



47

AICGSPOLICYREPORT

**TAMING THE FINANCIAL BEAST:
A STATUS REPORT OF FINANCIAL
REGULATORY REFORM IN THE
UNITED STATES AND THE
EUROPEAN UNION**

Stormy-Annika Mildner
Daniela Schwarzer



AT JOHNS HOPKINS UNIVERSITY

The American Institute for Contemporary German Studies strengthens the German-American relationship in an evolving Europe and changing world. The Institute produces objective and original analyses of developments and trends in Germany, Europe, and the United States; creates new transatlantic networks; and facilitates dialogue among the business, political, and academic communities to manage differences and define and promote common interests.

©2011 by the American Institute for Contemporary German Studies

ISBN 978-1-933942-33-9

ADDITIONAL COPIES:

Additional Copies of this Policy Report are available for \$5.00 to cover postage and handling from the American Institute for Contemporary German Studies, 1755 Massachusetts Avenue, NW, Suite 700, Washington, DC 20036. Tel: 202/332-9312, Fax 202/265-9531, E-mail: info@aicgs.org Please consult our website for a list of online publications: <http://www.aicgs.org>

The views expressed in this publication are those of the author(s) alone. They do not necessarily reflect the views of the American Institute for Contemporary German Studies.

TABLE OF CONTENTS

Foreword	3
About the Authors	5
Introduction	7
What Went Wrong? Why Reforms are Necessary	11
Reforming the Financial Regulatory Architecture	17
Closing Regulatory Loopholes	27
Addressing Moral Hazards: Eliminating “Too Big to Fail”	33
Conclusion: What Remains to Be Done	39
Abbreviations	41
Notes	42



FOREWORD

In the wake of the global financial crisis, initiated by bank and insurance failures on Wall Street, the United States and the European Union have acted not only to recover from the crisis, but also to implement regulatory reforms to prevent another crisis of this magnitude in the future. The path to reform, however, has not been smooth. Political debates over fundamental issues—the role of government in the market in the U.S. and the loss of individual nations' sovereignty in the EU—have slowed progress toward making meaningful reform in regulating the financial sector.

This Policy Report discusses the progress that has been made in regulatory reform and identifies areas for improvement. Such improvements include reducing information deficits, reducing excessive risk-taking behavior, and addressing the “too big to fail” problem. Beyond this, Stormy-Annika Mildner and Daniela Schwarzer make a case for transatlantic cooperation going forward, citing the need to prevent regulatory arbitrage, advance risk-minimizing standards, and adjust global macro-economic imbalances. The financial market is far too global—both in its actors and its consequences—to continue to allow an inward-looking system of regulation. Financial regulatory reform will be an on-going challenge as our economies struggle to rebound from the financial crisis. New, related challenges continue to emerge as we encounter burgeoning national debts and the related political and economic disturbances.

AICGS is grateful to the Draeger Foundation and the AICGS Business & Economics Program for their support of this Policy Report, to the authors for sharing their analysis, and to Jessica Riester for her work on this publication.



Jack Janes
Executive Director

ABOUT THE AUTHORS

Dr. Stormy-Annika Mildner (M.Sc.) is a member of the Board of Directors at the German Institute for International and Security Affairs (SWP), a policy-oriented think-tank based in Berlin. Her field of interest is international political economy, including transatlantic economic relations. She teaches classes on international economics at the Hertie School of Governance in Berlin. Dr. Mildner has previously worked for the German Council on Foreign Relations (DGAP), where she headed the program Globalization and the World Economy (2000-2002). In 2005-2006 she worked as Lecturer at the John F.-Kennedy Institute of the Free University Berlin. Dr. Mildner is a non-resident Senior Fellow of the American Institute for Contemporary German Studies in Washington, DC.

Dr. Daniela Schwarzer is currently the Head of the Research Division EU Integration at the German Institute for International and Security Affairs, Stiftung Wissenschaft und Politik (SWP) in Berlin. She joined the Institute in 2005. In 2010, she became a member of the team of academic advisors to the Polish Secretary of State for European Affairs in preparation of Poland's EU Council Presidency in 2011. In 2007/2008 she was a member of the working group "Europe" of the Whitebook Commission on Foreign and European Policy in the French Foreign Ministry and a visiting researcher at the French Institute for International Relations 'ifri' in Paris. From 1999 until 2004 she served as editorialist and France correspondent for the *Financial Times Deutschland*. Prior to this, between 1996 and 1999, she was chargée de mission and later Head of the Information Department at the Association for the European Monetary Union in Paris. She is the co-founding editor of www.eurozonewatch.eu (2006) and of the *European Political Economy Review* (2003). She regularly serves as a guest lecturer in German and international Universities. Dr. Schwarzer studied Political Science and Linguistics in Tübingen, Reading (UK), and at Science Po, Paris. She holds a PhD in Political Economy from the Freie Universität Berlin, co-supervised by the London School of Economics.



01

INTRODUCTION

TAMING THE FINANCIAL BEAST: A STATUS REPORT OF FINANCIAL REGULATORY REFORM IN THE UNITED STATES AND THE EUROPEAN UNION¹

“This crisis has been wrought by market excesses combined with insufficient regulation. We therefore have to draw the right lessons from this [...]. In other words, freedom always requires action by the state to provide a framework within which all may live in freedom. We will together strive to perform this task.”²

Angela Merkel, German Chancellor

“Every day we don’t act, the same system that led to bailouts remains in place, with the exact same loopholes and the exact same liabilities. [...] And if we don’t change what led to the crisis, we’ll doom ourselves to repeat it. [...] One way or another, we will move forward. This issue is too important.”³

Barack Obama, U.S. President

“[...] effective crisis prevention and management call for close cooperation and efficient information exchange between the supervisory authorities in various jurisdictions as well as between the central banks, whose tasks include the safeguarding of financial system stability, and the supervisors of individual institutions.”⁴

Lucas Papademos, Vice President of the European Central Bank

The financial and economic crisis of 2007-2009, the worst since the Great Depression of the 1930s, has revealed glaring shortcomings in both financial regulations and oversight in the United States and the European Union. Regulation and supervision fell short on four major accounts: to spot systemic risks in the markets, to send out early warnings, to implement effective regulatory safeguards, and set disincentives for excessive risk-taking behavior. The U.S. and the EU have initiated numerous regulatory reforms on matters such as micro- and macro-prudential regulation, bank capital and liquidity requirements, accounting standards, derivatives, alternative investment funds, credit rating agencies, and compensation schemes. But while some progress has been made,

much-needed reforms are still pending. This Policy Report identifies three areas in which further efforts are necessary: 1. the regulatory architecture to reduce information deficits, improve risk assessment, and minimize regulatory arbitrage; 2. rules and standards to reduce excessive risk-taking behavior; 3. rules and instruments to mitigate moral hazard and to tackle the “too big to fail” problem. Sound and transparent rules and oversight are necessary because a healthy financial sector is crucial to the entire economy of a country. Without more ambitious reforms, the system will remain very vulnerable to future crises. Failing to reform the regulatory system in the U.S. and the EU would be felt globally.

