

De-globalising bank regulation

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1. Introduction

The present paper argues in favour of a significant de-globalisation of banks and of their regulation and supervision. Section 2 explains how the process of bank globalisation has required supplementing liberalisation with the production and adoption of a series of minimum standards in order to discipline competition between both banks and national regulators. Markets were free to innovate for products and private institutions, thus leaving financial morphology to adapt endogenously to private interests. Regulation intervened in an attempt to force banks to adopt the best prudential practices produced by the industry. This approach has been reaffirmed as the basis of the regulatory reforms hastened by the recent crisis.

However, as discussed in section 3, the failure of regulation to deal swiftly with cross-border bank crises has induced many jurisdictions to ring-fence national banking systems, thus introducing *de facto* a certain degree of de-globalisation. This is producing two different tendencies. One aims to restore and deepen bank globalisation, significantly counting on stricter prudential standards and on international cooperation for resolving global banks. The other considers that in order to shield essential services and public finances, it is safer to introduce some type of national ring fencing in regulatory frameworks. To a certain degree, the balance between the two tendencies depends on how much the new reforms are credible in producing bank resilience. A relevant portion of the current debate concerns the safe level at which minimum regulatory requirements, in particular the level of capitalisation, should be set. Although there are

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reasons to expect that the first tendency will finally prevail, different national propensities for strengthening the requirements coming from international prudential standards might lead to the adoption of some national defensive measures.

In section 4, we argue in favour of a new regulatory approach. We show the limits of homogeneous capital requirements for stability purposes, since they conflict with the goal of banks serving the economy without producing inflationary or deflationary pressures. If banks must serve economic growth, regulation should base financial stability on mainly structural measures, and supervision should be transformed into one of the policy tools flexibly looking after local conditions.

2. Lessons from not just the last crisis

In the aftermath of Britain's exit from the gold standard, Keynes (1933) offered a profound rethinking of the merits of the globalisation model that had dominated economic thinking and policy in the second half of the 19th century, up to the First World War. Keynes criticised the extreme configurations of protectionism and globalisation for international trade, but proposed to keep finance national, and to reserve unfettered globalisation to the circulation of ideas and tourism. His arguments rest on the benefits of acquiring more degrees of freedom for directing policies towards national welfare.

Compared with the current discussions on the trilemma on the impossibility of simultaneously independent monetary policy, fixed exchange rates and free capital movements, Keynes eliminates one horn, and hence the trilemma, objecting to free international capital flows on grounds of volatility and stability. His more general position comes from an analysis of the early 20th century world, where the emergence of different political systems was reinforcing the view that structural heterogeneity had to be dealt with more degrees of freedom than those left by a full-fledged globalisation. As he also made clear in other writings collected in his *Essays in Persuasion* (Keynes, 1931), competing with fascism and communism, the liberal state had to adopt some sort of

national ‘planning’ with a lib-lab flavour, in order to couple freedom with a more diffuse welfare. Although in the context of a different world scenario, the recent crisis has reopened the discussion on the merits of globalisation, especially in the financial sector.

The international order designed at Bretton Woods shared Keynes’ position in keeping finance mainly national. However, starting from the 1970s, the resurgence of ‘old modes of thought’ (monetarism and the like), with their ‘classical’ policy solutions to problems that did not come from Keynesianism but from the political inability to cope with the rifts in the old world order, helped to reassert dominant private interests and their push for going global. The ensuing financial globalisation, with authorities that had largely renounced to rule their local roost while also not agreeing on a new global ‘hard law’ solution, could produce nothing but anarchy.

The increasing seriousness and frequency of financial crises, from the Herstatt Bank to Latin America’s foreign debt, convinced authorities and private players that some minimum common rules were necessary. The specific bent of these rules is the asymmetric story of all peace treaties, in this case dominated by the interests of the leading financial centres. It is marked by prudential requirements put on top of financial liberalisation.

Since the early 1990s, the solution was to accompany financial globalisation with global soft laws, i.e. minimum standards, to be converted into national hard law by local jurisdictions.¹ These minimum standards should have been capable of putting a floor to ‘unfair’ competition, between both private actors and national regulatory systems. National compliance with international standards soon became the key necessary for full admission to international financial circles.

The convergence on minimum standards represents a move towards the more ambitious goal of a levelled global regulatory playing field. Although the experience of recent decades shows that this goal is like the horizon, which shifts at the same pace as the observer is walking, the

¹ Hence the proliferation of international standard setters, like the Basel Committee on Banking Supervision (BCBS) for banks, International Organization of Securities Commissions (IOSCO) for markets, International Association of Insurance Supervisors (IAIS) for insurance, International Accounting Standard Board (IASB) for accounting, to name just a few.

crucial point concerns the adoption of the same types of rules rather than the homogeneous quantitative enforcement of these rules. In other words, in any case prudential rules are superimposed on a liberalised financial system.

