PSL Quarterly Review, vol. 63 n. 255 (2010), 299-362

Reforming financial systems after the crisis: a comparison of EU and USA

RAINER MASERA∗

The financial crisis, that began to unfold in the summer of 2007 in the United States and led to the worst economic downturn after the Great Depression, with huge direct and indirect costs to public finances, brought to the fore great weaknesses in the system of financial surveillance worldwide.

Macroeconomic imbalances were major underlying factors of the crisis, together with the a-critical celebration of the "invisible hand" and of markets' efficiency, rationality and self-corrective properties.

The need was, therefore, recognized to bring together a better understanding and adjustment of macroeconomic and financial issues. In particular, financial surveillance should be better designed and implemented around sustainable macroeconomic developments.

The Global Financial System (GFS) is an essential infrastructure to support the global economy, a central network to achieve the economy's potential at world level.

The GFS is a worldwide integrated dynamic innovative network of interactive components: intermediaries, securities (products), markets,

∗ University G. Marconi (Rome) and Member of the de Larosière Group. Email: r.masera@unimarconi.it.

I thank participants in conferences and seminars organised by: the Guglielmo Marconi University, the Polish Financial Supervision Authority, the Mentor Group, the Italian Banking Association, Assonime, the Long-Term Investors Club, the OECD, the Italian Ministry of Economy and Finance, the Bank of Italy and the Tor Vergata University of Rome for the valuable observations on previous drafts of this paper. I am especially grateful, without implicating, to Paolo Angelini, Franco Bassanini, Jacopo Carmassi, Jacques de Larosière, Stanislaw Kluza, Thomas Kosmo, Renato Maino, Philippe Maystadt, Giancarlo Mazzoni, Callum McCarthy, Stefano Micossi, Fabio Panetta, Antonella Pisano, Laura Segni, Federico Signorini and Kevin Warsh for helpful comments.

©Associazione Paolo Sylos Labini

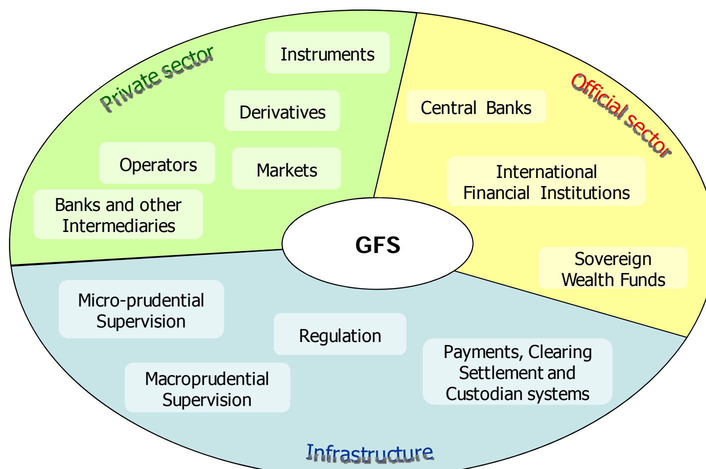
operators, derivatives, regulation and supervision, payments, clearing and settlements systems (see figure 1).

The analytical and policy mistake at the turn of the new millennium was to believe that financial innovation and "technical" market efficiency (information, allocation, stability) implied a fundamental break with the past (the New Economic Era), and notably that:

- markets became self-correcting, market failures became irrelevant; financial markets were more efficient than intermediaries in assessing and managing risks (complete and efficient markets);
- intermediaries, intrinsically based on asymmetric information and delegated monitoring, had, in any event, developed very powerful risk management and control techniques; hence the paradigm of (short-term) shareholder value creation.

In this framework, the capital standard for regulated intermediaries (banks and insurance companies) was regarded as a pillar change (the New Corner Stone) for regulation and supervision, which was complemented by the new international accounting principles and supported by the working of rating agencies and by financial innovation, notably derivatives and synthetic securitization.

Figure 1 – *The Global Financial System: main components*



The lessons of the crisis[1] have shown that all the points previously mentioned contained some grains of truth, but were fundamentally wrong:

- the market price is not always right: widespread mispricing of assets and significant market failures can occur;
- financial markets are not self regulating, but – as in the past – they are prone to speculative bubbles;
- market efficiency and investors' rationality cannot be taken for granted;
- the advances in risk management were flawed, mainly because of the inappropriate treatment of the assumptions behind the underlying models, based on derivative stochastic structures, which replaced traditional actuarial models (VaR models are a relevant example). Even the assumption of independence between the government risk-free rate and private risk premiums must be questioned;
- the crisis of Eastern European countries during the summer of 2008 and the sovereign debt crisis of Greece and other EU Member States in 2010 have clearly shown that the hypothesis of orthogonality (independence) between government bill rates (generally considered risk free) and the creditworthiness of private issuers (with their own risk premiums) can no longer be considered a general axiom. When a systemic crisis occurs, sovereign risk and bank credit risk become mutually dependent because of: a) increased risk aversion and b) general fear of contagion;[2]
- flawed corporate governance models did not allow for adequate checks and balances between risk takers and risk controllers, and developed wrong short- term incentive and remuneration systems;
- the workings of the GFS require good regulation and effective supervision, also as a result of its important and wide range externalities. The Basel capital standard, the IASB accounting standards – based on an

---

[1] An analysis and a comprehensive bibliography on the 2007-2009 crisis are offered in Masera (2009a).

[2] There is evidence that the Greek debt crisis could have sparked off the crisis of certain SIFIs with significant exposure to sovereign debt. On the two-way interdependence see Honohan (2010), Ruding (2010) and section 3 below.

a-critical application of mark-to-market principles – and the credit rating agency approach were instead affected by fundamental weaknesses, notably their pro-cyclicality; this is partly related to the analytical framework just described (as evidenced, for instance, by the very high leverage ratios reached also by many "well capitalized" European banks in the upward phase of the cycle);

- additionally, the Basel II internal models allowed systemically important global financial groups to take advantage of apparent diversification of risk across a broad range of markets, products, instruments, in the false belief that the increasing size and complexity of these financial institutions were adequately managed by the innovative risk management tools. This resulted in significantly reduced capital buffers, and hence dangerously increased leverage ratios;
- beyond good regulation and effective supervision, sound and sustainable economic policies are required to contain market failures and to control cyclical developments. Here again the false myth that "the cycle is dead" was exploded;
- the functioning of the global financial system requires consistent supervisory, regulatory and economic policy frameworks (hence strong cooperative arrangements) among major countries;
- price stability does not lead automatically to financial stability;
- liquidity and funding risks were inadequately treated by the Basel standards;
- prudential and capital requirements on individual institutions represent a necessary, but not a sufficient condition for financial stability;
- micro and macro-prudential regulation and supervision must be coordinated to avoid fallacy of composition.

In sum, a fully developed GFS is very sensitive and therefore potentially unstable. This is by no means a novel conclusion, but the lesson was largely forgotten in the past decade, when recognition of that instability was regarded both an analytical and a policy mistake. The contrary view, that the system was fundamentally self-correcting through competition and an "invisible hand" approach, had become the (nearly) common wisdom.

To ensure a good regulatory and supervisory framework, major changes had to be made to the whole regulatory framework, not only to the Basel standards. The regulatory framework behind the crisis was based on interrelated elements that were fundamentally flawed.

The Basel I approach did not address the issue of risk emanating from securitized instruments. In fact, it prompted regulatory arbitrage, by encouraging off balance sheet operations.

Basel II offered only partial correction and, in any event, it did not apply to investment banks in the US. Regulatory requirements (accounting standards and capital rules) created feedback loops, which enormously amplified the inherent pro-cyclicality of the system (the "dynamite model"[3]). Mark-to-market accounting of trading books of financial institutions pushed up profits, reserves and bonuses during the bull run, but required huge write downs in the bear phase, when important instances of market failures manifested themselves. Banks where forced to sell further assets and/or to reduce the loan volume to try to maintain capital levels (the fallacy of composition).

The Basel II framework needed fundamental review. It underestimated some important risks and over-estimated banks' ability to handle them. The perceived wisdom that distribution of risks through securitisation (the originate-to-transfer, OtT banking model) took risk away from the banks turned out, on a global basis, also to be incorrect. These mistakes led to too little capital being required. This had to be changed. The pre-crisis Basel methodology was too much based on recent past economic data and good liquidity conditions. A critical reflection was also needed with regard to the reliance of Basel II on external ratings.

The use of ratings should never eliminate the need for those making investment decisions to apply their own responsible judgment. A particular failing has been the acceptance by investors of the ratings of structured products without understanding the basis on which those ratings were provided. Furthermore, during the crisis it became evident

---

[3] Nitric acid plus glycerol are fairly safe if handled separately, but become explosive if put together.

that the regulatory and supervisory nets should extend, in a proportional manner, to all intermediaries, markets, operators, instruments and derivatives, that may have a systemic impact, even if they have no immediate links with the retail investors. The surveillance net should, therefore, cover systemic institutions as well as systemic situations.

Both the EU and the US are implementing an improved regulatory environment. The approach has two main common objectives: first, decreasing the likelihood of a similar financial crisis reoccuring; and second, ensuring that the costs of any failure of financial institutions are not borne by taxpayers, but by the failing bank and the financial sector more generally. To this end, resolution procedures must ensure that even systemically relevant financial institutions can be allowed to fail in an orderly manner.

The recently enacted Dodd-Frank Act (July 2010)[4] represents the most important change to financial regulation in the US since the Great Depression: it impacts all federal supervisory agencies and affects all major aspects of the financial services industry. The EU, in spite of an early start through the broad endorsement of the *de Larosière Report* (February 2009)[5], was lagging behind in terms of a paradigm shift in the European financial framework. However, in September 2010, the Economic and Financial Affairs Council (ECOFIN) endorsed an agreement with the European Parliament on the reform of the EU framework for financial supervision. The contents of the agreement will be examined in section 3.

A summary and an analysis of the different reforms will be presented in the following sections. A chronological-analytical perspective will be adopted: section 1 will recall the main features of the *de Larosière Report*; section 2 is a critical summary of the Dodd-Frank Act; section 3 outlines the financial regulatory reform in Europe. Some concluding remarks – which take account of the G20 global regulatory agreement reached in the November 2010 Seoul Summit meeting (Seoul Summit, 2010) – are presented in the final section. The agreement of the

[4] United States Congress, 111th (2010).
[5] De Larosière (2009).

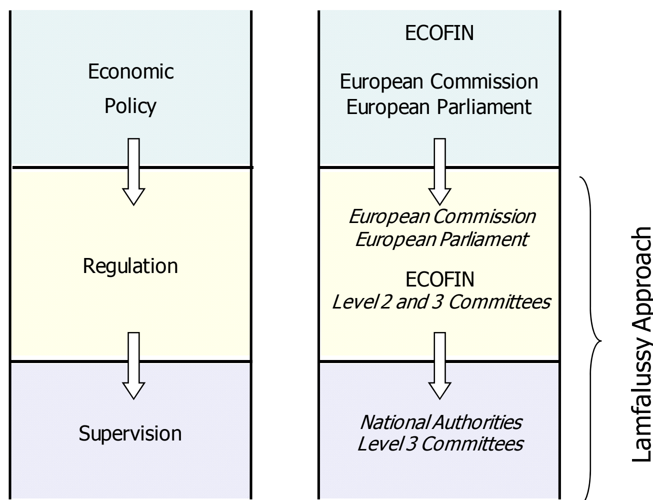
Basel Committee Oversight Body (BCOB) on quantification and timing of Basel III capital standards – which represents an integral part of regulatory repair – is summarized and assessed in the Appendix.

1. The *de Larosière Report*

1.1 The link between macroeconomic and supervisory policies

To design a new financial architecture in Europe consistent with global developments and international trends, the *de Larosière Report* examined the causes of the crisis and underlined the importance of sustainable economic policies and of macro-prudential oversight, also on economic policies, for financial stability. The *Report* was focused on the connections between the causes of the financial turmoil and the suggested elements of regulatory and supervisory reform. To this end, it presented a new interactive framework, which superseded the traditional EU Lamfalussy scheme (see figure 2).

Figure 2 - *The traditional "ladder" Lamfalussy approach to financial surveillance in Europe*



Four principal lines of action were outlined as the basis for financial reform:

I. The creation of a European Systemic Risk Board, largely coordinated by the European Central Bank, that would be responsible for the identification and monitoring of macro-supervisory risk and would have the duty of issuing specific recommendations for corrective actions also to policy makers.

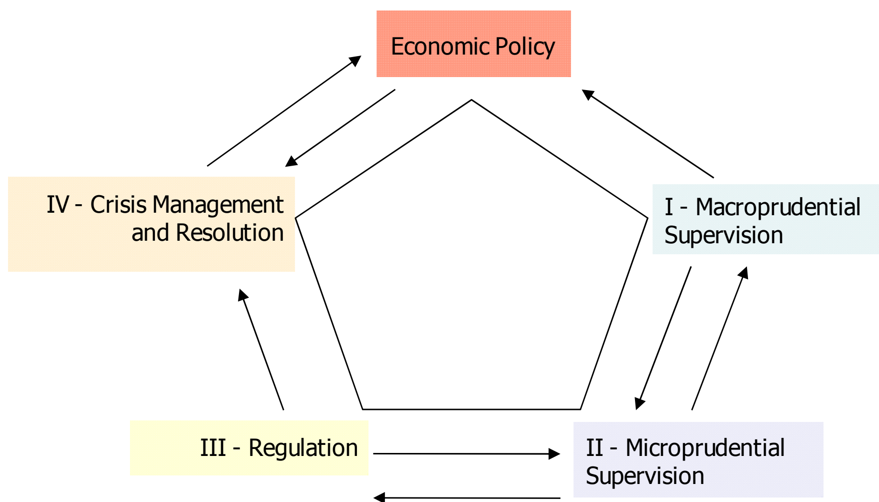
II. The creation of a European-level financial micro-supervisory framework based on three Authorities, to oversee banks, insurances and securities and markets, respectively. These Authorities would replace the Lamfalussy Agencies and would have formal decision making capabilities and binding powers.

III. Regulatory repair, notably with respect to the shortcomings and failures of the "faulty triad" (the capital standard, the accounting standard and the operation of credit rating agencies) and of securitised products and derivative markets, along the lines already indicated in the introduction; In this respect, the following recommendations were made: (i) to simplify and standardise over-the-counter derivatives, (ii) to introduce and require the use of at least one well-capitalised central clearing house for credit default swaps in the EU, (iii) to guarantee that issuers of securitised products retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged). Regulatory reform should be based on a comprehensive system, which would extend in a proportional way to all actors, intermediaries, markets and activities that embed potential systemic risk, also to avoid the problems of unsupervised "parallel banking systems".

IV. A procedure to deal with crisis management and resolution, covering both situations and institutions posing systemic risks, and capable of containing moral hazard and sheltering taxpayers from the costs of banking failures.

As clearly indicated in figure 3, the four building blocks of financial reform interact and help promote the soundness and sustainability of the macroeconomic framework for the EU and the global economy.

Figure 3 - *The innovative, interactive de Larosière approach to financial stability reform in Europe*



1.2 Macroeconomic surveillance and crisis management

The *Report* drew particular attention to the special supervisory management and resolution frameworks required, in Europe and globally, to deal with complex and large financial institutions posing systemic financial risks, without however entering into specific details on the procedures to be adopted. It argued that a comprehensive early warning system should be complemented by the creation of an international risk map and an international credit register. It underlined the need for a close coordination in financial reforms in Europe and the United States, with the cooperation of the Financial Stability Board (FSB) and the International Monetary Fund (IMF). It suggested that regulatory frameworks in all financial centers should be monitored and common international standards should be enforced.

The *Report* was endorsed by the Commission in May 2009.[6] In June 2009 EU leaders agreed in principle on the main proposals outlined

[6] European Commission (2009d).

above, concerning financial regulation and supervision, and gave a mandate to the Commission to proceed along these lines and to propose an operational solution for burden sharing of potential bail-outs/resolution plans for large cross-border banks.

