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A New Regulatory Framework Of Financial Institutions In The Aftermath Of The Global Financial Crisis

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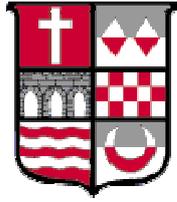
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**A NEW REGULATORY FRAMEWORK OF
FINANCIAL INSTITUTIONS
IN THE AFTERMATH OF THE GLOBAL FINANCIAL CRISIS**

Final Project Paper
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**FN 661 Global Financial Markets and Institutions
Prof. Dr. Lucjan T. Orłowski**

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I. INTRODUCTION

Three years since the outbreak of the global financial and economic crisis and two years since the global markets' turmoil following the Lehman Brothers' bankruptcy and the US government's bail-out of AIG, reforming the regulatory structure for financial institutions and platforms has achieved some visible progress. Though the new architecture is far from being finished, the main challenge is to implement what has been agreed upon in commitments and framework legislation, without losing track of the target to soundly improve global financial stability and effectively resolve future global crises on its way.

Against this background, this paper examines the emerging new regulatory framework of financial institutions in the aftermath of the global financial crisis of 2007-2010, focusing in particular on macro- and micro-prudential, capital market and related reform initiatives of the G20 and the FSB, of the US and the European Union,

and will:

- Review* the crises impact on the prevailing framework for safeguarding global financial stability.
- Identify* key proposals in the economic literature where financial-system reforms are necessary.
- Focus* on the following key stakeholders / platforms for international cooperation
 - the G20 and the FSB;
 - the US; and
 - the European Union (EU).
- Determine* recent and prospective reforms of each of these stakeholder.
- Compare* the following measures in a schematic overview
 - Macro-prudential supervision and systemic risk;
 - Micro-prudential supervision / Systemically Important Financial Institutions (SIFIs) and cross-border crisis resolution;
 - Capital and liquidity requirements;
 - Capital Markets (OTC Derivatives, Credit Rating Agencies);
 - Hedge Funds / Securitization;
 - Consumer /Investor Protection;
 - Remuneration;
 - Insurance.
- Analyze* the degree of convergence of the reforms in the before mentioned areas.
- Assess* outstanding aspects to improve the functioning and governance of the global financial system, and
- Wrap up* with key conclusions.

In summary, the conclusions of this paper are that

- The crisis is the catalyst of the new upcoming architecture that would not have emerged that way without the crisis; thus it has produced a first progress;
- International cooperation is the hallmark to trigger reforms for preventing future crises;
- International institutions must more closely cooperate on the reform and the performance of the global financial system; so must supervisory authorities and regulatory bodies. No other global financial architecture is up to the task and is politically feasible at this time;



- Concerns that reforms might expel financial markets away from the Europe and the US towards less regulated playing fields do not seem realistic as long as they are not distorting and do not hinder banks flexibility and initiatives.

II. LITERATURE OVERVIEW

The basic source for research used for this paper were the official websites and research engines of the FSB, the G20 Summits Information Centers, the ECB website, the databases for the EU (www.europa.eu), and for the USA the US Government Printing office, the Treasury, the Senate and other US Government resources. The supplementary literature referred to in the paper is listed in the References section.

III. THE CORE ANALYSIS

A. THE CRISES IMPACT ON THE PRE-CRISIS FRAMEWORK FOR GLOBAL FINANCIAL STABILITY

When risks gradually built up during the credit bubble and materialized in what was considered as the worst financial and economic crisis since the Great Depression (Reuters), a global financial system was well in place, covering private sector financial institutions, nations that have supervisory jurisdiction over private financial institutions, and international institutions through which the national authorities coordinate and cooperate at a global level. What the global crisis managed to reveal were regulatory failures and deficiencies of that architecture in the way certain international banks managed their business and risks (Mersch, 2010 p. 3).

Several factors have been hold responsible:

1. PURELY NATIONAL-ORIENTED PATCHWORK ARCHITECTURE

- The pre-crisis framework was just a patchwork architecture arbitrarily agglomerated over time in reaction tthat emerged; it was flawed both in its implementation and in its structure (Schinasi, Truman, 2010 p. 2).
- Frameworks built on predominantly national basis (Mersch, 2010 p. 4) failed when called upon to resolve cross-border problems.

2. DEREGULATORY AND LAISSEZ-FAIRE TENDENCIES

Deregulatory measures, particularly in the Clinton and Bush eras (1993–2009), to ease regulatory burden led changes of the financial system laws, weakening of their enforcement, and undermining the regulatory framework. To mention a few US examples:

- Restrictions on banks' financial practices were dropped in the Depository Institutions Deregulation and Monetary Control Act of 1980, banks' lending powers extended, and the deposit insurance limit was raised from \$40,000 to \$100,000, thus contributing to the problem of moral hazard (Federal Deposit Insurance Corporation, 1997).
- The Gramm-Leach-Bliley Act, signed into Law in November 1999, dismantling the 1933 Glass-Steagall Act and reducing the separation between commercial banks (which traditionally had a conservative culture) and investment banks (which had a more risk-taking culture).
- In 2004, the U.S. Securities and Exchange Commission (SEC) upon the request of major investment banks changed what was known as the “net capital rule”, which limited the amount of debt they could take on. In loosening the capital rules, the SEC not only allowed for fueling the growth in mortgage-backed securities supporting subprime mortgages, but also decided to



rely on these firms' own computer simulations to determine the riskiness of investments, thus further contributed to the crisis (Labaton, 2008).

- Supported by Federal Reserve Chairman Alan Greenspan, the self-regulation of the over-the-counter (OTC) derivatives market was admitted by the Commodity Futures Modernization Act of 2000. This deregulation led to a boost of innovative derivatives such as credit default swaps (CDS), used for speculation against particular credit risks: first traded in the late 1990, the notional outstanding amount of CDS increased from approximately USD 10 to 40 trillion, i.e. by a factor of four, in the two years between June 2005 and June 2007, to reach a record of USD 62 trillion December 2007 (according to the half-yearly BIS OTC derivative statistics). In the end, the financial crisis revealed the financial vulnerabilities associated with these instruments.

3. UNDERDEVELOPED CRISIS PREVENTION

Not spotting the crisis appropriately ahead of time was not just an intellectual failure; it was also partly a failure of machinery (Tucker, 2010 p. 1). While achieving progress in areas such as setting standards (e.g. capital requirements standards), no common policy was put in place for crisis management, especially for early action.

In the EU, for instance, crisis management was reduced rather to information sharing, or allocation of responsibilities (e.g. wide degree of central banks' involvement in national liquidity surveillance). Incoherent national approaches to tackle failures of financial institutions (most EU member states have only a few bank-specific regulations, and revert to general commerce bankruptcy laws resulting in procedural delays, even prohibiting in some cases the recapitalization of insolvent banks; some countries focus on the right of claimholders, others on the right of debtors; moreover, deposit insurance regulation varies among countries) opposed coordinated remedial action, based on early intervention and rapid decision-making.

One important lesson for global governance emerging from the crisis is that the international community lacks a set of ex-ante burden-sharing mechanisms for resolving the weaknesses or insolvencies of large, complex, interconnected financial conglomerates (Schinasi and Truman, 2010 p. 2).

A simplified overview of the pre-crisis framework for safeguarding global financial stability covering four important sources of global systemic financial risk (Global financial institutions, Global markets, Unregulated financial activities, Economic and financial stability policy mistakes) and the relevant lines of defense against them (Market discipline, Financial regulations, Micro-prudential supervision of financial institutions and products, Macro-prudential supervision of markets and the financial system as a whole, Crisis management and resolution) is attached in the Appendices.

B. PROPOSALS IN RESPONSE TO THE CRISIS

Against this background, it is not surprising that the regulatory system was in the pillory for having failed to mitigate the recent cycle in leverage, credit expansion and housing prices. It gave rise to widespread calls for changes in the regulatory system by politicians and business leaders, economists and the media.

1. PROPOSALS FOR MITIGATING SYSTEMIC RISKS

Against the background that financial firms are much more susceptible to systemic risks than non-financial firms, Bullard, Neely and Wheelock from the Federal Reserve Bank of St. Louis have taken up several proposals how to control and mitigate systematic risks in the financial system, which were published in the economic literature, and identified four broad and closely related areas for considering reforms of the global financial architecture (Bullard, Neely and Wheelock, 2010):



- a. Increased and broader supervision, amongst others
 - Creation of a financial regulator with responsibility for macro-prudential oversight of the financial system, especially of unregulated activity, and
 - Increased supervision of Systemically Important Financial Institutions SIFIs or “Too Big to Fail Institutions (TBTF) under the umbrella of a systemic regulator ;
- b. Offset excessive risk-taking leading to moral hazard, notably explicit or implicit government guarantees, such as government bail-outs;
- c. Mitigate systematic risks, amongst others
 - strengthening the imposition of minimum requirements for capital on large financial firms,
 - limiting the use of leverage, regulating particularly the use of short-term debt to finance holdings of long-term assets, and
 - modifying market value accounting rules;
- d. Resolve crisis management, corrective action, and resolution of large, complex financial institutions, including appropriate reductions in payments for bondholders given the unequal treatment of equity capital.

All of these recommendations will be part of actual reform measures outlined in the following sections. Among the large variety of further proposals addressing regulatory issues subject to reform, only a few shall be mentioned, due to the restricted scope of this paper:

2. REGULATORY REVIEW OF FINANCIAL INSTRUMENTS AND TRANSPARENCY

Lucian Orlowski has recommended, amongst others, regulating derivative instruments, subjecting trades in complex derivatives to central clearing, as well as putting off balance sheet financing under regulatory and supervisory scrutiny regarding transparency and minimum capital holdings (Orlowski, 2009).

3. EXECUTIVES COMPENSATION

Reforming executive remuneration is among the solutions outlined by Nobel prize winner Joseph Stiglitz: notably mitigate the incentives for excessive risk-taking and the short-term focus by extending the reference basis - in addition to reducing the scope for conflicts of interest and improving shareholder information about dilution in share value as a result of stock options (Stiglitz, 2008)

4. PRUDENTIAL LIMITS ON SHADOW BANKS

Against the background of the rise of the shadow banking system at the bottom of the crisis another Nobel laureate Paul Krugman proclaimed the rule: anything that does what a bank does, anything that has to be rescued in crises the way banks are, should be regulated like a bank (Krugman, 2009).

