

# Transatlantic Cooperation for Post-Crisis Financial Reform – To What End?

By Aldo Caliari, Center of Concern



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# ACRONYMS

AIFM	Alternative Investment Fund Managers
CCP	Central Counter Party
CDO	Collateralized Debt Obligation
CDS	Credit Default Swap
CFTC	Commodities Futures Trading Commission
CRA	Credit Rating Agency
ESRB	European Systemic Risk Board
FDIC	Federal Deposit Insurance Corporation
FMRD	Financial Markets Regulatory Dialogue
FSOC	Federal Systemic Oversight Council
OTC	Over the Counter
SEC	Securities and Exchange Commission
UCITS	Undertakings for Collective Investments in Transferable Securities

# EXECUTIVE SUMMARY

During the 2008-09 financial crisis, the Group of 20 (G-20) began to meet at the “Heads of State” level to formulate and implement emergency policy responses, on the one hand, and build consensus on the longer-term reforms required in the international financial system, on the other. Since then, the US and the European Union have been overhauling their own financial regulatory frameworks in parallel processes as well as working on regulatory frameworks in the context of G20 meetings where representatives of the US and five European governments and the EU hold seats.

This study examines the question: What are the key issues regarding financial regulation on which transatlantic cooperation (or lack of it) could have an impact?

Section I, which represents the heart of the paper, addresses this question and, in analyzing those key issues, also provides insights on the out-sized influence of the financial industry’s lobby on both sides of the Atlantic. However, areas are also identified where the advocacy agendas of parliaments and civil societies (in areas such as social justice, the environment, consumer affairs) are holding sway even in the face of this lobby.

Section II focuses on two areas that receive less attention in connection to debates about reform, despite their significant implications on the effectiveness of transatlantic financial regulatory efforts. These are: liberalization of financial services and the shadow banking system.

Section III identifies the key venues for transatlantic cooperation on international financial regulation.

Section IV focuses on the role of civil society in transatlantic cooperation processes and offers ideas on how to maximize, broaden and qualify their influence on such processes. Section V offers closing remarks and conclusions.

The paper also examines, in an annex, connections between the financial regulatory agenda and the search for solutions to the global imbalances that, arguably, played an important role as a trigger of the financial crisis. This annex helps respond the question of how an understanding of these connections might inform transatlantic cooperation.

# INTRODUCTION

*“There is evidence that the financial sector has been more profitable than the non-financial sector over the last two decades. This is not problematic as such if higher profit is related to high productivity. However, the high profitability of the sector could result from certain sector specific characteristics. For example, the financial sector is different from other sectors in respect of the existence of an (implicit or explicit) safety net which, combined with banking regulation may enable some institutions to enjoy economic rents; and in the relative ability of certain financial institutions to use leverage to increase returns.”<sup>1</sup> – European Commission*

The global financial crisis in 2008-09, which still reverberates throughout the world, has destroyed wealth on a massive scale and continues to do so. Few countries in the world have been spared. The crisis represents an expensive case study of how deeply financial regulatory choices affect the distribution of income and subvert the social contract in entire societies.

The crisis demonstrated that:

- As noted by the quote from the European Commission (above), the financial safety net for the financial sector was the implicit guarantee provided by the whole society through its promise of taxpayer funding to bail out financial institutions. The International Labor Organization confirms that, indeed, the financial industry is the main beneficiary of the process of financial globalization, but the consequences in terms of development setbacks, employment losses, and wage cuts, are still being paid. To an unfortunate extent, those that are paying for these consequences are the people who benefited the least from the preceding boom.
- The market’s failure to allocate and effectively absorb excess liquidity. The challenge is to replace or supplement such market allocation with strong regulatory approaches. It is to be expected that crises will continue to happen. Strong regulation is not intended to prevent crises from happening, as they are inherent to financial systems. But strong regulation can and should diminish their frequency and severity, mitigate the impacts, and ensure that the distributional consequences are fair. Those who take risks are the ones that should bear them.

Particularly in the immediate aftermath of the crisis when the need for an overhaul of financial regulation became clear, consensus emerged on the need for certain reforms to be undertaken on a cooperative basis. The G20 Heads of State expressed this message as they ramped up an emergency response to the crisis and declared the G20 as the premier forum for international economic decision-making.

Given the globalization of finance, it seems obvious that financial regulation must be undertaken on a global basis.

However, the consensus has weakened, as stated by the Managing Director of the International Monetary Fund, Mr. Dominique Strauss-Kahn:

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<sup>1</sup> European Commission, “Issues Note on Financial Sector Taxation.” August 2010.



*"While there is a process of collaboration to bridge the problem of local regulators dealing with global banks, many countries are approaching bigger-picture reforms from different directions and at different speeds. In the process, a central lesson of this crisis is being forgotten: that co-ordination works better than unilateralism."*

This paper is intended to contribute to a more nuanced view about when and where coordination works better than unilateralism. It also seeks to improve the reputation of unilateralism in certain circumstances. To quote economics Nobel Prize winner Professor Joseph Stiglitz:

*"As the saying goes, all politics is local, ... This, combined with deep philosophical differences ... mean the only agreements that are easy to come by are those involving the least common denominator, or small countries not at the table. Given the difficulties in achieving global co-ordination, insisting on such co-ordination may be a recipe for paralysis - just what the bankers who don't want regulations want. It is perhaps no surprise that they have become among the most vocal advocates of the need for global action."*

Indeed, the argument for global coordination and harmonization of standards seems to best suit the multinational firms that can benefit enormously from economies of scale and reduced transaction costs.

An examination of the evolution in financial regulation over the last two years shows that progress has been driven by issue-specific domestic forces, rather than international, or cross-border, politics. In fact, on the issues on which a certain degree of international agreement has been reached, such as capital requirements for banks, Professor Stiglitz's comments about the predominance of lowest common denominators are confirmed. The hope for financial regulation tends to come not from the globally agreed standards, but from individual jurisdictions that have unilaterally promised to move further than global standards require. The following section traces the supporting evidence for this premise and the implications for transatlantic cooperation across specific areas of concern.

# I. KEY FINANCIAL REGULATION ISSUES

This section reviews six major regulatory issues:

- Systemic risk and “to big, too complex or too interconnected to fail”
- Basel capital requirements
- Derivatives
- Hedge funds, private equity funds
- Credit rating agencies
- Financial sector taxation

The presentation of each issue is in two parts: 1) a description of the nature of the reforms under discussion; and 2) the status of reform issues both in the US and Europe, including where appropriate, which partner is furthest ahead in the reform process.

In the case of the US, the assessment is based on analysis of the “Dodd-Frank Wall Street Reform and Consumer Protection Act,” passed in final form by Congress in July 2010 and signed into law (enacted) in the same month. In the case of Europe, the financial reform agenda is fragmented into a number of legislative proposals that are at different stages in the process of deliberation and adoption.

It is important to mention that in both cases the legislation leaves many determinations to be made by regulatory authorities. So, the ultimate effectiveness of the law –and the validity of judgments made about it in this paper – will be contingent upon the ability of regulators to give adequate expression to the legislative intent.<sup>2</sup>

## I.1 Systemic risk and “too big, too complex or too interconnected to fail” policies

Large financial institutions that were seen as the culprits of the financial crisis had to be bailed out with public funding in 2008, both in the US and in Europe. In selected cases, bailouts continue to this day. There was massive public outrage at the perverse outcome – namely, that a number of firms that had taken excessive risks in order to boost unsustainably high profits were supported with taxpayer money.

This placed the spotlight on the so-called “too big to fail” problem.

Customarily, when a firm becomes insolvent, it files for bankruptcy and then follows a predetermined process for the distribution of assets among the creditors, including options for dissolution and /or transfer of ownership of the company’s assets. In contrast, in the case of financial firms, especially big ones, their failure is seen as having the potential to trigger a cascade of failures in other financial firms and even other sectors of the economy. Governments are often forced to assume not only the risks of financial institutions that are TBTF, but also the institutions that are deemed “too complex” or “too interconnected” to fail. While these characteristics are not always correlated with

<sup>2</sup> This cannot be taken for granted, particularly in the United States where the leadership of the new Congress – which has changed its majority from the time when the financial reform was passed last year – has vowed to erode it and considers the withholding of funding for regulatory agencies and the pressure on their authorities key weapons to use in that effort.

size, oftentimes big firms become too interconnected or complex as they grow – sometimes as the principal means of growing – in size.

Without a mechanism for the resolution of failing financial companies in an orderly way that does not disrupt critical banking activities, the government has no alternative but to rescue them.

One can argue, as the US government officials did at the time, that the consequences of not bailing out the companies would have been worse – a collapse of the economy. But it is undeniable that bailouts erode market discipline leading to major distortions in the economy. The existence of a credible resolution mechanism is critical not only to avoiding bailouts when an institution fails but, also, to the success and effectiveness of measures to prevent the kinds of excessive risk-taking that may cause a crisis.

As the Basel Committee of Banking Supervision argues:

*"A viable and commonly understood process for resolving cross-border financial institutions and financial groups may help support market discipline by encouraging counterparties to focus more closely on the financial risks of the institution or group. Discipline is enhanced if market participants clearly perceive that authorities are willing and able to effect a managed resolution of a financial institution."*<sup>3</sup>

The perception that some firms are exempt from a resolution process creates moral hazard and incentivizes the taking of excessive risks by rendering market disciplines that may limit such behavior ineffective.<sup>4</sup> It should be stressed that this is the case even when legal prohibitions for bailouts exist, as long as the bankruptcy-style process cannot credibly be implemented without the disruption of banking functions critical to the public or to the system.

The UK Central Bank Governor, Mervyn King, argues that the implicit taxpayer subsidy is at the heart of the profits made by the financial sector.<sup>5</sup> In the light of this, banks are not merely passive beneficiaries of this situation. Some authors go as far as saying that banks have an active strategy to grow in size and interconnectedness, as a way to bolster the "implicit safety net" and the increased profits that come with it.<sup>6</sup>

The general public shouldered the burden for the bailout through job losses, wage cuts, service reductions and, in many cases, tax and public fee increases.

There is widespread discontent with these unfair distributional effects. While many banks have paid this support back, this does not obviate the political question of whether, for instance, the

3 Basel Committee on Banking Supervision 2010. Report and Recommendations of the Cross-Border Banks Resolution Group, p. 3.

