

# **Empowering supervisors with more principles and discretion to implement them will not reduce the dangers of the prudential approach to financial regulation**

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Let us learn from Russian history. When faced with a problem such as the haemophilia of prince Alexei, it is of no use to place his health in the hands of a priest. It is safer to shield the prince from accidents. Today the haemophiliac prince is the financial system and supervisors are the priest. This is not to suggest that our supervisors are charlatans like Rasputin. Only that it is not safe to give them responsibility for a Rasputin type of mission impossible. The paper will argue that, on the contrary, this is what has happened in the past and will be continued with greater emphasis in the future.

## **1. The *laissez faire* approach to financial regulation**

The string of financial crises that has punctuated the last thirty years is correlated with the emergence of a new financial system design characterised by increasing doses of financial liberalisation and de-regulation. The first elements in the new design are micro-efficiency and the freedom of arbitrage that has produced tight interdependence among financial institutions. Stability is thought to be the result of creating micro-efficiency. The management of international imbalances left to private finance, with the result of persistent current account disequilibria

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I have greatly benefited from comments by Jan Kregel, Elisabetta Montanaro and Alessandro Roncaglia. The usual caveats apply.

financed by capital flows possessing high mobility and volatility, shows that such an arrangement does not smooth international imbalances; on the contrary, quite often they prosper.<sup>1</sup> The softening of internal regulations on domestic financial operators followed the same destiny on the argument that no substantial regulatory freedom should be left in national control (what is euphemistically described as a level playing field). International financial liberalisation and de-regulation are, therefore, part of the same system design. De-regulation was accompanied by a prudential re-regulation based on the enumeration of an increasing number of principles accompanied by few, increasingly complicated, prudential rules, imposed within a limited perimeter of regulated subjects, substantially banks.<sup>2</sup> The increasing role of the international standard setters then came to level the playing field with recommendations that further enhanced the role of supervisors in interpreting and implementing the principles.

Banking regulation is exemplary in this respect. Its pinnacle before the recent crisis is represented by the Basel 2 framework which opens up an enormous gap between matters subject to prudential rules (three types of risks) and those subject to principles. Basel 2 adds 4 new principles on supervisors' duties to the 25 principles (further divided into 236 criteria) already contained in the *Core Principles for Effective Banking Supervision* (BCBS 1997, 2006a, 2006b). In addition, critical discretion remained to supervisors within the rules, as for instance in the definition of regulatory capital. The existence of a large number of principles implies a large amount of discretion in their application given to supervisors subject to the generic mandate to make each bank more resilient. Further, the mandate also required supervisors to apply these principles by adopting the financial industry's own methodologies to measure and hedge risk.

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<sup>1</sup> On these processes see Cornfold and Kregel (1996) and Kregel (2004), (2008a), (2008b).

<sup>2</sup> With prudential regulation I do not mean, as often done, a regulation directed to assure financial stability, but a regulation based on prudential norms, not on structural rules. I will discuss more extensively this aspect later.

Coupling de-regulation with the increasing divergence between the promulgation of prudential principles and the increasing discretion in their implementation by supervisors produced what I call a *laissez-faire* financial design. It is a system based on the freedom of financial institutions to create and assume financial risks. Those who consider the financial system as heavily regulated may find this description paradoxical. This does not mean, as just seen, that every institution in the financial system enjoys unlimited freedom. It means that the freedom to create new instruments and new complex institutions, to increase and tighten the interconnections between financial operators, and to locate financial firms in favourable jurisdictions, allow global actions to evade tight sectorial or local regulation at negligible costs, while pushing regulators towards minimum standards.<sup>3</sup>

The correlation between the recent string of financial crises and the liberalisation/de-regulation/re-regulation process does not necessarily imply a specific causal direction. In my opinion, which I have expressed elsewhere,<sup>4</sup> the high frequency and the seriousness of the crises stem from the new financial system design. The crises are not the result of an unfinished project, of minor omissions easy to remedy, or of the excesses of greedy individuals; they are the result of the logic of the new design for the financial system. Increasing the role given to supervision cannot cure this haemophilia, while delegating supervisors with *de facto* regulatory powers may worsen the result.