2. The new US institutional financial framework

The New US Institutional Financial Framework is constructed around building blocks that should operate in an integrated and cooperative way, but with distinct responsibility and accountability, under a clear guidance of the Treasury. Primary regulations are extensive and well defined, but the final set of major secondary regulations is expected to be completed only by mid-2012. The blocks have been grouped here following the logical thread outlined in the *de Larosière Report*:

I. Macro-prudential supervision;
II. Micro-prudential supervision;
III. Correction of key aspects of the regulatory framework;
IV. Crisis Management and Resolution Framework;
V. Consumer Protection.

The new structure is outlined in figure 4.[7]

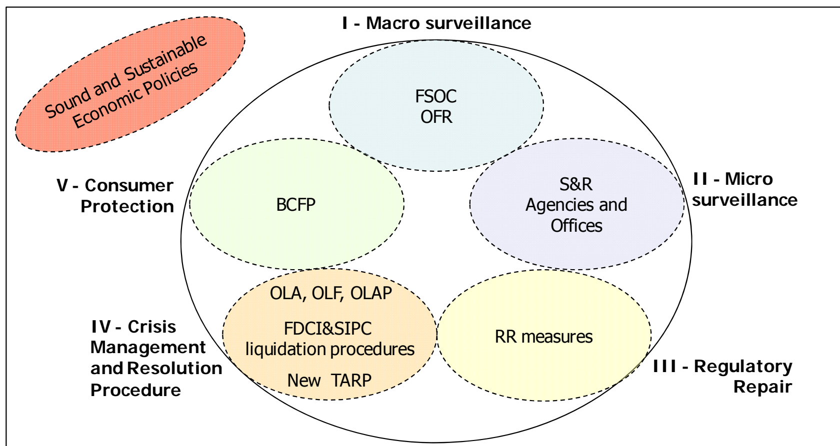
2.1 Macro-prudential supervision

The Financial Stability Oversight Council (FSOC) is created and tasked with (i) identifying risks to the financial stability of the United States, (ii) promoting market discipline and information, notably by eliminating expectations that financial and non-financial organizations will be shielded from losses in the event of failure and (iii) responding to emerging systemic threats to financial stability.

---

[7] For simplicity of graphical presentation, reference to the interactions between economic policies and the building blocks of financial reform is omitted. From an analytical and operational point of view, they are of paramount importance, as indicated in the introduction and in figure 3. The same order of presentation will be followed in the analysis of the European financial reform.

Figure 4 - *The New US Regulatory and Supervisory Framework for Safeguarding Financial Stability*[8]



The FSOC is chaired by the Secretary of the Treasury; the other nine voting members are the leaders of the main financial agencies, plus an independent member with insurance expertise.[9]

The Office of Financial Research (OFR) is created and established as a department within the Treasury. The Director of the OFR is in effect the

---

[8] After the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Barack Obama on July 21st 2010. A list of acronyms is available at the end of the article.

[9] The full composition of the Council is as follows: the Secretary of the Treasury, who shall serve as Chairperson of the Council; the Chairman of the Board of Governors; the Comptroller of the Currency; the Director of the Bureau of Consumer Financial Protection; the Chairman of the SEC; the Chairperson of the FDIC; the Chairperson of the CFTC; the Director of the FHFA; the Chairman of the NCUA Board and an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise. The nonvoting members, who shall serve in an advisory capacity as a nonvoting member of the Council, shall be: the Director of the Office of Financial Research; the Director of the Federal Insurance Office; a State insurance commissioner, to be designated by a selection process determined by the State insurance commissioners; a State banking supervisor, to be designated by a selection process determined by the State banking supervisors; and a State securities commissioner (or an officer performing like functions), to be designated by a selection process determined by such State securities commissioners.

executive director of the Council. The tasks of the FSOC extend into the micro-supervisory and resolution domains. Thus, the building blocks I and III are intertwined also from an institutional angle. The blurring of macro and micro mandates represents a clear difference with respect to the European approach. The FSOC is empowered to identify systemically important financial companies, thus bringing such companies under Fed supervision.

2.2 Micro-prudential supervision

The Fed is tasked with the supervision and regulation of all banks, thrifts, bank holding companies, non-bank financial institutions with assets over $50 billion. It is specifically responsible for the supervision of systemically important: (i) financial institutions (SIFIs) and (ii) financial market utilities (notably payment, clearing and settlements activities).

The Federal Deposit Insurance Corporation (FDIC) is responsible for supervision and regulation of state banks/thrifts with assets under $50 billion, and retains responsibility as the liquidator for most financial institutions, with the partial exception of SIFI's, as will be indicated in section 2.4. The Office of the Comptroller of the Currency (OCC) is responsible for supervision and regulation of national banks/thrifts with assets under $50 billion. The National Credit Union Administration (NCUA) is responsible for supervision and regulation of federal credit unions. The Securities Investor Protection Corporation (SIPC) retains its function as a non-profit membership corporation, notably in respect of liquidation procedures for broker-dealer companies. The Office of Thrift Supervision (OTS) is eliminated. The Federal Insurance Office (FIO) is created to monitor all major aspects of the insurance industry (except health insurance) and cooperate with the FSOC and the State insurance regulators on matters of systemic relevance.

A synthetic overview of the new framework of micro-supervision is offered in table 1.

Table 1 – *US Supervisory and Regulatory Framework of Financial Organisations/Products*

Institution/Product	Responsibility
State banks/thrifts with assets ≤ $50 billion	FDIC
National banks/thrifts with assets ≤ $50 billion	OCC
All other banks/thrifts, Bank and Financial Holding Companies	Fed
Credit Unions	NCUA/State supervisors
Insurance Companies	FIO/State supervisors
Systemically important financial market utilities (payment, clearing & settlements)	Fed
Asset backed securities	SEC and Federal Banking Agencies
Derivatives	SEC and CFTC
Broker-Dealer Companies	SIPC

2.3 Correction of key aspects of the Regulatory Framework

As already indicated, the regulatory framework behind the 2007/2009 crisis was based on interrelated elements (capital rules, accounting standards, credit rating agencies, OTC derivatives, securitization processes) which were fundamentally flawed and required urgent repair.

The excesses of mark-to-market and fair value principles of accounting standards have already been addressed by the FASB (Financial Accounting Standards Board), in particular with reference to evaluation of OTC derivative structures.

As to bank capital rules, major reforms are introduced in the Dodd-Frank Act, notably through the Collins Amendment.[10] The Amendment imposes, over time, the risk-based and leverage capital standards currently applicable to US insured depository institutions on US bank holding companies, including US intermediate holding companies of foreign banking organizations, thrift holding companies and systemically important non-bank financial companies. One of the effects of the Collins

[10] United States Senate (2010).

Amendment is to eliminate trust-preferred securities as an element of Tier 1 capital.

Implementing regulations must be issued no later than 18 months after enactment and there are highly negotiated transition periods and grandfathering exemptions. The Collins Amendment echoes changes that had been proposed by the Basel Committee on Banking Supervision in the "Basel III" process (see Appendix) and those that are contemplated in the new US systemic risk regulatory regime.

The appropriate Federal banking agencies must establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, depository institution holding companies and systemically important non-bank financial companies. The minimum leverage and risk-based capital requirements applicable to these institutions are subject to two floors. They must be:

(i) no "less than" the "generally applicable risk-based capital requirements" and the "generally applicable leverage capital requirements";

(ii) not "quantitatively lower than" the above requirements that were in effect for insured depository institutions as of the date of enactment.

2.3.1 Generally Applicable Risk-based and Leverage Capital Requirements

The Collins Amendment defines "generally applicable risk-based capital requirements" and "generally applicable leverage capital requirements" to mean the risk-based capital requirements and minimum ratios of Tier 1 capital to average total assets, respectively, established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure. The Collins Amendment clarifies that the requirement applicable to national banks to deduct investments in subsidiaries that are engaged in financial activities does not apply at the holding company level or to systemically important non-bank financial companies, except, in the latter case, if so required by the Federal Reserve or primary financial regulator. The Collins Amendment does not

expressly permit the US banking supervisors to amend capital adequacy guidelines in accordance with the standards that will be applied internationally, after the agreement on the Basel III process – reached at the G-20 Seoul Summit (2010) (see Appendix). As a result, the Collins Amendment creates a statutory floor and US banking regulators would be able to implement Basel III to the extent that it is consistent with the Collins Amendment, or rule-making will be required.

The US was slow to adopt the set of Basel II regulations, and regarded the system appropriate only for large international banks. To ensure coherent application of Basel III in the US and in the EU, the transitional arrangements for implementing the new standards will prove essential. The time framework presented by the Basel Committee on 12 September 2010 represents a compromise to improve the standards without creating a new credit crunch. However, in setting the phase-in periods extending to 2019-2022 for key capital instruments, the pendulum has gone too far, as will be argued in the Appendix. In any event, the process will have to be constantly monitored for appropriate review and calibration.[11]

The Collins Amendment also requires the appropriate federal banking agencies, subject to Council (FSOC) recommendations, to impose capital requirements on insured depository institutions, depository institution holding companies and systemically important non-bank financial companies to address the risks arising out of certain activities to "other public and private stakeholders." At a minimum, the requirements must address risks that relate to:

(i) significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repos;

(ii) concentrations in assets for which reported values are model-based;

(iii) concentration in market share for any activity that would substantially disrupt financial markets if unexpectedly discontinued by the institution.

---

[11] Basel Committee on Banking Supervision (2010c). On these points see also Bowers *et al*. (2010).

The Council (FSOC) also has authority to recommend heightened prudential standards to apply to certain activities and practices whether or not the institution in which they take place is systemically important. Further important provisions for the regulation of capital, which will have to be respected in the implementation of Basel III, are contained in the so-called Volcker Rule, which mandates that regulators will have to impose upon institutions capital requirements that are "countercyclical, so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction", to ensure the safety and soundness of the organizations. These points are taken up by the BCOB through the introduction of a countercyclical buffer (see Appendix).

According to the *de Larosière Report*, the idea that capital must increase in times of economic expansion and decrease in times of contraction appears unrealistic. When times get difficult, the market will not allow banks to reduce their capital. That is exactly the time when buffers are required. Things would be different if banks were to engage in countercyclical provisioning (which does not affect capital). This "Spanish model" would require appropriate adaptation in accounting and fiscal rules.

The Act creates transparency and accountability for derivatives. It comprehensively regulates most derivatives transactions on the basis of compulsory clearing via regulated Central Counterparties Clearing (CCC). The Act categorizes the derivatives transactions within its scope as either "swaps," which are subject to primary regulation by the Commodity Futures Trading Commission (CFTC), "security-based swaps," which are subject to primary regulation by the Securities and Exchange Commission (SEC), or "mixed swaps," which are subject to joint regulation by the CFTC and the SEC.

The most significant aspects of the derivatives section are: (i) mandatory clearing through regulated central clearing organizations and mandatory trading through either regulated exchanges or swap execution facilities, in each case, subject to certain key exceptions, (ii) new categories of regulated market participants, including swap dealers and major swap participants and (iii) the push-out from banks into bank affiliates of many swap activities. As with other parts of the Act, many of

the details of the new regulatory regime relating to swaps are left to the secondary regulators to determine through rule-making, which in most cases should occur during the first 360 days following enactment, but is facing significant market resistance.

As indicated, the Fed is now tasked with supervision and regulation of systemic market infrastructures and with financial stability. This paves the way for supervision of CCCs whose operations will, in my view, require both capital cushions and direct access to central bank liquidity.

As to Credit Rating Agencies, the Act increases internal controls, requires greater transparency of rating procedures and methodologies, provides investors with a private right of action, and provides the SEC with greater enforcement and examination tools regarding Nationally Recognized Statistical Rating Organizations (NRSROs). These provisions will raise costs and litigation exposure for NRSROs with few, if any, ongoing benefits from NRSRO registration. Unless otherwise specified, required rule-making must be completed within one year of enactment.

2.3.2 Other important regulatory changes

Other noteworthy changes contained in the Act are:

(i) The Volcker Rule[12] imposes limits to depository banks in proprietary trading[13] (but has only limited similarities to the prohibition of combined investment and commercial banking introduced after the Great Depression by the Glass-Steagall Act). Banks are allowed to invest up to 3% of their Tier 1 capital in private equity and hedge funds as well as trade for hedging purposes. The Rule also requires systemically important non-bank financial companies to carry additional capital and comply with certain other quantitative limits on such activities, although it does not expressly prohibit them. The Volcker Rule is not effective until two years after enactment, when a 2-year transition period begins, with the possibility of additional extensions thereafter.

---

[12] Obama and Volcker (2010).

[13] The Volcker restrictions do not apply to "principal investments", which imply higher capital charges. These deals continue however to remain attractive: the option is thus used to sidestep the Volcker rule.

(ii) Executive Compensation and Corporate Governance: the Act includes provisions relating to compensation arrangements at financial institutions and public companies. The Act does not impose rigid limits and prohibitions of the nature contained in previous TARP legislation, and most of the principles-based provisions require implementing regulations.

The Act highlights three areas of corporate governance at financial institutions and public companies. First, the Act requires certain financial and non-financial companies to establish a risk committee. Second, the Act requires companies to provide additional disclosure regarding its organization structure. Finally, the Act clarifies the SEC's authority to adopt proxy access.

(iii) Deposit Insurance Reforms: the FDIC must base deposit insurance assessments on an insured depository institution's average consolidated total assets minus its average tangible equity, rather than on its deposit base, though the FDIC may reduce the assessment base for custodial banks and banker's banks. This revision to the assessment calculations shifts the distribution of assessments to the larger banks, which fund a greater percentage of their balance sheet through non-deposit liabilities. The anticipated result will be to shift more of the cost of federal deposit insurance to the larger banks that rely on funding sources other than domestic deposits.

There is no longer an upper limit for the reserve ratio designated by the FDIC each year. The minimum designated reserve ratio may not be less than 1.35% (raised from 1.15%) of insured deposits or the comparable percentage of the assessment base. The Act overrides existing statutory provisions on restoring the reserve ratio to its minimum required percentage by allowing the FDIC until September 30, 2020 to raise the ratio to 1.35%.

(iv) The maximum deposit insurance amount permanently increases to $250,000, with retroactive effect for institutions for which the FDIC was appointed receiver or conservator between January 1st 2008 and October 3rd 2008.

(v) The Act raises standards and regulates Hedge Funds. It aims at ending the "shadow" financial system by requiring hedge funds and private equity advisors to register with the SEC as investment advisers

and provide information about their trades and portfolios necessary to assess systemic risk. This data will be shared with the systemic risk regulator (FSOC) and the SEC will report to Congress annually on how it uses this data to protect investors and market integrity.

(vi) The Act raises the assets threshold for federal regulation of investment advisers from $30 million to $100 million. This move is expected to significantly increase the number of advisors under state supervision; States have proven to be strong regulators in this area and subjecting more entities to state supervision should allow the SEC to focus its resources on newly registered hedge funds, thereby improving the overall supervision of the system. A question here is whether it might have been more appropriate to increase the resources of the SEC.

2.4 Crisis Management and Resolution Framework

As indicated in section 2.2, orderly liquidation procedures for most financial institutions, of non-systemic nature, remain broadly unchanged. The primary role rests with the FDIC and its independent management of the Deposit Insurance Fund (DIF).

A main novelty of the Dodd-Frank Act is the provision for liquidation of SIFIs – “micro” institutions, with macro-risk consequences (too big to fail) – through the creation of Orderly Liquidation Fund (OLF) and Procedure (OLP). The OLF is to be used by FDIC in the event of a SIFI liquidation. The Fund will be capitalized by collecting risk-based assessment fees. The Orderly Liquidation Procedure (OLP) and the Orderly Liquidation Authority (OLA) give a primary role to the FSOC, and to its Chairman. Risk-based assessments charged by the OLF will be implemented by the FDIC, according to a matrix recommended by the FSOC.