4 A recent IMF Discussion paper refers to the dangers in the current situation: "Confidence in financial systems is still highly dependent on explicit and implicit central bank and government support. Moral hazard has increased, in part as sectors have become more concentrated, while financial systems are still prone to stress and turmoil. Measures are needed to restore proper incentives and market discipline. Governments need to rethink how to reduce the threat that large financial institutions pose to systemic stability, including through reduced complexity, better capital structures, and, possibly, restrictions on their scope and activities." Claessens, Stijn, Ceyla Pazarbasioglu, Luc Laeven, Marc Dobliner, Fabian Valencia, Oana Nedelescu, and Katharine Seal 2011. Crisis Management and Resolution: Early Lessons from the Financial Crisis. Staff Discussion Note. March 9.

5 King, Mervyn 2010. "Banking: From Bagehot to Basel, and Back Again." The Second Bagehot Lecture, Buttonwood Gathering, New York City.

6 Kane, Edward 2010. Extracting Nontransparent Safety Net Subsidies by Strategically Expanding and Contracting a Financial Institution's Accounting Balance Sheet. Boston College. ("Even in financial-center countries, authorities have been slow to confront the complex ways in which any large financial organization can expand its access to implicit safety net subsidies. . . by increasing its portfolio size, balance-sheet complexity, or geographic footprint.")

US government should have provided support to the financial sector rather than other sectors. In other words, many sectors fail in a crisis situation and then the question that policy-makers face is how to distribute government support to these sectors. It is not a foregone conclusion that providing such high levels of support for the financial sector relative to industries of the “real” economy, or wages, is the right choice. Neither does it follow necessarily that directing support to the existing financial institutions (as opposed to, for instance, breaking up banks) is the best way to do it.

Another negative effect of the bailouts is that, without countervailing regulation, the financial sector is becoming more concentrated and less diverse, which aggravates the TBTF problem by reducing the incentives to make bankruptcy a credible threat to insolvent firms. Over the last 15 years, the assets of the largest five financial institutions in the US have grown from 17% of GDP to 63% of GDP. The share of all banking industry assets held by the top 10 banks rose from 24% to 44% and 58% in the years 1990, 2000, and 2009, respectively.

The actions of rating agencies foster further consolidation of the sector, since they assume that the government will continue to back up big firms with public funding when the need arises. This assumption is reflected in a rating premium for big firms compared to small ones. As a result, as the number of bank failures in the US continues to rise, the average size of failing banks is falling.

The plight of the smaller banks is also exacerbated by the fact that they bear a disproportionate burden of the credit-quality problems, but due to their weak financial position, they are unlikely to attract much-needed fresh capital from investors and depositors.

In the US, the plight of small banks is intensified by a new wave of mergers and acquisitions. This phenomenon further reduces the number of firms operating in the sector.

The employment implications of bank consolidation are significant. By reducing the number of participants in the market, particularly the smaller, local and regional financial institutions that were more accustomed to “relationship lending,” levels of credit to small and medium size entrepreneurs are likely to be cut. Given the fact that such entrepreneurs are the biggest source of jobs, their reduced access to credit will exacerbate the unemployment crisis.

### **Regulatory approaches in the US and European Union and transatlantic cooperation**

The US legislation is, with qualifications, more advanced: the debate that preceded it and the adopted principles such as the empowerment of regulators to limit bank size and the restrictions on banks’ excessively risky activities bode well. Significant exceptions to those principles, though, limit their effectiveness.

Given that firms that are “too big to fail” frequently operate across borders, this is an issue where transatlantic cooperation on the remedies is particularly relevant.

### **Approaches by the United States**

In the US, the centerpiece of the Dodd-Frank Act’s approach to preventing the buildup of systemic risk is a newly-created council, the Financial Stability Oversight Council<sup>7</sup>. The purpose of the Council is to

<sup>7</sup> The Financial Stability Oversight Council (FSOC or “the Council”), is a council comprising all regulators (chaired by the US Treasury) and charged with monitoring and responding to systemic risks posed by large, complex companies, products and activities. It can decide to extend the Fed jurisdiction to individual non-bank financial companies that may pose a threat to US financial stability.

focus on identifying, monitoring and addressing systemic risks posed by large, complex financial firms as well as products and activities that spread risk across firms.

A shortcoming of this approach is that its excessive reliance on regulators to spot and give early warning of systemic risk threats may be placing too much trust in the capacity of regulators who have failed to spot or act on threats in the past. The FSOC is, after all, just a re-grouping of existing regulators. The fact that the Fed is given a predominant role in several major decisions in the Council, does not help assuage such concerns. This is the case since the Fed has lost some credibility due to ways in which it contributed to the triggering of the global crisis by the US. Additionally, it is feared that the FSOC, which must be agile in order to prevent a crisis, could be compromised by cumbersome procedures and bureaucratic hurdles.

**Caps on size.** The recent legislation shied away from other measures to curb the TBTF problem, such as imposing caps on the size of financial firms. Instead, the Financial Stability Oversight Council can order certain companies to reduce their size (for example, by terminating one or more activities) or restrict their activities. This can happen when a company either holds more than US\$50 billion in assets, or is deemed “systemically important” and represents a “grave threat to the financial stability of the United States.” The legislation also created an Office of Financial Research, inside the Council, to monitor and study threats to systemic risk and report periodically to Congress. One important function of this Office would be to provide early warnings.

**Limits to concentration.** There are some limits to concentration, also. Banks that, as a result of a merger or acquisition, would grow to hold more than 10% of the aggregate consolidated liabilities of all financial companies are barred from consummating such an operation. However, the Fed can authorize such banks to proceed with the operation when the bank acquisition would result in only a “de minimis” increase of its liabilities. An acquisition may also go through when the bank targeted for acquisition is in default or in danger of default and also receives assistance from the FDIC. It is worth noting that a federal law enacted in 1994 already restricted any bank from holding more than 10 percent of the nation’s deposits and, yet, several of the largest banks had been granted waivers from that requirement or used loopholes to evade its intent.

**Limits on proprietary trading.** The legislation also tries to prevent bailouts by reducing opportunities for firms to become too interconnected to fail by adopting the so-called “Volcker Rule”: a requirement that banks not engage in proprietary trading or invest in hedge funds or private equity funds. These provisions intend to ensure that firms cannot bet on high risk vehicles while relying on the subsidy guarantee provided for deposit-taking institutions. In this way, the possibilities that a subsidy intended to protect depositors may end up supporting high risk activities would be limited. But this requirement was adopted with significant exceptions: the banks will be able to keep hedge funds and private equity fund units in-house, they can also invest up to 3% of their capital in hedge funds and private equity funds (whether or not in-house). In addition, the banks can engage in proprietary trading to hedge their own risks or facilitate clients’ needs.

In a similar spirit, there are provisions that prohibit Federal assistance for deposit-taking institutions that engage in derivatives dealing (analyzed under Section I.3, on derivatives).

## Approaches by the EU

As is the case in the US, the European Union has relied mainly on strengthening supervision of systemic risk. The lack of an entity in charge of macro-prudential oversight at the European level was, in fact, the main justification for establishing the European Systemic Risk Board. The body is similar to the US's FSOC in the sense that its members are existing regulators – in this case, among others, the Governors of European Central Banks and the European Central Bank. But, unlike the US FSOC, serious doubts remain about the ESRB's ability to implement its decisions, even assuming it has will and capacity to act. Although the ESRB is empowered to issue warnings of systemic risk and recommend remedial actions, the actions ultimately have to be implemented by the respective national authority. In this regard, the ESRB has been invested with no binding authority. The legislation states it has been conceived "as a 'reputational' body with a high level composition that should influence the actions of policy makers and supervisors by means of its moral authority."<sup>8</sup>

In the European Union, the possibility of imposing caps on bank size has not even entered into the legislative debate so far; nor is there discussion of placing restrictions on "proprietary trading," as called for in US legislation. In the UK, the coalition government appointed a five-member commission chaired by Sir John Vickers, the former chairman of the Office of Fair Trading, which will examine the structure of the UK banking sector, and look at structural and non-structural measures to reform the banking system and promote competition. The terms of reference of the commission specifically refer to recommendations on "Structural measures to reform the banking system and promote stability and competition, including the complex issue of separating retail and investment banking functions."<sup>9</sup> The commission is expected to issue its report in September 2011 at the earliest, but it is not clear that action will follow it.

## Mechanisms for cross-border resolution of failing financial institutions

With qualifications, the US is more advanced than the EU in addressing the challenge of cross-border resolution. Its legislation establishes principles conducive to orderly resolution, but questions remain as to whether designated processes for orderly resolution will be viable in practice. Moreover, without an agreed cross-border regime, both European and US companies will be hard to unwind.

## US regulatory approach

Because of the limited progress on measures, it is becoming urgent that transatlantic partners establish a mechanism for the orderly resolution of failing companies, since such a mechanism is the thing that can protect against public bailouts in the future. Without a credible system for resolution of cross-border companies, there is little credibility to the threat that a failing company will be wound down rather than bailed out.

In this regard, the Dodd-Frank law creates an Orderly Liquidation Authority for systemically important firms. In principle, this means the Federal Deposit Insurance Corporation can safely unwind failing nonbank financial firms or bank-holding companies that are insolvent and would, subject to

8 European Commission 2009. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on "Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board." Brussels, September 23.

9 Independent Banking Commission, Terms of Reference.

normal bankruptcy rules, generate systemic risk. During liquidation, no taxpayer funds can be used and shareholders and creditors would have to take losses. Each of the companies is required to maintain and submit to the Council a plan for a "rapid and orderly resolution in the event of material financial distress or failure," which has been called, in popular parlance, a "living will."

### European regulatory approach

In 2001 the European Commission issued a Directive on Credit Institutions Reorganization and Winding-Up which introduced a "single entity regime."<sup>10</sup> The functioning of this Directive illustrates the daunting character of the task of trying to implement a cross-border resolution regime. For instance, the existence of this directive was not enough to enable orderly resolution of Fortis, a relatively small Dutch-Belgian-Luxembourg financial services company. This leaves little room to be encouraged about the chances that a large and complex institution can be successfully resolved.

In recognition of these difficulties, the European Commission is working towards a common framework for crisis management of the financial sector and, after public consultation, intends to adopt a legislative proposal for bank recovery and resolution by June 2011. The European Commission's approach presumes, as does the US's, that while bankruptcy is the regime that should be applied to failing banks, there should be special regimes for dealing with systemically important financial institutions. The regime would apply in principle to banks, but also to investment firms with "systemic relevance," a term which the European Commission is trying to define.