In the pursuit of the causes and responsibilities of the recent crisis, reasoned judgments have apportioned blame evenly among financial institutions, regulators and supervisors. The point is that, apart from few fraudulent cases (Ponzi schemes are, however, easier to hide in the new complex design), financial institutions have only used their ingenuity to exploit the freedom they were given to innovate and to influence regulation through lobbying. It is not necessary to be a Florentine like me

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<sup>3</sup> The supervisory authority of a European country, highly rated in the independence ranking, received some years ago a call from the management of one of the largest domestic banks asking to abolish a rule related to requirements on liquidity mismatch; they would otherwise shift the bank headquarters to another European country. The rule was duly eliminated.

<sup>4</sup> I refer the reader to Tonveronachi (2010).

to reject the idea that markets and finance are naturally driven by ethics. Hence financial institutions cannot be the culprits. If something went disastrously wrong it is the architects of the system that are to blame.

The previous argument presupposes that alternative designs are possible. Let us see what they might be.

In an ideal Arrow-Debreu world all the future states of nature are given and known. An auctioneer capable of collapsing all future periods into a set of alternative intertemporal equilibria reigns supreme. This omniscient *deus ex machina* is not just an incredibly powerful machine; it must also possess something akin to Jupiter's powers, capable of eliminating the impact of anyone who dares not to follow the rules. The result is our old friend Pareto-optimality. This imaginary world has no room for money and finance. For many decades the majority of economists tried to give a more realistic face to this scheme while preserving its results. They have attempted to find a substitute for Jupiter in the introduction of perfect and complete spot and future markets: an elegant design, but as far from reality as Jupiter. Then they have proposed another Olympian myth, that of rational expectations, which unfortunately needs, among many other things, the perfect knowledge of the "true" economic machine itself. As the best exponents of this school have admitted, none of these theoretical schemes allows for a meaningful introduction of uncertainty, money and finance. Finally, they seem to have retreated to a Friedmanite-like methodology. Structural models depicting the economy are not necessary, although they may be useful as parables. What is needed is to show empirically that the system exhibits better behaviour when actual conditions best approximate each single mythical hypotheses. If something goes wrong it is because some piece of reality is not a good approximation to the corresponding precondition necessary for producing the Pareto-optimum. The very term 'imperfection' is obviously derived from their myths and parables. These efforts are particularly directed at showing the distortions coming from the intervention of government in economic matters, regulation included, when not following the best approximation criterion. Note that these distortions are identified by isolating and assessing each imperfection on

an individual basis, forgetting that the basis of the myths lies in the general equilibrium approach.

Intervention should be directed to lessen the degree of imperfections on each single issue. What we have before termed the *financial laissez faire* design is, in its purest form, the result of this approach. What, then, to recommend as a response to the current crisis? More of the same medicine.

Let me offer a different parable. After our ancestors were expelled from Heaven we gained the freedom of choice, but lost complete knowledge on the possible states of nature. Keynesian uncertainty then became our curse, and markets were neither complete nor perfect.<sup>5</sup> Given that, with some exceptions, we were transformed from *homo contemplativus* into *homo faber*, with the passage of time we succeeded in building an institutional solution. Money and finance could close the gap of the incompleteness of future markets for goods and services. Obviously financial markets cannot be perfect since this would require the complete set of information that would make non-financial markets perfect and complete. First-best solutions are then barred from this world. Furthermore, as Tobin (1984) argued, with Keynesian uncertainty financial micro-efficiency does not produce second-best solutions. Therefore, even if we make the heroic assumption that competition leads to micro-efficiency, the results coming from free markets for resource allocation and systemic stability would be inferior to a second best-solution. This realisation reinforces the crucial role of the financial system and opens the door to a possibly stringent public regulation.

Obviously, regulators share all the limits of living in this uncertain world. Their “intelligent design” is thus destined to be distorted. But how, and how much?

Attempts to dispose of finance, by designing the entire economic machine in a sort of approximation to the Arrow-Debreu parable, failed because it is simply too complex to comprehend and because the politburo could not replicate the Jupiter-auctioneer (although it tried to imitate him). That was based on an illusion of knowledge.

