies to combat money laundering and terrorism financing.
- **International Association of Deposit Insurers (IADI).** IADI develops standards for deposit insurance institutions. The U.S. representative is the Federal Deposit Insurance Corporation (FDIC).
- **International Association of Insurance Supervisors (IAIS).** IAIS is the international standard-setting body for the insurance sector. The U.S. representatives include the Federal Insurance Office (FIO), Federal Reserve, and National Association of Insurance Commissioners (NAIC).
- **International Accounting Standards Board (IASB).** IASB is an independent, privately funded UK-based organization, which has developed international accounting standards. Since 2002, the U.S. Financial Accounting Standards Board (FASB) has been working with the IASB on convergence with the U.S. Generally Accepted Accounting Principles (GAAP).
- **International Organization of Securities Commissions (IOSCO).** IOSCO develops and promotes securities regulatory standards. The U.S. representatives at IOSCO are the SEC and the Commodity Futures Trading Commission (CFTC).

Issues for Congress

Are International Financial Standards Effective?

Members of Congress may wish to consider the efficacy of the standards-setting effort. Regulators argue that recent agreements, such as the Basel III capital requirements for financial institutions, including a surcharge for financial institutions that the FSB has designated as globally systemically important financial institutions (G-SIFIs), represent significant progress toward their goal of developing a global macroprudential regulatory policy and improved practices within countries.

At the same time, the extensive volume of international financial standards, as well as national and regional implementing legislation, has grown increasingly complex and has hindered implementation, according to some observers. While the United States has embraced, and in many circumstances spearheads, the international financial reform agenda, inconsistencies remain between U.S. and international guidelines. For example, the Dodd-Frank Wall Street Reform Act requires banks to develop alternatives to credit ratings for the purpose of evaluating their capital reserve requirements. Basel III, negotiated with the participation of U.S. regulators, by contrast, makes extensive use of credit ratings. In these cases, implementation of financial standards may be incomplete.

Disagreement over the use of credit ratings, as well as the G-SIFI designation process, has led some Members to raise concerns that international agreements such as Basel III, are in effect, superseding U.S. laws. Other observers argue that the United States is placing itself at a disadvantage when U.S. authorities implement international financial standards, while others lag behind.

Should the Institutional Landscape Be Reformed?

Some observers contend that there is a limit to the progress that can be achieved by relying on a network of voluntary, non-binding international financial standards. During a financial crisis, there is often great pressure on governments to exercise "emergency power" to have more control of how the crisis is contained and how the losses are distributed. Also, even large bankruptcies, such as Lehman Brothers, are still resolved on a national level.

Some observers argue the IMF and/or FSB should be given greater regulatory power over some international financial transactions, or at a minimum, greater authority to supervise and promote compliance with international financial standards. Other observers argue that such efforts to centralize international financial regulation at the IMF, FSB, or some new body are overly ambitious and likely to face the same coordination and implementing challenges as the current standard-setting agenda. A more promising approach, they argue would be to continue to pursue policies to harmonize regulatory policies on the regional and international level.

Martin A. Weiss, mweiss@crs.loc.gov, 7-5407

IF10129