The European Commission's approach falls short of a common resolution authority for the European Union. While recognizing that the approach is an improvement, the commission states that cross-border resolution would be difficult "in the absence of a harmonised insolvency regime and of a Single European Supervisory authority for those entities." So the commission proposes "a coordination framework based on harmonised resolution tools."<sup>11</sup> Under this framework, the home resolution authority would lead the process of resolution and colleges of resolution authorities would be established to deal with the resolution of a cross-border institution. Some implications of this principle may make it difficult to overcome the normal disputes that ensue between states when a cross-border firm fails. First, the Commission explicitly states that the group resolution scheme would not be binding. Second, the whole point of the resolution framework may be undermined by accepting that "national authorities that disagreed with the scheme would not be prevented from taking independent action where they considered that necessary for reasons of national financial stability."<sup>12</sup>

The Commission subscribes to the principle that resolution costs should be borne in principle by shareholders and creditors, but also calls for resolution funds to be established in member states as a contingency in case some other costs are incurred, for instance, for establishing a "bridge bank." This is not very different from the US approach, where the principle of shareholder and creditor losses is adopted, but the FDIC is empowered to use public funding for the resolution, subject to certain conditions.

<sup>10</sup> Single-entity regime, also referred to as the "universal approach," is that where home country authorities apply an insolvency proceeding to a bank incorporated in their jurisdiction and all its branches in other countries. The opposite is the separate-entity, also referred to as territorial approach, to insolvency.

<sup>11</sup> European Commission 2010. Communication on Common Financial Sector Crisis Management Framework. October.

<sup>12</sup> Ibid.

The difficulties in resolving large and complex cross-border institutions reveal the need for significant transatlantic cooperation in order to ensure the credibility and viability of cross-border bank and financial companies' resolution regimes.

The difficulties arise not only with regard to harmonizing resolution regimes, but also banking – or financial – practices. For instance, it is not uncommon for a financial group to employ central liquidity management. In this case, host supervisors and creditors may quickly discover that all of the group's surplus liquidity is in another jurisdiction and available first to creditors there.

The Basel Committee on Banking Supervision has identified some of the key issues that represent an obstacle. One of them, perhaps the most important, is the probability of a government applying measures that seek to protect local interests and stakeholders. This is likely because it faces public and policy pressure to allocate financial resources in a way which reduces the burden for its own taxpayers.<sup>13</sup> The assessment of comparative burdens is more complicated because, in a cross-border crisis, there are different perceptions of the impact of failure of a cross-border institution and the willingness or ability of different authorities to bear their share.<sup>14</sup> Such assessment will also be affected by whether the jurisdiction is the home country of the financial institution or group or it is a host country, where the institution operates through a branch or subsidiary.<sup>15</sup> The assessment will also be affected, for host countries, by asset maintenance, capital or liquidity requirements that may be imposed on branches or subsidiaries.<sup>16</sup> Other measures that could contribute to limit the size of banks are more stringent capital requirements (analyzed in section II.2) and special taxes on financial companies (analyzed in section I.6).

Other measures that could contribute to limit the size of banks are more stringent capital requirements (analyzed in section II.2) and special taxes on financial companies (analyzed in Section II.6).

## I.2 Bank capital requirements

The crisis was seen as evidence of the inadequacies of the Basel II agreement – the international regime for the capitalization of financial institutions.

National regulators have traditionally set the capital requirements for the financial firms. But since the late 1970s, a regime for international cooperation in the determination of capital requirements has been established by successive agreements called "Basel Agreements." This is because the committee that developed them, Basel Committee on Banking Supervision (BCBS), is housed in the Bank for International Settlements in the city of Basel. The BCBS is a body with limited representation tasked with developing and implementing banking standards.<sup>17</sup>

Although the Basel agreement is not a treaty, the trend has been towards increasingly broader implementation of it through the adoption of domestic legislation or regulation by member countries.<sup>18</sup>

<sup>13</sup> BCBS Cross Border Bank Resolution Recommendations 2010.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> Since 2009, the BCBS has expanded its membership which now is constituted by representatives from these governments: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

<sup>18</sup> In 2006 a survey found that Basle II agreement was at some stage of introduction in 82 countries (a number that included countries in all regions of the world).



The significance of capital requirements is that they represent a bank's main buffer in the event that transactions go wrong. As the proportion of capital that a bank is required to hold rises relative to its volume of transactions, the bank becomes more constrained in undertaking such (lending or investment) transactions. In other words, one could also say that the higher the capital requirements, the less able an institution is to use leverage.

The original Basel Agreement required that banks hold a specified level of capital as a proportion of risk-weighted assets. Basel II, issued in 2004, allowed for two approaches to measure capital: the Standardized Approach and the Internal Ratings Approach. The Standardized Approach required countries to rely on external credit assessments – usually provided by credit rating agencies, whereas the Internal Ratings-Based Approach would allow banks, under certain conditions, to use their own internal risk assessment systems for the determination of the risk weight of assets.

Currently, there are fairly advanced discussions about issuing version III of the Basel agreement and several decisions have already been agreed in the BCBS as of December 2010. The most important changes to date appear in box 1.

### **Elements of Basel III**

- Common equity: the minimum capital that should be available in the form of common equity goes from 2% to 4.5% cent of risk-weighted assets.
- Capital conservation buffer: a capital conservation buffer – which is destined to absorb losses in periods of severe financial stress – is created and set at an additional 2.5%, that also has to be met with common equity, making the required minimum of common equity capital 7% of total risk-weighted assets.
- Additional countercyclical buffer: A countercyclical buffer is, subject to national conditions, also to be implemented.
- Liquidity requirements: Two main forms of liquidity requirements are established: a liquidity coverage ratio and a net stable funding ratio. The liquidity ratio is the requirement that banks keep a certain portion of cash or liquid instruments available to survive a scenario of 30 days of acute stress. The net stable funding ratio is geared to ensure that banks have sufficient stable sources of funding.
- Leverage ratio: This ratio is a supplementary ratio designed to keep a check on leverage. As opposed to the other ratios, this one is measured as a proportion (3%) of total, not risk-weighted, assets.
- Increased requirements for Systemically Important Financial Institutions (SIFIs): Stricter capital requirements apply to SIFIs.

### **Regulatory approaches**

Legislation in both the US and the European Union call for cooperation on the basis of the Basel Agreement, a framework that has significant shortcomings.

### **US regulatory approach**

In general, US legislation leaves the determination of capital requirements to regulators. This was done in the expectation that the regulator will follow, or at least rely strongly upon, the Basel III agreement once it is finalized.

## European regulatory approach

In the EU, the Capital Requirements Directive (CRD) made the Basel II mandatory for firms in the EU. The CRD was revised in 2009 and 2010 and a fourth version (CRD IV) will undoubtedly be issued to make Basel III applicable to firms operating in the EU.

## Comparison

At first glance, the fact that both the US and EU are consciously coordinating their policies around the Basel III requirements that are being negotiated on a cooperative basis simplifies matters in terms of the possibilities for transatlantic cooperation.

At the same time, the use of the Basel III framework as the basis for transatlantic cooperation raises some concerns.

**Weaknesses in the Basel III framework.** While Basel III would represent some significant changes, it should be noted that the foundations of the Basel II approach, namely, the reliance on internal risk management techniques to be implemented by the banks, themselves, remains in place. However, as former Chairman of the US Federal Reserve noted in Congressional testimony, his assumption that banks would take actions to protect their shareholders was proven wrong.

Basel III calls for banks to hold a higher proportion of common equity capital requirements – this being the most loss-absorbent form of capital, which is welcome. But critics believe that equity capital requirements should be much higher in order to prevent firms from using excessive leverage ratios.

**Problems with risk weighting.** The capital ratio (capital to risk-weighted assets) is at the core of the metrics to determine capital requirements in the Basel approach. In addition to focusing on the numerator of such ratio – and whether it is going up or improving its quality –, it is important to focus on the denominator. Regulators face many obstacles in addressing risk-weighted assets (especially if the risk-weighting is done internally by banks themselves) since they must understand, monitor and eventually challenge hard-to-understand risk management frameworks. Much more meaningful, therefore, is the leverage ratio, because its denominator is not risk-weighted assets, but total assets. However, critics contend that the current leverage ratio is too low to have an impact.

**Neglecting the risks implicit in high levels of short-term debt.** While the Basel reforms have placed a great emphasis on equity and the assets side of the balance sheet, they neglect the importance of non-deposit liabilities. As argued by Shin, the asset growth in boom times tends to have its counterpart in the growth of non-deposit liabilities, especially short-term debt.<sup>19</sup> This is because, in an environment where household wealth remains stable, retail deposits are unlikely to grow. Thus, the increase in assets can only be justified on the liability side by increasingly reliance on other (debt-based) liabilities. As assets grow and deposits in the system remain stable, liabilities can only grow through a growth of claims that different firms in the financial sector hold against each other (cross-exposure). The only aspect of the Basel reforms that has potential to address the mismatch between asset growth and short-term debt is the application of wise countercyclical requirements. But this is

<sup>19</sup> Shin, Hyun Song 2010. Macroprudential Policies Beyond Basel III. Princeton University.

an element that remains discretionary for the regulators and there is room to be skeptical about the ability of regulators to prick nascent financial bubbles.

**Effectiveness of capital requirements for SIFIs.** As mentioned above, capital requirement surcharges for SIFIs are an important measure to deter excessive risk-taking by large financial institutions. In this regard, the US legislation already contemplates that higher requirements will be in place for such institutions. What is not clear in the Basel approach is whether the level of surcharges will be high enough to prevent the distortions generated by “too big to fail” companies. In the opinion of one analyst, the expected capital surcharges for systemically important firms are unlikely to prove a sufficient incentive for reducing size or activities, and are particularly insufficient if they are not accompanied by more structural responses to “too big to fail.”<sup>20</sup> In light of the rating subsidy that such firms enjoy it would be necessary, at the very least, that they actually offset the benefits derived from such rating subsidy.

**Nature of the capital held by institutions.** Moreover, important areas of disagreement remain between the US and the EU as to the nature of the capital that will be used to meet such higher capital ratios. It is however becoming increasingly clear that if there are stricter requirements, banks will be allowed to comply with them via so-called contingent capital instruments. These are hybrid instruments that are initially issued as debt but include conditions that allow, upon determination by the regulator, the conversion of debt-holders’ stakes in a bank into loss-absorbing capital.

**Identifying SIFIs.** Should cooperation be satisfactorily reached on these points, that still leaves open the issue of which companies are to be considered systemically important and whether the US and EU will see eye to eye on that, or will have to make concessions in order to arrive at a jointly-agreed list. It is already known that the BCBS holds a draft list of 30 to 40 institutions that fit this category. This is a very small portion of globally operating institutions.

In principle, the Basel requirements apply only to banks. The US legislation empowers the regulator to also demand higher capital requirements from non-bank financial companies that are designated as systemically important. It may be problematic to develop such a list, particularly given the moral hazard implications.

Nevertheless, the issue of monitoring the capital requirements of non-bank SIFIs is an important one that, to date, has not been tackled by the European Union.