Under specific circumstances, the Chairman of the Council, with a 2/3 majority, may place financial institutions under special supervision, if they could endanger the financial stability of the US. The Council will discourage excessive growth and complexity by making recommendations to the Fed for increasingly strict rules for capital, leverage, liquidity, as companies grow in size and complexity, with

significant requirements on institutions that pose systemic risks to the financial system. The Council may also require any SIFI to submit specific certified reports. More specifically, the FSOC plays a key direct role in the micro crisis resolution process of SIFIs. The Council will require "funeral plans" ("living wills") to large complex financial institutions. Companies will be hit with higher capital requirements and restrictions on growth and activity, as well as divestment, if they fail to submit acceptable plans for their rapid and orderly shutdown, should the company go under. Plans will help regulators understand the structure of the institutions they oversee and serve as a road map for shutting them down if the company fails. Significant costs for failing to produce a credible plan create incentives for firms to rationalize structures and/or operations that cannot be unwound easily.

Under provisions for the "resolution regime" of SIFIs, the Council can place a financial company into receivership, if substantial evidence supports the conclusion of the Secretary of the Treasury that the company is in (or is in danger of) default. The procedure is subject to a confirmation of the conclusion of the Chairman of the Council by the Orderly Liquidation Authority Panel (OLAP),[14] established inside the US Bankruptcy Court for the District of Delaware.

The Secretary of the Treasury can activate, within the Ordinary Liquidation Procedure, authorisations to the Fed for extension of credit in "unusual or exigent" circumstances. The Secretary can also activate the Troubled Asset Relief Program (TARP), within reduced and restricted mandates. When liquidating a financial company under this title and procedure, a maximum limit has been set to government's liquidation obligation, i.e. the government's obligation cannot exceed (i) 10% of the total consolidated assets or (ii) 90% of the fair value of the total consolidated assets. A highly innovative Resolution procedure has thus been created for SIFIs. Differences and difficulties in Europe to introduce a set of rules in this crucial area will be examined in section 3.

[14] If disagreement persists, the procedure can move up in successive steps to the Supreme Court of the US.

2.5 Consumer Protection

The Bureau of Consumer Financial Protection (BCFP) is established as a new executive agency, tasked with regulation of consumer financial products and services, with a view to ensuring uniform standards for "plain vanilla" products. The new Agency will ensure that American consumers get a clear accurate information on products such as mortgages and credit cards, and protect them from hidden fees, abusive terms and deceptive practices. Even though the Bureau is placed within the Fed, it operates independently and with broad powers, and the Fed is prohibited from interfering with matters of the Bureau. The Bureau will assume most of the consumer protection functions exercised by regulators under existing federal consumer protection laws.

More generally, the Dodd-Frank Act aims to protect consumers from abusive financial services practices by improving transparency and accountability in the US financial system. Some remarks of systemic nature on the US reform will be presented in the concluding section of this paper, also to highlight analogies and differences with respect to the European construction. A general comment can be already advanced here, on the basis of the following chart (see figure 5), which summarizes graphically the new US system of supervisory, regulatory and resolution authorities and agencies, with the very complex web of links and shared responsibilities. A bolder and more focused simplification effort would have helped in achieving greater clarity and effectiveness.

The Dodd-Frank Act is process-focused and the procedures are well-engineered, but a more courageous streamlining of supervisory agencies would have resulted in a more resilient, less complex system, with greater attention to the prevention of possible conflicts of interest.

3. The new European framework for safeguarding financial stability

The New European of Financial Framework can also be presented as being built around the same building blocks, which should operate in an integrated and cooperative way:

I. Macro-prudential supervision;
II. Micro-prudential supervision;
III. Correction of key aspects of the Regulatory Framework;
IV. Crisis Management and Resolution Framework;
V. Consumer Protection.

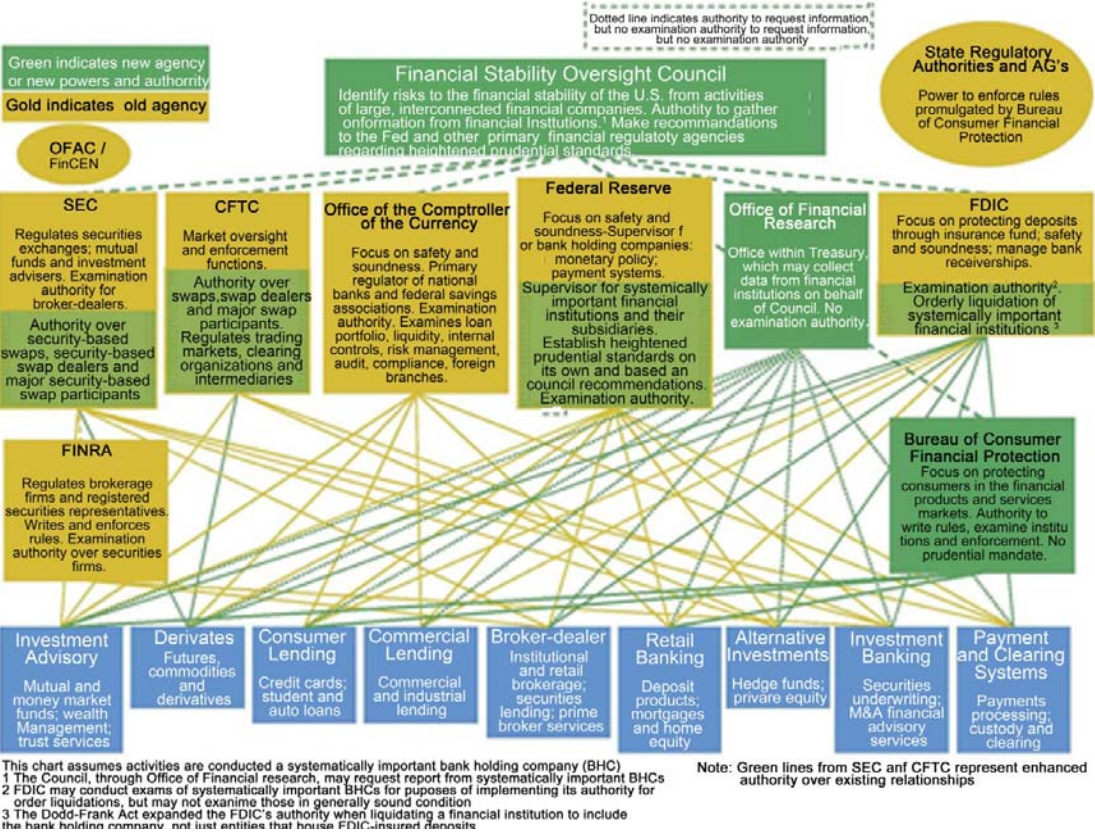
The new structure is outlined in figure 6 below. It must be stressed that, contrary to the US, the process of enacting and integrating the building blocks of the wide-ranging Commission Reform Program (published on March 4th 2009, shortly after the publication of the *de Larosière Report*)[15] into Regulations and Directives has encountered difficulties and delays, as recognized by the Commission itself in a Communication published on June 2nd 2010.[16]

In its June 2nd 2010 Communication, the Commission stressed the need to advance swiftly to complete remaining reforms from the 2009. Program, while introducing a number of new proposals and amendments to existing measures. In the Commission's view, the next nine months will be critical to the future of financial regulatory reform in the EU.[17] An important step forward was registered on September 7th 2010, no doubt also in response to the signing into law of the Dodd-Frank Act. The ECOFIN endorsed an agreement with the European Parliament on the reform of the EU framework for financial supervision with the creation both of the European Systemic Risk Board (ESRB) and the three European authorities proposed by the Commission. The texts have been adopted by the European Parliament on September 22nd. All the bodies will come into force from January 1st 2011.

In this paragraph we summarize the key areas addressed, following the same order of presentation adopted in the case of US, and underline changes with respect to the 2009 Program.

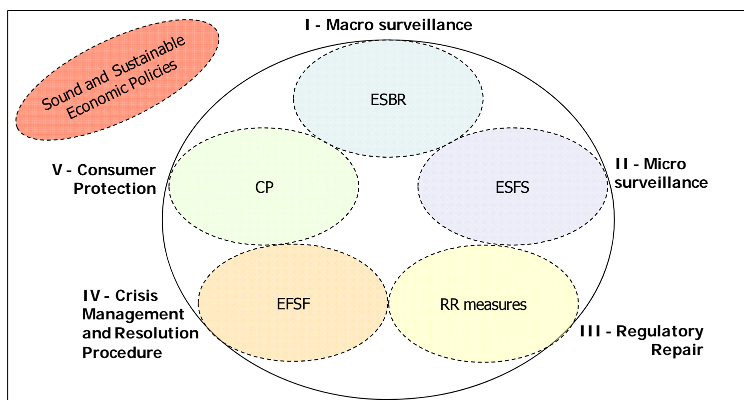
[15] European Commission (2009a).
[16] European Commission (2010c).
[17] On these points see also Barnier (2010).

Figure 5 – *The new US regulatory and supervisory system: strengthened but still fragmented*



Source: JP Morgan Chase.

Figure 6 - *The New European Framework for Safeguarding Financial Stability*



3.1 Macro-prudential supervision

The European Systemic Risk Board (ESRB) is designed to ensure that macro-prudential and macroeconomic risks are detected and dealt with.

Risks to the financial system can arise from the failure of one SIFI, but also by a common exposure of main financial institutions to the same risk factors. Macro-prudential analysis of the ESRB should, therefore, pay particular attention to common or correlated shocks and to shocks to those parts/institutions of the financial system (including asset bubbles) that trigger contagious knock-on or feedback effects.

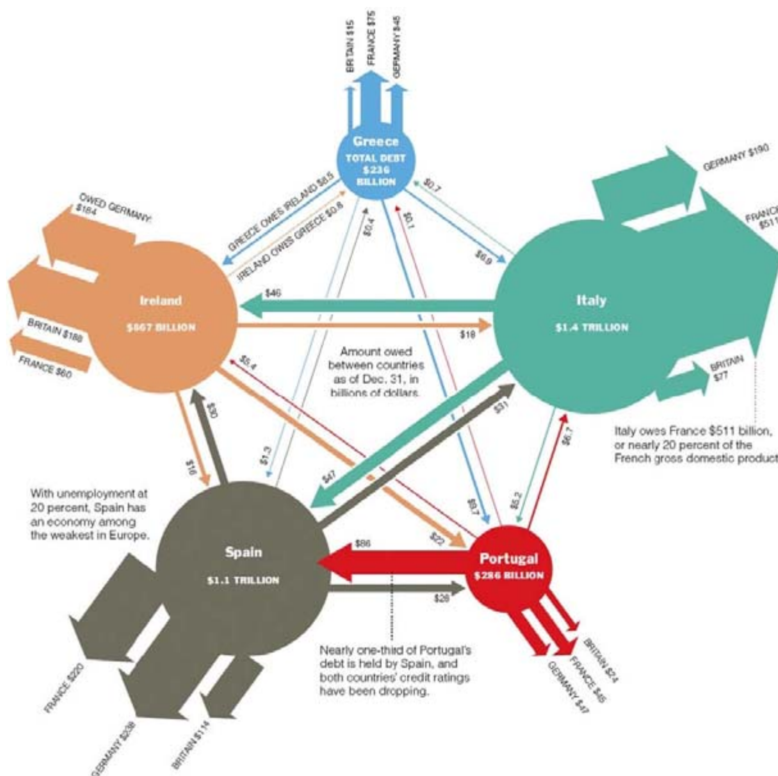
The ESRB should also identify serious problems arising in a Member State, endangering EU financial stability. In this case, the entire European Council should be alerted, especially if the national authorities have refrained from taking appropriate corrective measures. As already indicated, sovereign and SIFIs' banking crises can be correlated, as shown by the recent European experience.

Europe's banks and sovereign exposures are highly interconnected, as is evidenced by the following charts published by the *New York Times* and by Morgan Stanley, on the basis of BIS statistics (see figure 7 and table 2). For

years many market participants – including SIFIs – had assumed that an implicit guarantee protected the sovereign debt of Euroarea Member States. This presumption led to a systematic under pricing of risk, which made debt cheaper to issue than it should have been.

This experience is by no means new. The Latin American sovereign debt and the US banking crises of the early 1980s are another example worth recalling, because they represented a clear case of inadequate macro-prudential oversight, beyond banks' management and micro-supervisory deficiencies.

Figure 7 - *The interconnection of bank and sovereign exposures in Europe*



Source: New York Times (2010) and BIS (2010), *Consolidated Banking Statistics,* Table 9B.

A timely implementation of the ESRB would have helped in spotting the sovereign debt problems which erupted in the Spring of 2010 in Greece and

Table 2 – *Cross-border banks' Foreign Operations (at year-end 2007, $Bn)*

Banking System	BE	CA	CH	DE	ES	FR	IT	JP	NL	UK	US
Number of Banks[1]	18	17	23	1,801	96	135	724	106	49	17	33
Total Assets[2]	2,218	2,437	3,810	10,585	4,541	8,359	4,180	9,845	4,649	10,008	9,904
Asset Concentration (%)[3]	94.9	72.4	89.3	53.5	62.9	96.1	70.6	62.3	93.6	75.3	50.5
Foreign Claims[4]	1,608	912	3,390	5,177	1,416	4,456	1,543	2,571	2,962	4,378	2,285
% of total assets	72	37	89	49	31	53	37	26	64	44	23
% annual GDP	348	63	776	155	98	171	18	58	378	157	16
US$ share (%)	23	70	60	33	36	31	10	48	31	42	52

Seven core Eurozone banking systems have foreign claims that exceed their home country GDP, of which nearly 40% are denominated in US$.
The size of Europe's US$ exposure explains why Europe's central banks needed help from the US Federal Reserve during the 2008 crisis. The Fed stepped in to provide US$ liquidity via FX swap lines to Europe's central banks. The Fed stepped in again, in response to the Greek crisis

Source: Morgan Stanley (2010). *Notes*: (i) number of banking groups (headquartered in the country shown in columns) that report in the BIS consolidated banking statistics;(ii) total assets (including "strictly domestic assets") aggregated across BIS reporting banks. For reporting jurisdictions which do not provide this aggregate (DE, ES, FR, IT, JP), total assets are estimated by aggregating the worldwide consolidated balance sheets (from BankScope) for a similar set of large banks headquartered in the country; (iii) share of total assets accounted for by the five largest reporting institutions; (iv) foreign claims as reported in the BIS consolidates banking statistics (immediate borrower basis) plus foreign currency claims vis-à-vis residents of the home country booked by home offices (taken from the BIS locational banking statistics by nationality). Excludes inter-offices claims.

in November in Ireland. The ESRB shall have a General Board, composed of all the Governors of the national Central Banks in the EU, the President and the Vice-President of the European Central Bank (ECB), a Member of the European Commission (EC) and the Chairpersons of the three European Supervisory Authorities (European Banking Authorities (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA).[18] The ESRB will prioritize and

[18] National supervisors and the President of the Economic and Financial Committee will also form part of the Board, but without voting rights. The Chair will be elected for 5 years from among the Members of the General Board which are also Members of the General Council of the ECB.

issue macro-prudential risk warnings, which will be brought to the attention of the chairman of the Economic and Financial Committee (EFC), so as to ensure, with the Commission, the Council and the European Financial Stability Facility (EFSF), appropriate strategies and actions to address the risks.

More specifically, the main tasks of the European Systemic Risk Board are: (i) establish adequate procedures to obtain information about macroeconomic risks for financial stability, (ii) identify macro-prudential risks in Europe; (iii) decide on macro-prudential policy; (iv) provide early risk warnings to EU supervisors and to other relevant actors; (v) compare observations on macro-economic and prudential developments and give direction on these issues; (vi) determine how to achieve effective follow up to warnings/recommendations; (vi) ensure the independence of the ESRB.