C. KEY POST-CRISIS FINANCIAL REGULATION INITIATIVES

Resulting from the increasingly interconnected nature of financial institutions and markets, the need for coordinated action and global forums to address comprehensive regulation by national and regional regulators and supervisors was recognized. As the G8 as the principal forum for discussing such issues had proved to be inadequate, international bodies have come under scrutiny in the wake of the crisis and underwent a reform process.

Since then, the intensity of the international cooperation on financial regulation has been stepped up and three years after the worst financial-economic crisis since the 1930s began; a new international financial, regulatory and fiscal architecture has emerged, although incomplete, not yet implemented and inadequately coordinated between major countries. The primary actors for development policy debates were the UN and certain of their special organizations¹, the EU, the G20, BCBS, BIZ, IMF, and IOSCO. Due to the limited scope, the focus of this paper is on the US, EU and G20 initiatives only.

¹ There is a UN "Interactive Panel on the Global Financial Crisis", set up by the UN General Assembly. It held its first meeting in New York on 30 October 2008, led by Professor Joseph Stiglitz. It is involving a broader range of countries and lobbies for an



1. G20

a. THE G20 SUMMITS

Among the elements of the reforms were the creation of the G-20 summits in response both to the latest financial and economic crisis and to the lack of representation of the key emerging countries, and the shift from the G8 to the G20 as the new principal forum for global economic coordination and governance, as agreed upon at the Pittsburgh G20 Summit in September 2009. It is committed, among others, to implement the coordinated expansionary macroeconomic policies, and significantly enhance the financial regulations, notably by the establishment of the Financial Stability Board (FSB) (see below).

b. THE G20 AGENDA

Accordingly, the G-20 Summits have been held in Washington in 2008, in London and Pittsburgh in 2009, and in Toronto and recently in Seoul in 2010.

The first G20 summit in 2008 developed an extensive agenda for stabilizing the world economy and the financial system, with the aim of preventing future crises, mainly by improving global regulation and supervision, and strengthening of international financial institutions, including:

Macro-prudential supervision and Systemic risk	<ul style="list-style-type: none"> ■ Establish framework to deal with macro-prudential risks and develop tools; ■ International guidelines for definition of systemic importance, and avoidance regulatory arbitrage.
Systemically Important Financial Institutions SIFIs	<ul style="list-style-type: none"> ■ Improve oversight framework.
Prudential Regulation, incl. Capital and Liquidity	<ul style="list-style-type: none"> ■ Strengthen prudential regulatory standards; ■ Improve quantity and quality of bank capital; ■ Discourage excessive leverage; ■ Listen constructively to feedback & channel it to the right direction of change; ■ Strengthened liquidity requirements; ■ Adopt Basel capital framework.
Bank resolution	<ul style="list-style-type: none"> ■ Address cross-border resolution.
Comprehensive Data	<ul style="list-style-type: none"> ■ Ensure gathering relevant information and international consistency.
Hedge Funds	<ul style="list-style-type: none"> ■ Registration and conduct of business requirements.
Derivatives	<ul style="list-style-type: none"> ■ Improve OTC derivative markets; ■ Promote standardization and resilience of credit derivative markets; ■ Establish central clearing counterparties.
Credit Rating Agencies	<ul style="list-style-type: none"> ■ Registration; ■ Oversight rules.
Accounting Standards	<ul style="list-style-type: none"> ■ Strengthening compliance with international standards (especially in loosely regulated jurisdictions).

Source: G20 summits communiqués

c. THE G20 SUMMIT IN SEOUL ON 11 AND 12 NOVEMBER 2010

The G20 agenda was constantly updated and extended (e.g. resolution regimes, corporate governance); the new structure was ratified at the G-20 Summit in Seoul, which marked the delivery of the following central elements of the reform program launched in Washington:

agreement involving all members of the UN. Professor Joseph Stiglitz now (January 2009) being carried forward by a “Commission of Experts on Reform of the International Financial System”, also leads the panel’s work.



i. BANK CAPITAL AND LIQUIDITY STANDARDS

Aim: To reduce the likelihood and severity of future financial crises and create a less procyclical banking system that is better able to support long-term economic growth, to substantially raise the quality, quantity and international consistency of bank capital and liquidity and to constrain the buildup of leverage and maturity mismatches; and to introduce capital buffers above the minimum requirements that can be drawn upon in bad times.

Measures: Leaders endorsed the Basel III bank capital and liquidity framework. It has to be implemented into national legislation starting on 1 January 2013 and fully phased in by 1 January 2019.

ii. INCREASED SUPERVISION TO MITIGATE RISKS OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (SIFIs)

Aim: To provide the tools and the capacity to co-ordinate resolution across borders and respond to threatened failures of such firms without disruptions of the financial system and taxpayer exposure.

Measures: Leaders also endorsed the policy framework, work processes, and timelines proposed by the Financial Stability Board (FSB) to reduce the moral hazard risks posed by SIFIs, i.e. firms whose disorderly failure because of their size, complexity and systematic interconnectedness would cause significant disruption of the “wider” financial system and economic stability and address the too-big-to-fail (TBTF) problem.

SIFIs and initially in particular financial institutions that are globally systemic (G-SIFIs) should have higher loss absorbency capacity to reflect the greater risk that the failure of these firms poses to the global financial system; more intensive supervisory oversight; robust core financial market infrastructure to reduce contagion risk from individual failures; and other supplementary prudential and other requirements as determined by the national authorities which may include, in some circumstances, liquidity surcharges, tighter large exposure restrictions, levies and structural measures.

Additionally, G-SIFIs will be subject to a sustained process of mandatory international recovery and resolution planning. It was agreed reaction/traction risk assessment on these firms through international supervisory colleges and negotiate institution-specific crisis cooperation agreements within crisis management groups. Regular peer reviews will be conducted by the FSB on the effectiveness and consistency of national policy measures for these firms.

iii. SUPERVISORY INTENSITY AND EFFECTIVENESS

Aim: As the Basel III and SIFI measures on their own are not sufficient enough to ensure that every country is up to the task of backing up the new regulations by effective risk assessments and enforcement; it is necessary to empower supervisors to be able to detect problems proactively and to intervene early to reduce the impact of potential stresses on individual firms and therefore on the financial system as a whole.

Measures: Leaders reaffirmed their Toronto commitment to complete the new financial regulatory framework with more effective oversight and supervision and, endorsing the policy recommendations prepared by the FSB in consultation with the IMF, agreed to provide supervisors with strong and unambiguous mandates, sufficient independence to act, appropriate resources, and a full set of tools and powers to proactively identify and address risks, including regular stress testing and early intervention.

iv. FRAMEWORK FOR STRENGTHENING ADHERENCE TO INTERNATIONAL SUPERVISORY/REGULATORY STANDARDS

Furthermore, leaders committed themselves to a consensus on implementing the new architecture in an internationally consistent manner, including regulation of derivatives, compensation practices, accounting standards and reducing reliance on credit rating-agencies.



A very detailed report of the progress on the numerous economic and financial actions adopted by the London, Washington and Pittsburgh G20 Summits had been prepared by Korea, chairing the 2010 Seoul summit (G20 Progress report).

The overview table in the Appendices shows the implementation status based on summaries provided by each of the G20 and EU countries as to where they are on the road to regulatory reform.

d. ONGOING AND FUTURE G20 AGENDA

In addition, the G20 indicated areas requiring greater attention in their future work, including:

- i. Macro-prudential policy frameworks: The FSB, the International Monetary Fund and the Bank for International Settlements have been invited to conduct further work in this area, including tools to minimize the impact of excessive capital flows, in order to update the G20 Finance Ministers and Central Bank Governors at their next meeting.
- ii. Regulation and supervision of shadow banking: The FSB has been called on to collaborate with other international standard setting bodies in order to develop recommendations to strengthen regulation and oversight of the shadow banking system by mid-2011.
- iii. Regulation and supervision of commodity derivative markets: The International Organization of Securities Commissions' (IOSCO) task force on commodity futures markets is expected to report to the FSB on this issue in April 2011.
- iv. Market integrity and efficiency: IOSCO has been invited by June 2011 to develop, and report to the FSB, recommendations to promote markets' integrity and efficiency so as to minimize to the financial system by the latest technological developments.

2. FINANCIAL STABILITY BOARD (“FSB”)

a. ORGANIZATIONAL STRUCTURE AND SCOPE

The FSB represents the G-20 leaders' first major international institutional change. Established after the 2009 G-20 London summit in April 2009 as a successor to the Financial Stability Forum (FSF) with a broadened mandate, the FSB is designed as an international body that monitors and makes recommendations about the global financial system. Bringing together national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts, the Board of the Basle-based FSB includes all G-20 major economies, FSF members, Spain, and the European Commission. Given the FSB's role overseeing implementation of many of the G20 commitments and its working together with other bodies, the Secretary of the US Treasury Tim Geithner described the FSB as "in effect, a fourth pillar" of the architecture of global economic governance, alongside the IMF, the World Bank and the World Trade Organization (WTO)" (Geithner, 2009).

Though being fully supported from the IMF and the World Bank, FSB cannot work as it is expected to do with the current governance and resources, as none of its four committees and four working groups has permanent personnel.

b. FSB REFORM RECOMMENDATIONS – PRE-SEOUL

The 2008 FBF/FSB recommendations to enhance the resilience of financial markets and institutions submitted to the G7 Finance Ministers on 12 April 2008 comprised the same areas as for the G20 described above.



The FSB regularly reports to the G20 on progress achieved, the last detailed report on numerous economic and financial actions adopted on the G20 summits was prepared by Korea for to the 2010 Seoul summit.

c. FSB ONGOING REFORM PROGRAMME – POST-SEOUL

According to a communiqué of the FSB Chairman to the G20 Leaders on 9 November, the focus for the ongoing reform programme after Seoul will consist of:

- i. Assessing the need to apply regulatory safeguards to shadow banking
- ii. Thematic peer reviews of risk disclosures and of mortgage underwriting practices
- iii. Review of deposit insurance standards.