### I.3 Derivatives

Derivatives are financial assets whose value depends upon that of an underlying asset such as a commodity, a stock, a bond or a currency. This value of the underlying asset can be derived in many ways. A straightforward example is, for instance, a derivative whose price depends on the value that a stock is expected to have at a future time – a “forward.” But derivatives, such as credit default swaps, can also be linked to the probability of default on a certain bond.

Derivatives can be infinitely varied, as there is no limit to the forms that contractual parties to derivatives might decide to give to their agreement. Yet, a number of contracts have reached a certain degree of standardization such that they can be traded in regulated exchanges (although they

20 Cornford, Andrew 2010. Structural Reform of Systemically Important Financial Institutions: The FSB’s Response To Too Big To Fail (available at [http://www.networkideas.org/featart/dec2010/Andrew\\_Conford.pdf](http://www.networkideas.org/featart/dec2010/Andrew_Conford.pdf))

not always are). Other derivatives are traded Over the Counter (OTC), that is, by private agreement between the parties. The size of over-the-counter (OTC) derivatives market has increased from \$91 trillion in 1998 to some US\$605 trillion in 2008.

Derivatives represent an obstacle to the orderly resolution, without resort to taxpayer funds, of large financial companies. To the extent that the opacity and complexity of derivatives markets render the web of cross-exposures among large and complex financial institutions and the rest of the system very difficult to evaluate, they inhibit the feasibility and credibility of a bankruptcy-like remedy. This is because the collapse of a company would mean the partial or total loss of value of the derivatives held by other institutions in the system that are counterparties to the company.

During the recent crisis, for instance, derivatives markets were responsible for the threatened collapse of American Insurance Group (AIG) leading to the US government's decision to bail out the institution. American Insurance Group, then the world's biggest insurer, was found to be at risk of default on massive derivative transactions that had gone wrong. Since many of these transactions were insuring risk in Collateralized Debt Obligations<sup>21</sup> and pools of risky assets (that deteriorated during the crisis and were widespread throughout the system), the possibility of default on those contracts was deemed as carrying catastrophic consequences. So the government decided to err on the safe side and bail out the company. In a highly interconnected and opaque environment, the mere expectation that a large company might default can trigger broad-based loss of confidence and, in turn, a collapse, given the inability of investors to understand how the counterparties to their derivatives might be affected. Such opacity amplifies the impacts of the failure of a firm, as was the case with the failure of Lehman Brothers. Once a financial crisis is underway, contagion is fueled by the existence of pools of derivatives. The largest companies and those with highest volume of OTC derivatives trading closely overlaps, as over 80% of derivatives are controlled by JPM Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley.<sup>22</sup>

OTC derivatives also allow for excessive risk-taking via under-collateralized transactions. Because these transactions happen bilaterally, rather than in exchanges, traders can post less collateral and set lower margins than they would be required to otherwise. Recent estimates put the percentage of bilateral derivatives without collateral at nearly 23%. It is not known how much collateral is posted for the remainder of bilateral transactions.<sup>23</sup>

From the above, it can be seen that regulating derivatives is crucial to stabilize the financial system. It is also necessary to stem the speculation that has driven up the prices of food and energy commodities. Several independent analysts believe that since US commodity futures markets were deregulated (after the enactment of the Commodity Futures Modernization Act in 2000), speculators are able to drive up the price of these commodities. This legislation, as described by Gosh, "effectively deregulated commodity trading in the United States, by exempting over-the-counter (OTC) commodity trading (outside of regulated exchanges) from oversight by the Commodity Future Trading Commission (CFTC). Soon after this, several unregulated commodity exchanges opened. These allowed

21 Collateralized Debt Obligation is a pool of assets and/or mortgage backed securities with loans, bonds or other financial assets as the underlying.

22 DEMOS 2010, Biggest Banks, Riskier Banks.

23 Estimate by ISDA, quoted in Wellink, Nout 2010.

any and all investors, including hedge funds, pension funds and investment banks, to trade commodity futures contracts without any position limits, disclosure requirements, or regulatory oversight.”

One type of derivatives, credit default swaps, was blamed for exacerbating the Greek debt crisis in early 2010 and then the Irish crisis. These instruments are the source of still undetermined risks in the debts of a number of US municipalities and national governments with large sovereign debt burdens, such as Italy.

### **Regulatory approaches**

The US is more advanced than the EU because its legislation mandates transparency and safeguards in a large portion of derivatives transactions. The EU seems on track to follow, based on recent proposals for Regulation of OTC Derivatives and reform of the Markets on Financial Instruments Directive.

### **US regulatory approach**

In the US legislation, the main provisions related to derivatives are geared toward ensuring that most of these instruments are centrally cleared and publicly traded in regulated exchanges. Derivatives that cannot be centrally cleared and publicly traded will still need to be reported in “real time” and will need higher collateral than cleared ones. Derivative transactions where one of the parties is an end-user<sup>24</sup> are exempted from the clearing and public trading requirements. The legislation also empowers the US Treasury to decide whether foreign exchange swaps and forwards should be exempted from the clearing requirements and public trading requirements.

The legislation mandates position limits by market and by commodity for all traders. This is important since large traders, such as index funds, take large positions that frequently drive up the price of a commodity.

### **EU regulatory approach**

In the EU, the legislative process is ongoing through several separate but related tracks. In September 2010, the European Commission adopted a legislative proposal on the Regulation on OTC Derivatives, which contains broadly similar requirements for derivatives clearing as the US legislation.

However, the trading venue for derivatives is addressed in a separate piece of legislation, the Markets in Financial Instruments Directive, which is currently under review. It is likely that, in order to detect market abuse, the Directive will require the development of transaction reporting requirements for clearly specified OTC derivatives in conjunction with the clearing houses (called Central Counter Parties or CCPs in the European proposal – and trade repositories (entities that would operate as data warehouses for collecting information on trades).

It is also relevant to mention the Directive on Market Abuse, which is intended to prevent manipulative market behaviors. After a consultation period last year, the European Commission is preparing proposals for reform of this directive as well.

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<sup>24</sup> The “end-user” is a non-financial entity that uses the derivative to hedge real risks (according to the US legislation: “commercial risks”), such as would be the case of a transport company hedging the price of gasoline, or a furniture manufacturer hedging the price of oak wood.

## Comparison

**Clearing.** There are very positive aspects of the US law that are being replicated in the EU legislation on OTC Derivatives: By bringing more derivatives into central clearing, traders will need to post margin and collateral for them, reducing the overall leverage built in the system. The heightened transparency has the added benefit of allowing regulators to spot risks more easily. Collateral to back the transactions has to be monitored on a frequent basis – daily, in some cases. This is not necessarily done when the transactions are conducted outside of a clearinghouse.

Forcing OTC derivatives onto public exchanges also facilitates price competition and makes trading less profitable for bank dealers. It also enables regulators to improve their oversight, watch risks building up in the system, and prevent – or prosecute – fraud.

**Position limits.** The purpose of position limits for traders is to make speculation more difficult and to increase its costs. Position limits curb the ability of speculators to post contracts for the pure purpose of betting or getting exposure to the underlying commodity. The margin requirement is a percentage that traders have to post as collateral in their account for the derivative transactions they are conducting. The higher the margin requirements, the harder it is to maintain a position in a contract open.

Legislative provisions in both US and EU can be significantly eroded by regulators. In fact, the impact of the legislation to improve transparency and diminish risks generated by derivatives could, if regulators make the wrong decisions, be close to nil.

Regulators in both the EU and US have tremendous latitude for action which, if misused, can undercut the purpose of legislation.

**Clearing for end-users.** Probably the most important is the exception to the clearing for so-called end-users (in the European version called “non-financial counterparties”). On the one hand, it is important that end-users are not harmed by burdensome regulatory requirements. But, as the EC warned in its proposal for legislation on Derivatives, there is a risk that non-financial counterparties take systemically important positions in OTC derivatives. Also, a financial counterparty could easily circumvent the obligations set out in the Regulation by establishing a new non-financial entity and directing its OTC derivative business through it.<sup>25</sup> It is easy to see how if the regulators define “commercial risk”<sup>26</sup> in too broad terms, the purposes of the legislation could be thwarted by allowing exceptions for the very riskiest types of derivatives. For instance, a letter addressed to the CFTC by the Commodity Markets Oversight Coalition states:

*“Commercial risk” should not include risk that is purely financial in nature, including balance sheet risk. We reject the assertion that “commercial risk” is essentially any business-related risk other than risk associated with the movement of physical commodity prices. Such an interpretation would imply that the risk management needs of purely financial market participants are “commercial” in nature.”<sup>27</sup>*

25 European Commission 2010. Proposal for a Regulation of the European Parliament and of The Council on OTC derivatives, central counterparties and trade repositories, p.7.

26 See footnote 22 for an explanation on “commercial risk.”

27 Commodity Markets Oversight Coalition 2010. Letter to Commodity Futures Trading Commission. November 1.

**Collateral, margins and position limits.** Regulators must make effective determinations on these limits to discourage high-risk behaviors of speculators. What matters is whether the position limits will be significant – e.g., the regulator can set them at such a high level that they allow the continuation of “business as usual” for most or all traders. For instance, position limits could be set so high that they become irrelevant to the behavior of speculators. Margins could be set so low that they are irrelevant to attempts to limit position-taking for solely speculative purposes.

**Governance of clearinghouses.** Another area where regulators can undermine the intended purposes of the legislation relates to the regime for governing clearinghouses. In the US legislation, regulators are required to pass limits to the voting and ownership rights of dealers in the clearinghouses and exchanges. If regulators fail to generate sufficiently stringent caps, a few banks or dealers could collude to own a clearinghouse, thereby maintaining the kind of dominance over the derivatives transactions business that they enjoyed before the crisis.

### **Restrictions on derivative trading by publicly-insured institutions**

The US is more advanced than the EU, but with significant qualifications.

#### **US regulatory approach**

In one provision of the US legislation, deposit-taking institutions are required to spin off their derivative trading operations, though this rule is subject to a number of exceptions. The provision effectively requires most derivatives activities to be conducted outside of banks and bank-holding companies. The exceptions are for derivatives “involving rates or reference assets that are permissible for investment by a national bank” under the relevant legislation. This allows derivatives based on interest and exchange rates, gold and silver. In a separate provision, the law also allows trading of cleared, investment grade Credit Default Swaps (CDSs). Finally, trading is allowed through hedging that is directly related to the firms’ own activities.

#### **European regulatory approach**

The European legislation does not have provisions related to the spin-off of derivatives trading from publicly insured institutions. This omission would certainly represent a difficulty for unwinding systemically important institutions that fail in Europe. It could also diminish the transparency needed for an orderly wind down of companies also in the US, to the extent that derivatives might hide cross-exposure with affiliates of US-based financial firms.