Considered properly, the quest for the regulatory level playing field marks a further deepening of globalisation, increasing the defences of global actors against unwelcome local interferences. A prudential regulatory level playing field cannot, for instance, leave room for significant national structural measures limiting the operations of global actors.

The more recent financial crisis has made manifest that the real issue that had prompted previous global prudential regulation efforts, i.e. how to deal with the crises of large global banks, was still unsolved. Starting from the 1975 Basel Concordat and the first releases of the Basel Accords, explicitly focused on internationally active banks, the prudential regulatory and supervisory framework has not been capable of producing enough of the right incentives to keep global systemically important banks (G-SIBs) safe. Moreover, large parts of the unregulated or lightly regulated financial system, now more interconnected with banks, were able to favour the accumulation of financial fragilities and to amplify and generalise endogenous idiosyncratic crises.² The lesson that official authorities have derived (G20, 2009) is that the crisis was the result of “excesses”. To rein in these excesses a radical change in the regulatory approach was not needed. The previous framework had to be adjusted only where the right incentives were weak, and wrong incentives had to be eliminated. To this end, the scope of regulation also needed to widen, to include actors and markets interconnected with the banking sector. As a result, a plethora of reforms have been proposed and adopted, following the previous global prudential approach, under the coordinating watch of the Financial Stability Board (FSB).³

² This largely refers to the so-called shadow banking system, on which there is now a large body of literature. For a recent review, see Adrian and Ashcraft (2012).

³ See the web page *About the FSB* at <http://www.financialstabilityboard.org/about/overview.htm>.

The same authorities also agreed that these reforms should not interfere with the capability of the private financial sector to innovate. Translation: financial morphology, for both products and institutions, is better left in the hands of the private sector. Implication: regulators and supervisors have to forever play catch-up to the private sector's dynamic ability to elude regulation.⁴

3. National defensive strategies for old problems

The effect of the crisis on public finances has, however, opened a political fissure in the previous armour. Many countries had to face inshore effects of offshore crises, quite often linked to cross-border banking. As a result, public resources had to be used to mend situations over which national authorities had no previous control. More specifically, the home country control, especially of foreign branches, had not protected host countries.⁵ The new imperative commandment of permitting bailouts no more has often led to the adoption or proposal of defensive strategies based on so-called subsidiarisation, i.e. requiring foreign banks to establish themselves as subsidiaries that have to comply with local capital and liquidity requirements. The result is a certain degree of de-globalisation of G-SIBs, no more able to shift capital and liquidity freely according to their global interests.

Interesting, due to its wide implications, is a recent proposal by the Federal Reserve that requires US based relevant establishments of foreign banks to be grouped inside an intermediate US holding, thus having to satisfy all regulatory requirements on a local basis (Tarullo, 2012). Adding to it the old "Regulation W", which limits intra-group exposures, the USA

⁴ In the last decades, the financial sector was increasingly left free to innovate; new products and new institutional arrangements were often the means to elude the residual regulatory constraints. As a result, the authorities progressively lost control of the creation and allocation of risk. As is true for war, innovations make barriers erected to contain a repetition of the last crisis the best recipe for being found unprepared for the next one.

⁵ For instance, the UK government had to make good for British depositors left exposed to the failure of Icelandic banks and could not impede, before its formal failure, Lehman Brothers draining funds from its London branch.

would create an effective national ring-fence, leaving other jurisdictions to decide on how to deal with subsidiaries and branches of US G-SIBs. The justification offered by the proposal is the necessity of equal treatment for all banks operating in the US market, which displays a lack of trust in the home control of foreign banks and hence in the international level playing field.

The Vickers' proposal on ring fencing has analogous implications (ICB, 2011). The proposal, explicitly directed at shielding public finances from bank crises, ring-fences the regulatory requirements of the retail banking arm from the investment arm that coexists inside the same holding, and bars the former from foreign operations and participations. In line with this, all foreign banks operating in the UK retail market would be ring-fenced and obliged to satisfy regulatory requirements on a local basis.⁶

If all jurisdictions were to apply the Federal Reserve or Vickers proposals, the result would be to fragment G-SIBs into national banks of foreign capital, fully complying with regulation and supervision on local basis. A defensive strategy would thus produce a certain degree of de-globalisation of regulation and banking. This could open the door to more radical proposals on abandoning the international regulatory playing field defined as the adoption of the same prudential rules.