In addition, the FSB will, in cooperation with all the relevant bodies, focus attention on the further development of macro-prudential policy frameworks, on emerging markets’ financial stability issues, as well as on commodity derivatives markets and market integrity.

3. US

a. THE DODD-FRANK ACT

In the U.S., the most important restructuring of U.S. financial regulation since the 1930s affecting all Federal financial regulatory agencies and almost every aspect of the US financial services industry, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into law by President Barack Obama on 21 July 2010 after months of tough negotiations between Congress, Senate and the Obama administration.

Named after the Senate Banking Committee and the House Financial Services Committee leaders due to their involvement with the bill, the implementation of the 848 pages and 16 titles requires, according to a law firm’s count (Davis Polk, 2010), of regulators to create 243 rules, conduct 67 studies, and issue 22 periodic reports.

The Dodd-Frank agenda aims to promote financial stability by measures depicted in the below key areas²:

- | | |
|--|--|
| <p>Promote Robust Supervision and Regulation of Financial Firms</p> <p>Establish Comprehensive Regulation of Financial Markets</p> | <ul style="list-style-type: none"> ■ Creating a new council of federal regulators, the Financial Services Oversight Council, led by the Treasury secretary, to evaluate, coordinate the detection and respond to emerging systemic risks, as well as to promote market discipline; ■ Subjecting large, interconnected financial firms to consolidated supervision and regulation, incl. stricter capital, liquidity and risk management standards; ■ Require hedge funds and private equity funds to register. ■ Expanding comprehensive federal banking and securities regulation from its focus on banks and public markets to a wider range of financial companies to be subjected to government oversight; ■ Imposing regulation, for the first time, on "shadow markets" like the enormous trade in credit derivatives; ■ Increasing transparency of derivatives by requiring most trading to take place through open marketplaces (through exchanges or clearinghouses), monitored by the SEC or the Commodity Futures Trading Commission. |
| <p>Prudential Regulation, including Capital and Liquidity</p> | <ul style="list-style-type: none"> ■ Strengthen prudential regulatory standards; ■ Improve quantity and quality of bank capital; ■ Discourage excessive leverage; ■ Listen constructively to feedback & channel it to the right direction of change ■ Strengthened liquidity requirements; ■ Adopt Basel capital framework. |

² Given the similar tenor, please refer to the G20 section for the rationale of this US legislation.



- Protect Consumers and Investors from Financial Abuse
 - Strengthening investor protection by creating a powerful new regulator housed in the Federal Reserve (Fed), the Consumer Financial Protection Bureau, to shield consumers of financial products from abusive bank and financial services practices (whose first visible result, a simplified disclosure form for mortgage loans, is due in about two years).
- Provide Government with the Tools it Needs to Manage Financial Crises
 - Introducing tools for financial crises, including a "resolution regime" for Too-Big-To-Fail financial institutions, complementing the existing FDIC procedure, to allow for orderly winding down of failing firms,
 - Including a proposal that the Fed can receive authorization from the Treasury to extend credit in "unusual or exigent circumstances".
- Raise Intern. Regulatory Standards / Improve Intern. Cooperation "Volcker Rule"
 - Tightening accounting standards;
 - Introducing shareholder value oriented compensation practices;
 - Subjecting credit-rating agencies to still-undetermined supervision.
 - Former Fed Chairman Paul Volcker's proposal to restrict the ability of banks whose deposits are federally insured from trading for their own benefit.

Source: US Treasury. Financial Regulation Reform: A New Foundation. 2009 Final Report

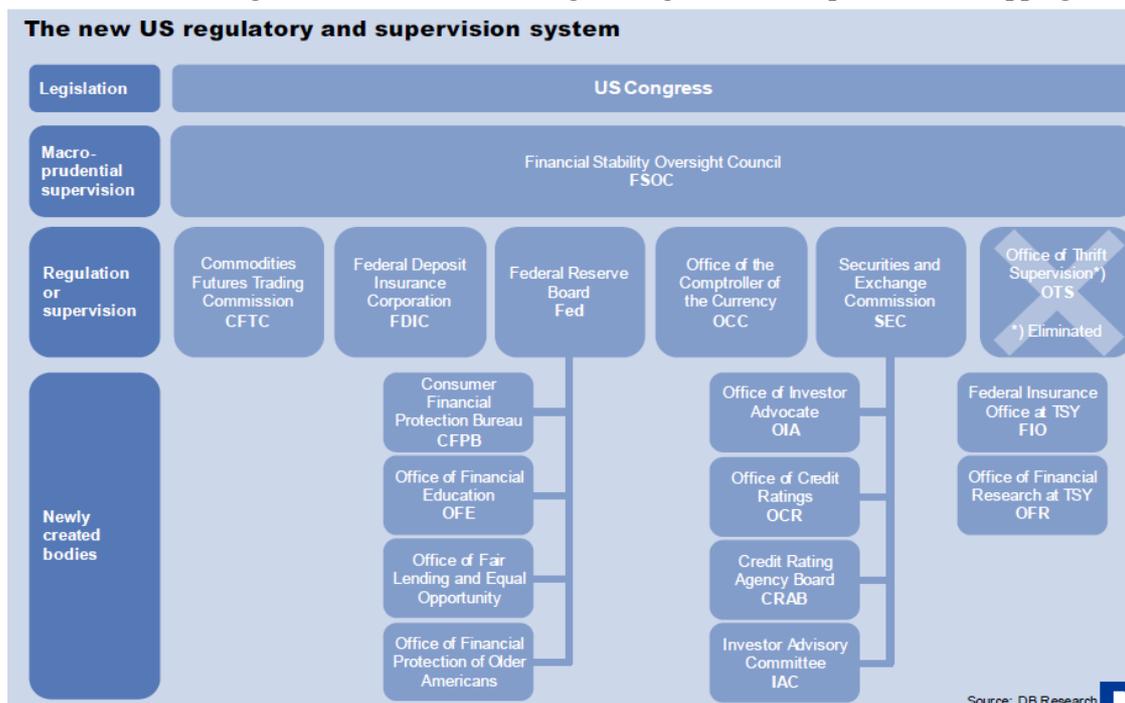
While the measure does not fully restore the toughest restrictions imposed after the Great Depression, it is a clear turning point, highlighting a new distrust of Wall Street, fear of the increasing complexity of technology-driven markets, and renewed government reliance to protect the consumer (New York Times, 4 November 2010).

b. UNRESOLVED ISSUES

Despite these important advances, the Act leaves important issues unresolved which already had been debated in the wake of the crisis and before, such as:

i. Rising number of supervisory institutions

Contrary to the widely held belief that the US system of financial market oversight needed streamlining, a systematic overhaul of institutions to arrive at a more coherent and efficient oversight framework was not feasible at a political level. While the Office of Thrift Supervision has been abolished and integrated into the Fed, additional Bureaus, Offices etc. have been added, leading to a patchwork of federal and state agencies involved in banking oversight with multiple and over-lapping mandates.



Source: Deutsche Bank Research. EU Monitor 77



ii. Systemic issues

How to identify systemic risks, and how to counter them effectively will be one of further issues subject to continued debate.

4. EU

Unlike the US all-in-one approach to meeting G20 provisions for new banking and financial regulation, the EU is taking a piecemeal approach.

a. NEW EUROPEAN FINANCIAL SUPERVISORY FRAMEWORK

A review of existing EU financial supervisory arrangements was launched against the background that despite substantial integration of EU financial markets, regulation had remained fragmented among Member States, resulting in inconsistencies and inefficiencies in supervising financial institutions or managing the systemic risks at the cross-border level. Based on the recommendation of a high-level expert group, chaired by Jacques de Larosière in 2009 (the so-called Larosière Report of 25 February 2009), the European Council agreed on the need to build a comprehensive cross-border framework for the prevention, management and resolution of financial crises in the EU.

In September 2010, the EU passed a "Financial Supervision Reform" as of 2011 (EU Council Report: Financial Supervision Reform covering the following areas:

- The text of the draft Regulations concerning the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA);
- The alignment of the text of the draft Regulations establishing the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) on the text agreed for EBA, and
- Certain outstanding issues relating to the EU Commission's proposal for a Directive amending a number of existing financial services directives (the "Omnibus Directive").

New EU financial supervisory bodies are:

i. European Systemic Risk Board (ESRB)

Purpose

The ESRB is designed to be a new macro-prudential regulator for the financial sector throughout the EU. Its primary purpose is to act as an early warning system and provide oversight of the systemic risks against financial stability.

Organization

The president of European Central Bank (ECB) will chair the ESRB for the first five years; located in Frankfurt at the ECB headquarter, its secretariat will also be provided by the ECB.

Function and Powers

The ESRB will develop common indicators to permit uniform ratings of the riskiness of specific cross-border financial institutions and to make it easier to identify the specific risks. In response to the risks identified, the ESRB can issue recommendations for remedial action and where appropriate, make them public.

The ESRB will have to notify the European Parliament and the three ESAs of an imminent emergency (when adverse developments may seriously jeopardize the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU), subject to follow-up procedures.



ii. European Supervisory Authorities ESAs

Purpose

At micro-level, the EBA, ESMA and EIOPA will be created as pan-EU supervisory authorities, and replace the existing coordinating committees CEBS, CESR and CEIOPS. They will be charged with oversight of the EU banking, securities and insurance markets.

Organization

The board of each ESA will be made up of national supervisors; they will be initially located in London (EBA), Paris (ESMA) and Frankfurt (EIOPA), and staffed with about 40 to 60 people in the beginning.

Function and powers

The ESAs will take over all existing functions from the respective coordinating committees, which they replace, and be responsible for setting common supervisory rules to be applied by all competent authorities across the EU, to share information and coordinate harmonized and effective action by the colleges of supervisors and to arbitrate any disputes between the competent authorities.