#### **Systemic risk from trading concentration in clearing-houses**

The US and EU have similar shortcoming in their approaches to this issue. By obliging institutions to clear derivatives trades, regulators protect against some risks that were, otherwise, borne by dealers and that contribute to uncertainty in a crisis situation. Whereas dealers would have carried out bilateral transactions with doubtful or limited collateral and complex cross-exposures to other dealers, clearing processes guarantee that cross-exposures will be recorded, netted out on a multilateral basis, and will count, to absorb losses, with the benefit of posted margins and clearing funds.

But it is worth noting that such an obligation also means concentrating the risks in the clearinghouses. In the US legislation, clearinghouses are among the “financial market utilities” that the FSOC could declare of systemic importance. This declaration, in turn, would enable the clearing institutions in question to access extraordinary discount and borrower facilities, as well as reserve requirements exceptions. As a result, the possibility that publicly-funded bailouts may be needed to support derivatives bets gone awry is not totally precluded. In the European Union, no similar provision exists so far, but it is arguable the clearing houses would have to be bailed out in a crisis situation, nonetheless.

EU legislative deliberations are considering banning of certain derivatives, so is on track to be ahead of the US legislation on this point.

It is also important to keep in mind that clearinghouses are not a silver bullet. There are certain types of derivative markets in which a few traders hold large positions and, in such markets, the clearinghouses might not be able to effectively mitigate counterparty risk.<sup>28</sup>

Therefore, it is important to ban certain types of derivatives transactions when they are deemed too risky. The European Union has made some movement towards banning dangerous derivatives, such as CDSs and naked short-selling, whereas no such determination has been made in the US.

#### I.4 Hedge funds, private equity funds

Hedge funds can be defined as “private pools of funds that invest in traded instruments (both cash securities and derivatives).” In a simpler definition, hedge funds are funds established for the purpose of investing the money of their participating partners. Because hedge funds specialize in pursuing highly sophisticated, high-risk investment strategies to achieve above average returns, they are usually engaged in highly leveraged bets (e.g., the use of “short” positions) that could carry risks for the entire system. They also invest in companies which they subsequently restructure and sell for a profit. In general, they are not regulated.

While the lines between hedge funds and private equity funds are blurred, and the lack of exact definitions does not help distinguish them, one could say that private equity funds are also pools of funds that generally invest in private – that is, closely-held – companies. In theory, access to hedge funds was supposed to be limited to high net worth individuals, which also ensured that average consumers were not exposed to the risk. However, over time, retail investors’ access to the funds has increased. Ominously, governments have also increasingly been investing their pension programs money in hedge funds. For example, in 2004, the Securities and Exchanges Commission reported that about 20% of US corporate and public pension plans were using hedge funds in 2002, up from 15% in 2001, and the trend was rising. In the last few years, public pension funds are among the entities that, have sharply increased the amount of money invested in hedge funds in an effort to boost their returns and diversify their holdings.

European hedge funds have been more accessible to investors of modest means than US funds. In France, hedge funds could be accessed by individuals with a minimum amount of €10,000 and, in Germany, investors could buy into hedge funds managed by Deutsche Bank in units of less than

<sup>28</sup> Wellink, Nout 2010. Mitigating Systemic Risk in OTC Derivatives Markets, in Banque de France, Financial Stability Review, No. 14, Derivatives – Financial innovation and stability, July. Schlegelmilch/Bunse 2008.



€125. The European Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) tightly regulated a number of funds that were widely used by retail investors.<sup>29</sup> But these instruments, with more recent changes to the law, have allowed the funds to go into riskier activities. Reportedly, hedge funds are also repackaging their products and offering them to retail investors in ways that are consistent with the UCITS and, thus, can be offered to retail investors.

Some argue that the 2008-09 crisis had nothing to do with hedge funds, demonstrating that fears about these instruments are ill-placed. In fact, many hedge funds closed during the crisis without drawing on public monies. However, recent data released by the Fed has shown that hedge funds were among the beneficiaries of Fed emergency bailout programs, effectively meaning that taxpayers supported profits in these supposedly high risk-high return vehicles for wealthy investors. Hedge funds contributed to the crisis in additional ways (see section I.4). They had significant linkages to banks and other financial firms' whose excessive risk-taking they made possible by taking the counterparty positions in risky transactions – hedge funds were also in many cases housed or owned by banks and other companies.

### **Regulatory approaches**

The US is more advanced than the EU because its legislation applies to more hedge funds and demands enhanced transparency from them.

The US law introduces requirements that managers of hedge funds and private equity funds must register with the SEC. The legislation has also empowered the SEC to require reporting and filing requirements for hedge funds and even conduct on-site inspections of their records. The requirement will enhance disclosure and transparency in ways that will help the FSOC assess threats to systemic risk. While funds with less than US\$150 million under management can be exempted from the registration, the SEC is still empowered to demand that they file information deemed necessary for the protection of the public interest. As previously mentioned, in Europe, there is a Directive on UCITS that regulates funds to which retail investors have access. The funds covered by the UCITS Directive have, to some extent, served as a vehicle for hedge funds.

The recently-passed Alternative Investment Fund Managers' Directive imposes disclosure and capital requirements on managers of some hedge funds. These requirements only pertain to managers of hedge funds that are not covered by the UCITS, as long as their assets are more than €100 million.

In general terms, the EU legislation provides less coverage of these vehicles than the US legislation, since it excludes from regulation funds under the threshold for assets under management (whereas in the US the regulator is empowered to require disclosure of information).

### **Leverage Limits**

The EU is more advanced than the US with regard to setting limits on leverage.

The EU Directive empowers the Commission to set leverage limits whereas, in principle, US law does not. But if a US hedge fund is designated as "systemically important," then the monitoring of leverage as well as other aspects of the financial structure that pose risks could fall under the

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<sup>29</sup> This support was provided to some hedge funds through the Term Asset-Backed Securities Loan Facility (TALF).

jurisdiction of the FSOC. As elaborated upon in section I.1, though, such actions by the FSOC are cumbersome and unlikely to be taken frequently.

### **Marketing to retail investors**

Legislation in both US and EU is highly unsatisfactory because it permits firms to market risky, complex funds to retail investors.

### **European regulatory approach**

The EU's Alternative Investment Fund Managers Directive does not give firms the right to market hedge funds and private equity funds to retail investors. However, it also states that different member States may add their own requirements thus making the funds marketable to retail investors. Therefore, under this framework, it is possible that countries may issue requirements that obviate the UCIT's rules.

### **US regulatory approach**

US law fails to prevent firms from marketing to retail investors. The Dodd Frank Act only calls for a study to analyze "the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds."

### **Restricting use of tax avoidance and evasion strategies**

The EU legislation is more advanced in the sense that it demands some standards on exchange of information.

### **European approach**

To some extent, the use of dubious tax strategies by hedge funds is addressed in the EU legislation, which prohibits funds which are domiciled in third countries from marketing shares unless such third countries comply with standards in the OECD Model Tax Convention<sup>30</sup>. The purpose of this provision is to ensure that national tax authorities obtain all necessary information from the tax authorities of the third country in order to tax domestic professional investors investing in offshore funds. But the reliance by EU-based hedge funds on offshore tax havens is not addressed, nor is it clear that the information provided under OECD Model Tax Convention will enable tax authorities to tackle this practice.

### **US approach**

The US law does not even the reference to the OECD Tax Convention. But, US-based funds trying to market their products in Europe will have to comply with this requirement.

## **I.5 Credit rating agencies**

Institutional investors (such as pension funds, mutual funds) and banks relied on credit rating agencies (CRAs) for the assessment of risk of assets in their portfolios. As a result, the risks of financial products

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<sup>30</sup> The standards concern Art. 26 of the said convention regarding exchange of information.

such as Mortgage-Backed Securities and Collateralized Debt Obligations – were grossly underestimated. Importantly, without the blessing of such ratings, there would have been no market for many of the toxic products that were at the heart of the financial crisis.

In many cases, the reliance on assessments by CRAs was due to legally-mandated requirements. In other words, the law would prescribe that certain funds could only invest in securities that were rated as Triple A. Ratings are also critical when banks assess the risks of their assets in relation to the Basel II agreement on capital requirements. Hence, although banks in the US were using the Internal Ratings Based approach of Basel II<sup>31</sup>, resort to ratings was the only option available for rating structured finance products, such as Collateralized Debt Obligations (CDOs)

Credit Rating Agencies employ the “issuer pays” business model. That is, the company issuing securities pays the agency examining them. Hence, the CRAs have a fundamental conflict of interest. Reforms should prevent companies from shopping around to find the CRA that would offer them the most favorable rating. To date, CRAs access to business was actually dependent on their ability to keep clients happy by providing high ratings for their products.

### **Regulatory approaches**

US legislation is more advanced in regulating conflicts of interest and imposing liability standards. EU legislation may catch up and, possibly, surpass US standards. Substantial deficits in reforms remain in both US and EU.

### **US regulatory approach**

The US law granted new powers to the SEC to monitor and supervise CRAs. It also established a number of procedural safeguards that CRAs must adopt regarding:

- disclosure of information (both to the SEC and to investors) about rating methodologies,
- required elements of the methodologies, themselves,
- disclosure of the performance of methodologies,
- assumptions built into ratings,
- due diligence,
- governance requirements (e.g. that a certain number of Board members should not have an interest in credit ratings being assessed), etc.

Many of the measures the legislation takes are, in fact, broadly similar to requirements contemplated in the European Union 2009 Directive (described below).

The most dramatic measures, however, represent a higher standard than provided for by the European Union. One such measure removes requirements for CRA ratings from legal instruments. For instance, this means that where certain funds were required to invest in Triple A-rated instruments they will now have to have other safeguards that do not refer to ratings.

The second measure strengthens the liability borne by CRAs for their assessments. The law states that CRAs can be sued for failing to:

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<sup>31</sup> Under Basel II, banks can choose either a Standardized Approach or an Internal Ratings-Based approach to measure the capital requirements. The former relies on “external credit assessment institutions” – these can be either Credit Rating Agencies or export credit agencies. The latter relies on banks’ own internal models to assess risk, so in principle would not require reliance on credit rating agencies.

*“(i) conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) obtain reasonable verification of such factual elements... from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.”*

Finally, the Act calls for a study on how to avoid conflicts of interest generated by the “issuer pays” model. In two years, rules should be issued on how to ensure that the issuer, sponsor, or underwriter of a structured financial product does not exhibit bias in selecting a CRA to determine the initial credit ratings of such products. It also requests a study on mechanisms for compensating CRAs in ways that provide an incentive for them to provide more accurate credit ratings. This study should be completed within 18 months.