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<sup>5</sup> For a discussion of Keynesian uncertainty see Roncaglia (2009).

In a market economy – I omit the term “free” knowingly – the incompleteness of information due to Keynesian uncertainty includes the knowledge of the machine. Not only we do not have all the information that we should feed into the model; beforehand, we must also try to discern the main features of the dynamic reality and then model them. Given that we are “imperfect” but *faber*, alternative interpretations abound, obliging regulators to choose. Since this choice is capable of shaping the system, it gives rise to opposing interests; regulators bend towards those capable of exerting the more effective pressure. The past experience with the *laissez faire* design has been a mixture of ideology, vested interests and encrustations left from the previous design.

## **2. Prudential regulation and supervisors’ discretionary powers**

Let us see how the institutional set up of “light-touch” prudential regulation and supervision works. High level regulators, generally parliaments, produce laws that state the general goals, specify the principles to be followed, and outline the institutional supervisory design, comprehensive of the powers attributed to each supervisory authority. Generally, these laws contain few rules, whose specific content and more general meaning depend in the end on the more comprehensive set of rules that supervisors have to emanate as they translate the received principles into operative measures. In a prudential environment regulators do not transform all received principles into rules; they transfer some of them to the regulated entities (duly rephrased). The recommendations coming from international standard setters (again made up of a combination of principles and rules) usually will not pass through the parliamentary process before going to the competent supervisory authorities. This makes sense because the national supervisory authorities participate in framing those standards at the international level, and it is generally held that technical details are to be left to technical authorities. The problem is that the Devil is in the details. In any case, the result is that supervisors become overloaded with principles and discretionary power.

These discretionary powers transform supervisors into *de facto* regulators. The relevance of their action increases dramatically when *de jure* regulation is based on principles. It is not by chance that regulation and supervision are often taken as synonyms, not only by laymen. These are questions in which there is no strict correspondence between goals and principles on one side and policy measures on the other side. As a result supervisors are caught between the general goals transformed into principles and the specific, strong and often non-homogeneous interests of the financial industry. They face a complex multi-layer and multilateral principal-agent problem. However, when, as in the *laissez faire* design, the principles state or suggest that regulation and supervision must not restrain the freedom of the private sector to innovate, and when the methodologies that are suggested, or auto-suggested, in order to transform the principles into rules comes from the financial industry, the message is clear: interpret and implement principles with a “light-touch.”

That this was a dangerous construction became evident well before the recent crisis. Regarding supervision, concerns on this institutional set-up were already producing an increasing number of studies on matters like supervisors' governance, independence, accountability, transparency, integrity, capture, auto-capture, enforcement powers, resources and legal protection.<sup>6</sup> These are very elegant discussions, but they do not touch the fundamental problem represented by the implicit instruction to apply discretion, unless we make the unacceptable hypothesis that technocrats lack any ideology and are capable of better interpreting existing reality. Lord Turner, the President of the British Financial Services Authority, has recently affirmed that “what occurred was not just a crisis of specific institutions and regulations, but of an intellectual theory of rational and self-equilibrating markets” (Turner, 2009, p. 1). A system design that is so sensitive to intellectual fashions is based on illusion, in the sense we used before.

It is necessary to remark that the *laissez faire* project was still unfinished when the recent crisis exploded. In many countries supervisors

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<sup>6</sup> See for instance Barth *et al* (2004) and Masciandaro *et al* (2008).

had maintained enough potential powers and discretion to oppose what now are seen as excesses. Kregel (2010) has offered a reconstruction of the de-regulation process in the USA, showing that much of it came from supervisors using discretionary administrative measures. An international comparison easily shows that where supervisors acted more prudently banks did not suffer as much from the first financial wave of the recent crisis. Significant additional capital requirements for creating Special Investment Vehicles impeded their creation in Spain. Strong requirements for consolidated financial accounts had the same consequence in Italy. A weak and politically motivated supervision on the quality of the assets of the German Landesbanken allowed something that resembled a gamble for resurrection. The forbearance of the Financial Services Authority for banking textbook monstrosities led to the Northern Rock debacle. Equally alarming is the *post factum* decision of the FSA to maintain 15 permanent officers in each large bank. All over the world supervisors pushed or allowed financial intermediaries to grow domestically and internationally in the name of efficiency,<sup>7</sup> thus heightening their systemic relevance. These few cases show how dangerous it is to leave supervisors with such large degree of discretion.