In principle, the ESAs will not have direct powers to supervise individual financial institutions or markets, except for the ESMA, which was granted direct supervisory powers over European credit rating agencies by the EU Regulation on Credit Rating Agencies.

Exceptionally, however, the ESAs will be empowered to take decisions, which are directly applicable to individual financial institutions in cases of (a) manifest breach or non-application of EU law and (b) disagreement between the competent authorities of member states, as described below.

The key functions and powers of the ESAs are:

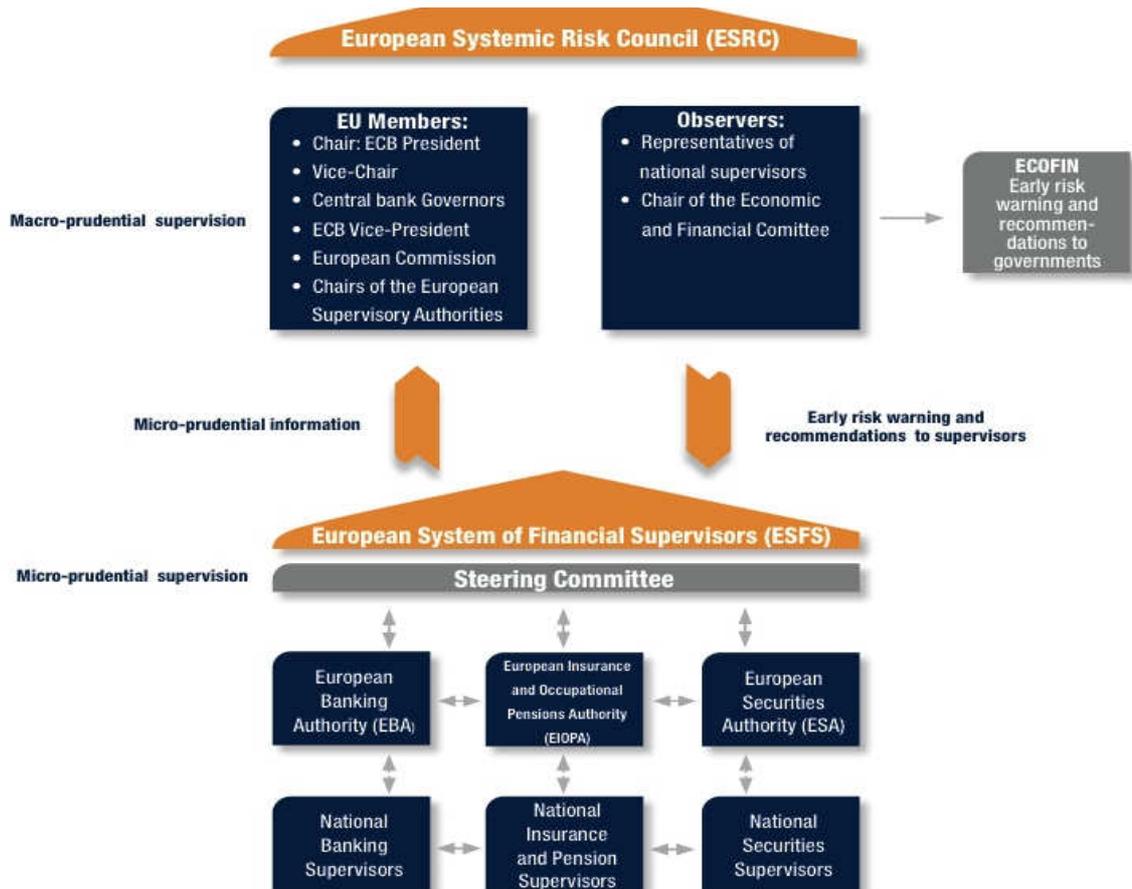
- Monitoring how national supervisors implement their obligations under EU laws and enforcement in case of non-compliance;
- Imposing binding mediation on national supervisors in case of disagreement;
- Power to temporarily prohibit or restrict financial activities or products;
- Power to investigate to assess risk exposure;
- Mandate to protect consumers.

iii. Joint Committee of the ESAs

A Joint Committee of the ESAs will be established to serve as a forum in which they cooperate and ensure cross-sectoral consistency in relation to:

- financial conglomerates;
- accounting and auditing;
- micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability;
- retail investment products;
- anti-money laundering measures;
- exchanging information and developing relationships with the ESRB.

Although national supervisors will retain responsibility for supervision and enforcement in their jurisdiction, the proposals represent a significant move towards coordinating prudential regulatory rules and standards in the EU.



Source: ABBL Luxembourg Bankers Organization, Annual Report 2009, P. 13

b. **FRAMEWORK FOR CROSS-BORDER CRISIS MANAGEMENT IN THE BANKING SECTOR**

In October 2010, the EU Commission issued a crisis management communication that covers measures needed at all stages of a bank's failure— from early intervention, resolution to insolvency reorganization, not only for national as well as cross-border insolvencies. Emphasis is on avoidance of public sector bail-outs and on facilitating private sector solutions without contagion and without disruption of banking activities, including enhanced information exchanges and co-operation among supervisors.

The implementation of this framework would pose significant challenges due to structure, functioning and scope of the European Union: obstacles to overcome are not only the heterogeneity of insolvency laws in the different Member States, the existence or not of bank-specific bankruptcy regulations, but also issues related to burden sharing, or intra-group asset transfers during periods of crisis. In this context, it may be more realistic to pave the way for a second best approach i.e. a nationally based framework for cross-border crisis management associated with a binding process for cooperation and information exchange (Mersch, 2010 p. 6).

Furthermore, the EU Council endorsed the establishment of Cross Border Stability Groups for all large EU cross-border financial groups by mid 2011, accompanied by the signature of Cross-Border Cooperation Agreements.

Due to the restricted scope of this paper, other key elements of the EU regulatory reform will be covered in the overview outlined in the following section.



D. COMPARISON OF THE REGULATORY REFORMS OF THE G20, THE EU AND US

This overview is based on research of documentation on the databases and official websites of the above-mentioned stakeholders, e.g. (the G20 Summits Information Centers, the ECB website, the databases for the EU (www.financialstabilityboard.org/; www.europa.eu; www.gpo.gov/; www.banking.senate.gov etc.)

AREA	EU ACTION	US ACTION	G20/FSB ACTION
CAPITAL & LIQUIDITY	<p>BASEL III, as adopted by the Basel Committee on Banking Supervision at the Bank for International Settlements (BIS) in Basel, Switzerland in 2010, is under adoption in the EU, tightening ratios of core capital held to liabilities incurred to seven percent by 2015, and increasing the quality of the assets used to meet those ratios. The new system will also require of banks to build up reserves (“capital buffers”) counter-cyclically during good times to be protected in bad times, a maximum leverage ratio, and proposed new minimum liquidity ratios for a stock of high quality liquid assets and for a more robust funding structure. The EU proposal revising the Capital Requirement Directives (CRD IV) shall be presented in spring 2011.</p>	<p>The Dodd-Frank Act does not make transposition of the Basle Agreement mandatory.</p> <p>The US agreed to implement Basel II; in December 2007 US bank regulators published the rule for US implementation of Basel II (effective since April 2008), covering only few core banks (>\$250 billion consolidated total assets, or >\$10 billion total on-balance sheet foreign exposure), while Guidelines for application of the Supervisory Review Process are fewer and less detailed. The form of the next steps in Basle II implementation is still under discussion.</p> <p>Nevertheless, the US authorities have been active in the Basel III negotiations.</p> <p>Also awaiting confirmation if and when the trading-book requirements will be implemented.</p>	<p>By endorsing the Basel III capital and liquidity framework, the G20 has made a significant step forward in strengthening global standards. They include substantially higher minimum requirements for the highest quality capital (equity and retained earnings), the proposed counter-cyclical capital buffer, a maximum leverage ratio, and proposed new minimum liquidity ratios for a stock of high quality liquid assets and for a more robust funding structure.</p>
SUPERVISION & SYSTEMIC RISK	<p>Creation of macroeconomic oversight board European Systemic Risk Board (ESRB), supported by the ECB, involving all of the EU, as well as 3 sectoral securities, banking and insurance authorities with significant powers to gather information and to coordinate activities of national supervisors.</p> <p>The ESRB will monitor risks to the financial system as a whole and set out “early warnings” in the event of increased risk, and also provide non-binding recommendations on how to deal with these risks.</p> <p>From a micro-prudential perspective, the ESFS will be a network of member state financial supervisors working in conjunction with the new EU-level supervisors in the banking, insurance, and securities sectors to detect systemic risks in SIFIs.</p>	<p>To head off future systemic risks, Creation of <i>Financial Stability Oversight Council</i> (FSOC), which must identify threats to financial stability, promote market discipline, and respond to emerging systemic risks. Meeting at least quarterly, the FSOC will include the Fed and other regulators and be presided over by the Treasury Secretary. A new Office of Financial Research will facilitate generation and coordination of research bearing on financial stability for the FSOC.</p> <p>Slight consolidation of the regulatory patchwork reining the US dual banking system that dates back, in some cases, to the 19th century.</p> <p>Fed continues to “identify, measure, manage and mitigate risks to the financial stability of the United States” in conjunction with the FSOC; also to supervise +/- 35 of larger (>\$50 billion assets) bank holding companies.</p>	<p>The G20 is committed to addressing macro-prudential risks to limit the build up of systemic risk and to empower regulators to gather relevant information on all material financial institutions, markets and instruments in order to assess the potential for failure or severe stress to contribute to systemic risk; the FSB itself has created a “Vulnerabilities Group”</p>