3.2 Micro-prudential supervision

Alongside national supervisory authorities, which will continue to be responsible for day-to-day supervision of firms, three European Supervisory Authorities (ESAs) will be created: European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA). The proposed new supervisory architecture should provide the backbone for a harmonized European supervisory system, also through the creation of a "Single Rule Book" for financial services (see figure 8).

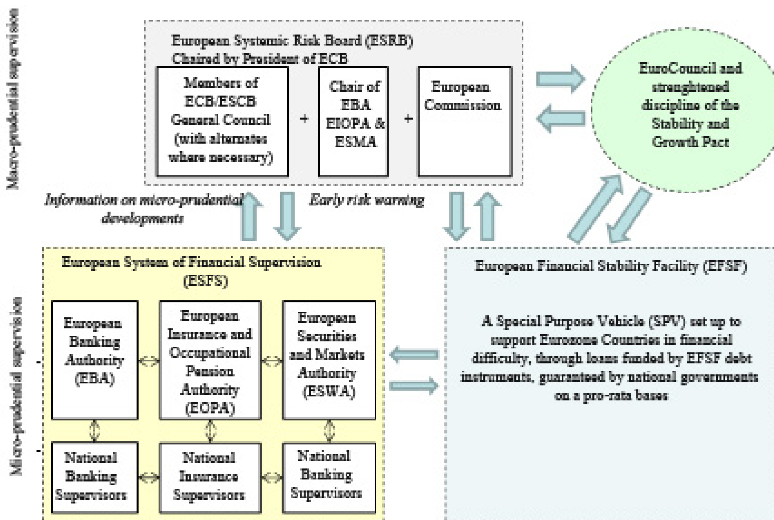
The ESFS would, therefore, represent a network of national financial supervisors working with the three new authorities, to overcome financial fragmentation and to ensure much higher standards of micro-prudential supervision. The main objectives of the ESFS can be summarized as follows: ensure a set of common rules and their consistent application in the EU; assume all the tasks of the current EU committees of supervisors; help create a common supervisory culture, notably by ensuring that colleges of supervisors develop successfully and consistently, including by defining the necessary information to be distributed and managing an appropriate database; help achieve better balance and resolve the issues posed by the interaction of home and host authorities; colleges and local lead supervisors,

foreign branches and subsidiaries of cross-border institutions; help coordinate and effectively manage crisis situations; ensure the independence of the ESAs; cooperate to define safeguards to avoid impact on Member States' fiscal responsibilities.

More specifically, the tasks of the ESAs are: (i) legally binding mediation between national supervisors, (ii) adoption of binding supervisory standards, (iii) oversight and coordination of colleges of supervisors, (iv) licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies), (v) binding cooperation with the ESRB to ensure adequate macro-prudential supervision, (vi) possible coordinating role in respect of binding technical decisions applicable to individual institutions, and (vii) strong coordinating role in crisis situations.

A common system-wide objective is to ensure that the three new institutions work together cooperatively and consistently to identify and react to crosscutting elements that impact financial stability in Europe.

Figure 8 - *The three new key components of the European framework for safeguarding financial stability*



The areas that required prompt and substantive correction to the regulatory framework, had been clearly indicated by the *de Larosière Report*. Significant work has been made by the Commission to detail the regulatory changes, but the process has encountered implementation difficulties as outlined in this paragraph.

3.3.1 Alternative Investment Fund Managers Directive

The proposed Alternative Investment Fund Managers Directive ("AIFMD")[19] is intended to provide a framework at European level for the regulation of fund managers and notably of hedge funds, with the aims of strengthening financial stability and increasing transparency towards investors. The AIFMD introduces for the first time a genuine "single market framework" for this sector, which will allow AIFM to "passport" their services throughout the EU on the basis of a single authorization. In accordance with the 2009 Program, the Commission produced a draft in April 2009, but it has been the subject of much criticism and debate and has undergone many amendments. In 2010, the European Parliament and the Council of Ministers both adopted amended versions of the AIFM Directive.[20] The AIFMD is broadly consistent with the rules adopted in the United States as part of the Dodd-Frank Act described above.

3.3.2 Capital requirements

The European Commission will present a further revision to the Capital Requirements Directive to improve the quality and quantity of capital held by banks, introduce capital buffers and promote counter-cyclical capital requirements, so that banks will build capital reserves during times of economic growth[21]. The amendments will also address

[19] European Commission (2010a).
[20] The importance of this proposed Directive has been underlined by Masera (2010c).
[21] On 26 February 2010 the European Commission launched a public consultation on further possible amendments, which was closed on April 16th 2010. On April 26th 2010, the European Commission hosted a public hearing on them.

banks' perceived excessive reliance on leverage and introduce an effective liquidity regime. The Commission envisages that these measures will become law by the end of 2011; they will incorporate the work done by the Basel Committee on Banking Supervision (see Appendix). The new capital requirements on financial intermediaries in Europe are also based on the (onerous) Solvency II Framework Directive on insurance companies.

3.3.3 Credit Rating Agencies

The Credit Rating Agencies Regulation[22] was adopted in 2009 as part of the 2009 Program, and regulators and credit ratings agencies ("CRAs") are currently preparing for implementation of these rules. The CRA Regulation provides for mandatory registration for all CRAs operating in the EU and sets out requirements to improve oversight and regulatory standards, and to reduce conflicts of interest.

On June 2nd 2010, the Commission proposed amendments to the CRA Regulation, in particular to introduce centralized EU oversight of CRAs, entrusting ESMA with powers over EU CRAs that the CRA Regulation granted to national supervisors. ESMA would have powers to request information, launch investigations and perform on-site inspections. The proposed revisions would also require issuers of structured finance instruments to provide all interested CRAs with access to the information they give to their own CRA, in order to facilitate publication of unsolicited ratings. In addition, to align the CRA Regulation with the proposed AIFM Directive, alternative investment funds using credit ratings for regulatory purposes would have to use a CRA registered or certified in the EU. These proposals have now passed to the European Council and the European Parliament and should come into force in 2011.

The proposal are not as innovative as the *de Larosière Report* suggested, and do not go as far as the Dodd-Frank Act in reducing regulatory privileges for CRAs.

---

[22] European Parliament and European Council (2009b).

3.3.4 Derivatives markets

The Commission published Communications on derivatives markets, consistent with *de Larosière Report* recommendations, in July[23] and October[24] 2009 as part of the 2009 Program. In June 2010, the European Parliament adopted a Report entitled *Efficient, safe and sound derivatives markets: future policy actions* (the "Langen Report")[25], which broadly adopts the Commission proposals. The Commission proposed further legislation to improve the transparency of the derivatives markets in September 2010. The legislation will provide European supervisory authorities access to derivatives information in trade repositories. The legislation will also promote the standardization of derivatives contracts and develop central clearing parties for derivatives contracts to reduce risk. These proposals appear largely based on standards for reform set out in the 2009 Program and are in principle consistent with the Dodd-Frank Act.

In addition, the Commission plans to propose measures on short selling and credit default swaps based on its findings in the ongoing investigation into the functioning of financial markets, in particular focusing on sovereign debt and the circumstances in which "naked" credit default swaps should be prohibited. The Commission proposes that national regulators, in coordination with ESMA, be given emergency powers to deal with issues such as the speculative use of the credit default swap market. The Market Abuse Directive ("MAD")[26] will be extended to include derivatives markets, and the Commission will also propose amendments to the Markets in Financial Instruments Directive ("MiFID")[27] in order to bring more derivatives onto organized trading venues. These derivatives-related measures were generally not part of the 2009 Program. The Commission envisages that these measures will become law by the end of 2011.

---

[23] European Commission (2009e).
[24] European Commission (2009f).
[25] Langen (2010).
[26] European Parliament and European Council (2003).
[27] European Parliament and European Council (2004).

3.3.5 Corporate governance and remuneration

As part of the 2009 Program, the Commission presented two Recommendations on remuneration principles in April 2009.[28] The Commission now goes well beyond the reforms contemplated in the 2009 Program, proposing further measures aimed at improving internal controls and governance inside companies.

On 2 June 2010, the Commission adopted a *Green Paper on Corporate Governance in financial institutions and remuneration policies*,[29] launching a consultation on a wide range of corporate governance and remuneration issues (the "Green Paper"). The Green Paper solicited comments by 1 September 2010, with a view to establishing a broad consensus to be followed by an impact assessment.

3.4 Crisis Management and Resolution Framework

In response to the unravelling of the Greek debt crisis, which was threatening financial stability in Europe (see figure 9 and Masera and Mazzoni, 2010), the 27 Member States of the EU on May 9th 2010 agreed that the euro-area Member States and the Commission should set up a European Financial Stability Facility (EFSF). This is a Special Purpose Vehicle (SPV), based in Luxemburg designed to rescue countries, and, by request of single countries, also to intervene in support of credit institutions.[30] It was set up under art. 122, Paragraph 2, of the Treaty on European Union, which states that "where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken".

---

[28] European Commission (2009c, 2009d).
[29] European Commission (2010d).
[30] EFSF Framework Agreement, June 7th 2010.

On this basis, Member States of the Euroarea have signed a "framework agreement," which identifies conditions, procedures and tools to intervene.[31] The mechanism is put to the test by the renewed pressures on sovereign debt in Ireland in November 2010, and the EU decision to grant financial aid with a € 90 billion plan.

The establishment of a permanent European crisis mechanism under a sounder legal basis, by 2013, decided by the Euro Council in November 2010, will require Treaty changes, presumably under the new Lisbon simplified revision procedure. The issue of a specific complementary tool for prevention and resolution of failing banks is under study and the Commission has indicated that it will publish an action plan on this problem. The 2009 Program contemplated a *White Paper* on tools for early intervention to prevent a banking crisis by the end of June 2009, but this *White Paper* was never published. Instead, on 20 October 2009, the Commission published a Communication on cross-border crisis management in the banking sector[32] followed by a Communication on options for bank resolution funds on May 26th 2010.[33] This Communication states that, in October this year, the Commission will publish an action plan on crisis management leading to legislative proposals for a complete set of tools for prevention and resolution of failing banks.

The EFSF should not be a bank rescue plan in disguise. It is, therefore, necessary to set up a well defined specific procedure for SIFI resolution, parallel and complementary to the scheme to support sovereign debt (see Ruding, 2010, and Forti, 2010).[34]

---

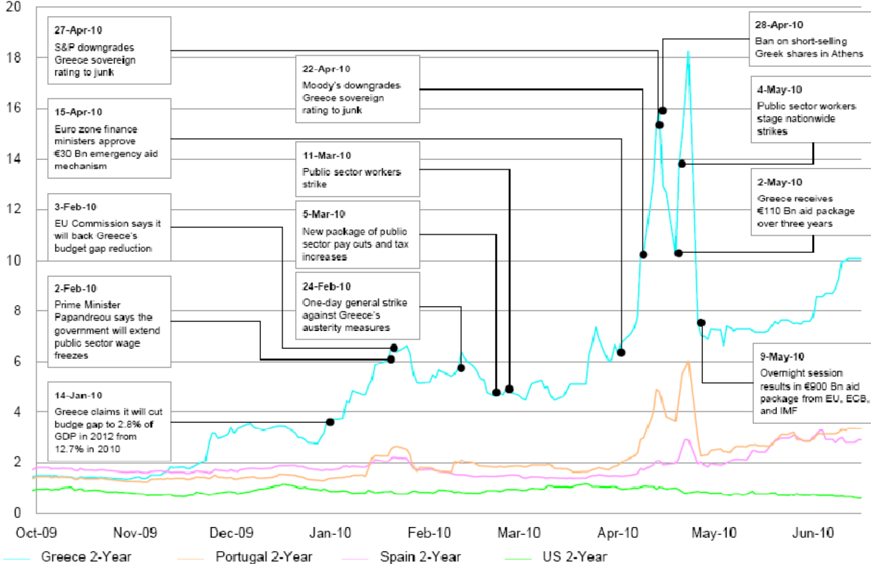
[31] The legal basis for the stabilization mechanism (art. 122) makes reference to exceptional occurrences beyond the control of a Member State. It is not easy for an economist to understand the use of a legal clause designed for earthquakes and other catastrophic or potentially extreme unforeseen circumstances to excessive public debts and deficits, which appear to be explicitly addressed by art. 125 of the Treaty on the Functioning of the European Union (the no-bail-out clause): "The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State […]".

[32] European Commission (2009g).

[33] European Commission (2010b).

[34] Orderly bankruptcy procedures for banks present difficulties, because of the very liquidity of their deposit liabilities. In the US, the FDIC regularly decides when to seize banks, and insolvency legislation has been adapted correspondingly (the OLP and the OLA, in respect of

Figure 9 – *The European sovereign credit crisis*



Source: Bloomberg.

The definition of a clear and credible set of procedures for the provision of financial support to euro-area Member States in serious financial distress is necessary to preserve the financial stability of the Euro area. The framework for conditional financial assistance should strengthen euro-area financial stability, while avoiding moral hazard. The creation of the EFSF is, therefore, to be accompanied by reinforced economic policy coordination. This will involve both deepening and broadening economic surveillance arrangements to guide fiscal policy over the cycle and in the long term and, at the same time, address divergences in growth, inflation and competitiveness. To this end, the

SIFIs, described above, are the latest example of this adaptation). In Europe, depending on the jurisdiction, the "rights" of creditors are very different, and rewriting consistently across the EU insolvency laws for banks and other financial institutions is a daunting task. For these reasons Carmassi *et al.* (2010) propose an enhanced role of the EBA, to coordinate colleges and national instances.

Excessive Deficit Procedure (EDP) will represent the cornerstone of the corrective part of the Stability and Growth Pact.[35] The EFSF can issue debt instruments on the market, backed by guarantees by the Euro-zone Member States on a pro-rata basis, in accordance with their share in the paid-up capital of the ECB, up to a maximum of €440 billion. The EFSF can also draw funds from the European Financial Stabilization Mechanism of the European Commission (up to €60 billion) and from the IMF (up to €250 billion). The total safety net could thus reach a theoretical maximum of €750 billion in loans to distressed countries.

The Facility obtained a preliminary triple-A rating to its bonds, which should be eligible for ECB refinancing, but in the rating process the facility has shrunk significantly. To start with, the €440 billion technically represent guarantees, not lending capacity. Beyond the fact that, under current circumstances, Greece and Ireland cannot be in a position of guarantors, in the event of need, not all other countries will necessarily be able/willing to provide guarantees. Additionally, to obtain the preliminary triple-A rating for the Facility, when only six[36] of the fifteen Eurozone countries enjoy this rating, the EFSF will have to maintain a proportion of each insurance in Euro-monetary base. As rating agencies indicated, this reserve is comprised of two elements. First, there is a general cash reserve funded by an 0,5% fee plus the net present value of the interest margin on any loan. This will be deducted from the proceeds to the borrower. The second part is an additional cash buffer to compensate for the fact that nine of the guarantors currently are not triple-A. This amount will vary from loan to loan and depend on the configuration of borrowers and guarantors at the time. These deductions could significantly reduce the amount of loans available with respect to theoretical limit.[37]

---

[35] On the Stability and Growth Pact (secondary legislation based on articles 121 and 126 of the Treaty on the Functioning of the European Union), see ECB web site Fiscal Policies (2010). See also European Council (2010c).

[36] As of September 2010 these countries are Austria, Finland, France, Germany, Luxemburg and the Netherlands.

[37] Barley (2010).

3.5 Consumer Protection

Beyond the general principle of improving consumer protection through: (i) greater transparency of financial markets, notably in respect of systemically important financial entities, and (ii) improved supervision and effective enforcement of competition laws, the objective of consumer protection is regarded as very important in Europe, but it remains fundamentally an issue of national concern and responsibility.