INTRODUCTION

The global financial and economic crisis of 2007-2009 was the worst period of financial turbulence since the Great Depression of the 1930s. In September 2008, the world economy stood at the brink of collapse. In the following months, growth rates plunged in all big industrialized countries, and world trade and investment flows declined dramatically. Governments responded with a multitude of fiscal and monetary measures to stabilize financial markets and to overcome the economic downturn: Troubled financial institutions such as AIG, Fannie Mae, and Freddie Mac in the United States and Hypo Real Estate in Germany were bailed out in order to prevent a breakdown of the entire financial system. Large fiscal stimulus packages were passed to smooth consumption and production. When the immediate effects of the crisis were contained, governments moved to an equally daunting task: financial regulatory reform.

While more than regulatory reform is necessary to establish a stable and sound global economy, U.S. Senator Carl Levin is right in emphasizing “the recent crisis was not a natural disaster, it was a manmade economic assault. It will happen again unless we change the rules.”⁵ The financial crisis unveiled numerous deficiencies within regulation (rules) and oversight (regulatory agencies and regulatory architecture). At the G20 summit in Pittsburgh in September 2009, the G20 leaders therefore emphasized: “Where reckless behavior and a lack of responsibility led to crisis, we will not allow a return to banking as usual.” They committed themselves to “act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global

firms responsible for the risks they take. Standards for large global financial firms should be commensurate with the cost of their failure.”⁶ The U.S. and the EU member states such as Germany have been at the forefront of these demands.

Almost two years after the G20 summit in Pittsburgh, many reforms have been initiated in both the U.S. and the EU on matters such as micro- and macro-prudential regulation, bank capital and liquidity requirements, accounting standards, derivatives, alternative investment funds, credit rating agencies, and compensation schemes. However, despite initial reform activism, some regulatory reforms have run into considerable opposition. In the U.S., for example, the Republican-dominated House of Representatives has started to flex its muscles, threatening to revise parts of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act if necessary with the power of the purse. Much-needed reforms are also still pending in the EU, while some European legislation that was actually adopted was considerably down-scaled in the process of negotiation by member states fearing too much interference in domestic affairs.

Regulatory reform proposals tend to fall into three categories: 1. Better regulation and oversight to identify and mitigate systemic risks; 2. clear and predictable rules that reduce excessive risk-taking behavior; and 3. increased international coordination and cooperation to reduce regulatory arbitrage. We will focus on three issues in particular: reforming the financial architecture, closing regulatory loopholes, and tackling “too big to fail” (TBTF) problems. Apart from the introduction and the conclusion, our analysis is divided into three parts. In the first section we will analyze reforms targeting the financial regulatory architecture before focusing on rules and incentive

structures to curtail excessive risk-taking behavior in the second part of our Policy Report. The third part is devoted to the problem of “too big to fail.” A good regulatory system should not only promote innovation and competitiveness, it should in particular provide transparency, and ensure safety and soundness.⁷ We believe that the reforms taken are important steps in this direction. However, there are some disappointing shortcomings in particular with regard to the regulatory architecture and tackling TBTF problems. In the final part of the Policy Report, we review the unresolved issues in both the U.S. and the EU and discuss the case for transatlantic cooperation as they are still the largest players in the international financial markets. Without proper reform in both economies and transatlantic cooperation on some key regulatory issues, the international system will fail to reduce its vulnerability to future financial crises. Transatlantic cooperation is necessary to prevent regulatory arbitrage and to ensure an international level playing field. As the two big economic powers are for the time being important standard setters in the G20, the way they handle finance sets important examples for the rest of the world.⁸



WHAT WENT WRONG?

02

WHAT WENT WRONG? WHY REFORMS ARE NECESSARY

The global financial crisis of 2007-2009 is a glaring case of systemic failure. Its length, intensity, and international spreading can be explained by a failure both of governments and markets which mutually reinforced each other. Rainer Masera (2010), a member of the De Larosière group, highlights several lessons to be learned from the crisis, in particular: 1. financial markets are not self regulating but prone to crises and market failures; 2. risk management and corporate governance models were deeply flawed and assets were widely mispriced; 3. micro- and macro-prudential regulation were not sufficiently linked; and 4. regulations were often insufficient and procyclical.⁹

2.1 Market Failures

According to the political scientist Barry Eichengreen, increased competitive pressure encouraged excessive risk-taking in the financial sector.¹⁰ In the European Union, international competition through globalization of finances was exacerbated by the single market leading to a further increase in cross border competition. According to figures provided by the European Commission, there are more than 8,000 banks in Europe, but two-thirds of their total assets are held by only forty-four multinational institutions.¹¹ As a result of internationalization and growing competition, "it is no coincidence that previously sleepy German *Landesbanken* (state banks) were so heavily exposed to toxic securities."¹² Several of them, which had invested heavily in the mortgage market, lost millions through speculation. A similar development could be witnessed in the United States. The Gramm-Leach-Bliley Act of 1999 aimed at improving the competitiveness of U.S. commercial banks in international financial markets by repealing the 1933 Glass-Steagall Act. It thereby removed the separation between commercial banks and invest-

ment banks, which the Glass-Steagall Act had established in the Great Depression.¹³ This fuelled the growth of large financial conglomerates. Furthermore, low interest rates after the bust of the new economy bubble (2000) and the terrorist attacks of September 11, 2001, together with high capital inflows (macro-economic imbalances) fuelled a boom of easy credit and mortgage lending, a reduction in credit standards, the housing bubble, and the international trade in asset-backed securities (ABS), which spread risks around the world, including to the EU.¹⁴

At the same time, both in the EU and the U.S., financial markets became more vulnerable due to an explosive growth of the financial sector relative to the real economy, the increasing use of opaque derivative products, informal trading, high leverage and low reserves, as well as weak oversight.¹⁵ Highly complex financial conglomerates emerged. Large risks were externalized off-balance into so-called special purpose vehicles, often located in less regulated financial centers, fuelling the emergence of an increasingly complex and opaque shadow banking system. Furthermore, the increasing size and interconnectedness of financial institutions rendered many of them too big, too interconnected, or too systemic to fail, creating a severe moral hazard problem.¹⁶

High performance incentives (e.g., compensatory schemes), combined with little transaction transparency, further incentivized financiers to take on enormous and unsustainable risks. The same holds true for creative financing structures: Investors believed they could receive the benefits of success while being "insured" against losses, in that they could pass risks on to other parties (moral hazard). This lack of accountability and a focus on short-term profits instead of long-term sustainability portrays

how business practices were not related to the increasing risk in the markets.¹⁷ A prime example is mortgage backed securities in the U.S.: Unusually low interest rates and low capital ratios coupled with weak oversight created an atmosphere that rewarded quantity rather than quality of loan generation. Often, mortgage brokers did not check the financial credentials of a borrower thoroughly and granted loans to high risk lenders. Banks, knowing that they could resell the loans to other investors, did not worry much about the quality of the loans they underwrote. Investors who purchased the banks' loans learned to bundle and repackage them into asset backed securities for resale to yet other investors (securitization), which again would bundle them into even larger ABS. The business promised profits without risks. Inflated ratings of these securities by rating agencies, opaqueness of these instruments, and a belief in the infallibility of the housing market also contributed to a market structure that incentivized financiers to take on too much risk and to hold too little capital.