AREA	EU ACTION	US ACTION	G20/FSB ACTION
<p>SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (SIFIs) & CROSS-BORDER CRISIS RESOLUTION</p>	<p>An EU framework for crisis management in the financial sector will be discussed in 2011, targeting at preventative measures, early action to remedy problems and resolution tools for supervisors.</p> <p>The EU Commission considers that ex-ante cross-border resolution funds funded by levy on banks and built on harmonized system of national funds, could be used to pay for the costs of future bank resolution.</p> <p>The new banking authority is supposed to ensure coordination of resolution.</p> <p>Member States continue to discuss a possible tax on financial institutions to recoup the costs of state support during the crisis.</p>	<p>Fed's power is expanded to oversee the largest, most inter-connected financial institutions (now called "Tier 1 FHCs") - even if they are not banks.</p> <p>Imposition of stricter prudential supervision standards and regulations, incl. higher capital and liquidity requirements, on financial services companies that are big enough or interconnected enough to put the entire economy at risk.</p> <p>The bill also creates a process for the government to liquidate failing companies at no cost to taxpayers, which is similar to the F.D.I.C. process for liquidating failed banks.</p>	<p>G20 is committed to a policy framework to include cross-border resolution/orderly wind-down tools, strengthened prudential and supervisory requirements, and core financial-market infrastructures.</p> <p>Moreover, in setting out the broad policy framework for addressing SIFIs, the FSB now refers to higher capital requirements applying 'initially and in particular' to Global SIFIs, thereby creating for the first time a distinction between globally active and domestic SIFIs. This introduces significant uncertainty for large global banks and could result in an unlevel playing field for globally active SIFIs competing in national markets with predominantly local SIFIs.</p>
<p>SECURITIZATION</p>	<p>Originators of all securitized positions required to retain at least 5% "skin in the game" to share some risk during the securitization process.</p> <p>Strict due diligence procedures for originators and investors. If an investor does not comply with the due-diligence rules, a capital penalty charge applies.</p>	<p>Companies that issue products like mortgage-backed securities are required to keep at least 5% of their issues so that they retain part of the risk.</p> <p>Requires issuers to provide more information about the assets backing the securities</p>	<p>Originators should retain a part of the risk of the underlying asset.</p>
<p>DERIVATIVES</p>	<p>Proposal for a Regulation on derivatives adopted by the EU Commission on 15 September 2010, comprising risk, prudential and ownership requirements for central counterparties (CCPs), mandatory clearing of eligible OTC derivatives with central counterparties and trade repositories, imposing strict requirements for CCPs to ensure their safety and ensures unfettered access to data by European regulators (trade repositories). The EU is not requiring derivatives traders to use a central clearinghouse; provisional plans envisage the new EU capital-markets authority has to determine which products will be subject to mandatory central clearing.</p> <p>Higher capital requirements for non-CCP cleared transactions foreseen in CRD IV.</p>	<p>Imposition of tighter restrictions on the largely unregulated derivatives market by requiring most derivatives to be traded through exchanges or central clearinghouses, monitored by the Securities and Exchange Commission or the Commodity Futures Trading Commission.</p> <p>Code of conduct for dealers and participants.</p> <p>Transparency of transactions through trade repositories.</p> <p>Banks are prohibited from in-house derivative operations, except those related to interest-rate, foreign-exchange and high-quality credit swaps.</p> <p>Corporate end-users, however, are provisionally exempt from margin, capital and clearing requirements.</p>	<p>G20 commitments include standardization of contracts, mandatory central clearing of standard OTC, reporting to trade repositories.</p> <p>In Seoul, the G20 welcomed FSB market reform recommendations on the central clearing and trade reporting of OTC derivatives concerning standardization, central clearing, organized platform trading, and reporting to trade repositories.</p>



AREA	EU ACTION	US ACTION	G20/FSB ACTION
VOLCKER RULE / PROPRIETARY TRADING	•/•	After the House passed its bill, President Obama disclosed a proposal that he called after its proponent former Fed chairman Paul A. Volcker: His proposal aims at limiting the activities of banks in business that are considered particularly risky: it prohibits – with exemptions – any form of proprietary trading by banks (using their own money to place directional market bets that are unrelated to serving customer), prohibits banks from owning a hedge fund, acting as one, bans deposit taking institutions from investing more than 3% of their capital in hedge funds and private equity funds, restricts securitization underwriting and imposes a concentration limit on mergers and acquisitions in the banking sector.	•/•
HEDGE FUNDS	The proposed Alternative Investment Fund Managers Directive, targeting Hedge Funds and Private Equity Funds, contains comprehensive new rules regarding the structure, registration, activities, marketing, capital and liquidity requirements, depositaries, remuneration, risk management, governance etc. Also market access of third country funds. After a political agreement of the European Parliament on 11 Nov. 2010 and the formal approval by the Council in the next few weeks, the Directive should come into force in early 2011 and be transposed into national law and applied by Member States by 2013.	All hedge funds that manage more than \$100 million have to register with the SEC and provide information about their trades and portfolios. The data will be shared with systematic risk regulator. Greater role for state supervisors.	Hedge Funds must register with relevant authorities and provide relevant and timely information, including on leverage. Hedge funds oversight to ensure that they have adequate risk management (London summit 2009)
INVESTOR / CONSUMER PROTECTION	Limited to investor / consumer protection mandate within new EU sectoral supervision authorities, though further legislation related to corporate governance of financial firms and reform of market-abuse directive anticipated.	Creation of a new regulator, the independent Consumer Financial Protection Bureau within the Fed with broad powers to write rules, but limited enforcement powers to banks and credit unions with assets of at least \$10 billion; nonbank mortgage companies, including loan originators and servicers	•/•
INSURANCE	EU insurance regulation consolidated under “Solvency II”, already developed before the crisis.	Creation of Federal Insurance Office within Treasury to streamline communication among state-based insurance supervisors etc.	•/•



AREA	EU ACTION	US ACTION	G20/FSB ACTION
CREDIT RATING AGENCIES (CRAs)	<p>The EU Regulation on CRAs introducing mandatory registration and supervision of CRA will be fully applied as of December 2010.</p> <p>A proposal to move the CRA supervision to the new EU Securities and Markets Authority (ESMA), which will have significant powers of inspection of CRA, activates is in progress.</p> <p>New rules require of CRA to publish their ratings methodologies and greater disclosure of information to CRAs of rated entities.</p> <p>Consultation document on various issues, such as over-reliance on credit ratings by financial markets; sovereign debt ratings; lack of competition, including the need for a EU rating agency; and reduction of conflict of interest due to the issuer-pays model.</p>	<p>In 2007, the SEC approved CRA registration & oversight rules, consistent with the international Organization of Securities Commissions (IOSCO) principles.</p> <p>The Dodd-Frank Act has strengthened provisions on accountability and transparency of CRAs. An Office of Credit Ratings within the SEC is created for specific CRA supervision.</p> <p>Provisions in the Act include rules to prevent that ABS issuers choose the CRA, possibly through a random process. SEC will also set a mechanism to qualify CRAs to provide rating to structured finance products.</p> <p>Agencies are required to disclose their methodologies</p> <p>The Act introduces more stringent thresholds of evidence when bringing lawsuit against CRAs and CRA liability for reckless use of information.</p>	<p>CRAs used for regulatory purposes are subjected to regulatory oversight, consistent with IOSCO. Enforcement of compliance by national authorities.</p> <p>Seoul: The Basel Committee had been expected to report by Oct. 2010 on reducing the reliance on credit ratings within the regulatory capital framework. This has been delayed, but the G20 welcomed FSB's more general recommendations to reduce requirements and references to credit rating assessments in laws and regulations, remove or replace them remove them or replace them by suitable alternative standards of credit worthiness and to generate a clear expectation that banks, institute. investors & other market participants do not rely solely or mechanistically on credit ratings.</p>
REMUNERATION	<p>Comprehensive new rules linked to capital requirements for banks, copied over for non-UCITS investment funds. Bonuses are more closely linked to salaries, limiting cash values in bonuses, issuing bonuses in non-cash instruments such as shares and establishing a claw-back mechanism. The rules will apply in relation to bonuses paid after the rules have to be implemented at national level (by 1 January 2011), regardless of when the bonus was awarded or the contractual arrangements were entered into.</p>	<p>The US adopted a supervisory, not a regulatory approach with a public discussion of a Fed's draft guidance on pay practices at banks to implement the FSB Principles /Standards, a review of 28 large banking organizations and the SEC adopting enhancements to compensation disclosure requirements for publicly-traded issuers in the US, as of Feb. 2010.</p> <p>Shareholders get more say in selecting corporate board members, as well as an advisory vote on compensation and "golden parachute" severance packages. Executive compensation must be rescinded if based on inaccurate financial statements.</p> <p>However, no statutory are controls foreseen.</p>	<p>G20 Commitment to aligning compensation with long-term value creation, not excessive risk-taking, for example deferral of variable pay for senior executives, restrictions on compensation where necessary to rebuild capital base, and banded disclosure requirements.</p> <p>The FSB conducted its first peer group review in March 2010 of how countries have implemented these principles and will undertake a follow-up review in 2011.</p>
ACCOUNTING STANDARDS	<p>The EU is officially committed to IFRS but has delayed endorsement of IFRS 9 approach on financial instruments due to pressure from certain member-states.</p>	<p>SEC has not taken a decision yet if and how to move to International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB); a decision expected in 2011.</p> <p>SEC favors a full "fair value" model for financial instruments rather than the "mixed measurement" model (fair value, amortized cost) preferred by IFRS.</p>	<p>G20 is committed to simplification of standards for financial instruments, clarity and consistency for international valuation standards, and move towards global standards for accounting.</p> <p>Seoul: The G20 encouraged IASB & FASB for more convergence in fin. instrument accounting standards by end of 2011. Though many countries converted to IFRS, there is still much divergence to US-GAAP.</p>



IV. EMPIRICAL EVIDENCE: ASSESSMENT OF CONVERGENCE OF THE G20/FSB, EU AND US REGULATORY REFORMS

Three years after the crisis and two years after charging the newly empowered G20 with driving the reform of the international financial regulatory architecture, not only high-level commitments have been made, but on the basis of the global framework endorsed by the G20 both the EU and US have progressed significantly with the adoption of new laws, regulations and structures. Given differences in approaches, diverging historical and institutional background and national discretion, it will be interesting to analyze the degree of convergence of outcomes.