The MiFID and the AIFMD, however, introduce common European standards and a passport for main "alternative" financial assets and, therefore, ensure common levels of protection. As indicated, the EC proposes far-reaching changes to the MiFID, notably with a view to better regulate so-called dark pools, the markets operated by large financial institutions for their clients, allegedly with minimal national governments' oversight in certain countries.

The aim to ensure transparency, vis-à-vis regulators, supervisors and the consumer is correct. The idea of imposing tighter regulation at EU level, above and beyond national scrutiny, is bound to face difficulties and stir controversy. The best approach lies presumably in relying on the new powers of the ESMA.

4. Concluding remarks

The financial system is global and requires a global consistent infrastructure (figure 1). The EU-US coordination on financial reform is essential, to prevent regulatory arbitrage, to avoid loopholes, to ensure a level playing field. EU-US cooperation sets the basis for a sound global macro-financial environment, because other countries are led to work along similar lines within the G-20, the IMF, the BIS. It must be underlined that the shift in economic weight towards emerging countries is reflected and even heightened by the growth in the relative importance of international financial centers and large banks' capitalization in emerging economies. Worldwide coordination of financial reforms under the G-20 umbrella is therefore essential.

After the crisis regulatory and supervisory objectives across the Atlantic were broadly similar, and a common agenda was shared. A convergence was also recorded in terms of principles: the reform should be based on interactive building blocks, as originally outlined in *de Larosière Report*. Macro-supervision; micro-supervision and consolidated supervisory frameworks; crisis management and resolution procedures; regulatory repair; consumer protection, without putting taxpayers money at risk, were the shared pillars of financial adjustment. There was also agreement in principle on the importance of the effective, independent, macro-prudential oversight on: (i) all sectors of finance, (ii) the macroeconomic context and (iii) sustainable economic policies, to foster financial stability. With the Dodd-Frank Act, the US has taken the lead and have detailed a comprehensive framework, with one notable exception, the mortgage sector. This represents evidently an important omission in view of the role, in igniting the crisis, played by the mortgage sector, by synthetic securitizations and by low capital requirements for asset-backed securities in the trading book of banks. In particular, the need to overhaul Fannie Mae and Freddie Mac, whose bailouts may have cost some $150 billion to taxpayers, is both evident and urgent. But no agreement was possible, so far, on maintaining (and to what degree) or abandoning government guarantees for mortgages.

In spite of the common elements, both in objectives and in instruments, in the two reforms on the two sides of the Atlantic, it appears now that the implementation processes imply important differences. In particular, the US has created a resolution regime for systemic situations and institutions. The EU is lagging in this area of crucial importance, taking into account the intertwining in Europe of sovereign and SIFIs risks. It is important that a consistent approach is developed, perhaps under the auspices of the IMF. SIFIs are, as a rule, not only pan-European or pan-American institutions, but global companies, irrespective of their national “home” (G-SIFIs, globally systemic financial institutions).

A common goal that still must be met is to ensure full disclosure and transparency of SIFIs, also with a view to assuring better market discipline. More specifically, objective criteria should be developed to identify SIFIs. A

completely mechanical approach would not be appropriate, but exclusive reliance on subjective assessments should be avoided.[38]

Another reason for concern is the issue of convergence of accounting and supervisory standards. For example, the FASB is now considering the possibility to mark-to-market also loans and receivable portfolios of the banks, not only their trading books. Stress tests on European banks incorporating sovereign haircuts also on loans portfolios would be appropriate, and would have major impacts.

More generally, the excesses of mark-to-market and fair value principles of accounting standards have already been addressed by the FASB, in particular with reference to evaluation of OTC derivative structures. Nonetheless, risk of fragmentation could still emerge at the accounting level from the coming adoption of new rules (IFRSs), under parallel approval by the IASB and the FASB. These potential divergences could seriously threaten the comparison of accounting reports and management accountability in different markets.

In a public letter to the International Accounting Standards Board (IASB) (June 30th 2010) the CEBS stated that – from a convergence perspective – concerns arise about the fact that FASB and IASB are moving into different directions. This is particularly marked in some main areas: principles on financial instruments characteristics, recognition of impairment, provisioning rules and fair value option with respect to financial liabilities. Potential new divergences could arise also on matters still under discussion, like hedge accounting and the presentation of the income statement. In this last field, according to FASB's Exposure Draft, the income statement would be reported in a single, continuous statement of financial performance, including both profit or loss and OCI ("other comprehensive incomes"). Instead, according to IASB, such gains or losses would be presented using a "two-step approach:"

(i) as a first step, an entity would present the full change in fair value in profit or loss;

[38] Quantitative approach have been advanced by Adrian and Brunnermeier (2008) and Masera and Mazzoni (2010).

(ii) in the second step, the portion relating to OCI would be presented as an offsetting entry in profit or loss statement.

Given the significance of impairment accounting for entities' statements of financial positions and income, different approaches raise apprehension from a level-playing field perspective and can exacerbate the pro-cyclicality of management conduct.

Going back to the supervisory issues, both in the EU and, especially, in the US (recall the amazing web in figure 5), the consolidation of supervisory and regulatory agencies should have gone further, to avoid fragmentation. To this end, the swift implementation of the three Authorities in Europe is of paramount importance, as indicated in section 3.2.

As to the creation of a systemic risk oversight authority, the common objective is being realized in different ways. In the US the FSOC and the OFR are under a clear guidance of the Treasury and its Secretary, but the Fed, whose Chairman sits in the FSOC, clearly plays also a crucial rôle. In Europe, the Systemic Risk Board is under the guidance of ECB. The issue of effective and independent surveillance and oversight of macroeconomic policies must be underlined. A reflection should be made both in the US and in the EU on whether a higher degree of independence (independent directors?) should be given to the macro-supervisory authorities in the assessment of economic policies.[39]

According to the Dodd-Franck Act, the tasks of the macro-supervisor extend into the micro-supervisory and resolution domains. In particular, the FSOC plays a major direct rôle in the crisis management and resolution framework designed to deal with ailing SIFIs. The Council and its Chairman can put a financial institution into receivership if the company is in (or is in danger of) default. The procedure is based on a direct confrontation/confirmation of the Secretary's conclusion with the OLAP, established inside the US Bankruptcy Court for the District of Delaware. The Secretary of the Treasury can activate authorizations to the Fed for the special extension credit as well as the TARP, albeit within reduced and

---

[39] In this respect reference can be made to the thought provoking paper by de Larosière (2010).

restricted mandates with respect to the 2008 Emergency Economic Stabilisation Act.[40]

The Fed has been tasked with the supervision and regulation of SIFIs, within guidelines that can be given directly by the FSOC. The Fed has now five main roles. To the traditional four (maximum employment, stable prices, moderate long term interest rates, promotion of sustainable economic growth), a fifth has been detailed: to "identify, measure, monitor and mitigate risks to the financial stability of the US." To this end the Fed (micro) supervisory powers on systemically important financial companies and utilities have been increased. On the basis of Title XI (Federal Reserve System Provisions) of the Dodd-Frank Act, the new important micro-supervisory tasks assigned to the Fed have been accompanied by governance and oversight changes aimed at preventing possible conflicts of interest.

In particular, a new position has been created on the Board of Governors: the "Vice Chairman for supervision" who is responsible for developing policy recommendations to the Board regarding supervision and regulation of financial institutions under Fed surveillance, oversees the supervision and regulation of such firms and reports directly to Congress on a semi-annual basis.

In the US institutional setting, contrary to the EU, no conflicts of interest are felt, as a matter of principle, between independence of monetary policy, freedom of analysis of macro-prudential risks (including oversight of economic policies) and micro-prudential responsibilities.

The debate in Europe on the pros and cons of assigning to the ECB micro-prudential responsibilities in respect of large cross-border financial institutions was centred on these points, as well as on the recognition that the ECB has no European "sovereign" balance sheet behind its action (contrary to the Fed in the US), and tilted the balance against the option, and in favour of the institutional setting described in Paragraph 4.[41] This is a clear example of the broader problem that the Eurozone is a monetary union, but not a full-fledged economic and political union. It remains an open question in Europe

---

[40] United States Congress, 110th (2008).
[41] On this point, see de Larosière (2009), pp. 42-44 and Masera (2009b), pp. 20-22.

whether the Resolution Authority of SIFIs should be independent of the institutional regulators. As indicated above, this is the case in the New Regulatory Framework in the US. The argument is that the Resolution Authority should be separated from the Supervisory and Regulatory Agency, because of possible conflicts of interest between the supervisor and the decision to resolve a SIFI ("Terminator vs. Guardian Angel").[42] In Europe, a rigid separation of supervisory and resolution processes appears difficult because of the intrinsic national and Treasuries' responsibilities. In respect of large banking groups, the debate in Europe is open on whether the Authorities or the ECB should, in the medium term, acquire supervisory powers.

Perhaps the key difference in regulatory infrastructures on the two sides of the Atlantic lies in resolution procedures. As indicated, in Europe efforts have concentrated on the EFSF, while no systematic procedure has been created for SIFI's. The issue is complicated by the intertwining of sovereign and bank risks, which was evident in the rescues of both Greece and Ireland, with very large exposures notably of German banks. The correct idea that losses in both instances should not fall on European taxpayers, but should in principle extend to both shareholders and unsecured, uninsured creditors has added to the political and practical difficulties of examining these policies.

Until Europe defines a consistent and comprehensive framework, the need to address the problems in the Euro-area, and at international level, to cope with the G-SIFIs cannot have a concrete solution. It is, in any event, of the utmost importance that the second arm of the new EU supervisory architecture – the ESFS – should be quickly enacted without any watering down of the original proposal and the three new institutional components of the European framework for safeguarding financial stability – ESRB, ESFS, EFSF – should work together cooperative and consistently, to identify and react to elements endangering financial stability.

The Dodd-Frank Act details important measures of regulatory repair, which have been described in Paragraph 3. In particular, the Collins

---

[42] An early analysis of what has become the official view in the US was anticipated by Bair (2009); a different approach is suggested by Masera and Mazzoni (2010).

Amendment and some provisions of the Volcker Rule introduce corrections to the risk-based and leverage capital standards in advance of the Basel III process and the new CAD in Europe. The G20 has the task of overseeing the process of convergence of Basel III (see Appendix), the new rule making in the US and the new European capital directive.

Europe must hasten the pace of its financial reform. Perhaps the most important difference in the speed of action can be found in the regulation of derivatives transactions – and notably OTC credit default swaps – on the basis of compulsory clearing via regulated CCCs, enacted by the Dodd-Frank Act. The importance of this point had been clearly recognised in the de Larosière Report, with recommendations for swift action to simplify and standardise OTC derivatives. The issue is still under discussion in Europe, but – as indicated – in the meantime a new Report has been produced and approved. EU initiatives must now conform to the US model. They face the additional difficulties inherent in the fact that London is the major financial centre for derivative operation in Europe, but transactions are mostly in Euros and in Dollars and CCCs should, therefore, have access to liquidity in the two currencies, as indicated above. This represents, therefore, another example of the need for cooperative, consistent, arrangements in Europe and in the United States: differences between the US and EU approach lead to regulatory arbitrage and distort market functionality. Transatlantic differences currently exist in respect of important points: the US law indicates that transactions which are centrally cleared must be executed on an exchange or swap execution platform, no such description is foreseen in Europe; US derivatives dealers may be subject to the Volcker's rule on proprietary trading; clearing house collateral from a US derivatives customer must be held in the United States; finally there are differences in ring fencing clients' collateral.

Finally, on both sides of the Atlantic more reliance should be put on effective, competent supervision of institutions, markets and operators, with attention and focus on the quality and the independence of enterprise risk management, while avoiding overly burdensome primary and secondary regulation. In any event, regulation should be simpler, less discretionary and

rely more on market-based incentives and market transparency and discipline.

REFERENCES

ACHARYA V. (2009), “A Theory of Systemic Risk and Design of Prudential Bank Regulation”, in ACHARYA V., RICHARDSON M. (eds.), *Restoring Financial Stability: How to Repair a Failed System*, Hoboken (NJ): John Wiley & Sons.

ACHARYA V., PEDERSEN L., PHILIPPON T., RICHARDSON M. (2009), “Regulating Systemic Risk”, in ACHARYA V., RICHARDSON M. (eds.), *Restoring Financial Stability: How to Repair a Failed System*, Hoboken (NJ): John Wiley & Sons.

ACHARYA V., YORULMAZER T. (2008), “Information Contagion and Bank Herding”, *Journal of Money, Credit and Banking*, vol. 40, n. 10.

ADRIAN T., BRUNNERMEIER M. (2008), “CoVaR”, *Staff Report*, n. 348, Federal Reserve Bank, New York.

AGUILAR L.A. (2010), “An Insider’s View of the SEC: Principles to Guide Reform”, Speech, U.S. Securities and Exchange Commission, Berkeley, October 15th.

AKERLOF G. (2002), “Behavioural Macroeconomics and Macroeconomic Behaviour”, *American Economic Review*, June.

ALLEN F., BABUS A. (2008), “Networks in Finance: Network-based Strategies and Competencies, Chapter 21”, *Working Paper*, n. 08-07, Wharton School, Philadelphia.

ALLEN F., GALE D. (2000), “Financial Contagion”, *Journal of Political Economy*, vol. 108, n. 1.

ATHANASOPOULOU M., SEGOVIANO M., TIEMAN A. (forthcoming), “Banks’ Probability of Default: Which Methodology, When, and Why?”, *IMF Working Paper*, International Monetary Fund, Washington (DC).

BAIR S. (2009), “Too Big To Fail”, Committee on Banking, Housing and Urban Affairs, US Senate, Senate Office Building, May 6th.

BANK FOR INTERNATIONAL SETTLEMENTS (2010), “International banking and financial market developments”, *Quarterly Review*, Basel.

BANK FOR INTERNATIONAL SETTLEMENTS, *Consolidated banking statistics*, available online at the URL: http://www.bis.org/statistics/consstats.htm

BARLEY R. (2010), “Europe’s incredible shrinking bailout”, *The Wall Street Journal*, September 21st.

BARNIER M. (2010), “Building a new financial framework together”, Speech, European Institute, Washington, May 11th.

BARNIER M. (2010), “Effective Financial market Regulation After Pittsburgh – Achievements and Challenges”, Speech, Berlin, May 20th.

BARONE-ADESI G. (2009), “Seven Pillars of Wisdom”, The Swiss Finance Institute, University of Lugano, May 14th.

BASEL COMMITTEE ON BANKING SUPERVISION (2010a), *Agreement on Basel Committee capital and liquidity reform package. Annex*, BIS, Basel, July 26th.

BASEL COMMITTEE ON BANKING SUPERVISION (2010b), “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability”, *Consultative Document*, BIS, August 19th.

BASEL COMMITTEE ON BANKING SUPERVISION (2010c), "Group of Governors and Heads of Supervision announces higher global minimum capital standards", *Press release*, BIS, Basel, September 12th.

BERGER A., HERRING R., SZEGÖ G. (1995), "The Role of Capital in Financial Institutions", *Working Paper*, n. 9501, Wharton Financial Institution Centre.

BERGO J. (2002), "Using Financial Soundness Indicators to Assess Financial Stability", *IMF Conference*, September 17th.

BERNANKE B., GERTLER M. (1989), "Agency Costs, Net Worth and Business Fluctuations", *American Economic Review*, vol. 79, n. 99.

BLACK F., SCHOLES M., 1973, "The Pricing of Options and Corporate Liabilities", *Journal of Political Economy*, vol. 81, n. 3, pp. 637–59.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, OFFICE OF THE COMPTROLLER OF THE CURRENCY, FEDERAL DEPOSIT INSURANCE CORPORATION (2010), "U.S. Banking Agencies Express Support for Basel Agreement", *Joint Press Release*, September 12th.

BORIO C., DREHMAN M. (2008), "Towards an Operational Framework for Financial Stability 'Fuzzy' Measurement and Its Consequences", *Financial stability, monetary policy and central banking,* 12th Annual Conference of the Banco Central de Chile, Santiago, November 6th–7th.