At the same time, risk management systems within financial firms did not keep pace with changes in the financial system. In particular big banks showed a striking weakness in their internal risk management, as managers were partly deliberately ignorant or overwhelmed by the risks featured by these complex products. As financial products became increasingly difficult to understand, investors relied more and more on external ratings.

Rating agencies, however, based their ratings on false assumptions and models, thus underestimating systemic risks. In addition, the structure of the rating market incentivized the inflation of grades. Rating agencies were paid for their ratings by the issuer of a security ("issuer-pays-model"). In addition, they also sold consulting services to them, guiding the issuer how to package a structured product to then also get a high rating. The problem this entails is obvious as it leads to a potential conflict of interest. As a consequence of inflated ratings, banks' capital buffers often turned out much too low.¹⁸

2.2 Regulatory Failures

Market failure was accompanied by a failure of governments and regulatory authorities to provide regulation and oversight that could effectively prevent activities that had the potential to destabilize the financial system. Regulation and oversight had not kept up with the fast-changing financial system, and regulators had not quite adjusted to the integration of traditional lending and capital market activities as well as the emergence of the shadow banking sector. According to Acharya et al. (2010), "regulatory naiveté in the face of the ingenuity of the financial sector, the ideology of the times, and a cognitive failure by everyone, to appreciate fully the unintended consequences of existing regulations and to develop the tools to deal with them" prevented legislators from adjusting the regulatory framework.¹⁹ In the EU, regulatory loopholes emerged from the attempts to complete the single market for financial services with the objective of providing an internationally competitive model in the EU—while the integration and liberalization was not matched by EU-wide regulation. This could hardly be compensated on the national level, as for instance in the euro-zone, one country imposing harsh financial restrictions will affect that country's economy severely. Thus, financial institutions might choose to move their assets to another EU country—a threat increasing with the deepening of European integration. In the U.S., growing international competition led to a deregulation of financial markets (including the repeal of the Glass-Steagall Act), while regulatory oversight was not prepared to deal with the large financial conglomerates and the shadow banking system that subsequently emerged.

Supervisory structures were insufficient, in particular in the field of macro-prudential surveillance. Regulators failed to spot growing systemic risks because they were too focused on the safety and soundness of individual institutions (micro-prudential regulation), and not on the whole, interconnected system (macro-prudential regulation). It is no secret that financial markets are particularly vulnerable to systemic risks because of the high interconnectedness of financial firms, high leverage ratios, the tendency to fund long-term assets with short-term debt (maturity mismatch), and the susceptibility to overreactions such as herding behavior. But systemic

risks can only be seen from a bird's eyes perspective, which was missing in both the U.S. and EU regulatory approach.²⁰

Micro-prudential supervision, meanwhile, depends on technology but also on knowledge and understanding of financial markets. In a U.S. Senate hearing on 20 May 2010, Mary Shapiro, the current Chairwoman of the Securities and Exchange Commission (SEC), admitted that the technology of the SEC had fallen behind in recent years.²¹ A 2009 Government Accountability Office (GAO) report found that a lack of funds hindered the work of the Enforcement Division of the SEC, listing a number of problems, including inadequate support staff, outdated document management systems, and inability to share information between divisions. Information asymmetry was another problem. Due to the complexity of transactions, regulators often lag behind their market counterparts; in particular as they depend on the information they get from them.²² In times of computerized trading and massive amounts of data, regulating can thus be a daunting task. As the Warwick Commission pointed out, this "partially led regulators to see supervision as an exercise in legal compliance rather than an assessment of risk and risk capacity."²³

Risks were also missed because of fragmented regulatory systems, a dispersion of authority, and jurisdictional overlaps.²⁴ The consequence of the fragmented regulatory structure was an invitation to "regulator (or charter) shopping." In the U.S., in search for weak regulations and low fees, financial institutions could easily switch between charters and thus between various regulators. Accordingly, the Financial Crisis Inquiry Commission, which was established by the Obama administration to investigate the causes of the financial crisis, criticized that "the government permitted financial firms to pick their preferred regulators in what became a race to the weakest supervisor."²⁵ The financial crisis unveiled yet another problem: Large, diversified financial institutions such as the insurance giant AIG fell under the jurisdiction of several regulators. For example, the Office of Thrift Supervision (OTS), arguably the weakest of all the federal bank regulators, became responsible for AIG's financial products unit. Neither having the experience nor the capacity to supervise large holding companies such as this insurance giant,

OTS missed the overexposure to credit default swaps (CDS) leading AIG to the brink of collapse, which could only be prevented by government intervention.

In the EU, according to the European Commission, "nationally based supervisory models have lagged behind the integrated and interconnected reality of today's European financial markets, in which many financial firms operate across borders."²⁶ The fragmented supervision gave rise to two problems: First, financial institutions could shift transactions to jurisdictions with lower standards. Second, financial instability could spread faster from one country to another as European economies increasingly integrated (contagion effects).²⁷ Fragmented and incomplete information of national authorities together with an inadequate exchange on both the extent of the financial crisis as well as possible solutions, also posed a severe challenge for effective crisis management. At the time of the crisis, each of the member states tried to save its respective banks without coordinating, often lacking crucial experiences its neighbors had already made. The economists Sebastian Dullien and Hansjörg Herr (2010) argue that this problem was amplified by a strong moral hazard problem, arising due to an implicit obligation of liability among the EU members for the debts of an individual country, as the Greek crisis has spectacularly illustrated.²⁸