The strange thing is that we find almost no discussion on sensible alternatives, such as restricting supervisors' discretion via a different approach to regulation.

### **3. Regulatory reactions to the recent crisis**

We have seen that the liberalisation and de-regulation processes of the last decades were the result not only of legislative and administrative measures, but also of a general climate that strongly oriented supervisors to accommodate product and institutional innovations. The morphology of the financial system became *de facto* a dependent variable, favouring the birth of non-banking intermediaries, also aimed at regulatory and supervisory arbitrage. Even prudent supervisors are impotent when

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<sup>7</sup> Kregel (2010) and Haldane (2010) convincingly argue that there are no efficiency gains above a medium-size dimension.



transactions are shifted outside their jurisdiction. And it is in the nature of the *laissez faire* design to have different approaches for banking and non-banking activity while leaving them effectively integrated. Then, a rather ineffectual regulatory design has been made even more inefficient by giving supervisors large discretionary powers and permitting regulatory arbitrage and black holes.

How are official authorities responding to the shortcomings in regulation and supervision brought to light by the recent crisis?

At the international level, a new institutional architecture has been put in motion. The G20 is trying to offer a unified front on the general outlines of regulatory reforms, while devolving to the Financial Stability Board the quasi-technical role of *trait d'union* with the international standard setters. The IMF will have to monitor the international compliance with the agreed principles. Although a convergence on critical details will be not easy to reach, the preparatory work undertaken by the FSB and the communiqués released at the end of G20 meetings offer substantial continuity with the past. Some passages taken from recent official declarations help to clear the point:

The G20: “Financial markets will remain global and interconnected, while financial innovation will continue to play an important role to foster economic efficiency” (G20, 2009a, p. V).

The President of the FSB: “The goal will be to strengthen the resilience of the system without hindering the process of market discipline and innovation that are essential to the financial sector’s contribution to economic growth” (Draghi, 2008, p. 7).

The US Treasury Secretary: “[T]he central objective of reform is to establish a safer, more stable financial system that can deliver the benefits of market-driven financial innovation even as it guards against the dangers of market-driven excess” (Geithner, 2009, p. 2).

The G20: “[W]e agreed [... t]o make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis. Where reckless behavior and a lack of responsibility led to crisis, we will not allow a return to banking as usual” (G20, 2009b, p. 2).

We must not, therefore, expect a radical change of program. Financial reforms will try to eliminate imperfections in existing

regulation and supervision in order to impede future “excesses” that are seen as the main causes of the recent crisis.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act*, currently considered as the most complete financial reform produced up to now, may constitute a case study. Its 848 pages appear to be a formidable re-writing of existing regulation and supervision (Dodd-Frank Act 2010). Most commentators judge the Act as the most radical financial reform since the Glass-Steagall Act of the 1930s. As might be expected, a great deal of space is given to matters for which the current crisis exposed critical deficiencies in the US financial system. The supervisory institutional structure has been redesigned in the attempt to close holes, arbitrage potential and inconsistencies. The Financial Stability Oversight Council is one of the more interesting novelties. Its voting members are the Treasury, whose Secretary holds the Chair of the Council, the highest representatives of the federal financial supervisory agencies and an independent member appointed by the President. For many decision the affirmative vote by the Chairperson is required.<sup>8</sup> Its duties include macro-prudential supervision and non-binding recommendations to resolve supervisory jurisdictional disputes among Council members. The chosen supervisory model is, in fact, composed of a plurality of agencies with inevitable overlapping competences. The Office of Thrift Supervision disappears and the Bureau of Consumer Financial Protection is created. The Act also treats extensively financial products, especially mortgages and structured instruments, the organisation and supervision of