BOWERS T., HAMOIR O., MARRS A. (2010), "Financial Services Practice. What's next for global banks", *McKinsey Quarterly*, March.

BRUNNERMEIER M., PEDERSEN L.H. (2008), "Market Liquidity and Funding Liquidity", *Review of Financial Studies*.

BRUNNERMEIER M., CROCKET A., GOODHARD C., PERSAUD A., SHIN H. (2009), "The Fundamental Principles of Financial Regulation", *Geneva Reports on the World Economy*, n. 11, CEPR.

CAPRIGLIONE F. (2009), *Crisi A Confronto (1929 e 2009). Il caso italiano*, Cedam: Padua.

CAPUANO C. (2008), "The option-iPoD. The Probability of Default Implied by Option Prices Based on Entropy", *IMF Working Paper*, n. 08/194, Washington (DC).

CARMASSI J., HERRING R. (2009), "The Corporate Structure of International Financial Conglomerates", in BERGER A., MOLYNEUX P., WILSON J. (eds.), *The Oxford Handbook of Banking*, Oxford: Oxford University Press.

CARMASSI J., LUCHETTI E., MICOSSI S. (2009), "Overcoming too-big-to-fail. A regulatory framework to limit moral hazard and free riding in the financial sector", Centre for European Policy Studies (CEPS), Brussels.

CARPENTER A. (2010), "INREV Introduction", *EU Directive Seminar*, London, January 15th.

CHAN-LAU J.A. (2009), "The Global Financial Turmoil and its Impact on Chilean Banks", International Monetary Fund, Washington (DC), *mimeo*.

CHAN-LAU J.A., AMADOU S. (2007), "Distance-to-Default in Banking: A Bridge Too Far?", *Journal of Banking Regulation*, vol. 9.

CONOVER C.M., FRIDAY S.H., SIRMANS G.S. (2002), "Diversification Benefits from Foreign Real Estate Investments", *Journal of Real Estate Portfolio Management*, vol. 8, n. 1.

CONT R., MOUSSA A., MINCA A., BASTO E. (2009), "Too Interconnected to Fail: Contagion and Systemic Risk in Financial Networks", Lecture presented at the IMF, May.

COUNTERPARTY RISK MANAGEMENT POLICY GROUP (CRMPG) II (2005), "Toward Greater Financial Stability: A Private Sector Perspective", July 27th. Available online at the URL: www.crmpolicygroup.org

COUNTERPARTY RISK MANAGEMENT POLICY GROUP (CRMPG) III (2008), "Containing Systemic Risk: the Road to Reform", August 6th. Available online at the URL: www.crmpolicygroup.org

COVER T.M., THOMAS J.A. (2006), *Elements of Information Theory*, 2nd Edition, New York: Wiley.

DAVIS P., KARIM D. (2008), "Could Early Warning Systems Have Helped to Predict the Sub-Prime Crisis?", National Institute of Economic Review.

DAVIS P., WARDWELL L.L.P. (2010), "Agreement on Quantification and Timing of Basel III Capital Standards", *Client Memorandum*, September 13th.

DE LAROSIÈRE J. (2009), *Report of the High Level Group on Financial Supervision in the EU*, European Commission, Brussels, February 25th.

DE LAROSIÈRE J. (2010), "Monetary policy has played a major role in the run up to the financial crisis", *EUROFI*, February.

DEMIRGUC-KUNT A., DETRAGIACHE E. (1998), "The Determinants of Banking Crises in Developing and Developed Countries", *IMF Staff Paper*, vol. 45, n. 1.

DEMIRGUC-KUNT A., DETRAGIACHE E. (1999), "Monitoring Banking Sector Fragility: A Multivariate Logit Approach", *IMF Working Paper*, n. 99/147, International Monetary Fund, Washington (DC).

DEMIRGUC-KUNT A., DETRAGIACHE E. (2005), "Cross-Country Empirical Studies of Systemic Bank Distress: A Survey", *IMF Working Paper*, n. 05/96, International Monetary Fund, Washington (DC).

DEUTSCHE BANK (2008), "Monitoring Banking Sector Risk", Deutsche Bank Research, October 28; Available via the Internet: www.dbresearch.com.

DI NOIA C., MICOSSI S., CARMASSI J., PEIRCE F. (2009), "Keep It Simple Policy Responses to the Financial Crisis", Centre for European Policy Studies (CEPS), Brussels.

DORNBUSCH R., PARK Y.C., CLAESSENS S. (2000), "Contagion: Understanding How It Spreads", *The World Bank Research Observer*, vol. 15, n. 2.

DRAGHI M. (2009a), *Indagine conoscitiva sulle tematiche relative al sistema bancario e finanziario*, Commissione VI (Finanze) della Camera dei Deputati, Rome, March 17th.

DRAGHI M. (2009b), "Remarks at the Turner Review roll-out", *The Turner Review Conference*, Financial Services Authority (FSA), London, March 27th .

DRAGHI M. (2009c), "Keynote Speech" at IOSCO's Annual Conference *Financial Stability in the global environment? Learning the lessons from the market crisis*, Tel Aviv, June 10th.

DRAGHI M. (2010), "Annual Report. Concluding Remarks", Rome, May 31st.

DRAGOMIR L. (2009), "European Prudential Banking Regulation and Supervision", London: Routledge.

DUNGEY M., FRY R., GONZÁLEZ-HERMOSILLO B., MARTIN V. (2006), "Contagion in International Bond Markets during the Russian and LTCM Crises", *Journal of Financial Stability*, vol. 2.

DUNGEY M., FRY R., GONZÁLEZ-HERMOSILLO B., MARTIN V. (2007), "Unanticipated Shocks and Systemic Influences: The Impact of Contagion in Global Equity Markets in 1998", *North American Journal of Finance and Economics*, vol. 18.

DUNGEY M., FRY R., GONZÁLEZ-HERMOSILLO B., MARTIN V. (forthcoming), "Are Financial Crises Alike? − From the 1998 Russian/LTCM Crisis to the 2007 Subprime Debacle and Liquidity Crisis", *IMF Working Paper*, International Monetary Fund, Washington (DC).

ELSINGER H., LEHAR A., SUMMER M. (2006), “Systemically Important Banks: An Analysis for the European Banking System”, *International Economics and Economic Policy*, vol. 3, n. 1.

EUROFI (2010), “Defining priorities to reform the regulatory and supervisory financial framework in the global context”, *Eurofi high level seminar co-hosted by the Spanish EU Presidency*, Madrid, April 14th-15th.

EUROPEAN CENTRAL BANK (2006), “Special Feature on Identifying Large and Complex Banking Groups for Financial Stability Assessment”, *Financial Stability Review*, Frankfurt, December.

EUROPEAN CENTRAL BANK (2008), “Special Feature on Recent Policy Initiatives to Strengthen the Resilience of the Financial System”, *Financial Stability Review*, Frankfurt, December.

EUROPEAN CENTRAL BANK (2010), *Fiscal Policies*, available online at the URL: http://www.ecb.int/mopo/eaec/fiscal/html/index.en.html

EUROPEAN COMMISSION (2009a), “Communication to the Spring European Council, Driving European Recovery”, March 4th.

EUROPEAN COMMISSION (2009b), “Recommendation on remuneration policies in the financial services sector for the remuneration of directors of listed companies”, Brussels, April 30th.

EUROPEAN COMMISSION (2009c), “Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime”, Brussels, April 30th.

EUROPEAN COMMISSION (2009d), “Communication on European Financial Supervision”, Brussels, May 27th.

EUROPEAN COMMISSION (2009e), “Communication on Ensuring efficient, safe and sound derivatives markets”, Brussels, July 3rd.

EUROPEAN COMMISSION (2009f), “Communication on Ensuring efficient, safe and sound derivatives markets: Future policy actions”, Brussels, October 20th.

EUROPEAN COMMISSION (2009g), “Communication on An EU Framework for Cross-Border Crisis Management in the Banking Sector”, Brussels, October 20th.

EUROPEAN COMMISSION (2010a), “Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Found Managers (AIFMD)”, Brussels, April 30th.

EUROPEAN COMMISSION (2010b), “Communication on Bank Resolution Funds”, Brussels, May 26.

EUROPEAN COMMISSION (2010c), “Communication on Regulating Financial Services for Sustainable Growth”, Brussels, June 2nd.

EUROPEAN COMMISSION (2010d), “Green Paper. Corporate governance in financial institutions and remuneration policies”, Brussels, June 2nd.

EUROPEAN COMMISSION (2010e), “Proposal for a Directive of the European Parliament and of the Council amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC as regards the supplementary supervision of financial entities in a financial conglomerate”, Brussels, August 16th.

EUROPEAN COMMISSION (2010f), “Proposal for a Regulation of the European Parliament and of the Council on enforcement measures to correct excessive macroeconomic imbalances in the euro area”, Brussels, September 29th.

EUROPEAN COMMUNITY (2008), “Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries on the European Union on Cross-Border Financial Stability”, Brussels.

EUROPEAN COUNCIL (2010a), “Council to negotiate with Parliament on draft EU rules for hedge funds managers”, Brussels, 7500/10 (Presse 64), May 18th.

EUROPEAN COUNCIL (2010b), “Press release 3030th Council meeting Economic and Financial Affairs”, September 7th.
EUROPEAN COUNCIL (2010c), “Strengthening Economic Governance in the EU”, Report of the Task Force to the European Council, Brussels, October 21st.
EUROPEAN PARLIAMENT AND EUROPEAN COUNCIL (2002), “Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate”, Brussels, December 16th.
EUROPEAN PARLIAMENT AND EUROPEAN COUNCIL (2003), “Directive 2003/6/EC on insider dealing and market manipulation (market abuse) (MAD)”, Brussels, January 28th.
EUROPEAN PARLIAMENT AND EUROPEAN COUNCIL (2004), “Directive 2004/39/EC on markets in financial instruments (MiFID)”, Brussels, April 21st.
EUROPEAN PARLIAMENT AND EUROPEAN COUNCIL (2009a), “Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating toundertakings for collective investment in transferable securities (UCITS) (Recast of the Directive 85/611/EEC)”, Brussels, July 13th.
EUROPEAN PARLIAMENT AND EUROPEAN COUNCIL (2009b), “Regulation (EC) No. 1060/2009 on credit rating agencies (CRA)”, September 16th.
FEDERAL RESERVE BANK OF DALLAS (2008), “Fed Intervention: Managing Moral Hazard in Financial Crises”, *Economic Letter*, vol. 3, n. 10, October.
FINANCIAL SERVICES AUTHORITY (FSA) (2009), “The Turner Review. A Regulatory Response to the Global Banking Crisis”, March. Available online at the URL: http://www.fsa.gov.uk/
FINANCIAL TIMES (2010a), “Brown hails move on global bank tax”, April 4th.
FINANCIAL TIMES (2010b), “The new disintegration of finance”, September 10th.
FORTI N. (ed.) (2010), *Preventing and Managing Future Crises. New Regulation, Resolution Funds and Deposit Insurance as tools for European banking groups*, Rome: Bancaria Editrice.
FRANK N., HESSE H. (forthcoming), “Financial spillovers to Emerging Markets during the Global Financial Crisis”, *IMF Working Paper*, International Monetary Fund, Washington (DC).
FRANK N., GONZALEZ-HERMOSILLO B., HESSE H. (2008), “Transmission of Liquidity Shocks: Evidence from the 2007 Subprime Crisis”, *IMF Working Paper*, n. 08/200, International Monetary Fund, Washington (DC).
FURFINE C. (1999),“Interbank Exposures: Quantifying the Risk of Contagion”, *BIS Working Papers*, n. 70, June.
G20 (2010), *Seoul Summit Document*, available online at the URL: http://www.seoulsummit.kr/
GASPAR V., SCHINASI G. (2009), “Global Financial Crisis, Current Market Conditions and Remaining Policy Challenges”, *BEPA Monthly Brief*, March.
GELTNER D. (1993), “Estimating Market Values from Appraised Values Without Assuming an Efficient Market”, *Journal of Real Estate Research*, vol. 8, n. 3.
GENEVA ASSOCIATION (2010), *Systemic Risk in Insurance, Special Report of the Geneva Association Systemic Risk working Group*, Geneva, March.
GILIBERTO M.S. (1990), “Equity Real Estate Investment Trusts and Real Estate Returns”, *Journal of Real Estate Research*, vol. 5, n. 2.

GONZÁLEZ-HERMOSILLO B. (2008), "The Role of International Investors' Risk Appetite in Global Financial Crises: 1998-2007", *IMF Working Paper*, n. 08/85, International Monetary Fund, Washington (DC).

GONZÁLEZ-HERMOSILLO B., HESSE H. (forthcoming), "Global Market Conditions and Systemic Risk", *IMF Working Paper*, International Monetary Fund, Washington (DC).

GORDON J. (1998), "The Real Estate Portfolio Manager: DIPs, SIPs and REITs", *Journal of Real Estate Portfolio Management*, vol. 4, n. 2.

GORDON J., CANTER T.A., WEBB J.R. (1998), "The Effect of International Real Estate Securities on Portfolio Diversification", *Journal of Real Estate Portfolio Management*, vol. 4, n. 2.

GORTON G. (2008), "The Panic of 2007", prepared for the Federal Reserve Bank of Kansas City *Jackson Hole Conference*, August.

GRAY D.F., MALONE S. (2008), *Macrofinancial Risk Analysis*, John Wiley & Sons.

GRAY D.F., JOBST A.A. (2009), "Systemic Contingent Claims Analysis – Estimating Potential Losses and Implicit Government Guarantees to Banks", *IMF Working Paper*, International Monetary Fund, Washington (DC).

GROUP OF TEN (2001), *Consolidation in the Financial Sector*, Bank for International Settlements, Basel.

GROUP OF THIRTY (2009), *The structure of financial supervision – Approaches and Challenges in a Global Marketplace*.

GROUP OF TWENTY, WORKING GROUP 1 (2009), "Enhancing Sound Regulation and Strengthening Transparency", *Final Report*, March. Available online at the URL: http://www.g20.org/366.aspx.

GYOURKO J., KEIM D.B. (1992), "What Does the Stock Market Tell Us about Real Estate Returns", *Journal of the American Real Estate and Urban Economics Association*, vol. 20, n. 3.

HICKS J. (1967), *Critical Essays in Monetary Theory*, Oxford: Oxford University Press.

HICKS J. (1977), *Economic Perspectives: further Essays on Money and Growth*, Oxford: Oxford University Press.

HONOHAN P. (2010), "Two-way interdependence between the banking system and the State", *BIS Review*, n. 66.

HUANG X., ZHOU H., ZHU H. (2008), "A Framework for Assessing the Systemic Risk of Major Financial Institutions", *BIS Working Papers*, n. 281.

HUTCHINSON M.M. (2002), "European Banking Distress and EMU: Institutional and Macroeconomic Risks", *Scandinavian Journal of Economics*, vol. 104, n. 3.

HUTCHINSON M.M., MCDILL K. (1999), "Are All Banking Crises Alike? The Japanese Experience in International Comparison", *Journal of the Japanese and International Economies*, vol. 13.

INTERNATIONAL MONETARY FUND (2009), *Global Financial Stability Report*, April.

INTERNATIONAL MONETARY FUND (2010), *Crisis Management and Resolution for a European Banking System*, March.

INTER-INSTITUTIONAL MONITORING GROUP (IIMG) (2007), *Final Report Monitoring the Lamfalussy Process*, Brussels, October 15.

KAHNEMAN D. (2007), "Economia della Felicità", *Il Sole 24 Ore*.

KAMINSKY G.L., REINHART C.M. (1999), "The Twin Crises: The Causes of Banking and Balance of Payments Problems", *American Economic Review*, vol. 89, n. 3.

KIM O., VERRECCHIA R.E. (1997), "Pre-announcement and Event-period Private Information", *Journal of Accounting and Economics*, vol. 24.