But the regulatory system did not only fail to keep pace with growth and innovations in the financial services industry. The crisis revealed that regulators repeatedly failed to exercise their existing authority to contain risks. Thus, regulators operated in an environment which was characterized by a belief in the infallibility of markets. In the U.S., deregulation and reliance on self-regulation of the financial sector, which was promoted by Republicans and Democrats alike, was considered a contribution to strengthening the American financial industry in light of growing international competition. Great faith was placed in self-regulation of financial institutions. In the EU, the years in the run-up to the financial crisis were characterized by a strong appetite for cross-border market liberalization in an attempt to complete the single market. Meanwhile, neither the President of the European Commission, José Manuel Barroso, nor then-Single Market Commissioner Charles McCreevy

had a strong interest in accompanying regulation. At that time, risk management of the private sector financial institutions was regarded as exemplary on both sides of the Atlantic. The outsourcing of risks in special purpose entities as well as trade in credit derivatives such as CDS were interpreted rather as an expression of innovation and progress than as a phenomenon that required new regulations. Years without a serious economic recession had bred complacency among financial institutions and regulators. SEC Chairwoman Shapiro noted: “I think everybody a few years ago got caught up in the idea that markets are self-correcting, and that people in Wall Street will do a better job protecting the financial system than the regulators would.”²⁹

According to the economist Ross Levine, policy-makers thus maintained policies that incentivized excessive risk-taking behavior, destabilizing the whole financial system.³⁰ Joseph Stiglitz accordingly wrote in the midst of the crisis: “If government appoints as regulators those who do not believe in regulation, one is not likely to get strong enforcement.”³¹ In the U.S., the Financial Crisis Inquiry Commission’s report emphasized that there was a lack of political will to enforce the rules. “We do not accept the view that regulators lacked the power to protect the financial system. They had ample power in many arenas and they chose not to use it,” the Commission emphasized, arguing that regulators either took no action or even aggravated the situation by positively evaluating their subordinate institutions—even in the presence of evident difficulties.³²

The problem was amplified by regulatory capture. In particular in the U.S., time and again, regulators became employees of the industries they previously regulated; and in some instances, regulators were recruited from the financial sector (revolving door effect). The consequences of these regulatory failures are well known: “The financial system failed to perform its function as a reducer and distributor of risk. Instead, it magnified risks, precipitating an economic contraction that has hurt families and businesses around the world,” admitted U.S. Treasury Secretary Timothy Geithner.³³

Last but not least, implicit government guarantees induced moral hazard and thus excessive risk-taking.

Mario Draghi, Governor of the Bank of Italy, emphasized in October 2010, “addressing the ‘too big to fail’ problem is perhaps the most challenging remaining legacy of the crisis.”³⁴ The problem gained prominence in March 2008 with the controversial rescue of the investment bank Bear Stearns by the Federal Reserve and the subsequent decision to let Lehman Brothers fail in September 2008. “Too big to fail” (TBTF or “too interconnected to fail”) describes the assumption that an institution is so large or so interconnected with counterparties that its creditors (possibly even shareholders) must be rescued by the government in times of financial stress, otherwise risking contagion and a failure of the whole financial system. While TBTF is not a new problem, it was amplified by the extent of governments’ interventions world-wide to prevent the complete collapse of the financial system. Morrison/Véron (2010) highlight, among others, two pressing policy challenges presented by TBTF: 1. Implicit government guarantees create massive liabilities for states, which can endanger their financial sustainability as has been illustrated dramatically by the crises in Iceland (2008-2009) and Ireland (2009); 2. TBTF institutions distort competition as they receive higher credit ratings due to implicit government guarantees, a prime example being Bear Stearns and AIG but also the U.S. mortgage companies Fannie Mae and Freddie Mac.³⁵ Due to consolidation during the crisis, financial institutions have become even bigger, amplifying TBTF.



REFORMING THE FINANCIAL
REGULATORY ARCHITECTURE

03

REFORMING THE FINANCIAL REGULATORY ARCHITECTURE

“Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by co-movements (correlation) among most or all the parts.”³⁶

Gerald P. Dwyer, Director, Center for Financial Innovation and Stability, Federal Reserve Bank of Atlanta

3.1 Reforms in the United States

When the crisis hit the U.S., its regulatory architecture was fragmented, lacked a regulator with an overarching responsibility for mitigating systemic risk, and featured many jurisdictional overlaps. The economist David Singer called the regulatory structure an “alphabet soup of regulatory agencies with overlapping jurisdictions.”³⁷ The Dodd-Frank Act addressed many of these issues, albeit it did not lead to the much needed overhaul of the regulatory architecture.

3.1.1 THE REGULATORY ARCHITECTURE BEFORE THE CRISIS

The U.S. regulatory architecture was (and in parts still is) a 1930s Depression-era patchwork. Its greatest weakness was its fragmentation. Characterized by institution-specific regulation, i.e., federal and state agencies focusing on specific industry sectors such as commercial banking, securities firms, and insurance companies, there is a high dispersion of regulatory authority. Before the crisis, no regulator with overarching responsibility watched over the entire system from a bird’s eye perspective.³⁸

On the federal level five regulators were responsible for financial stability: the Office of the Comptroller of the Currency (OCC), the Federal Reserve (Fed), the Federal Deposit Insurance Corporation (FDIC), the

Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA). These regulators were independent of each other; cooperation among them was voluntary and often not sufficiently deep. Banks with a national charter (national banks) were supervised by the OCC, banks with state charters (state banks) fell under the supervision of state regulators, unless they were members of the Federal Reserve System. In this case, the Fed was responsible for them.

Federally-chartered savings and loan associations, also known as thrifts, were regulated by the OTS, a special regulator, which was part of the Treasury. Since banks and thrifts have nationally insured deposits, they were also subjected to the supervision of the FDIC. Credit unions were regulated by the NCUA. Investment banks, on the other hand, were regulated by the Securities and Exchange Commission (SEC). The SEC oversees securities exchanges, securities brokers and dealers, investment advisors, and mutual funds, and enforces securities law. The Commodities Futures Trading Commission (CFTC) regulates commodity futures and option markets. Insurance companies were not regulated at all at the federal level, but underlay the jurisdiction of state institutions. Some non-bank actors such as the multitude of financial companies that were active on the mortgage, consumer credit, and business lending markets largely escaped regulation and supervision altogether.

Legislators had two options of how to reform the regulatory architecture. The first option was to radically merge and consolidate regulators, creating single federal agencies for the three segments of the financial market (securities market, banking, and insurance). This would have meant merging the functions of the five bank regulators (FDIC, OTS, NCUA, OCC, and Fed) in one agency, the two regulators responsible for securities and derivative oversight (SEC and CFTC) in another, and creating a new federal agency for the insurance market. The second option was to continue with the system as it stood, creating a new overarching regulator to spot systemic risks. U.S. policymakers chose the second—and in many respects more disappointing—option.