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<sup>8</sup> Another novelty is the Office of Financial Research established within the Department of the Treasury. “The purpose of the Office is to support the Council in fulfilling the purposes and duties of the Council ... and to support member agencies, by (1) collecting data on behalf of the Council, and providing such data to the Council and member agencies; (2) standardizing the types and formats of data reported and collected; (3) performing applied research and essential long-term research; (4) developing tools for risk measurement and monitoring; (5) performing other related services; (6) making the results of the activities of the Office available to financial regulatory agencies; and (7) assisting such member agencies in determining the types and formats of data authorized by this Act to be collected by such member agencies.” The Director of the OFR “shall be appointed by the President, by and with the advice and consent of the Senate” (Dodd-Frank Act, Sec. 152 and Sec. 153). The influence of the government on the Council is thus strengthened.

derivatives markets, the clearing of OTC instruments, executive compensation and rating agencies.

Although the legislators' concern for idiosyncratic and systemic stability is evident in Title I of the Act, the reform does not change the existing approach to regulation and supervision. It continues to be based on prudential principles, on the morphology endogenously created by private operators, and gives even larger regulatory powers to supervisors for writing rules, refining definitions and often for changing those same principles. International Accords on financial standards go directly for implementation to the competent supervisory agency. To have an idea of the wording of the Act, the term "may" has 1,845 recurrences and the term "discretion" 77. Very critical issues, such as the "too big to fail" problem, are left entirely to supervisors to master. This is one of the few occurrences in which potential structural powers were given to supervisors. Legislators' main worry seems to have been to avoid fiscal costs for taxpayers, devoting the entire Title II to crisis resolution, rather than lessening the probability of financial crises. Attempts to introduce a few clearly binding structural rules, such as those proposed by Volcker on banks' proprietary trading and relations with hedge funds and private equity funds, have been watered down. Undoubtedly, progress has been made in some matters, such as the organisation of supervision, the use of ratings and executive compensation. However, they do not amount to a change of direction. The redecorated building looks like an attempt to give a new try to the old project. I thus remain convinced that the most radical reform after the Glass-Steagall Act was the liberalisation and de-regulation process of the last decades that was enshrined in the 1999 Modernisation of Financial Services Act.

The extra-large regulatory powers attributed to supervision amplify the difficulties facing supervisors in choosing a sustainable path, while increasing the danger of their being captured by the general climate, current political majorities and lobbies.<sup>9</sup> The governance of the Agencies is not protected against the spoil system and it has been reformulated

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<sup>9</sup> Recently, an exponent of the US financial lobby told *The Economist* how now they feel relieved for having to deal with supervisors after the tough negotiations with legislators. The same relief has been expressed for the new drafts of some EU Directives.

without paying much attention to incentives. Accountability now depends on the dialogue between Agencies, on supervision by the Council, chaired by the Treasury, and on periodic reporting requirements. Overall, it seems that the political powers wanted to retain a higher degree of control than in the past, perhaps not being fully confident on how the Agencies might use their enhanced discretionary powers. The greatest enemy of accountability is, however, complexity. The financial system will continue to become more highly complex and supervision will follow this trend. The 848 pages of the Dodd-Frank Act are in effect only a small part of the US financial legislation and are nothing in comparison with the rule-books and technical instructions that supervisors have to prepare for the financial industry.<sup>10</sup> They are not easy reading, especially for politicians. In addition, all these efforts may remain ineffective at critical points, irrespective of supervisors' *bona fides*. After the explosion of the recent crisis, supervisors candidly admitted that *ex ante* they had no idea where risks were located and how they were concentrated. Having left the tight interconnections between different types of financial institutions untouched, and with risks that move and accumulate at the speed of light, supervisors deceive themselves if they think that they will be able to counter what they consider the excesses of the past with their new powers. Finally, once the fear of overreaction by high-level regulators evaporated, the financial industry resumed the fight to ensure that the enhanced discretion is used to maintain the light-touch approach to supervision. The industry responses to the Basel Committee consultative document on the new discipline on capital and liquidity requirements, the so-called Basel 3, are a clear example.<sup>11</sup>

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<sup>10</sup> Davis Polk and Wardwell (2010), a law firm, has estimated that the Dodd-Frank law will require no fewer than 243 new formal rule-makings by 10 different federal agencies plus the Treasury, some of whom are joint rule-makings. It is also estimated that the Act will require 22 new periodic reports.