### **European regulatory approach**

In 2008, the European Commission had already started to reform the regulation of CRAs. Therefore, by mid-2009, it was able to issue a new Directive. The Directive aimed at increasing oversight of CRAs operating in EU jurisdictions by requiring the agencies to submit to EU registration and supervision processes. The regulation covered conflicts of interest, rating analysts, methodologies, disclosure and presentation of credit ratings, transparency, and registration requirements.

However, further changes are now being debated with the goal of approving additional reforms in 2011. Ongoing consultations introduce the possibility of adopting additional reforms, including those imposed by the US – namely, reducing reliance on CRA ratings, changing the “issuer-pays” model, and strengthening the standard of liability for CRAs in the US legislation.

In the current review, the EU is considering two additional measures which would represent advances over the US law. One measure would require CRAs to “enhance the transparency and monitoring of sovereign debt ratings.” These could include, for instance, that when CRAs are rating a country’s creditworthiness, they must inform the country of the rating at least three working days before it is published. When they inform a country, the CRA must provide information on the grounds on which the rating is based and make the relevant research available free of charge. A second measure would require increased competition in the credit rating business.

### **I.6 Financial sector taxation**

As a consequence of the crisis, new attention has been paid to proposals to tax the financial sector both in the US and in Europe.

Taxation is one of the ways that the size of “too big to fail” firms could be reduced and it is also a way to reduce or limit excessive risk-taking. In addition, the taxes on the financial sector have been advocated for revenue-raising goals (raising revenue for national and global public goods) and to ensure a fairer distribution of the burden of bailouts between public and private sectors.

## Regulatory approaches

The EU is on course to implement different forms of financial sector taxes. Some individual European states have already implemented such taxes or are preparing to do so. The European Parliament has voted in favor of a Financial Transaction Tax (a non-binding vote) and the Commission is considering its adoption.

### US regulatory approach

In the US, important measures were dropped from both the House and Senate versions of the Dodd-Frank legislation, which would have protected taxpayers from paying for future bailouts. The House version would have required the financial sector to create a fund to underwrite any future bailout. Contributions of US\$150 billion would be required by banks with more than US\$50 billion in assets and hedge funds with more than US\$10 billion in assets. The Senate version contained a similar measure, but envisioned a fund of US\$50 billion to be paid by entities with more than US\$50 billion in assets, and in proportion to the potential benefit they stood to derive from the fund.

Another measure was dropped that would have required banks to pay fees to finance implementation of the law at a cost of US\$19 billion.

The law retained the requirements which prohibit the use of taxpayer funds for resolution and, if this requirement is breached, the financial institutions are directed to reimburse the public budget for any expense incurred.

It should be noted that the taxes were not intended to be a mechanism for reducing the size of the financial sector, but rather one for compensating taxpayers for the losses in previous bailouts or preventing speculative activity. Only the bank levy proposed by President Obama<sup>32</sup> had some anti-speculative elements insofar as the basis for collecting the tax would be the non-insured debt liabilities of the companies.<sup>33</sup>

### EU regulatory approach

In the EU, more progress has been made towards introducing a number of special taxes on the banking sector, though the scope, extent, and purposes of the measures are rather diverse across countries. In a Resolution of June 2010 the European Council stated:

*"Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk."*<sup>34</sup>

It also agreed that:

*"The EU should lead efforts to set a global approach for introducing systems for levies*

<sup>32</sup> President Obama's proposed "Financial Crisis Responsibility Fee" was for a levy to be assessed on the institutions' covered liabilities – their assets – minus tier one capital and federally insured deposits. The levy would have affected lenders with more than US\$50 billion in assets.

<sup>33</sup> A number of proposals targeting financial transactions for special taxes were introduced throughout the year, but not attached to the Dodd-Frank bill. Some examples are the "Let Wall Street Pay for Wall Street's Bailout Act of 2009" introduced by House Representative DeFazio and the "Investing in Our Future Act of 2010," introduced by House Representative Stark.

<sup>34</sup> European Council. Resolution of June 17, 2010.

*and taxes on financial institutions with a view to maintaining a world-wide level playing field and will strongly defend this position with its G20 partners. The introduction of a global financial transaction tax should be explored and developed further in that context.*<sup>35</sup>

It is reported that, in implementing the European Council agreement, European states have already taxed the balance sheet or the risk-weighted assets of institutions as incentives to minimize risky activities.<sup>36</sup>

In conclusion, the imposition of financial sector taxes has been very uneven among countries and prospects for multilateral adoption of such taxes are dim, with the possible exception of multilateral adoption at EU level. However, one interesting finding that emerges from the post-crisis debate is that, on this particular issue, multilateral coordination may not be as important as claimed. European taxes on financial institutions have not provoked the catastrophic migration of financial sector activity that some forecast. This is not to say that such migration of activity would necessarily be negative – in fact, defenders of the tax have long argued that having the most risky financial behaviors migrate away from a jurisdiction is a positive and intended, not a negative, consequence of the taxes.

Moreover, the review of experience showed how many countries already had special taxes on financial transactions, or on financial institutions, without adverse effects. Paradigmatic of this, in a report last year the IMF asserted:

*"Unilateral STTs<sup>37</sup>, even if levied on fairly narrow bases, are certainly feasible as witnessed by their use in numerous developed countries. The fact that major financial centers such as the U.K., Switzerland, Hong Kong, Singapore, and South Africa levy forms of STTs indicates that such taxes do not automatically drive out financial activity to an unacceptable extent. Indeed, given the apparent agglomeration effects in financial activity, established financial centers may face a less elastic base than peripheral countries. Other factors than taxes, including regulatory regimes, legal institutions, and clientele location, also impact the cost of transacting in a particular financial center."*<sup>38</sup>

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<sup>35</sup> Ibid.

<sup>36</sup> Financial Times Reporters 2011. European States Brace for Tax Backlash. January 11.

<sup>37</sup> The IMF paper adopts the nomenclature of referring to Securities Transaction Taxes (STTs), or taxes on trades of securities.

<sup>38</sup> IMF 2010. Financial Sector Taxation: The IMF Report to the G20. Background Material, p. 176. It is worth noting that, nonetheless, the IMF advises the collaboration in imposing STTs because of challenges from cross-border integration. Nonetheless, since increasing cross-border integration of financial markets may otherwise increase the elasticity of the tax base or worsen revenue collection.

## II. THREATS TO PROGRESS ON FINANCIAL REGULATION

Two areas are generally downplayed or ignored in the debate on financial regulation despite the fact that they could undo the best regulations of the financial sector. These areas are “shadow banking” and financial services liberalization.

### II.1 Regulating “shadow banking”

The “shadow banking” system is that part of the financial system which, while operating in a bank-like manner, that is, intermediating funds between savers/ investors and borrowers, escapes most or all of regulation. What characterizes the shadow banking system is that it transforms funds, such as those of investment banks (short term and confidence-sensitive) into assets that are similar to those of commercial banks, that is, long-term, illiquid consumer and commercial credit. Companies that qualify as part of the shadow banking system include investment banks, finance companies, money market funds, some hedge funds, and special purpose entities and conduits, among other vehicles.

In theory, the shadow banking system is not supposed to be publicly-insured as are banks that take deposits and provide credit. However, in the recent crisis, the web of connections between banks and shadow banks rendered it impossible to distinguish insured from uninsured losses. Recently, the IMF estimated the volume of funds in the shadow banking system at US\$25 trillion, as compared to US\$30 trillion in the regulated financial system.<sup>39</sup> any investment banks engaged in shadow banking – Goldman Sachs, Morgan Stanley, Merrill, Bear Sterns. Among the finance companies, GE Capital, GMAC, CIT, AMEX, Discover. All benefited from government bailouts.<sup>40</sup>

The analysis of the interconnections among banks and shadow banks reveals interesting connections to offshore centers. Although the analysis is hampered by data limitations, the IMF states

*“the rise of offshore financial centers gives the impression of a seemingly dispersed or decentralized global financial architecture with many centers. But the analysis of holdings and cross-border exposures in the funds data reveals a core group of centers or nodes, such as the United States, United Kingdom, Luxembourg, and France, around which the offshore centers are clusters and to which they channel funds sourced globally.”<sup>41</sup>*

The recent US financial reform has been very lenient in its treatment of the shadow banking system. This paper has mainly addressed the issue by underscoring the unsatisfactory regulation of hedge funds.

Some of the vehicles operating in the shadow banking sector were Industrial Loan Companies, thrifts and credit card companies. These companies were deposit-insured entities and, in principle, companies owning them should have submitted to the stricter capital requirements of bank-holding

<sup>39</sup> IMF 2010. Understanding Financial Interconnectedness. Powerpoint presentation delivered at Twenty-Third Meeting of the IMF Committee on Balance of Payments Statistics. Washington, DC October 25-27, 2010.

<sup>40</sup> Drawing upon Konczal and Date 2010.

<sup>41</sup> IMF 2010.

companies. But, because of an exception introduced in 1987, non-bank holding companies were exempted from such requirements. This created an opportunity for arbitrage. Investment banks were allowed to operate with the taxpayers' safety net provided by FDIC, but without submitting to the stricter regulation on capital and type of activities to which banks were subject. The Industrial Loan Companies exception was key to the high levels of leverage that characterized several of these companies at the time of the crisis.

Thirty percent of all U.S. taxpayer support under the Troubled Asset Relief Program has been directed to parent companies of Utah's Industrial Loan Companies.<sup>42</sup> Specifically, because of this legal exception, eight out of the 12 corporate parents of the largest Utah-chartered industrial loan companies either received substantial taxpayer support during 2008 and 2009 or failed.

In the US Administration's initial financial reform bill submitted to Congress, it proposed abolishing the exception for these companies, stating that:

*"By escaping the [Bank Holding Company] Act, these firms generally were able to evade effective, consolidated supervision and the long-standing federal policy of separating banking from commerce... These firms were able to build up excessive balance-sheet leverage and to take off-balance sheet risks with insufficient capital buffers because of the limited consolidated supervision and weaker or non-existent consolidated capital requirements at the holding company level. Their complex structures made them hard to supervise. Some of the very largest of these firms failed during the current crisis or avoided failure during the crisis only as a result of receiving extraordinary government support."*<sup>43</sup>

The final legislation, however, failed to dismantle the exception and settled for a study (due within 18 months of enactment) to determine whether dismantling the exception is necessary in order to guarantee safety and soundness of the institutions and the stability of the financial system.