LAMFALUSSY A. (2001), *Final report of the Committee of Wise Men on the regulation of European Securities Markets*, Brussels, February 15th.

LANGEN W. (2010), *Report on derivatives markets: future policy actions*, Brussels, June 7th.

LASTRA R. (2006), *Legal Foundation On International Monetary Stability*, Oxford: Oxford University Press.

LEHNE K.H. (2008), *Report of the European Parliament with recommendations to the Commission on the transparency of institutional investors*, Brussels, July 9th.

LO A. (2009), "Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008", Written testimony to the US House of Representatives Committee on Oversight and Government Reform, November 13th.

MAINO R. (2009), "Credito e mercato dopo la crisi: appunti per regole e regolatori post Basilea II", *Bancaria*, n. 2.

MAINO R., MASERA R., MAZZONI G. (2010), "Reform of the Risk Capital Standard (RCS) and Systemically Important Financial Institutions (SIFIs)", in FORTI N. (ed.), *Preventing and managing future crises. New Regulation, Resolution Funds and Deposit Insurance as tools for European banking groups*, Rome: Bancaria Editrice.

MARSH I., STEVENS I., HAWKESBY C. (2003), "Large Complex Financial Institutions: common influence on asset price behavior?", BOE, *Financial Stability Review*, December.

MASERA R. (ed.) (2009a), *The Great Financial Crisis. Economics, Regulation and Risk*, Rome: Bancaria Editrice.

MASERA R. (2009b), "Global finance, regulation and supervision in the light of the de Larosière report", in *Rapporto sulla finanza immobiliare 2009*, Bologna: NOMISMA.

MASERA R. (2010a), "Crisi finanziaria e rimedi normativi", in AA.VV., *Scritti in onore di Francesco Capriglione*, Padua: CEDAM.

MASERA R. (2010b), "Towards a new regulatory and supervisory framework of the financial sector in Europe: role and contents of the AIFMD, with specific reference to Non-listed Real Estate Funds", *Rivista Trimestrale di Diritto dell'economia*, n. 2.

MASERA R. (2010c), "Crescita, stabilità, regole di bilancio e regolazione finanziaria: l'Unione monetaria dopo la crisi della Grecia", *L'industria. Rivista di economia e politica industriale*, n. 2.

MASERA R., MAZZONI G. (2007), "Actuarial and Continuous Time Risk Models: Towards a Synthesis", *Proceedings of the CLADAG Conference*, Macerata, September 12th-14th.

MASERA R., MAZZONI G. (2010), "Contributi - La riforma dei requisiti prudenziali e la proposta di un Fondo di risoluzione per la gestione delle crisi / Crises and systemic risk: the proposal for a Resolution fund financed by Sifis", *Bancaria*, n. 6.

MATTHEWS B.C. (2010), "Preventing the Next Financial Crisis: Coordination and Competition in Global Finance", *American Society of International Law Annual Meeting*, Washington (DC), March 26th.

MERTON R.C. (1974), "On the Pricing of Corporate Debt: The Risk Structure of Interest Rates", *Journal of Finance*, vol. 29.

MERTON R.C. (1995), "A Functional Perspective of Financial Intermediation", Financial Management, Summer.

MERTON R.C. (1973), "Theory of Rational Option Pricing", Bell Journal of Economics and *Management Science*, Spring.

MERTON R.C. (1990), "Continuous Time Finance", Oxford: Blackwell.

MESSORI M. (2009), “The financial crisis: understanding it to overcome it”, Milan: Assogestioni, September.

MOODY’S (2009), “European Corporate Default and Recovery Rates”, May.

MORGAN STANLEY (2010), “Quarterly Short-Term Credit Market Update”, 2nd Quarter.

MORRISON & FOERSTER (2010), “The New Global Minimum Capital Standards Under Basel III”, *News Bulletin*, September 15th.

NEW YORK TIMES (2010), “Europe’s Web of Debt”, May 1st.

NUTTALL R., SANDOVAL S. (2010), “The new value at stake in regulation”, Mc Kinsey, March.

OBAMA B., VOLCKER P. (2010), http://www.whitehouse.gov/photos-andvideo/video/volcker-rule-financial-institutions, January 21st.

PAGLIARI J.L., SCHERER K.A., MONOPOLI R.T. (2003), “Public versus Private Real Estate Equities: A Risk-Return Comparison”, *Journal of Portfolio Management*, vol. 29.

PEDERSEN L., ROUBINI N. (2009), “A Proposal to Prevent Wholesale Financial Failure”, *Financial Times*, January 29th.

PIANALTO S. (2010), “Regulatory Reform: The New Face of Bank Regulation”, *Joint Convection of the Ohio Bankers League and the Illinois League of Financial Institutions*, French Lick (IN), September 11th.

QUAN D.C., TITMAN S. (1997), “Commercial Real Estate Prices and Stock Market Returns: An International Analysis”, *Financial Analysts Journal*, May–June.

RASMUSSEN P.N. (2008), *Report of the European Parliament with recommendations to the Commission on Hedge funds and private equity*, Brussels, September 11th.

REINHART C.M. (2010), “La carta straccia è ancora nei bilanci”, *Corriere della Sera*, September 20th.

REINHART C.M., ROGOFF K. (2009), *This Time Is Different: Eight Centuries of Financial Folly*, Princeton: Princeton University Press.

RONCAGLIA A. (2010), *Why the economists got it wrong*, Anthem press.

ROSENGREN E. (2009), “Challenges in resolving systemically important financial institutions”, The Institute of Regulation and Risk North Asia, Hong Kong, May 5th.

ROSSI S. (2010), *Metodi di analisi economica: cenni ed esempi*, Gangemi Editore.

RUDING O. (2010), *From National to European regulation. Towards European Financial Supervisory Authorities*, Frankfurt, May 19th.

SACCOMANNI F. (2008), “La Crisi Internazionale: Elementi Di Dialogo Con Gli Operatori”, Proceedings of the Conference *La turbolenza dei mercati finanziari: dialogo fra autorità e operatori*, Milano, February 19th.

SACCOMANNI F. (2009), “Nuove regole e mercati finanziari”, SSPA - Scuola Superiore della Pubblica Amministrazione, Rome, January 19th.

SARCINELLI M. (2009), “2007: La Crisi da Subprime”, in PEREZ R. (ed.), *Finanza privata e finanza pubblica,* San Marino: Maggioli.

SAVONA P., OLDANI C. (2009), “Crisis, Response And Innovation In Europe”, *Proceedings of “The 2009 Pre-G8 Summit” Conference*, Rome, June 30th.

SEGNI L. (2010), “Verso un nuovo assetto della vigilanza europea”, in MARCHESI D. (ed.), *Priorità nazionali. Trasparenza, Istruzione, Finanza, Energia*, Milan: Francoangeli.

SEGOVIANO M., GOODHART C. (2009), “Banking Stability Measures”, *IMF Working Paper*, n. 09/04 International Monetary Fund, Washington.

SEILER M.J., WEBB J.R., MYER F.C.N. (1999), “Diversification Issues in Real Estate Investment”, *Journal of Real Estate Literature*, vol. 7, n. 2.

SPAVENTA L. (2009), "La crisi della nuova finanza", in PEREZ R. (ed.), *Finanza privata e finanza pubblica*, San Marino: Maggioli.
STRAUSS-KAHN D. (2009), "Speech", School of Advanced International Studies, Washington (DC), April 23.
STRAUSS-KAHN D. (2010), "Speech", European Commission Conference, Brussels, March 19th.
TARULLO D.K. (2010), *Comments on "Regulating the Shadow Banking System"*, Federal Reserve System, Washingoton (DC), September 17th.
TREMONTI G. (2009), "International Legal Standards", available online at the URL: www.tesoro.it/documenti/open.asp?idd=20499
TRICHET J.C. (2010a), "Macro-prudential Regulation as an Approach to Contain Systemic Risk: Economic Foundations, Diagnostic Tools and Policy Instruments", Speech at the 13th conference of the ECB-CFS Research Network, Frankfurt am Main, September 27th.
TRICHET J.C. (2010b), "Keeping the momentum for financial reform", Keynote address at the EUROFI Financial Forum 2010, Brussels, September 29th.
TRICHET J.C. (2010c), "Europe's frameworks for macro-prudential oversight and economic governance", Speech at the Economic Club of New York, New York, October 12th.
TRICHET J.C. (2010d), "Global economic governance and euro area economic governance", Speech at the World Policy Conference Marrakech, October 16th.
UNICREDIT GROUP (2009), *Forum on financial cross-border groups*, March.
UNITED STATES CONGRESS (110th) (2008), *Emergency Economic Stabilization Act of 2008*, October 3rd.
UNITED STATES CONGRESS (111th) (2010), *Dodd–Frank Wall Street Reform and Consumer Protection Act*, July 21st.
UNITED STATES SENATE (2010), *Collins Amendment SA 3879*, May 6th.
WELLS S. (2002), "UK Interbank Exposures: Systemic Risk Implications", *Bank of England Financial Stability Review*, December.
WHITE W.R. (2003), "International financial crises: prevention, management and resolution", Berne, March 20th.
WOLF M. (2010), "Basel: the mouse that did not roar", *Financial Times*, September 15th.

APPENDIX

The Agreement by the BCOB on Quantification and Phasing-in of Basel III Capital Standards: main features and points for discussion.

On September 12th 2010, the Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision ("BCBS"), issued a press release[43] announcing a substantial strengthening of the capital requirements, and its full

[43] Basel Committee on Banking Supervision (2010c).

endorsement of the agreement it had reached on July 26th 2010[44] in relation to the proposed reforms to the Basel II framework. These elements are intended to form part of a package of reforms to be known as Basel III, which has been endorsed by the November 2010 G-20 Summit.

As was argued, repair of the capital standards is a crucial component of the overall reform of the financial system. The new agreement represents an important step in the right direction. A fair and comprehensive assessment is not easy, largely because several key issues remain unresolved even at the Committee level, including the amount and form of additional capital that will be required for systemically important institutions. Additionally, many of the details of the new framework will remain unclear for some time to come.

The basic thrust of the new system goes in the right direction and must be supported, notably in respect of both the quality and the quantity of the capital base. The wave of criticism – epitomized by the lead article of the FT on September 15th 2010 by Martin Wolf (2010), according to whom the new Basel III will not help create a safe system ("the mountain of Basel has brought forth a mouse") – should not be followed. But certain key areas of the agreement appear, in the light of the analytic framework presented in this paper, in need of refinement/reconsideration. Accordingly, the Appendix is structured as follows: sections A.1-2-3 (and figures A.1 and A.2) summarize the key elements of the proposed framework. Some suggested areas of adaptation are outlined in section A.4.

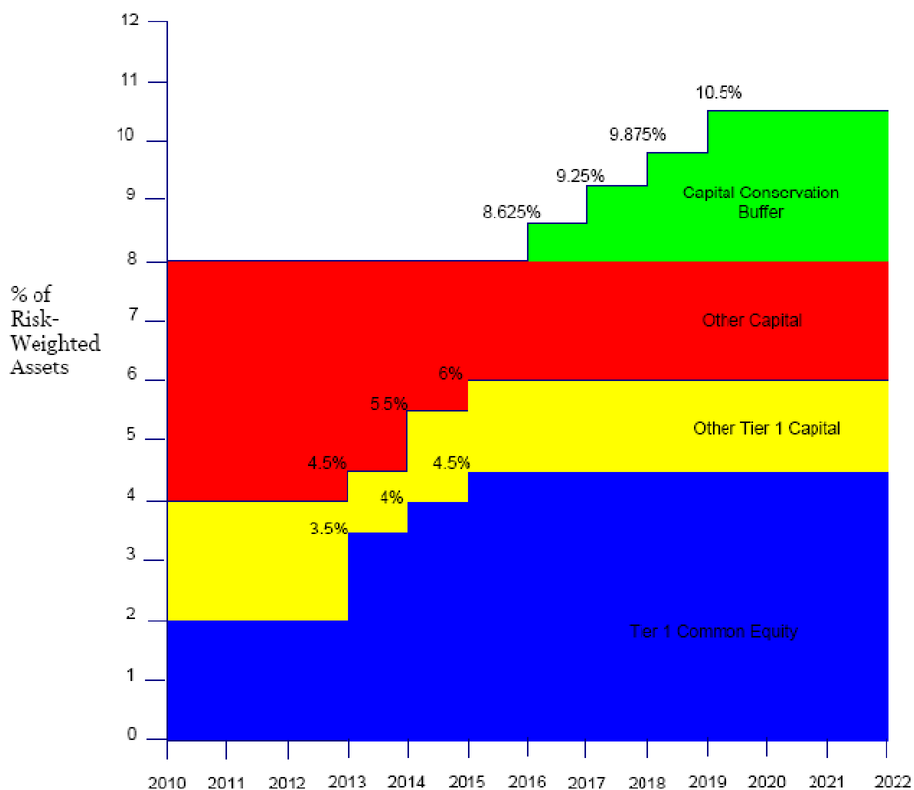
A.1 Increased Minimum Capital Requirements

- *Common Equity Risk-Based Capital*

The minimum requirement for the common equity component of Tier 1 capital will be increased from 2% of risk-weighted assets under the current framework, measured before the application of capital deductions, to 4.5% of risk-weighted assets, measured after the application of the stricter capital deductions required under the Basel III framework. However, when combined with the capital conservation buffer (described below), the resulting common equity requirement under Basel III will be 7% of risk-

[44] Basel Committee on Banking Supervision (2010a).

Figure A.1 - *Basel III: Minimum Capital Requirements*



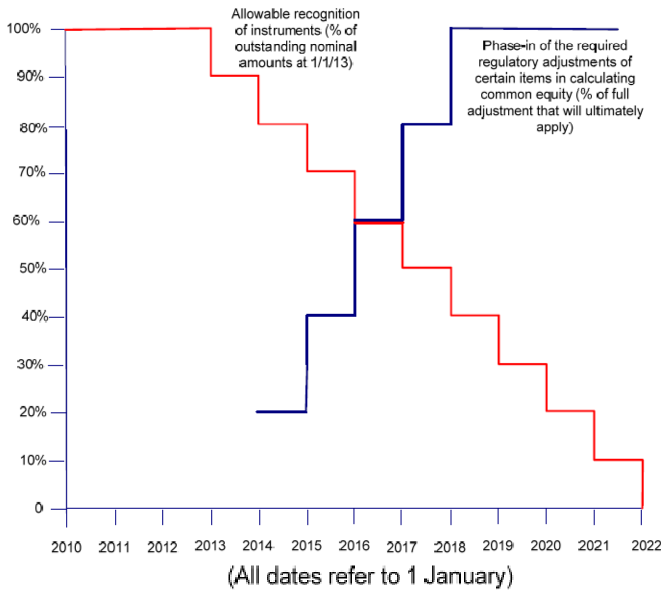
Source: Morrison & Foerster (2010).

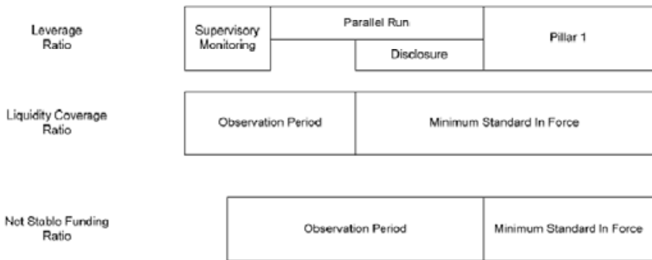
weighted assets. The new minimum requirement for common equity will be phased-in beginning with a 3.5% requirement in January 2013 and increasing to 4.5% by January 2015.

- *Tier 1 risk-based capital*

Over the same transition period (i.e., 2013 to 2015), the minimum tier 1 capital requirement will increase from 4% of risk-weighted assets, as under the current framework, to 6% of risk-weighted assets using Basel III's narrower definition of Tier 1 capital.