However, subsidiarisation is not defence enough when the crisis hits a G-SIB, because subsidiaries may be systemic, and because any crisis in other components of the G-SIB may have repercussions for the local unit. This explains why official attention is increasingly directed at new resolution mechanisms for systemic banks. The problem, the same one that previous global regulatory efforts could not solve, is how not to make public finances pay for these failures, while preserving essential financial services, and how to distribute losses to private investors across different jurisdictions. The task of regulators who want to re-establish full global banking is to produce a new international standard for bank resolution (Bailey, 2013). The argument runs as follows: if a credible and internationally shared resolution regime were capable of eliminating the

⁶ Probably due to the strong reactions from the City, the bill on ring fencing presented by the Treasury to Parliament (HM Treasury, 2013) does not ban transactions with non-residents.

national fears that have recently encouraged subsidiarisation, a more comprehensive and accepted regime of the home country control could be attained.

The Financial Stability Board (2011) has produced a set of “Key Attributes of Effective Resolution Regimes for Financial Institutions”, adding more recently a consultative document on how to make the key attributes operational (FSB, 2012). Roughly speaking, we have two models. The single point of entry (SPE), which delegates to the resolution authority of the home country to fix the ex-ante resolution requirements and the management of the resolution process; and the multiple point of entry (MPE), which gives resolution powers to the national authorities in which subsidiaries or relevant branches are located. For both models, the FSB calls attention to the necessity of cooperation between all national authorities involved; however, the substance is that only the SPE is fully consistent with the principle of the home country control that lets banks fully profit from globalisation. Supporters of global banking oppose MPE because it implies a high degree of fragmentation and rigidity of the resources of a G-SIB.

When coming to lay down the conditions to make SPE operational, the FSB recognises that much trust, cooperation and common rules are required, i.e. those same tight conditions that for many decades have impeded any agreement on loss sharing across different jurisdictions. Worth noting is that the adoption of the SPE should not be so appealing for bank headquarters and especially for their resolution authority, if both were to give credible guarantees on the future availability of resources to deal with the failure of foreign branches and subsidiaries.

The recent draft produced by the European Council, of a Directive concerning the minimum harmonisation of recovery and resolution legislation for EU member countries, helps one gain some insight (European Council, 2013). In a region devoted to strengthening its single financial market, of which the proposed legislation should be one of the key pillars, it is recognised that national interests may be invoked for the adoption of the MPE. In this case, national resolution authorities would be in charge of resolution plans for the subsidiaries and relevant branches of foreign banks, and resolvability requirements would be decided upon and

met on a local basis. Since those requirements come from stressed scenarios and are designed to keep the bank, or part of its operations, afloat mainly by bail-in proceedings, the MPE would have paramount effects on the entire supervisory framework.

4. An alternative perspective on bank regulation

There are good reasons why we should transform and enhance the defensive strategy outlined above in a positive proposal. The main reason concerns the dangers coming from the current focus on stability and from global homogeneous rules on capitalisation. A simplified exercise may help to make the point.

Suppose a bank in a steady growth. Given its leverage, the rate of growth of its assets is equal to the rate of growth of its capital. If the bank retains all its profits, the two previous rates are equal to the return on equity (*ROE*). Given the return on assets (*ROA*: net profit after taxes / total assets), a minimum regulatory leverage ratio (L_m = minimum equity / total assets) determines the maximum rate of growth of assets (AG_M). Formally:

$$AG_M = ROE = ROA/L_m \quad (1)$$

Table 1 shows the sensitivity of AG_M to alternative hypothetical values of *ROA* and L_m . The three minimum leverage ratios refer to the 3% proposed by Basel III, the 6% proposed in the USA, and the 15% proposed by several economists in a letter published in the *Financial Times* (Admati *et al.*, 2010).

Table 1 – AG_M for alternative levels of *ROA* and L_m

	ROA = 0.2%	ROA = 0.5%	ROA = 0.8%	ROA = 1.2%
Leverage ratio = 3%	6.6	16.5	26.4	39.6
Leverage ratio = 6%	3.3	8.3	13.3	20.0
Leverage ratio = 15%	1.3	3.4	5.4	8.0

Source: author's computation.