3.1.2 REFORMS RESULTING FROM THE CRISIS EXPERIENCE

The Dodd-Frank Act kicked off a major regulatory reform, which reflects a re-thinking of the role of financial oversight, but it does not overcome the complexity of the system. According to U.S. President Barack Obama, a strong financial market needs clear rules, “not to squelch it, but to promote competition, growth and prosperity.”³⁹ President Obama announced a break with the benign neglect of the financial markets and the deregulation policies of his predecessors, as he blamed an outdated and inadequate regulatory system for the severity of the crisis. He also promised a more transparent and, above all, effective regulatory system: Investment banks, mortgage brokers, and hedge funds, which previously were subject to a weaker supervision than regular banks, would be regulated more thoroughly. Rating agencies were to be examined for possible conflicts of interest with the companies they created ratings for. And consumers were to be protected from unfair behavior of financial actors.

In June 2009, U.S. Treasury Secretary Timothy Geithner presented a comprehensive reform plan. Together with Larry Summers, then-Director of the National Economic Council (NEC), he explained the existing problems as follows: “Our framework for financial regulation is riddled with gaps, weaknesses and jurisdictional overlaps, and suffers from an outdated conception of financial risk.”⁴⁰ Contrary to many observers’ hopes, the Obama administration,

however, did not propose a complete overhaul of the financial regulatory system, as there was little support for a single regulatory agency for banking, securities, and insurance.⁴¹ With one exception, the OTS, all other agencies were not only to remain in place, but new ones were proposed. The Fed and the FDIC were to maintain their respective roles in the supervision and regulation of state chartered banks, and the NCUA was to maintain its authorities with regard to credit unions. Within the White Paper *Financial Regulatory Reform: A New Foundation* the Obama administration proposed charging the Fed with systemic risk oversight. In the future, the Fed was to supervise all firms that could pose a threat to financial stability, even those that do not own banks. The Fed was to share this responsibility with a newly created interagency council, the Financial Stability Oversight Council (FSOC), which was tasked to serve as an early warning mechanism, identifying emerging systemic risks, and to improve interagency cooperation. The OCC and OTS were to be merged into a single National Bank Supervisor to supervise all federally chartered banks. A new Consumer Financial Protection Agency was to protect consumers and investors from financial abuse.⁴² The proposal did not go as far as some of the more radical approaches. Senator Christopher Dodd, Chairman of the powerful Senate Banking Committee, for example, had proposed to merge various federal banking regulators into one agency, essentially stripping these powers from the Fed.⁴³

There was considerable disagreement on the right regulatory approach and framework, not just among politicians but also among regulators and academia. While some proposed a single regulator for financial institutions to increase efficiency and effectiveness, for example, others believed that regulatory competition is actually a good thing as multiple agencies might prevent the politicization of supervision and rule-making. The Fed itself was not keen on the idea of creating a single supervisor for banks, arguing that it needed the supervisory authority of its member banks for an effective analysis of the state of the economy and monetary policymaking. The OTS and the FDIC also shied away from this idea, fearing a loss of power and influence if the bank supervisors were to be merged into one large regulator.

The Wall Street Reform and Consumer Protection Act adheres to many of the administration's propositions but it falls short on really overcoming the fragmentation of the system. The so-called Dodd-Frank Act passed in the House of Representatives on 11 December 2009, with 223 ayes against 202 nays, and the Senate with 59 ayes to 39 nays on 20 May 2010. A conference committee was then created to resolve the many differences between the Senate and House versions of the bill. After weeks of political bargaining, the House passed the bill with a 237-192 vote on 30 June, the Senate followed suit with a 60-39 vote on 15 July 2010. Both Houses of Congress decided largely along party lines. President Obama signed the bill into law on 21 July 2010. To reduce the odds of future crises, the House and Senate decided, first, to reform the regulatory architecture, also granting regulators more authority to monitor financial institutions and their instruments; second, to close regulatory gaps, also shedding more light on the shadow banking sector; and third, to tackle TBTF problems by introducing orderly resolution mechanisms. Dodd's more radical proposal, on the other hand, did not find its way into the final Dodd-Frank Act. The regulatory architecture remained largely the same. The only regulator abolished was the OTS.

To overcome the fragmentation of the regulatory system, the Dodd-Frank Act established a Financial Stability Oversight Council (FSOC). The FSOC has ten voting members: the Treasury Secretary who acts as the Chairperson, the Chairman of the Board of Governors of the Fed, the Comptroller of the Currency (OCC), the Director of the CFPB, 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, and an insurance expert, in addition to five non-voting members. The Council is tasked with a long list of duties, foremost monitoring the financial markets to identify and address systemic risks posed by large, complex companies, products, and activities; promoting market discipline and information; and responding to emerging risks in the financial system.⁴⁴ If the FSOC finds that banks or non-bank financial institutions pose a systemic risk, it can place them under the supervision of the Fed. The FSOC further has the power to recommend higher prudential standards,

including capital and liquidity requirements, for systemically important institutions designated for Fed supervision. These recommendations are based on a long list of factors, including "the company's leverage, off-balance-sheet exposure and interconnectedness to other large financial institutions; the importance of the company as a source of credit and liquidity; [... and] the degree to which the company is already regulated."⁴⁵ Last but not least, the FSOC is designated a significant role in determining whether a firm that poses a "grave threat" to financial stability should be broken up.⁴⁶ The Council is thus tasked with both macro- and micro-prudential regulation, which poses a considerable difference to the European approach.⁴⁷

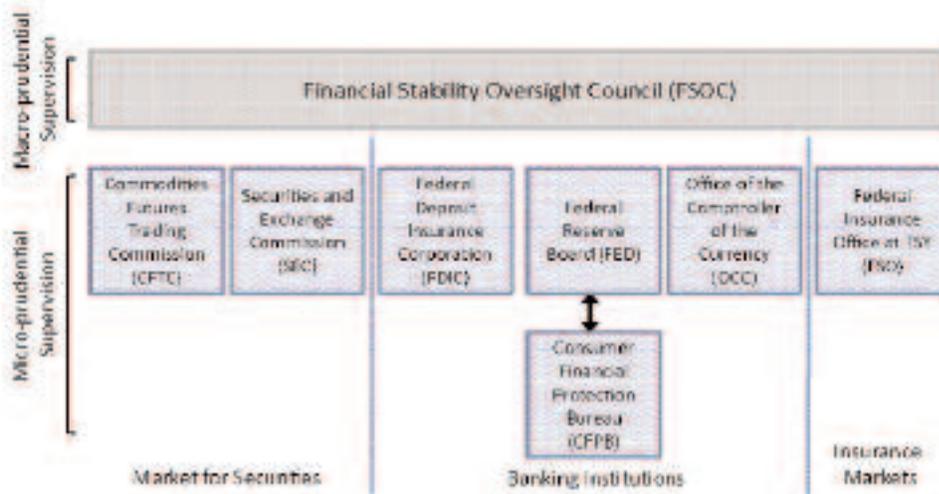
The Fed not only kept its supervisory authority of banks, it also acquired new powers to regulate big non-financial companies.⁴⁸ The Dodd-Frank Act thus added a third mandate to the Fed's responsibilities of securing price stability and full employment: financial stability. The Fed is responsible for supervising and regulating systematically important companies (banks, thrifts, bank holding companies, and non-bank financial institutions) with total consolidated assets of \$50 billion.⁴⁹ State banks/thrifts with assets under \$50 billion fall under the supervision and regulation of the FDIC; national banks/thrifts with assets under \$50 billion are the responsibility of the OCC, while the NCUA is responsible for federal credit unions.⁵⁰