Figure A.2 - *Recognition of (a) Non-common equity instruments (issued before 13 September 2010)*[45] *that no longer qualify as Tier 1 or Tier 2 capital, and (b) Certain non-joint stock company instruments no longer qualifying as Common Equity Tier 1 capital*[46]





Source: Morrison & Foerster (2010).

[45] Capital instruments issued after September 12th 2010 cannot benefit from the phase-out arrangements.
[46] Generally, capital instruments no longer meeting the requirements for inclusion in common equity Tier 1 capital will be excluded from common equity Tier 1 from January 1st 2013.

- *Total risk-based capital*

The minimum requirement for total capital under the Basel III framework remains unchanged at 8% of risk-weighted assets. Again, however, the 8% requirement must be satisfied using Basel III's more stringent definition of capital. Thus, when combined with the capital conservation buffer, the total capital requirement under Basel III is effectively 10.5%: this should effectively be compared with 2% under Basel II, a five-fold increase!

- *Capital Conservation Buffer*

The capital conservation buffer, which must consist of common equity, is a capital cushion to be maintained above the Basel III minimum capital requirements that is intended to be available to absorb losses during times of financial stress. Under the Basel III framework, the capital conservation buffer will be set at 2.5% of risk-weighted assets. Although banks will be permitted to draw on the conservation buffer during periods of stress, as regulatory capital levels get closer to the minimum requirements (i.e., as the buffer is depleted), greater constraints on earnings distributions such as dividend payments and discretionary employee bonuses will be triggered. Institutions subject to Basel III are likely to target levels of capital that exceed not just the regulatory minimums, but rather the regulatory minimums plus the capital conservation buffer.

- *Leverage Ratio*

As announced in July, the minimum risk-based capital requirements under Basel III will be supplemented by a non-risked-based minimum tier 1 leverage ratio, which has been tentatively set at 3%. The appropriateness of the 3% ratio (and the use in the numerator of Tier 1 capital as opposed to total capital or common equity) will be assessed during a parallel run period from 2013-2017, with the leverage ratio requirement not becoming final until 2018.

A.2 Transition Arrangements

The increases to the minimum common equity and tier 1 capital ratios will be phased-in over two years beginning in January 2013, with the full

increases taking effect in January 2015. This will be followed by a three-year phase-in beginning in January 2016 of the capital conservation buffer, with the full 2.5% buffer requirement taking effect in January 2019. In addition, the deduction from tier 1 capital of excess (i.e, over 15% of common equity in the aggregate) minority investments in financial institutions (FIs), mortgage servicing rights (MSRs), and certain deferred tax assets (DTAs) will be phased-in over a five-year period in 20% increments beginning in 2014, so that the full deduction will not take effect until January 2018.

Public sector equity investments are fully grandfathered until January 1st, 2018. Instruments no longer qualifying as non-common equity Tier 1 capital (e.g., trust preferred securities) or Tier 2 capital will be phased out over a 10-year period beginning in January 2013, with recognition of those instruments as qualifying capital being reduced by 10% each year, using the nominal amount outstanding on January 1st, 2013, as a baseline. Capital instruments that no longer qualify as common equity, however, generally will be excluded altogether from common equity as of January 1st, 2013.

A.3 Outstanding Issues

Although the minimum capital requirements and transition arrangements constitute crucial components of the Basel III package, other important issues have yet to be resolved.

- *Systemically important institutions*

The Basel III release confirms, without providing any further detail, that systemically important banks will be expected to maintain capital beyond the minimum regulatory requirements. The announcement simply notes that the Committee, together with the Financial Stability Board, continues to work on a “well-integrated approach” to systemic institutions that could include “combinations of capital surcharges, contingent capital and bail-in debt”. G-SIFI’s are supposed to have even higher loss absorbency capacity.

- *Countercyclical capital buffer*

In addition to the capital conservation buffer, the Basel III framework also contemplates a countercyclical capital buffer that would be funded on a jurisdiction-specific basis during periods of excess credit growth resulting in

a build-up of systemic risk. According to the announcement, the countercyclical capital buffer would cover a range of 0% to 2.5% of risk-weighted assets, would need to be composed of common equity "or other fully loss absorbing capital" when funded, and would be implemented "according to national circumstances".

- *Net stable Funding Ratio*

The Basel III release reiterates the Committee's commitment to issue a revised minimum net stable funding ratio (NSFR), which is intended to promote longer-term structural funding of banks' balance sheets, off-balance sheet exposures and capital markets activities. As first announced in July 2010, the NSFR released as part of the December 2009 Basel III proposal is in the process of being revised, and a new NSFR proposal is expected by year-end 2010. The revised NSFR is not scheduled to take effect as a minimum standard until 2018.

A.4 Suggested adaptations

- *Timeline*

It is no doubt difficult to strike the right balance between strengthening banks balance sheets and allowing financial institutions to sustain economic recovery. The new capital, leverage and liquidity standards described above were undoubtedly influenced by concerns about the impact of higher capital requirements on bank lending and the faltering pace of economic recovery.

As a result, the timeline for implementation of the new requirements (grandfathering) is exceptionally long (12 years), as indicated in detail in figure A.3. Lengthy transitional periods to implement announced long-term targets may have important drawbacks. If the truly "sound" standards are to be met so faraway, the markets, in case of impending stress, may well react adversely and force financial institutions towards immediate respect of the stricter criteria. This would exacerbate procyclicality. There are already worrying signs that markets push for a very early implementation of the new final quantitative standards, which is detrimental to the still fragile recovery. Let us remind that available estimates indicate that Basel III reforms, when fully in place, would cost

European banks some €1.2 trillion in extra-capital and €3.4 trillion in debt, to finance lending. [47]

Non risk-based complementary requirements

The phase-in period is especially long in respect of these crucial limits. As indicated, one of the fundamental defects of the traditional Basel approach was the misuse of Risk Weighted Assets (RWA) in the assessment of required capital. There were three main problems with this approach:

(i) it was backward-looking since it assumed that the securities which had been risky in the past would be the same as the securities that would become risky in the future. This is not necessarily true;

(ii) it was easy to game. Taking any additional measurable risk requires more capital. The game became how to increase returns without increasing measured risk! Correct application is, therefore, of fundamental importance. It was here that the supervisory process proved inadequate;

(iii) models used were inappropriate, since they were based on too short historical references and on normal distributions.[48]

Risk could be made exceedingly small in Basel I and Basel II. Even in Basel III very high leverage is allowed, especially in respect of securities with very high ratings. The RWA methodology is an important step forward and the basic approach is fundamentally right. The solution to avoid past mistakes is not to go back to non-weighted schemes, but to find the right balance between the various measures. As indicated, the balance rests fundamentally on competent understanding and application of the analytical models used and on sound, effective analysis and supervision of banking groups and firms. What must at all costs be avoided is a mechanical application of across-the-board coefficients.

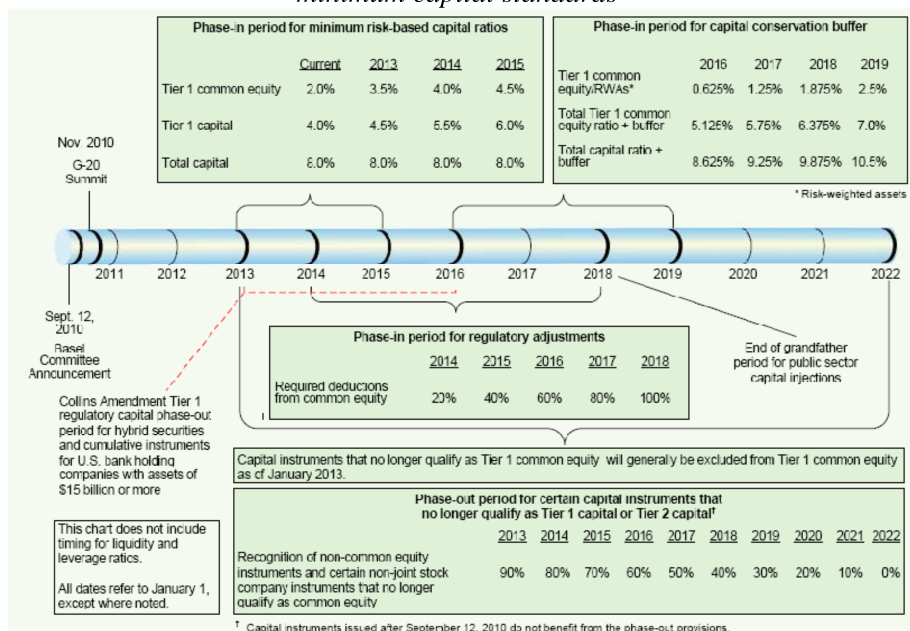
This is the reason why un-weighted criteria, such as leverage and liquidity coefficients, should also be taken into account, to avoid relapses into the excesses of the past. Doubts can, therefore, be expressed on the proposed time horizon of their implementation. As indicated, the leverage

---

[47] McKinsey&Company (2010).

[48] For an elaboration of these points see Masera (2009a).

Figure A.3 - *Basel Committee: yearly timeline for global minimum capital standards*



Source: Davis Polk & Wardwell LLP (2010).

ratio, which represents a key back-stop to the risk-based measures discussed above, will be phased-in only by 2017, and applying a minimum threshold of 3%. Migration to a Pillar I treatment would take place in 2018. Also the liquidity ratios will undergo long observation periods, prior to their introduction, as minimum standards, due to take place ultimately in 2018.

- *Capital buffers*

The new additional capital conservation buffer is introduced to absorb losses in periods of financial and economic stress, and should be met exclusively with common equity. The BCOB also agreed on a countercyclical buffer. This buffer will be triggered in good times, so that banks can be more stable during financial crises. But no objective trigger

point has been indicated to signal when banks will need to build up the buffer and when they will be allowed to draw on that capital if needed. This decision will be left to regulators in each individual country. The problem with RWA incentives is that, if they are large and remain mechanically in place over the long term, they can produce unintended consequences, like over-exposure to a specific sector or form of lending for which there is no historical experience and a consequent under-pricing of risk. They can also, as the US mortgage experience and the fallout on the entire housing market has demonstrated, cause behaviors and forms of regulatory arbitrage that create but disguise risk. Good supervision and enterprise risk management are the first lines of defense against distortions.

The envisaged framework is complex and burdensome from an operational point of view. The case has already been made that reliance on countercyclical provisioning by banks, with appropriate adaptation of fiscal and accounting rules, would represent a sounder and simpler approach. No bank is allowed by the markets to run down its capital base precisely when things get difficult.

- *Commercial banking vs. investment banking*

After the collapse of Bear Stearns and the failure of Lehman two years ago the demise of investment banking seemed inevitable. But, in spite of the Volcker Rule, the regulation to distinguish clearly between investment and commercial banking, is waning. Basel III does not endorse in any way the split approach. It is instead consistent with subsidiarization, and well specified living wills. Paradoxically it could lead commercial banks to increase funding in wholesale markets. The intrinsic stability of a well-run "traditional" bank model, based on core deposits, is not recognized. And yet this should be a clear lesson of the crisis, particularly evident from the Italian experience. Thus, the banking model most conducive to financial stability and growth in economies characterized by the importance of SME's might be a casualty of the Basel framework.

- *Trading and banking books and government bonds*

The capital Risk-Weighted-Assets approach proved inadequate in averting the crisis. This was partly due to the deficiencies of risk models,

based on normal probability distributions, which were carried over to stress tests. The lessons have been taken home, but some important issues are not yet fully recognized. The point was made that the hypothesis of orthogonality between government "risk free" interest rates and risk premiums of private borrowers cannot be regarded as a general axiom. Stress tests, according to the Basel framework, also very recently, have been conducted without full recognition of this point. Specifically, the use of haircuts to government paper only in respect of the trading book should be questioned.

More generally, as has been rightly observed (Reinhart, 2010), the Basel III approach continues to push banks towards investment in (domestic) government bonds. This may be "politically correct" under current circumstances, but may entail significant risks, especially in the European context. Markets are aware of this, as witnessed by the fact that very sound industrial and services corporations, based in triple-A rated countries, are able to borrow in better terms than most banks and many governments.

- *Systemically important banks and resolution procedures*

This especially important area is still work in progress in Basel. The following remarks are, therefore, only tentative suggestions on the basis of available information. The BCOB states that SIFIs should have higher "loss absorbing capacity" than required by the new standards. The integrated approach potentially includes combinations of capital surcharges, contingent capital and bail-in debt, in addition to the measures to strengthen resolution regime. As we have seen, the Dodd-Frank Act imposes some general principles and also details the basic procedures for resolution. The position of the present author is that SIFIs should be made to bear the systemic risks they pose, so that bail-outs with public money are ruled out. The existence of excessively large, complex, difficult to manage and to supervise financial conglomerates with no clear specialization and focus should be discouraged. However this should be done preferably through systemic-risk-related fees, to be paid to a resolution fund (a model similar to that outlined in the Dodd-Frank Act), rather than by imposing capital surcharges (Masera and Mazzoni, 2010). In this respect, objective criteria should be developed to identify such institutions and monitor their contribution to risk.

More generally, the problems posed by SIFIs cannot be effectively dealt with without simultaneously addressing the issues of crisis management and resolution regimes. The Dodd-Frank Act shows clearly this point, which is not yet satisfactorily treated in the new Basel framework. We have indicated that in the EU important difficulties must be overcome in this area. National authorities and jurisdictions will detail their own resolution regimes, which must be made consistent at European level. Additionally, the specific business models of systemically important financial institutions in Europe can be very different, and their dangerousness evidently varies. This critical issue is not yet satisfactorily addressed.

From a supervisory angle, Basel III must ensure full disclosure and transparency of SIFIs, also with the view to ensuring better market discipline. The intertwining of sovereign and SIFI risks should be recognized and appropriately dealt with in the new capital standard.

Finally, the very high capital charges that are targeted in the medium term, but can be forced by markets much sooner, propose again the issue of regulatory arbitrage and the operation of the “shadow banking system”.

ACRONYMS

AIF	Alternative Investment Funds
AIFM	Alternative Investment Fund Managers
AIFMDD	AIFM Draft Directive
BCBS	Basel Committee on Banking Supervision
BCFP	Bureau of Consumer Financial Protection
BCOB	Basel Committee Oversight Body
BIS	Bank for International Settlements
CAD	Capital Adequacy Directive
CCC	Central Counterparty Clearing
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CERS	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission
CP	Consumer Protection

CRA	Credit Rating Agency
CRD	Capital Requirements Directive
EBA	European Banking Authorities
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FASB	Financial Accounting Standards Board
Fed	Federal Reserve System
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FINRA	Financial Industry Regulatory Authority
FIO	Federal Insurance Office
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
G20	Group of Twenty
GFS	Global Financial System
G-SIFI	Globally Systematically Important Financial Institution
IASB	International Accounting Standards Board
IFRSs	International Financial Reporting Standards
IMF	International Monetary Fund
INREV	Investors in Non-listed Real Estate Vehicles
MAD	Market Abuse Directive
MIFID	Market in Financial Instruments Directive
NCUA	National Credit Union Administration
NRSRO	Nationally Recognized Statistical Rating Organization
OCC	Office of the Comptroller of the Currency
OCI	Other Comprehensive Incomes

OFR	Office of Financial Research
OLA	Orderly Liquidation Authority
OLAP	Orderly Liquidation Authority Panel
OLF	Orderly Liquidation Fund
OLP	Orderly Liquidation Procedure
OTC	Over-the-Counter
OtT	Originate-to-Transfer
RR	Regulatory Reform
SEC	Securities and Exchange Commission
SIFI	Systematically Important Financial Institution
SIPC	Securities Investor Protection Corporation
SPV	Special Purpose Vehicle
S&R	Supervisory and Regulatory
TARP	Troubled Asset Relief Program
UCITS	Undertakings for Collective Investment in Transferable Securities