It is also worth highlighting the treatment of re-securitization. Securitization is the process of pooling together assets, such as mortgages or loans, into a vehicle that issues securities. Holders of such securities will receive a share of the financial flows from the underlying package of assets. The re-securitization process entails the pooling together of securities into new vehicles that will, in turn, issue new securities. The US legislation forces originating institutions to retain 5% of the originated assets, as a way to ensure they maintain an incentive to exercise due diligence in issuing such assets. But 95% of originated loans are still susceptible to transfer through securitization and re-securitizations. The entities on the receiving end of those transfers are the institutions that are part of the shadow banking system, so the role of unregulated entities such as Special Purpose Vehicles and conduits that were absorbing such risks remains crucial. If legislative efforts are curtailing the activities in the shadow banking system in a limited way, if at all.

42 Cambridge Winter 2009. Industrial Loan Companies and Shadow Banking. Research Note. Center for Financial Institutions Policy. August. Utah-based ILC parents included Morgan Stanley, Merrill Lynch, Goldman Sachs, Lehman Brothers.

43 US Department of the Treasury 2009. Financial Regulatory Reform: A New Foundation. Rebuilding Financial Supervision and Regulation, p. 33-34.



## II.2 Financial services liberalization in the context of trade and investment agreements

Regulatory changes are being made in the absence of any consideration of whether commitments undertaken in the context of trade and investment agreements will uphold, or undermine, such changes. Discussions of financial regulation take place in an entirely separate sphere from the negotiations of the Financial Services Agreement of the WTO's General Agreement on Trade in Services (GATS) or regional and bilateral trade and investment agreements. These agreements establish a legal framework and basis for challenging certain financial regulations.

Agreements to liberalize trade in financial services are basically a catalogue of restrictions on the state's legal and regulatory autonomy. Such disciplines and restrictions are enforceable through supra-national dispute settlement bodies. These restrictions may pre-empt regulatory measures to:

- Limit size or total number of financial service suppliers in certain sectors
- Ban risky financial services
- Ban financial products deemed risky by consumer or public interest agencies

Importantly, under GATS, members commit to ensure that regulations are "not more burdensome than necessary to ensure the quality of the service" and are "objective," "reasonable," and "relevant." Should one country's regulatory measure be challenged by another country, the WTO's Dispute Settlement Panel would make a ruling on whether the measure is allowable.

Many bilateral and regional Free Trade Agreements place more restrictions on state regulatory actions than the GATS.

Several economic analysts – from a broad political spectrum have criticized the inclusion of financial disciplines in trade agreements. Notably, the UN Commission of Experts on the Reform of the International Monetary and Financial System, chaired by economic Nobel Prize-winner Joseph Stiglitz, stated:

*"The framework for financial market liberalization under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors."<sup>44</sup>*

A prominent supporter of free trade, Professor Jagdish Bagwati, has questioned the inclusion in trade agreements of prohibitions on the use of capital controls by member countries in order to control financial booms and busts.<sup>45</sup>

In the case of GATS, there is a provision that seems to allow countries to implement prudential regulations. Article 2(a) of the Annex on Financial Services states that:

44 United Nations 2009. Report of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System. New York. September, p. 82.

45 Bhagwati, Jagdish 2003. Testimony Before Subcommittee on Domestic and International Monetary Policy, Trade and Technology. US House of Representatives. Committee on Financial Services. April 1.

*“Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system.”*

Unfortunately, the meaning of the above statement is negated by a subsequent provision:

*“Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement”*

This renders the protection for prudential regulation self-cancelling or, at the very least, ambiguous enough to invite challenges through litigation. Moreover, the meaning of “prudential” is limited to financial prudence, so should a government need to establish regulations to protect other important public interest values, such as food security or environment, the protection may not hold.<sup>46</sup>

It is worth noting that disciplines on “trade in services” have evolved in times when policy-making was underpinned by a conviction that capital markets are capable of effective self-regulation. Although the financial crisis has demonstrated the fallacy of this belief, the premises and models used to negotiate such agreements, as well as the rules embedded in existing ones, have not changed accordingly.

Analysis should be undertaken to identify whether or how regulatory actions relative to each of the key above-listed issues could conflict with commitments in trade and investment agreements. Without such analysis, conflicts will lay dormant until a government or firm issues a challenge to one or more financial regulations. In the meantime, there should be no mistaking the fact that regulations are not “safe” as long as the potential for a legal challenge exists. For instance, disciplines in the WTO Financial Services Agreement could undercut certain tax on the financial sector. In reference to the currency transaction levies, a staff paper of the European Commission stated:

*“the compatibility of such a levy with Article XI of the General Agreement on Trade in Services (GATS), which provides that WTO Members cannot apply any restrictions on international transfer and payments for current transactions relating to their specific commitments, would have to be further assessed. As the EU has taken specific commitments relating to financial transactions, including lending, deposits, securities and derivatives trading and these commitments relate to transactions with third countries, a currency transactions tax could constitute a breach of the EU’s GATS obligations.”<sup>47</sup>*

<sup>46</sup> While the idea of invoking food security reasons to establish prudential regulations may seem, at first sight, far-fetched, it is actually not so considering the trends towards “financialization,” that is, increased role of financial instruments or derivatives of them on a number of real economy exchanges. In 2008, for instance, reports indicated that India banned certain commodity derivatives over concern that they were being used to drive up the prices of essential food staples. (See Leahy, Joe 2008. India extends futures ban in drive to contain prices. In Financial Times. May 9).

Two other examples of potential conflicts follow:

One or more governments may address the “too big to fail” problem by establishing a system for the orderly resolution of cross-border systemically significant companies in the event of a crisis. But for such a system to work across borders, governments will likely require SIFIs to meet certain criteria before granting them a license to operate in their territory. However, requiring SIFIs to meet certain criteria as preconditions for licensing could violate several of the existing trade agreements on financial services.

If a government bans specific derivatives deemed unsafe or too risky, it could be challenged for imposing a “market restriction.” Or, pro-consumer regulations may be challenged if such regulations are not “least trade restrictive.”

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47 European Commission Innovative Financing at a Global Level 2010. Commission Staff Working Paper. April 1, p. 27.

### III. INSTITUTIONAL VENUES FOR TRANSATLANTIC COOPERATION

Some venues and forums exist to advance transatlantic cooperation on these issues.

The Group of 20 (G20) is an informal body that brings together members of the Group of 8 (G8) plus 12 more countries, including 9 of them that are “emerging market” economies. With leadership from the US and Canadian Finance Ministers, the group was created in 1999 in response to the 1997 East Asian financial crisis in order to “ensure broader participation in discussions on international financial affairs among countries whose size or strategic importance gives them a particularly crucial role in the global economy.” G20 Finance Ministers met regularly until November 2008 at which point the G20 Heads of State began meeting. At the 2009 Summit in Pittsburgh, Heads of State declared the G20 to be “the premier forum for our international economic cooperation.” The G20 invites non-member countries to attend – namely those representing the AU (Equatorial Guinea), NEPAD (Ethiopia), ASEAN, the Gulf Coordinating Council, the Global Governance Group (3G), the Gulf Coordinating Council and Spain.

The International Monetary Fund, the Financial Stability Board and the Bank of International Settlements, including its Basel Committees, are other institutions that provide a venue for transatlantic cooperation. Since the 2008 Summit outlined a large agenda for post-crisis reforms, these groups have acquired a more important role as they operate as research bodies and lead the intellectual work required to implement the mandates on financial reform entrusted to them by the G20.

Transatlantic talks are also held with certain frequency. Various US officials (high-level officials from the Administration and Federal Reserve) talk to equivalent officials from the European Commission, Council of Ministers, and European Central Bank.<sup>48</sup>

Through the informal dialogues of the EU-US Financial Markets Regulatory Dialogue (FMRD), there are also more frequent and detailed discussions at the level of senior civil servants and, occasionally, their immediate political superiors. The original core member organizations on the US side include the Treasury, the Fed, and the SEC, although this has expanded to the CFTC and the National Association of Insurance Commissioners (in lieu of a federal insurance regulator, which does not exist in the US). The core member on the EU side has been the Commission, although here too other organizations have been included in particular discussions.<sup>49</sup>

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48 See Atlantic Council 2010. The Danger of Divergence: Transatlantic Cooperation on Financial Reform. October, p. 6.

49 Ibid.

## IV. THE ROLE OF PARLIAMENTS AND CIVIL SOCIETY

As noted at the beginning of this paper, the global financial crisis in 2008-09 demonstrated how financial regulatory approaches and choices have the potential to subvert the social contract of entire societies. Decisions on the allocation of public resources, employment, the provision of essential services, and other aspects of a democratic society are the result of delicate social balances managed through the political process. The crisis which continues at the national level in Europe and especially the subnational, state level in the US is undermining social contracts in order to address high levels of debt and budget deficits that are the legacy of the crisis.

Yet, the financial sector defies efforts at re-regulation. This is due to the power and resources of financial institutions to buy votes, the lack of transparency and accountability of these institutions as well as the technical nature of many regulatory questions. Reportedly, there are some four financial industry lobbyists for every member of the US Congress.

Moreover, for decades, the state has been demonized through campaigns against its role as regulator and provider of safety nets, such as social security.

As a result, the debate on the decisions and choices about financial regulation tend to be lopsided with the financial industry routinely prevailing. Legislators in the European Parliament have declared that, for democracy to prevail, it is imperative that a citizens' lobby emerge to counter the influence of the financial sector (see [www.finance-watch.org](http://www.finance-watch.org)). Such a citizens' lobby is developing on both sides of the Atlantic that expresses the viewpoints of broad sectors of society (e.g., consumers, service users, workers, public interest advocates). In the US, Americans for Financial Reform (AFR) had significant successes in influencing the Dodd-Frank bill and, in Europe, groups are making headway in promoting the financial transaction tax (FTT) as a means of both curbing speculation and raising revenues to address developmental and environmental challenges.

The attempt to establish harmonized or global standards on financial regulation is predicated on the undeniable need to ensure the scope of regulations matches the global nature and mobility of financial flows. While that remains a desirable goal, it is important to remember how hard it is to forge financial regulations at a national level which are accountable to the general public. By further removing the processes and decisions from national context, the increased role of international organizations and bodies in financial regulation can distance and alienate exactly those constituencies with the most at stake in the debate. It also can be expected to reinforce the lack of non financial industry voices in the debate. Moreover, to the extent that such efforts force the acceptance of the lowest common denominator acceptable to the most countries, they risk undermining the quality and effectiveness of regulations, on the one hand, and making citizens impotent in their attempts to uphold country-specific or locality-specific social contracts.

In reviewing of the status of efforts on both sides of the Atlantic to regulate finance it is clear that the struggle to upgrade regulatory standards has been uphill and uneven. In most, if not all, cases, progress toward re-regulation has been driven by domestic political dynamics, particularly pressure by citizens' groups. In cases, such as the US's, one can pinpoint the successes of coalitions

of CSOs and grassroots groups, such as Americans for Financial Reform, that have built their capacity to understand and interpret legislative proposals, offer counterproposals and mobilize around aspects of financial reform. In the EU, a broad, well-organized lobby has emerged to promote the FTT, but a lobby with broader scope is still in the making.