Furthermore, the Dodd-Frank Act created a consumer protection agency, the Bureau of Consumer Financial Protection (BCFP), for credit cards, mortgages, and other financial products to curb abusive lending practices. The Act reacts to the fact that consumers often lacked the basic knowledge to make informed decisions about financial products and the high degree of financial illiteracy. The BCFP is tasked with protecting consumers from discrimination and "unfair, deceptive, or abusive acts and practices,"⁵¹ such as rate hikes and hidden fees.⁵² The original House bill had initially designed the BCFP as an independent agency, while the Senate version placed it within the Fed.⁵³ A compromise was struck: the BCFP is now an independent executive agency within the Fed and has its own director appointed by the U.S. President. It has

comprehensive rulemaking, supervisory, and enforcement powers over all market participants engaged with consumer financial products or services, with certain exceptions applying to SEC and CFTC registered entities. It consolidates consumer protection from other financial institutions including, among others, the Fed, OCC, OTS, FDIC, and FTC (Federal

Trade Commission). At the center of its tasks stands the mortgage sector: In comparison to the past, lenders are required to assess more meticulously the financial standing and credit worthiness of customers. A notable innovation is that irresponsible lending practices will be fined more strictly in the future.⁵⁴

Figure 1: New Financial Market Supervisory Structures in the U.S.



Source: adapted from Steffen Kern, "U.S. Financial Market Reform. The Economy of the Dodd-Frank Act," Deutsche Bank Research (2010), <http://www.fpssc.com/DB/TreasuryPulse/PDF/DB-Research_%20US_Fin_Mkt_Reform_092810.pdf>.

While the Dodd-Frank Act does not significantly re-regulate the insurance market (authority remains on the state level), it represents a significant step by the government into this area. First, the FSOC has the right to subject large, interconnected insurers to Fed supervision. Second, effective of 22 July 2012, the Act creates a new Federal Insurance Office (FIO) within the Treasury to monitor, gather information, and report on the insurance industry. While the FIO does not regulate the insurance sector, it is tasked with identifying gaps in insurance regulation that could contribute to a systemic crisis. Unlike other financial regulation, most insurance regulation remains in the hands of the states. The FIO has little power itself, relying on other regulators, for example by recommending to the Council that it subjects an insurer to Fed supervision.⁵⁵

While the Dodd-Frank Act kicked off the largest financial regulatory reform since the Great Depression of the 1930s, the translation of the Act into concrete

rules has run into severe difficulties. Implementation of the bill is anything but cheap: More than ten agencies, including the Fed, SEC, and CFTC, are required to complete hundreds of rulemakings and sets of formal guidelines, as well as a number of studies and reports. A 2011 Government Accountability Office report estimated that implementation of Dodd-Frank will require 2,600 new full-time employee positions and could cost eleven federal agencies approximately \$2.9 billion.⁵⁶

Partisan battles over the implementation and obstruction of the Act have raged for months. In particular, the now Republican-dominated House of Representatives is trying to block the implementation of the Act in any possible way, most prominently by employing the power of appropriations.⁵⁷ However, members of the Democratic Party are also reportedly wavering in their support for the Act, fearing a substantial loss of Wall Street campaign contributions for the elections in 2012. Wall Street, fearing high costs through

stricter rules and supervision, has substantially lobbied to prevent and undermine the new agencies. Several Democratic senators have thus been teaming up with the Republicans, for example in their opposition to the “Durbin amendment,” which encompasses limits on debit interchange transaction fees that are heavily contested by the banking industry, credit unions, and credit card companies.⁵⁸ Under the leadership of Democratic Senator Jon Tester (D-MT), a bipartisan group of four Democratic and five Republican Senators⁵⁹ took action in March 2011 and formally introduced the Debit Interchange Fee Study Act of 2011, which implements a two-year delay and a one-year study of the consequences of the proposed limits.

One of the main targets of Republican opposition is the freshly established Consumer Financial Protection Bureau (CFPB). The House Republicans proposed to cut the budget of the CFPB to \$80 million instead of the \$134 million proposed in the 2011 fiscal year budget.⁶⁰ Republicans bemoan that the independence of the CFPB creates an unchecked power structure and claim that this far-reaching authority is potentially harmful⁶¹ and have thus called for greater accountability of the agency toward Congress.⁶² In early May, forty-four Republican senators sent a letter to President Obama warning that they would block any nominee to lead the agency unless it was restructured in a way that would reduce its power and independence.⁶³ The Republicans have further introduced several bills; one among them mandates the CFPB be run by a five-member bipartisan board instead of one director.⁶⁴ Elizabeth Warren, the Assistant to the President and Special Advisor to the Secretary of the Treasury on the CFPB, rightly criticized that the politicization of the funding of bank supervision will create a dangerous precedent.⁶⁵

Apart from the CFPB, the SEC and the CFTC are also principal targets of the Republican Party’s strategy to weaken parts of the Dodd-Frank Act: “I’m worried that (committee Republicans) are complicit with the appropriators in underfunding the SEC and the CFTC. That’s the biggest problem. [...] Those are the two areas where I think they are most eager to weaken things,” Barney Frank, the senior Democrat on the House Financial Services Committee and

sponsor of the Dodd-Frank Act, cautioned.⁶⁶ The House Republicans have proposed cuts to both agencies, criticizing increasing costs for businesses, government overreach, and placing funding outside of traditional congressional appropriations process.⁶⁷ The SEC and CFTC share the vital task of regulating the highly profitable derivatives market. The Dodd-Frank Act proposed a doubling of the SEC’s budget in five years from its 2010 level.⁶⁸ Mary Schapiro, the SEC chairwoman, has requested \$1.407 billion for the agency in fiscal year 2012, which is \$264 million above the level under which the SEC is operating at present. According to Schapiro, the funds are necessary to create 780 additional positions, 40 percent for core SEC operations and 60 percent for the implementation of the Dodd-Frank Act. Recognizing a lack in high-level expertise, Schapiro states: “Many of these new positions would be used to hire experts in derivatives, hedge funds, data analytics, credit ratings, and other new or expanded responsibility areas, so that the agency may acquire the deeper expertise and knowledge needed to perform effective oversight.”⁶⁹

Overall, the reform of the regulatory architecture is a step in the right direction, and the creation of the Financial Stability Oversight Council, the Financial Consumer Protection Bureau, and the Federal Insurance Office is laudable. Macro-prudential regulation and supervision is thus strengthened and financial stability is likely to improve. At the same time, many weaknesses remain, foremost the fragmentation of the system. This is most visible with regard to non-systemically important banks, which are still regulated by different agencies determined by their function and charter. Another severe shortcoming is the lack of a federal regulator for the insurance market. Thus it is questionable whether the FSO is sufficient to oversee this complex sector. The effectiveness of the regulatory system depends on how well the newly created institutions will work, how they will interact with each other, and whether they are sufficiently funded to fulfill their supervisory and regulatory tasks. It remains to be seen whether the FSOC will succeed in overcoming the fragmented regulatory system, which largely remained intact despite the reform efforts.