Higher leverage ratios produce a lower maximum rate of growth of bank assets for any given levels of *ROA*. To stay in the market, the bank must distribute a share of its profits; therefore, for any given rate of growth it must realize a higher *ROA* than in the previous case. If *RR* is the retention ratio, we can write:

$$AG_M = (RR \cdot ROA) / L_m \quad (2)$$

Equation (2) gives the maximum rate of growth of bank assets consistent with barely complying with the minimum leverage ratio and with the bank's pay-out policy. Even if we allow for the contribution of external capital, it should be safe to assume that in the long term this contribution would be linked to bank profitability, hence to the asset growth based on internal resources.

According to the new Basel III framework, the minimum leverage ratio should prevent outlier positions that could possibly result from applying Basel's rules on capitalisation, as exemplified in equation (3):

$$AG_M = \frac{RR \cdot ROA}{MCR \cdot (RW_b \cdot \frac{A_b}{A} + RW_t \cdot \frac{A_t}{A})} \quad (3)$$

where *MCR* is the minimum capital requirement, *RW_b* and *RW_t* the risk weights of the banking and trading book, *A_b* and *A_t* the assets of the banking and trading book. The control variables are the minimum capital requirement and the two average risk weights.

These prudential variables are calibrated for resilience, not for *AG*. Just to give a quantitative flavour to the argument, let us consider the case of Deutsche Bank (table 2).

The data for loans and securities are a rough approximation for the banking and trading book, as it is attributing the same *ROA* to the two books in order to compute the two standalone *AGs*. However, the overall picture is substantially correct in showing how the lower risk weight of the trading book permits the poor profitability of this universal bank to finance a higher growth of its commercial banking activity. The overall 9.7% of asset growth permitted by the 8% of minimum capitalisation comes out without any relation to the financing of the real economy.

Table 2 – *Deutsche Bank, average 2010-2011*

	Assets (million €)	Risk Weighted Assets	Risk Weights	Leverage ratio (%) for MCR=8%	ROA %	RR	AGM, % standalone	AGM, % universal
Loans	537,310	273,839	0.51	4.1			3.3	9.7
Securities	1,297,051	45,876	0.04	0.28			47.7	9.7
Total	1,834,361	319,715	0.17	1.4	0.18	0.77		9.7
Actual leverage	Total Equity/Total Asset			2.6				
	Tangible Common Equity/ Tangible Assets			1.7				
				3	0.18	0.77		4.6
Proposed minimum leverage ratio				6	0.18	0.77		2.3
				15	0.18	0.77		0.9

Source: author's computation on data from BankScope.

If we safely assume that the bank tends to maximise its profits more than to serve the economies in which it is present, the proportion between the two books and the growth of assets are directed at that primary goal. Moreover, two alternative measures of Deutsche Bank's average leverage ratio for 2010-2011 show that the bank would have been an outlier even applying the more generous Basel III floor. As a consequence, its long-term rate of growth of assets would be strongly reduced if complying with the three leverage floors.

The third release of the Basel Accords raises the minimum capital requirement and increases risk weights. The current discussions focus on whether this is enough for increasing bank resilience. While many analysts propose to increase more substantially the floor of the leverage ratio, bank managers oppose this argument on the grounds that it would imperil real growth. From our perspective, both camps fail to present metrics for the adequate minimum leverage ratio and are right or wrong depending on national specificities.

Looking at national banking systems, there should be some close relation between the growth of bank assets and the growth of nominal GDP (\dot{Y}). This means that fixing the leverage ratio on stability grounds could equally result in allowing bank assets to outgrow GDP or to constrain its growth.

Table 3 shows the average *ROA* for several banking systems over an extended period. Due to a lack of aggregate data we assume a common retention ratio of 0.5 and then compute *AG* for alternative values of the minimum leverage ratio.

Table 3 – Averages 1992-2007, %

	<i>ROA</i>	<i>AG_M</i> (%) for leverage ratio equal to			\dot{Y}
		3% (Basel)	6% (USA)	15% (Admati <i>et al.</i>)	
Austria	0.43	7.1	3.6	1.5	3.7
Belgium	0.35	5.9	2.9	1.2	3.9
Denmark	0.79	13.1	6.6	2.7	3.8
Finland	0.98	16.2	8.2	3.3	4.4
France	0.32	5.3	2.7	1.1	3.3
Germany	0.22	3.6	1.8	0.7	2.6
Greece	0.89	14.7	7.4	3.0	4.8
Ireland	0.84	13.8	7.0	2.8	7.3
Italy	0.47	7.7	3.9	1.6	2.5
Netherlands	0.50	8.2	4.2	1.7	4.3
Norway	0.82	13.6	6.8	2.8	7.3
Portugal	0.66	10.9	5.5	2.2	3.7
Spain	0.71	11.7	5.9	2.4	4.2
Sweden	0.80	13.2	6.7	2.7	3.7
UK*	0.69	11.3	5.8	2.3	4.5
USA	1.13	18.6	9.4	3.8	5.1

Source: author's computation on data from OECD Bank profitability database and Eurostat.