<sup>11</sup> Liquidity, in particular, is banks' *bete noir*. Interestingly, the recent *Interim Report* by the Macroeconomic Assessment Group (2010), jointly established by the Financial Stability Board and the Based Committee on Banking Supervision, employs very light-touch additional liquidity requirements when assessing the macroeconomic impact of Basel 3.

As the memory of the current crisis vanishes, most probably we will find ourselves where we stood before it. It may be that my scarce knowledge of the US institutional architecture impedes me to see some relevant correctives. Certainly I would not recommend the US solution to be replicated elsewhere.

Nonetheless, with consideration for differences due to the peculiarity of its construction, Europe is proposing an institutional architecture along lines that are similar to those adopted in the USA. At the pinnacle of the new approach is the European Systemic Risk Board (ESRB) composed of the President and Vice-President of the European Central Bank, the Governors of National Central Banks, the Chairs of the new three European Supervisory Authorities for Banking, Insurance and Securities, the European Commission, and, as non-voting members, one representative of the competent national supervisors per Member State plus the President of the Economic and Financial Committee. The three independent Authorities, and their joint committee, are linked to national supervisors into what is defined the European System of Financial Supervisors. The duties of the ESRB include macro-prudential supervision and recommendations to the relevant authorities. The most interesting novelty of this architecture, yet to be fully agreed upon, is, perhaps, the power given to the three European Supervisory Authorities to settle disagreements among national supervisors and to propose rule-books aimed at creating a narrower corridor for national discretion. Much will depend upon future legislation. If the goal of a unified European financial market prevails, and this is not certain, the peculiarity of the European construction will produce more rules and less discretion. On the other hand, with the day-to-day supervision left in national hands it will be hard to eliminate important differences for those areas where national discretion prevails.<sup>12</sup> Furthermore, future rule-making might go either in the direction of simply re-painting the old building, or towards a more relevant regulatory restructuring. The inclusion of international standards

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<sup>12</sup> As the recent crisis clearly shows, EU cross-border banking does not mean a unified European financial area when supervision, deposit guarantee schemes and crisis resolution interventions remain for the most part a domestic affair.

and pressures from the industry, and from some member countries, make the first alternative the more probable.

#### 4. Conclusions

Concluding, both the US and Europe are not abandoning the fundamentals of the previous prudential regulatory system. They are enlarging the discretionary space of supervisors-regulators on prudential requirements and leave them the difficult choice on the eventual adoption of a few structural measures. My opinion is that if we leave risks free to be created and restrict regulation to prudential measures, dealing effectively with systemic stability it would require such stringency as to make the system not viable. Presently, we can only make extrapolations on the direction that supervisors-regulators will take and how the financial morphology will endogenously adjust to the new architecture. Since private finance attracts eminent representatives of *homo faber*, and has plenty of cash, the odds are in its favour.

As an alternative we could first design the financial morphology by means of structural rules,<sup>13</sup> having in mind both the needs of the economy and financial stability, and then complement this design with few and very simple prudential measures. Supervisors would face restricted discretion and clearer general rules. That was more or less the nature of the Glass-Steagall Act. I am not proposing to go back to its specific features; what I am proposing is to go back to its methodology.<sup>14</sup> A design along these lines would permit to contain more easily systemic risks, neatly separate regulation and supervision and enhance accountability at both levels.

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<sup>13</sup> To dispel possible misunderstandings, it is necessary to clarify that structural rules have nothing to do with fixed rules. While the latter impose automatic responses, as would be the case for a fixed leverage, structural rules dictate what is allowed or forbidden. The Volcker rules, if properly adopted, are a case in point.

<sup>14</sup> For a proposal in this direction see Tonveronachi and Montanaro (2010).

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