3.2 Reforms Undertaken in the European Union

The European Union is currently engaged in a far-reaching process of reforming its economic governance structures as a response to the financial and, since 2009, the sovereign debt crisis. A first milestone was reached in 2010 with the decision to create new European supervisory structure in order to improve surveillance on the European level in an integrated European financial market.

3.2.1 THE REGULATORY ARCHITECTURE BEFORE THE CRISIS

The regulatory architecture of the EU before the financial crisis was characterized by fragmentation and weak European coordination and exchange of information. Financial institutions were mainly controlled by national authorities even though the industry was increasingly engaged in cross-border activities as a result of the efforts to integrate financial markets. There were three committees supervising EU banks, insurances, and securities: the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS), and the Committee of European Securities Regulators (CESR). These committees provided advice to the European Commission on supervisory standards and guidelines. Its recommendations, however, were not binding. A body for macro-prudential oversight did not exist. As in the U.S., large systemic risks thus escaped the supervision of national regulators.

3.2.2 REFORMS RESULTING FROM THE CRISIS EXPERIENCE

In October 2008 European Commission President José Manuel Barroso—recognizing the spreading financial crisis—tasked Jacques de Larosière with establishing a high-level group on financial supervision. Its objective was to issue proposals on how to improve financial supervision in the European Union. There was a strong consensus among the EU member governments, shared by the European Commission, that financial regulation and supervision had not kept pace with the integration of the European financial market and that cooperation had

to be strengthened considerably on these matters.

The De Larosière Report, presented in February 2009, makes the case for an EU-wide system for micro- and macro-surveillance. The latter was to be assured by a European Systemic Risk Council (ESRC). In March 2009, the European Commission restated that one of the major lessons is that cross-border cooperation by member state supervisory authorities within the existing regulatory framework was ineffective and unresponsive.⁷⁰ In line with the De Larosière Report, the European Commission then tabled a Communication on Financial Supervision in Europe on 27 May 2009.⁷¹ A Communication by the European Commission is a non-binding statement of policy principles, which is often a first step in the elaboration of a legislative proposal. It agreed with the De Larosière Report that the European Central Bank's (ECB) powers over macro-supervision to prevent systemic risks should be strengthened and that national cooperation over micro-prudential supervision of cross-border financial groups needed to be enhanced.⁷² It followed the report in proposing a European Systemic Risk Council (later it was changed into European Systemic Risk Board) for macro-prudential supervision (ESRB) and European Supervisory Authorities for micro-prudential supervision. In late September 2009, the Commission put forward its legislative proposal, which kicked-off a legislative co-decision procedure in which the European Parliament acted as a full co-legislator along with the Council.

Proponents of a truly European regulatory structure, including vocal members of the European Parliament, criticized both the European Commission and the De Larosière Group for being unambitious as they did not suggest the establishment of a single EU supervisor with binding powers. But despite this “modesty,” opposition from the national capitals toward the Commission's plans was significant. Many EU member governments, including the German one, feared that even the modest reform proposed could deprive them of effective control over the financial institutions operating in their territory, ultimately affecting their fiscal responsibilities. An issue high on the agenda was the problem of burden-sharing in the case of a cross-border bank failure. A group of member states, among them important players such

as the United Kingdom and Germany, opposed the idea that the new authorities should be able to take any decisions with fiscal consequences for member states. Finance Minister Wolfgang Schäuble emphasized that European supervisory structures needed to be made more efficient and effective, but without weakening national authority. Likewise, the rights of national parliaments needed to be respected (referring to their authority over fiscal policymaking).⁷³ Otto Bernhardt, the Christian Democratic Union's former speaker for financial issues in the Bundestag, argued that European intervention was only desirable with regard to systemically-relevant financial institutions, not medium and small financial companies. Without a doubt he was thinking about Germany's *Sparkassen* (thrift institutions).⁷⁴

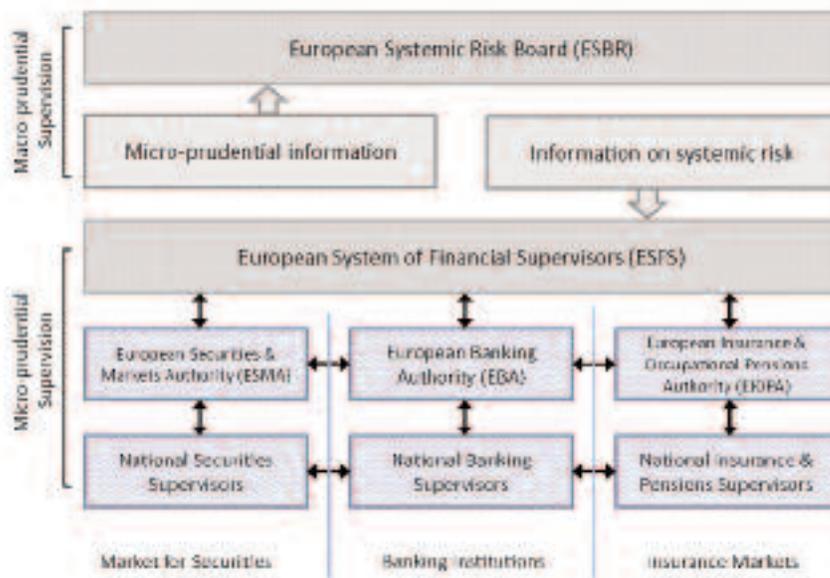
On 2 December 2009, the EU finance ministers agreed on their position on the proposed reforms, albeit with quite a few changes regarding the power of the new institutions.⁷⁵ Contrary to what the De Larosière Report and the Commission proposal had suggested, the finance ministers did not wish to grant the European regulators the authority to give direct orders to the relevant financial institution during a crisis. Furthermore, decisions by the European regulators could be overturned by a simple majority within the Economic and Financial Affairs Council (Ecofin).⁷⁶ The European Parliament, which approached the legislative proposal from a more supranational point of view, was not able to substantially alter this approach, but still introduced relevant points.⁷⁷ The most relevant amendment the European parliamentarians introduced was probably the obligatory review of the functioning of the new authorities as early as 2013/14, which can, in the medium term, lead to an expansion of the pan-European powers of the European Supervisory Authorities (ESAs). Every three years, the European Commission will have to report back to the legislators in particular on the questions of whether it is desirable to integrate the separate supervision of banking, securities, pensions, and insurance, on whether the ESA should have further supervisory powers, notably over financial institutions with pan-European reach, and on the benefits of having all ESA headquarters in one city. Furthermore, the European Parliament inserted a provision for the ESRB. In order to improve its capacities of risk identification, its Advisory Scientific Committee will