*Large banks only

Given the wide dispersion of *ROA*, and its imperfect correlation with the rate of growth of nominal GDP, table 3 makes it clear that one size does not fit all. The critics of Basel III are right, but for a different reason,

that the proposed floor of 3% to L_m is too low. The higher US floor of 6% remains generous for most countries. However, the minimum leverage ratio of 15% proposed in the letter published in the *Financial Times* would prove disastrously high for many countries, especially European ones.⁷ Here we should also note that the European Union is far from presenting conditions coherent with a single market and a single rulebook.

Ultimately, the resilience of banks comes from profits, actual and prospective. With low profits, high capital requirements cannot but constrain the growth of bank assets. The US banking sector is resilient, or may reacquire more promptly its resilience, since it is profitable. Many European banks are fragile because they produce too little profit.

The plethora of new prudential requirements is adding significant compliance costs that are worsening the situation. No serious thought is given to why in many cases profitability is so dangerously low, especially for commercial banking. Overall, one can dispute the previous exercise for taking past values and assuming a common retention ratio. The point, however, is that under a common capitalisation rule there is no mechanism capable of matching bank profitability with a sustainable local growth of nominal GDP.

Basel's supporters cannot argue that the adoption of risk weights, instead of a crude leverage ratio, does the trick. Uniform capital rules are nonsense because they may either permit inflationary pressures and asset bubbles or constrain real growth.

It is then necessary to rethink anew the role of bank regulation. Following a suggestion of Minsky (1986), we could take the growth of nominal GDP as a policy target and transform the prudential variables of current regulation into policy variables. We can rewrite equation (1) as:

$$AG = \frac{RR \cdot ROA}{L} \simeq \dot{Y}_T \quad (4)$$

⁷ Many among the proponents of higher capitalisation argue that in the (distant) past banks, although not subject to prudential rules, presented a much higher level of capitalisation (for a review see Admati and Hellwig, 2013, chapter 2). They fail to take into account the then much higher level of *ROA*.

where \dot{Y}_T is the target rate of growth of nominal GDP, resulting from employment and inflation targets. RR and L should be used as policy variables, to be included in a consistent general policy set together with fiscal and monetary tools. According to Minsky, while L should be rather stable, calibrated for the average conditions of banks, acting on RR for individual banks would permit to obtain results consistent with both the general objectives and idiosyncratic and local conditions.

The dynamic path of equation (4) avoids both bubbles and constraints on real growth. The focus on leverage derives from the belief that mixing with questionable methods for measuring risks by private operators should not be the business of supervisors (Roncaglia, 2012; Tonveronachi, 2010a; 2010b).

Let us briefly dwell upon this point. The previous averages of ROA hide significant differences within each national banking system. If, for instance, large banks were more profitable than small ones, a tendency to increased bank concentration would be the result of imposing common capital rules. In the risk-sensitive environment of Basel, this result also comes from the different methods used to compute risk weights. Recent analyses show how much capital large banks save by using internal rating models with respect to standardised ones (*The Economist*, 2013).

Moreover, we have seen in the previous example concerning Deutsche Bank how different requirements for the banking and trading books constitute a strong incentive for universal banks to strengthen the activity of their investment arm. The result is that a risk-based prudential approach necessarily interferes with the incentives of banking operations, thus producing unwanted structural results with little import on the sustainable demands coming from the economy.

Banks should be left free to judge the risk they take, as well as they should then be left free to fail. This requires radical structural reforms on financial morphology and safety nets (Montanaro and Tonveronachi, 2012). If we recognise that regulation has structural effects anyhow, it would be better to start directly with structural measures devoted to mould financial morphology according to social interests, going beyond the sole goal of stability.

Stability should be primarily pursued through adopting structural measures, thus making capitalisation measures more meaningful and

permitting more flexibility for fixing the minimum leverage ratio. A higher leverage ratio is a necessary although not sufficient condition for stability, but it must be reached by keeping banks healthy. Banks should be restrained from excessive expansion but capable of financing economic growth. Consistent active policies for safeguarding bank profitability, where needed, are necessary.

We may not be capable of reaching stability and growth if we push at the same time for high competition, high leverage ratios, high regulatory compliance costs and high taxation. The global economy is not the sum of homogeneous national economies, and the global financial system is not the sum of homogeneous national financial systems. This is why regulation should be kept mainly national and at the same time part of a consistent set of policy tools.

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