These reflections show a clear way forward on one of the questions initially raised in this paper, namely: how can interest groups that represent sectors other than the financial industry and parliaments hold greater influence over financial regulatory processes? The review of the evidence shows that the more that financial regulatory processes remain accountable to local and national political processes, the greater the chances are that groups other than the financial industry can have an impact. It is true that this conclusion should not be taken to extremes. Indeed, if there was too much fragmentation across jurisdictions, globally mobile financial firms could take advantage of such fragmentation to pit different levels of regulation against each other, which is a common form of forum-shopping or arbitrage.

## V. FINAL REMARKS

This paper has identified a number of key areas in which transatlantic cooperation could “level up” or upwardly harmonize financial regulation, building on progress made in individual jurisdictions. Specifically, concerted action across transatlantic constituencies could help put pressure towards better regulation in the following areas:

### **Systemic risk and “too big, too complex and too interconnected to fail”**

US law adopted important principles in the areas of limits on bank size and concentration and restrictions on bank proprietary trading activity to prevent excessive risk-taking and ensure that such risk-taking is not underwritten through deposit insurance. Large exceptions endanger the effectiveness of the principles. These principles have not yet been articulated in Europe, although the UK Commission on Banking may do so. US law has also adopted principles intended to allow for the safe and orderly resolution of failing financial companies without distress to the system, an issue on which Europeans have not yet acted. It is critical that they do so because in the absence of mechanisms to deal with cross-border resolution, it will be hard and in some cases impossible for the US to be effective.

### **Bank capital requirements**

The US and the EU have chosen the Basel Agreement as a vehicle for cooperation and the third version of the agreement is nearly complete. The agreement has critical shortcomings. Therefore, it is important to have concerted political efforts in individual jurisdictions. These efforts should prevent implementation from eroding the limited effectiveness of the framework, promote complementary regulatory actions, and build up the critique of key features of Basel III that may fail as crisis prevention tools. These weak features include the reliance on the banks’ own internal risk assessment frameworks as the main mechanism for setting and evaluating capital requirements and the failure to take into account non-deposit liabilities – specifically short-term debt – as a factor of risk.

### **Derivatives**

The US law includes principles that the EU would be wise to follow. However, it is important to work on both sides to ensure regulatory implementation does not create new loopholes used for arbitrage. The US is not discussing the possibility of banning certain derivative transactions when deemed too risky or costly in social terms, but some European jurisdictions are.

### **Hedge funds, private equity funds**

The European Union legislation has stricter requirements for hedge funds than US law. For instance, Europe has been more effective than the US in curbing the ability of hedge funds and private equity funds to use tax avoidance and evasion schemes as a way to boost their gains. On the other hand, the US has adopted legislation with greater coverage than that in the European Union – though regulatory action could limit its real scope. A significant problem in both EU and US legislation is the limited

attention given to the practice of self-regulation by investors of these highly complex funds.

### **Credit rating agencies**

Based on the Dodd-Frank legislation the US now has a stronger regulatory framework for Credit Rating Agencies that features an increased standard of liability for CRAs and deadlines to establish a mechanism to address the conflict of interest implicit in a business model in which issuers of securities also pay CRAs for their ratings (“issuer pays”).

The EU may also adopt such elements into its regulatory framework.

### **Financial sector taxation**

The European Union as a whole and individual country members have clearly made more progress towards the adoption of special taxation measures on the banking sector, compared to the US where no such measures were introduced, yet, and they receive extremely limited attention in the official debate.

### **Shadow banking and financial services liberalization**

Two clear threats to financial regulatory efforts loom over in both the European Union and the US. One is the possibility that the “shadow banking system” could elude regulation and, thus, offer opportunities for arbitrage and the non-transparent build up of risks that could have systemic impacts. The other threat arises from the continued negotiation of trade and investment agreements (e.g., the Financial Services Agreement of the WTO’s General Agreement on Trade in Services (GATS)) that liberalize and effectively deregulate the financial services industry. Such agreements, which are proliferating especially through regional and bilateral channels, contain measures that could either restrict or have a chilling effect on financial regulatory actions. Transatlantic cooperation should emphasize efforts to press authorities into overcoming an apparent state of denial about these two areas that could generally undo any payoffs of re-regulation.

In conclusion, global or transatlantic cooperation and coordination of regulators to harmonize financial regulations should not be seen as an end in itself. It should be seen as an opportunity for improved regulation that better serves the real economy, employment and social justice not only in the US and EU, but also at the global level. Periodic financial crises are inevitable in capitalist systems. But frequent and severe crises are not inevitable and, when crises do occur, their impacts need not penalize the poor and vulnerable at the expense of others.

To preclude such outcomes, finance can and should be the subject of public intervention through proper regulatory action. But proper regulatory action, if it is going to adequately balance the interests of the whole of society, can hardly emanate from the authorities in consultation with only financial industry representatives and their experts.

For this purpose it is critical to promote transatlantic cooperation not just among the respective authorities, but also among their civil societies, grassroots and other sectors of society. Only such cooperation can help produce sound and just financial regulation and oversight in ways that are accountable to the public good.



## ANNEX.

### GLOBAL IMBALANCES AND FINANCIAL REGULATION

One important development before the crisis was the build-up of global imbalances. These imbalances are characterized by the growing level of trade surpluses by countries, such as China, which had, as a counterpart, the growing level of deficits in other countries, particularly the US. This phenomenon coincided with a credit boom and the relaxation of regulations and lending standards in advanced economies.<sup>50</sup> Some advanced economies blame China for creating the problem by maintaining its currency at an artificially depressed value, which makes exports cheaper and imports more expensive.

The US current account deficit grew virtually without interruption since the mid 1990s, to peak in 2005 and 2006 at over 1.5% of world GDP. With the sharp fall in world trade during the crisis, the imbalances narrowed but then resumed a pace upwards.

There are differing views on what exacerbated the crisis – global imbalances or the deregulation of finance. It has been difficult to identify whether one of these dynamics led to the other – or whether they just happened to take place at the same time, with catastrophic synergies.

However, it seems uncontroversial to suggest that: 1) these two developments took place simultaneously; 2) global imbalances played some role in triggering the crisis; and 3) global imbalances and financial deregulation fueled each other, leading to worse consequences than either of those two factors alone would have produced.

The interdependence expressed in number 3, above, suggests that the goal of reducing global imbalances requires progress on the re-regulation of finance. As described by one researcher, the ability of the financial system in the US to relax regulations and produce artificial “safe debt” instruments was instrumental to the generation of the global imbalances.<sup>51</sup>

The composition of the demand for US\$-denominated assets changed in 2001 and onwards, as China and other emerging market governments began to increase their trade surpluses and accumulation of reserves. As a result, the demand for safe debt assets outstripped what the US system could supply through Triple-A rated instruments. Then the US financial system began to generate ostensibly safe assets from unsafe ones by pooling assets and issuing senior claims on the payoffs of the pools.<sup>52</sup>

The agenda of post-crisis reform efforts entails a push to address both financial regulation and global imbalances in a simultaneous way and, arguably, giving them the same level of priority – noticeably at the Group of 20. But there is still a need to link them, which may shed light on where reform agendas may be working at cross-purposes. For instance, the agenda for reducing global imbalances

50 A detailed survey confirming similar views in a number of sources such as Financial Stability Forum/Board, Bank of International Settlements, International Monetary Fund and others can be found in Caliri, Aldo 2010. Assessing Global Regulatory Impacts of the U.S. Subprime Mortgage Meltdown: International Banking Supervision and the Regulation of Credit Rating Agencies, in *Transnational Law and Contemporary Problems*, Vol. 19:145, at Section II.

51 Caballero, Ricardo 2009. The “Other” Financial Imbalance and the Financial Crisis. Working Paper 09-32. Massachusetts Institute of Technology. Department of Economics. December.

52 Caballero illustrates this tracking the global issuance of CDOs which grew from \$185 billion in 2000 to \$1.3 trillion in 2007—carrying a Triple-A rating at the time.

includes a detailed plan for structural reforms that may entail further liberalization of financial services. This, in turn, could be in conflict with the goal of re-regulating financial markets, as shown in this paper (see section I.6).

Another set of reforms that exacerbate global imbalances are those that foster labor flexibility. To the extent that these reforms diminish collective bargaining rights and lower wages in surplus countries, they depress workers' demand for goods and services and, thereby, heighten imbalances. In other words, the imbalances are due, in part, to high savings rates in some emerging market countries which arise from weakness in employment and social protection systems in those countries. In a recent paper, Serven and Nguyen conclude "If the ultimate determinants of this equilibrium – the underdevelopment of financial markets, or the weakness of the social protection system, respectively – remain unaltered, global imbalances and uphill capital flows can persist indefinitely."<sup>53</sup>

From another viewpoint, the global imbalances are evidence of the so-called "Triffin dilemma," so named in honor to economist Robert Triffin, who described the dangers of excessive demand for the currency of the reserve issuer.

Such demand makes it easy for the issuer of the reserve currency to finance a trade deficit. At the same time, this leads to growing amounts of debt issued by the reserve currency issuer and widening deficits, which undermine confidence in the currency to act as an effective store of value. But diversifying reserves away from the dominant currency generally would backfire. So reserve holders are forced to build even higher levels of reserves and, thereby increase demand, fueling a vicious circle.

But the impact that a diversification of reserves away from such currency would have, forces reserve holders to intensify a strategy of building reserves in it, further increasing the excess demand and fueling a vicious circle.

Thus, it is unlikely that a lasting response to the problem of global imbalances can be found without a substantive reform of the global monetary system. A full discussion on the monetary system reforms needed to address global imbalances is beyond the scope of this paper. Suffice it to say here that reformers should tackle simultaneously the need for genuine coordination between trade surplus and deficit countries, the space for countries to impose capital controls, and an overhaul of the reserve currency that places a supranational currency – not the currency of any specific country – at the center of the system.<sup>54</sup>

53 Serven, Luis and HA Nguyen 2010. Global Imbalances Before and After the Crisis- World Bank Policy Research Working Paper 5354. June.

54 For a more detailed analysis of necessary reforms, including which ones can be achieved within the current international monetary law framework, see Caliari, Aldo 2010. Updating the International Monetary System to Respond to Current Global Challenges: Can It Happen Within the Existing Legal Framework?, Paper prepared for ASIL International Economic Law Interest Group Biennial Conference: International Economic Law in a Time of Change, November 18- November 20, 2010, University of Minnesota Law School, Minnesota, United States.





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