A. CAPITAL & LIQUIDITY REQUIREMENTS FOR BANKS

The latest Basel III Agreement (September 2010) on levels and components of core capital and liquidity requirement for banks, endorsed by the G20 in Seoul, should result in significant changes and, optimistically, greater convergence in run-up to 2013 deadline for capital rules and securitization positions. However, the G20 considers that the long transitional periods for the new standards may unintentionally allow fractures to occur in international consistency, as markets and some regulators will press firms for more rapid implementation.

The option for regulators to exceed the minimum requirements may scatter the level playing field. The partial implementation of Basle II - only few core banks have to apply Basel II with fewer and less detailed Guidelines up to now - undermines convergence. Recently, a 24-line section of the Dodd-Frank Act, which requires regulators to remove all references to credit ratings of securities from their rules, is blamed for delaying the US implementation of the Basel committee on banking supervision standards on how much capital banks need to hold against such assets in their trading books, as these standards rely on such ratings (Onaran, 2010).

Given these delays and current public attacks of the new standards (amongst others, Citibank CEO Vikram Pandit at the at the Buttonwood Gathering in New York this October) (Guerrera/Pimlott, 2010), remains to be seen to what extent Basel III will be implemented in the USA, despite the fact that US authorities have been active in the negotiation of the final agreement of Basle III.

B. SUPERVISION AND SYSTEMIC RISK

Generally speaking, the US institutional reforms focus on improving existing structures, whereas the EU pursues a systematic overhaul of its institutional and procedural framework.

As the creation of the FSOC mirrors that of the ESRB, there is convergence as to the constitution of macro-systemic monitoring bodies, but divergence in respect to the proceeding of micro-level supervision: sectoral (3 supervisory authorities) in the EU versus systemic approach in the US.

However, in the US the supervisory authorities will have at federal level more powers, e.g. to deal with systemic risks; stricter rules concerning transparency requirements, equity ratio, liquidity provisions as well as risk management can be imposed on any financial institution, including non-banks, which are considered to be of systemic relevance.

As efforts to arrive at one single regulator for the banks were politically not enforceable, equipping the Federal Reserve with additional responsibilities for systemically important institutions risks an overlapping of tasks and uncertainty about the location of ultimate responsibility for supervision - in contrast to clear lines of responsibility in the EU.

C. SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (SIFIs)/CROSS-BORDER CRISIS RESOLUTION

Though the Basel Committee did not meet the G20 deadline to put forward detailed proposals on additional regulatory requirements for SIFIs, there is large convergence on the necessity of



putting in place a process to solve the “too big to fail” phenomenon for large, interconnected firms whose failure threatens to bring down the financial system. Divergence, however, prevails whether this should be an ex-post levy (US approach) or an ex-ante resolution funding by levy on banks (EU Commission, but resistance among some member-states).

In favor of the US system of ex-post funding for liquidation speaks that its administration seems less complex as that of a pre-funded resolution fund and that this approach raised less expectation among investors to be bailed out (reduction of moral hazard).

According to opposite view the ex-ante approach is rather discouraging moral hazard (in that way the Luxembourgish Central Bank Governor Yves Mersch) as funds are part of the set of tools of a financial stability framework that includes crisis management, thus prevent moral hazard³ (Mersch, 2010 pp. 6/7).

D. SECURITIZATION

The adopted rules are equivalent. Stricter rules for securitization positions were one of the first legislative reactions of the EU to the crisis. The US followed, but solely applied the holdback of 5% of issues to be maintained for “subprime” mortgage-backed assets.

This primary focus on the “crisis” issue in the form of “subprime” MBS shows the much narrower scope of the US approach and leads to a considerable divergence in application of US and EU rules.

E. DERIVATIVES

The G20 stressed the importance of internationally consistent implementation of the OTC derivatives rules in order to minimize the potential for regulatory arbitrage. However, with so many details as to scope and reach of new rules that still to emerge from separate US and EU approaches, this risks to continue to be an area of policy divergence.

Though there is divergence between the two approaches – the US focusing on contracts, the EU focusing on actors – the outcome is similar, notably both reforms require mandatory clearing for OTC derivatives. More ambitious plans to separate derivatives from banking in the US were not enforceable.

However, on the trading side OTC derivatives are less regulated in the US.

In the EU, all OTC derivatives brokers are subject to MiFID authorization and supervision, covering conduct of business rules, capital and organizational requirements. In the EU, some transparency requirements will be “upgraded”, while the US will just regulate “major swap dealers”, which is only one part of OTC trading.

There is some concern in the US regarding the separation of supervision between two agencies, the SEC and the Commodity Futures Trading Commission (CFTC).

F. VOLCKER RULE / PROPRIETARY TRADING

There is no equivalent of the Volcker rule in the G20 commitment.

Nor has the European Union so far considered binding prohibitions such as proprietary trading or limitations of business activities due to the EU’s attachment to the universal bank model and its conviction that prudential stability can be ensured through other means.

A stricter version of this rule, which would have completely prohibited links between banks and hedge funds, fell prey to negotiations in the US conference committee.

³ In Luxembourg, the Central Bank has suggested an innovative framework for an ex-ante bank resolution fund through the establishment of a privately pre-funded structure covering both issues of an orderly resolution, i.e Deposit guarantee scheme (DGS) and Bank resolution fund. In order to avoid any conflict of interest or misallocation of DGS reserves, this shall be an earmarked component of the fund. In addition, this framework is designed such that liquidity constraints taking effect during a transitional period would be minimized in order to safeguard the flow of capital into the bank resolution fund. This can be ensured via a dual mechanism, which allows for the substitution of loans granted to the fund by the purchasing of an equivalent amount of bonds issued by contributing credit institutions.



G. HEDGE FUNDS

The G20 commitments are the basis of both the EU and the US regulations.

Thus, there is a large convergence between the two approaches, such as the requirement to register and provide systemic risk information. While the EU regulation of hedge funds is still under negotiation within the EU, regulation of the complex structures of the industry already appears more detailed in comparison to the US, - some argue even “excessive” -, in particular in relation to the protection of the investors. However, large hedge funds of systemic nature in the US may also be submitted to more stringent supervision of the SEC empowered to introduce more detailed requirements as necessary. A final comparison and assessment of conversion will not be possible until the AIFM Directive has been finalized.

Afraid of protectionist moves that exceed the G20 commitments, the Obama administration is said to be closely monitoring the EU’s legislative procedure of Alternative Investment Fund Managers Directive and its requirements for the EU-passport allowing non-EU (e.g. US) hedge/private equity funds to act in the 27 EU nation block on the basis of one single registration in one EU country.

H. INVESTOR / CONSUMER PROTECTION

The US is showing strong lead in the consumer protection segment with the creation of an entirely new institution, the Consumer Financial Protection Bureau (CFPB). However, rulings by the new watchdog in the banking and financial institutions segment risk to conflict with prudential supervision concerns, given its limitation to the banking sector (for banks with assets above USD10 billion) and for some other financial institutions more in contact with consumers (mortgage banks, student loan institutions, etc.), while investment services and insurance will be outside its scope.

In the EU where consumer protection is of national competence in the hands of EU Member States, the creation of an EU body similar to US watchdog is not feasible in short term, also because the individual national laws not harmonized.

On the other hand, the main argument used in favor of the creation of the CFPB - that until now the various regulatory bodies had put consumer protection as a secondary objective of their activity - is also valid in Europe; therefore, the new sectoral EU Supervisory Authorities will have a mandate to protect consumers of financial services.

I. CREDIT RATING AGENCIES (CRAs)

The FSB is leading work in order to “reduce the extent to which credit rating agency ratings are inscribed into, or embedded in the regulatory fabric of our capital markets” (Tucker, 2010 p. 3).

Between the US and the EU, there is convergence on greater transparency and specific supervision of CRAs, but differences regarding to strategic approaches, rules and liability:

- The US aims at reducing overall reliance on ratings for investment decisions.
- The EU’s intention is to bring the reflection even further, looking also at ways to enhance competition for “Big 3” CRAs and the way sovereign debt is rated.

In the US, the Dodd-Frank Act has strengthened the legislation (e.g. provisions on accountability and transparency of CRAs, quality of ratings, disclosure and conflict of interests) in order to bring it in line with the EU legislation, and this should allow for granting equivalence.

Overall, while regulating CRAs will not improve their forecasts, there would be potential for conflict of interest since governments are large-scale issuers of debt.



J. REMUNERATION

Critics will say that in reality the FSB Principles have made little difference to levels of remuneration (KPMG, 2010). Maintaining a supervisory approach, not a regulatory approach, the Dodd-Frank Act addresses the compensation issue by means of establishing broad principles aimed at balancing risks and rewards and getting shareholders more involved in the decision on compensation schemes – without introducing significant controls on remuneration of financial managers. Thus, the new US rules are unlikely to address the negative role remuneration practices played in encouraging risky behavior by bankers e.g. by deferring compensation to a sort of debt contract, so that the managers and workers in large firms eventually become creditors of the firm and so they themselves have the same risks as other debt holders (Brunnermeier, 2009).

The EU rules currently under negotiation are likely to be more detailed, including rules on salary composition, variable components, and deferral conditions.

K. ACCOUNTING STANDARDS

The Dodd-Frank Act does not cover the issue of accounting standards, where the U.S. has not yet delivered on the G20 commitment to adopt the internationally agreed IFRS standards,. Convergence still is possible in 2011, but different views on accounting for financial instruments makes that difficult.

The EU approach of consistently adhering to international standards on bank capital, financial reporting requirements, and securities markets in line with G20 commitments, creates a level playing field for investors, and reduces the risks from regulatory arbitrage.

L. INSURANCE

Despite creation of a Federal Insurance Office (FIO) with minor enforcement powers, the US insurance regulation will remain almost exclusively under State supervision.

While in the US a centralized federal insurance regulation approach is not even in view for insurance regulation and supervision, the EU is far ahead discussing economic risk-based solvency requirements in the 2009 launched Solvency II Directive and updating consolidated supervision of financial institutions with insurance, deposit and credit activities covered by the Financial Conglomerates Directive.

V. WHAT REMAINS UNDER DISCUSSION

Although progress has been made against the challenges set by the G20 principles of the reform package, further progress is needed. To pick out just a few of the multiple issues under discussion:

A. FINANCIAL TRANSACTIONS TAX

In Europe, prominently Germany, France and Austria advocate for the introduction of a tax on financial transactions, a concept was originally dreamed up by US Nobel Laureate economist James Tobin in the early 1970s, and was initially devised as a tax on currency trading as a means of reducing volatility. Although the proposal has not met with approval at the 2010 G20 Summit in Toronto, the proponents continue to move in that direction, considering the possibility of a Euro zone-only financial transaction tax, if a deal amongst the full EU-27 proved impossible. However, European Central Bank President Jean-Claude Trichet put a damper on the project, stating that such a financial transaction tax could only work globally in order not to hurt the competitiveness of the European financial services industry.

B. SHORT SELLING

The EU is supposed to propose a draft Regulation on short selling in which the ESMA shall be given emergency powers to ban short selling temporarily for three months in shares, sovereign bonds, derivatives relating to sovereign bonds and credit default swaps linked to government bonds.



As these restrictions would go beyond those in the US and other financial centers, they would risk to distort capital movements between the EU and third countries as transactions might be diverted into non-EU jurisdictions, thus diminishing the EU's competitive capacity.

C. INSTITUTIONAL DESIGN OF THE FSB

Given the continuing challenges for financial stability and ongoing necessity for regulatory reform, the FSB in his current organizational set up cannot work as it is expected to do. It should therefore be financed and staffed based on an international treaty, and furnished with minimum compliance mechanism such as peer review and surveillance as part of its founding documents. It should also be authorized to convert international standards into international treaties, which should not be obstructed by the consensus process. Without being set up as real staffed international institute to coordinate the way to the stable international financial system, the FSB risks to wither out (Jeong, 2010).

Overall, as globally coordinated standards are vital to ensure stability in the financial markets, we should strive for more bilateral consultations and yet closer coordination all new policy measures in the area of financial market regulation of national, bilateral or international dimension.

VI. CONCLUSIONS

- The global financial and economic crisis highlighted the interconnectedness of the global financial system and increased awareness of systemic risk as a perpetual threat to the entire system.
- Cross-border financial activities have played a positive role in the process of globalization. At the same time, they have enhanced the need for ever-closer cooperation among competent authorities.
- In the process of tackling regulatory weaknesses, developing international cooperation was a hallmark for triggering reforms to prevent future crises, notably via the G20 platform.
- Though not addressing other macro-economic issues in response to the crisis beyond the framework of macro-prudential oversight, these G20 reform commitments served as a sound foundation. However, their soft design, reflecting diverging political and economic interest within the G20, has left ample room for individual states' maneuvers when implementing the policies into national law.
- Alongside carpentering the G20 architecture, both the US and the EU have progressed visibly (the US with the adoption of the Dodd-Frank Act and in the EU with the agreement on the supervision package), but with differences in pace (the US as first mover, while the EU is awaiting the proposals to be made by the global-level) and emphasis (driven by concerns to maintain competitiveness e.g. in the areas of capital adequacy and liquidity or SIFIs).
 - With the Dodd-Frank Act, the US has set the pace and an important regulatory response to the crisis addressing all priorities and key issues identified and agreed in conjunction with its partners in the G20.
 - The EU's new architecture is a significant first major move towards an effective trans-EU regulatory structure since the creation of the ECB. In comparison, the Dodd-Frank legislation is more a reshuffling of the regulatory patchwork and may not address the underlying structural problems. The decisive factor is now implementation and further enhancement of the reform packages.
- Without the crash, none of this new architecture would have emerged. Thus, one can look at it that way that the crisis has produced a first progress so far.
- Given the global dimension, there is concern that stability and regulatory reforms might, in the end, incite by-passing and push financial markets away from the Europe and the US towards less regulated playing fields. However, as only appropriately regulated markets provide a safe haven, the fi-



nancial reform regulation might even attract market players, as long as it is not distorting and does not hinder banks flexibility and initiatives.

- The dynamic nature of financial markets and the information asymmetry between regulators and financial institutions will require continuously improved transparency and more effective supervision of financial institutions.
- Also, as one central lesson of this crisis learnt is that financial and supervisory authorities and regulatory bodies will need to act more speedily and coherently than in the past, this will require ongoing monitoring of emerging risks and regulatory weaknesses, co-ordination in regulatory and supervisory matters and political accountability for defining and implementing mitigating actions.
- While Basel III has been an efficient step in the right direction of risk management, another facets are vital to get to the heart of the matter, e.g. accuracy and transparency of financial service providers' financial statements as well as diminishing the use of off-balance sheet activities and properly reporting thereof (Orlowski, 2010).
- While there is hardly any hope to prevent crises in the future completely, maybe there is the chance to reduce them by implementing better regulation - in view of that "Unknown unknowns"⁴ might cause the next crisis.

⁴ There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know. (Donald Rumsfeld)



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APPENDIX 1

PRE-CRISIS FRAMEWORK FOR SAFEGUARDING GLOBAL FINANCIAL STABILITY

This simplified overview of the pre-crisis framework for safeguarding global financial stability covers

- ❑ the four important sources of global systemic financial risk.
 - Global financial Institutions,
 - Global markets,
 - Unregulated financial activities, and
 - Economic and financial stability policy mistakes, and
- ❑ the lines of defense against them:
 - Market discipline,
 - Financial regulations,
 - Microprudential supervision of financial institutions and products,
 - Macroprudential supervision of markets and the financial system as a whole, and
 - Crisis management and resolution.

Table 2 Pre-crisis framework for safeguarding global financial stability

Lines of defense	Sources of cross-border systemic risk			
	Global financial institutions	Global markets	Unregulated financial activities	Economic and financial-stability policy mistakes
Market discipline and transparency	Partial	Primarily	Exclusively	Committee structures; peer pressure; lack of clarity and transparency No explicit framework and ineffective coordination and cooperation
Financial regulation	National orientation with international cooperation on capital requirements	No formal regulation	No regulation	
Microprudential supervision	National orientation with cooperation on best practices via Basel process	Not applicable	No supervision	International cooperation proved inadequate to supervise systemically important financial institutions
Macroprudential supervision	If systemically important	National market surveillance; IMF multilateral surveillance; FSF vulnerabilities discussions	Some via surveillance of national markets and financial institutions	National authorities and international cooperation failed to adjust macroeconomic and supervisory policies in advance of systemic pressures
Crisis management and resolution	National legislation and orientation	National orientation with some central bank cooperation and coordination	No framework	No framework and ineffective cooperation and coordination

Source: Adapted from Schinasi (2007 and 2009a).



APPENDIX 2

PROGRESS ON G20 FINANCIAL REGULATION REFORM

The following table is based on summaries provided by each of the G20 and EU countries as to where they are on the road to regulatory reform (Source PWC).

Country	Progress on G20 Financial Regulation Reform
Argentina	<ul style="list-style-type: none"> ■ Measures to increase financial sector soundness and update the regulation of risk management practices. ■ Measures to facilitate widespread access to the banking system, particularly for low-income households.
Australia	<p>As financial market conditions have normalized, bank funding guarantee has been withdrawn and withdrawal of a sub-national government borrowing guarantee announced.</p> <ul style="list-style-type: none"> ■ FSB scheduled to undertake a peer review of Australia’s financial system in 2011. ■ Commitment to adopt enhanced international capital and liquidity standards (Basel III). ■ Strengthened the executive remuneration framework. ■ Established independent regulatory arrangements for formerly self-supervised markets. ■ Reforms announced to improve quality of financial advice. ■ Announced tax reform to support further competition from foreign financial institutions in the domestic market.
Brazil	<ul style="list-style-type: none"> ■ All financial institutions are required to allocate capital according to standardized approaches for credit, market and operational risks as recommended by BCBS. Capital requirements for market risk were amended to include the use of stressed VaR parameters. ■ The introduction of advanced approaches for capital requirement is under way and will be complete by 2013 ■ While already applying prudential parameters that are quite strict, Brazil intends to promptly adopt the revised Basel III standards. The same applies for FSB’s compensation principles. ■ Initiatives to further deepen and make banking services more broadly available to society.
Canada	<ul style="list-style-type: none"> ■ Continued effective risk-based prudential regulation & supervision, incl. regular 5 year review reviews of regulatory framework. ■ Transition to a Canadian Securities Regulator with participating provinces and territories. ■ Committed to implement agreed-upon G20 financial sector reforms by established deadlines.
China	<ul style="list-style-type: none"> ■ China will improve instruments & means for macro-prudential policies, a regulatory regime for SIFIs, & the financial safety net. ■ Ongoing work to set up leverage ratio and liquidity requirements in banks; reform capital markets, including improving institutional infrastructure and investor structure; introduce risk-based capital requirement in the insurance sector; and strengthen convergence with international accounting standards.
EU	<p>Financial sector initiatives include:</p> <ul style="list-style-type: none"> ■ The creation of the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility



Country	Progress on G20 Financial Regulation Reform
	<p>(EFSF) to address tensions in the sovereign debt markets in the euro area.</p> <ul style="list-style-type: none"> ■ Stress tests to increase transparency and accelerate financial repair. ■ A supervisory package to establish a European systemic regulator and three European supervisory authorities to monitor financial markets, safeguard stability, and improve supervision of cross border entities. ■ A comprehensive regulatory reform programme incl. microprudential issues to improve efficiency of fin. markets & safeguard stability.
France	<ul style="list-style-type: none"> ■ Adoption of G20 compensation principles, enhanced capital requirements, committed to a systemic levy to protect taxpayers from the costs of resolving distressed financial institutions. ■ New regulation to promote responsible consumer lending. ■ Renewed European regulatory and supervisory framework. ■ Creation of the French Prudential Authority and extension of the French Securities Market Authority's power and scope.
Germany	<p>Measures to improve financial stability include:</p> <ul style="list-style-type: none"> ■ Implementation of the EU Regulation on Rating Agencies ■ Prohibition of naked short sales of German shares and of government debt issuances in the Euro zone ■ Prohibiting trade in Credit Default Swaps on government bonds in the Euro zone, except for hedging purposes ■ Implementation of the FSB remuneration standards for financial institutions developed on the basis of G20 resolutions.
India	<ul style="list-style-type: none"> ■ Monetary policy responses have been calibrated with an objective of price stability while sustaining a growth recovery in the broader context of persistent global uncertainty. ■ A Financial Stability & Development Council (FSDC) will be created to improve inter-regulatory agency coordination, and promote financial stability. ■ India has announced the creation of a financial sector legislative commission that will rewrite and clean up financial sector laws. ■ India has requested a joint IMF/World Bank Financial Sector Assessment Programme. ■ The Reserve Bank of India has issued guidelines based on FSB compensation principles for the private sector and foreign banks. ■ India is making progress in a number of areas of the G-20's financial sector reform agenda, including the adoption of Basel capital adequacy norms, convergence with international financial reporting standards, development of a roadmap for adopting a cross-border supervision framework, finalization of guidelines on OTC foreign exchange derivatives, and the development of guidelines on the introduction of CDS for corporate bonds. ■ The interest rate regime has been largely deregulated in order to achieve better price discovery and efficient resource allocation.
Indonesia	<ul style="list-style-type: none"> ■ Participates in Financial Sector Assessment Program & prepares action plans to strengthen adherence to int. standards based on the FSAP results. ■ Complete implementation of Basel II with adjustments to this regulatory regime following the final BCBS proposal to strengthen global capital and liquidity standards (Basel III). ■ Supplement the regulatory policy on prudential requirement with the power of respective regulators to impose additional requirements on specific financial institutions. ■ Applying risk-based supervision method for all regulated entities with more frequent audit activities. ■ Seek to pass the Financial System Safety Net Law to strengthen financial regulation and supervision.



Country	Progress on G20 Financial Regulation Reform
	<ul style="list-style-type: none"> ■ Establish stricter prudential regulations and stronger monitoring of important financial institutions.
Italy	<p>Strong measures have been adopted to strengthen and support the financial sector, even though it has not been heavily affected by the crisis due to effective supervision:</p> <ul style="list-style-type: none"> ■ At national level, specific rules have been issued by the Bank of Italy on remuneration practices to ensure their consistency with sound and prudent management and the Government has been recently delegated by the Parliament to ensure full transparency in this field by listed companies. ■ In addition, measures have been implemented to support households' home loans, the provision of financing and capital to businesses, in particular SMEs and for investment in research and innovation, and more effective consumer finance supervision. ■ Within the EU, firm action has been taken to preserve stability and ensure market functioning, through the creation of the European Financial Stability and Mechanism and the approval of the supervisory package.
Japan	<ul style="list-style-type: none"> ■ The Financial Instruments and Exchange Act, etc. amended in May mainly to : (i) improve the stability and transparency of the settlement of OTC derivatives transactions, and (2) strengthen group-wide regulation and supervision.
Korea	<p>The Government is taking financial reform measures to enhance financial stability and create a sound and resilient financial system. Improving financial regulatory and supervisory system by:</p> <ul style="list-style-type: none"> ■ Implementing the "Guideline for the Compensation Principles“. ■ Adopting the international financial reporting standards as of Jan 1, 2011. ■ Establishing Central Counterparties by 2012. ■ Aligning capital regulation measures with the BCBS decisions. ■ Preparing for SIFI regulation in line with international standards. ■ Developing financial market and industry by: working on related legislations such as “Financial Institution Governance Act "and “Financial Consumer Protection Act” and ■ Facilitating the long-term bond market by resuming the issuance of inflation-linked Treasury Bonds in 2010.
Mexico	<ul style="list-style-type: none"> ■ Financial System Stability Board was created in July 2010. The board is designed as a coordination mechanism to oversee the stability of the Mexican financial system. ■ New Basel standards will be reached within the agreed timeframe. Mexico already complies with most of the capital adequacy requirements. ■ Plans to promote financial deepening through regulatory changes and measures to increase access to banking services. ■ Plans to expand regulatory perimeter to cover systemic non-bank entities. ■ Strengthen framework for bank bankruptcies. ■ Completed FSB peer review.
Russia	<p>Russia is improving regulation and supervision of the financial sector in line with international standards and G-20 and FSB initiatives, taking into account national circumstances. It plans to take the following broad steps to develop its financial market:</p> <ul style="list-style-type: none"> ■ Increase capacity and transparency of the financial market. ■ Ensure efficiency of the market infrastructure. ■ Form a favorable tax climate for financial market participants.



Country	Progress on G20 Financial Regulation Reform
	<ul style="list-style-type: none"> ■ Improve legal regulation in the financial market. ■ Measures to adopt the International Financial Reporting Standards and strengthen the remuneration framework in the state and private sectors. ■ Accreditation procedures for rating agencies. ■ Within the framework of establishing the International Financial Centre in Russia, work will continue to ensure the appropriate regulation of organized trading and clearing operations and clearing activity.
Saudi Arabia	<ul style="list-style-type: none"> ■ Saudi Arabia's FSAP update scheduled for 2011. ■ Issued Rules on Compensation to implement FSB Principles and Standards. ■ Regulatory reforms to further strengthen banking supervision are continuing. These include encouraging banks to adopt advanced approaches of Basel-II, strengthening of the stress testing process, conducting risk based on-site examinations, and updating prudential regulations. ■ Strengthening of market infrastructure by undertaking new initiatives in payment and settlement systems.
South Africa	<ul style="list-style-type: none"> ■ Key objectives include: strengthening financial stability, broadening financial services for the poor; increasing competitiveness and efficiency; and promoting investor and consumer protection, including regulating credit ratings agencies and increased oversight of hedge fund and private equity industries. ■ Crisis contingency framework has been reviewed.
Spain	<ul style="list-style-type: none"> ■ A new regulation for the saving banks was passed in July. The reform gives them greater flexibility in access to capital resources. Besides, it makes corporate governance more professional and improves the representation of the stakeholders (in particular, elected positions and high level officials cannot be members of governing bodies. ■ The implementation of the Second reform of the Capital Requirements Directive (CRD II) will improve prudential requirements on securitizations and large exposures.
Turkey	<ul style="list-style-type: none"> ■ Regulation and supervision of financial sector will be enhanced in line with international standards and EU actions ■ Istanbul International Financial Centre Strategy and Action Plan will be implemented decisively. ■ An FSAP update is scheduled for 2011.
United Kingdom	<p>The government is taking firm action to reduce systemic risk in the UK financial sector:</p> <ul style="list-style-type: none"> ■ The framework for financial regulation and supervision is being reformed through internationally-agreed measures on capital and liquidity and by providing the Bank of England with control of macro-prudential regulation and oversight of micro-prudential regulation. ■ A levy on banks' balance sheets will be introduced from 1 January 2011 to encourage banks to adopt less risky funding profiles. ■ The government is also establishing an independent Banking Commission to consider reforms to the structure of banking in the UK and the state of competition in the industry.
United States	<p>The Wall Street Reform and Consumer Protection Act includes a broad range of provisions within four broad reform objectives:</p> <ul style="list-style-type: none"> ■ Strengthening supervision to reduce systemic risk and by closing gaps and loopholes in the regulatory regime, incl. SIFIs ■ Enhancing regulation of critical markets, including regulation of securitization markets. ■ Improving protection for consumers/investors through the creation of a consumer financial protection agency.



APPENDIX 3

G20 AGENDA-IMPLEMENTATION IN THE US AND THE EU

The following table provides a detailed overview of legislative measures dealing with the implementing of the G20 agenda in the US and on the European union level.

Implementing the G20 agenda – US and EU in comparison ¹⁶				
G20 commitment	Measure	EU legislation		US legislation
				Adoption
Macroprudential risks and financial oversight	– COM(2009) 499 – European Systemic Risk Board			2010 Title I
	– COM(2009) 501 – European Banking Authority			2010 Title III
	– COM(2009) 502 – European Insurance and Occupational Pensions Authority			2010
	– COM(2009) 503 – European Securities and Markets Authority			2010
	– COM(2009) 576 – Omnibus Directive			2010
Basel capital framework	– <i>CRD II – Liquidity buffers</i>			2009 Title VI
	– <i>CRD III – Trading book and securitisation</i>			2010
	– <i>CRD IV – Bank capital, leverage ratio, liquidity buffers, counter-cyclicality</i>			End-2010
Accounting standards	– <i>IAS Regulation 1126/2008 – Adoption of International Accounting Standards</i>			2008 Title VI
	– Endorsement of IASB Standards			Ongoing
Compensation	– <i>Recommendations on remuneration of Directors and financial services – sound principles</i>			2009 Title VI
	– CRD III			2009
	– AIFM			End-2010
	– Solvency II, Level 2			2011
	– Un-specified measures on non-banking financial services			2011
Bank risk management and internal controls	– <i>CRD II – liquidity risk, large exposures</i>			2009 Title VI
	– <i>CRD III – securitisation, due diligence, retention</i>			2010
	– <i>CRD IV – counterparty risk</i>			End-2010
Insurance	– Level 2 – governance, internal control, risk management			2011 Title V
Corporate governance	– Green paper			2010
OTC derivatives	– EMIR – mandatory clearing			2011 Title VIII
	– CRD IV – capital requirements from non-CCP transactions			End-2010
	– MIFID review			2011
	– MAD review			End-2010
	– Unspecified measure based on forthcoming FSB recommendations			2011 Title II
Bank resolution	– <i>Immediate changes to Deposit Guarantee Directive 94/19/EC</i>			2009 Title VI
	– Overhaul of Deposit Guarantee Directive 94/19/EC			2011-2012 Title VII
	– Overhaul of Investor Compensation Scheme Directive (97/9/EC)			2011-2012 Title IX
	– White Paper on Insurance Guarantee Schemes			2011-2012 Title XII
HF, PE	– AIFM			Title XIV 2011 Title IV
Credit rating agencies	– <i>CRA Regulation 1060/2009</i>			2009 Title IX
	– Amendment of CRA Regulation			2011

Source: DB Research

Source: Deutsche Bank Research