comprise a broader range of skills and backgrounds than initially foreseen. Regarding the Board's communication, the ESRB has to develop a common set of indicators to permit uniform ratings of the riskiness of specific cross-border financial institutions. It will also establish color-coded grades that indicate the risk level when the ESRB issues warnings or recommendations on risk build-up. The Parliament also secured a veto on the appointment of ESA chairpersons and will have a say in the development of the technical standards and implementing measures. The ESRB president (who, upon pressure of the EP to ensure a maximum of visibility and credibility, will be the ECB president for the first five years) will keep the ECON committee chair and the vice-chairs updated on ESRB activities.

All in all, the major innovation of the four legislative acts that were finally adopted in November 2010, is that macro-prudential supervision is placed in the hands of the ESRB. By monitoring and assessing risks to the stability of the financial system as a whole (systemic risks), its job is to prevent major disruptions to the EU's financial markets. If necessary, its board can issue early warnings and make recommendations to the Community as a whole, to individual member states, or to national supervisory authorities.

While oversight of specific financial institutions (micro-prudential regulation) will remain in the hands of national authorities, three new EU authorities, the European Supervisory Authorities, are tasked with coordinating supervision and establishing a more consistent application of rules to financial institutions in the EU: the European Banking Authority (EBA) in London, the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt, and the European Securities and Markets Authority (ESMA) in Paris.

Figure 2: Financial Market Supervisory Structures on the EU and Member State Levels



Source: adapted from Barbara Ridpath, "Financial Regulatory Reform: Comparative Analysis of US vs. EU," International Center for Financial Regulation (2010).

The European Supervisory Authorities will develop proposals for technical standards and better regulation principles, resolve cases of disagreement between national supervisors, and coordinate national crisis management—ideally not involving strategic or political decisions.⁷⁸ ESA authorities can issue warnings with respect to financial activities in the event of a considerable threat to the stability of the financial system. In crisis situations they may ultimately also restrict financial activities or even ban them all together if the proper functioning and integrity of the financial markets are threatened.

The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010.⁷⁹ The EBA is entrusted with broad competences, foremost strengthening supervisory coordination and providing advice to the EU institutions in the areas of banking, payments, and e-money regulation as well as on issues related to corporate governance, auditing, and financial reporting. Its tasks further include preventing regulatory arbitrage and guaranteeing a level playing field by fostering regulatory harmonization. Unlike its predecessor, the

powers of the EBA go beyond issuing recommendations. It cannot only conduct stress tests; it also has the power to overrule national regulators if they fail to properly regulate their banks. The EBA is currently working on a new and stricter negative stress test scenario. The results of the test are to be published in June 2011.

The task of the European Insurance and Occupational Pensions Authority (EIOPA), established by EU Regulation No. 1094/2010, is to support the stability of the financial system and transparency of markets and financial products, as well as to protect policyholders, pension scheme members, and beneficiaries.⁸⁰ As the EBA, EIOPA is called upon to monitor and identify potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors. The European Securities and Markets Authority (ESMA) works in the field of securities legislation and regulation with the goal to ensure the integrity, transparency, efficiency, and orderly functioning of securities markets, as well as enhancing investor protection.

Overall, the functions and responsibilities of the new

authorities have increased considerably compared to those of their predecessor committees, which is also reflected in their budgets and staffing levels. While the establishment of the European regulatory agencies is thus a considerable improvement to the status quo, much criticism has remained concerning the institutions' ability to effectively manage crises. Thus, guidelines and recommendations remain in principle non-binding; compliance with them can only be achieved by means of political pressure. The members of Parliament had ideally wanted the ESAs to be able to issue decisions directly to a financial institution without having to get national authorities involved, every time the national supervisor has not been able to change some of its practices that are considered unsound.⁸¹ This has not been achieved inasmuch as it is still a national decision whether or not crisis management is needed—also, the ESAs draw on national intelligence to complete their databases.⁸² Moreover, Members of the European Parliament considered the selection of the new Supervisory Authorities' personnel inapt, which in their eyes professed a bad start for the new institutions.⁸³ Unclear relations with lobbying organizations as well as the suggested insufficient experience of the candidates were criticized. In particular, the nomination of the new head of EIOPA, Gabriel Bernardino, apparently angered many.

All four supervisory bodies have taken up their activities in late 2010 or early 2011, thus annulling the competences of previous institutions in the field. While it is too early now to discuss operational malfunctioning, it is still possible to identify conceptual weaknesses. These should guide the evaluation of the new structures that is scheduled for the end of 2013/beginning of 2014. With regard to the ESRB, it seems highly recommendable to revisit its mandate, which is kept rather vague. This is mostly a consequence of the imprecise definition of “systemic risks,” a refinement may well be possible after three years of practical experience.

A particular feature of the ESRB is the predominant role of the ECB. Given the two distinct functions of the two institutions, situations are foreseeable in which conflicting objectives may be at play: While the ECB pursues monetary stability, the task of the ESRB is to secure financial stability. Unlike the three

ESAs, the ESRB does not have its own legal personality, which is also a signal of lesser independence.

Another crucial question is how the work of the ESRB and the macro-economic supervision which is currently negotiated as part of a wider reform of European economic governance structures will interact. In particular, the role of the European Commission vis-à-vis the ESRB needs to be discussed. Also, the Administrative Council of the ESRB seems impractically large, which risks preventing deep discussions and substantial decisions. For all of these elements, practical experience will allow identifying whether they are true weaknesses and make substantial reforms necessary. Given the review scheduled for 2013, it is possible that the new European supervisory structures will be further developed in the years to come.



CLOSING REGULATORY LOOPHOLES

04

CLOSING REGULATORY LOOPHOLES

“Institutions matter. However, it would be very unwise to believe that the creation of new bodies at the European or global level and some institutional reform alone will prevent the reoccurrence of a similar crisis. Ultimately, it is the regulation of financial markets that matters when it comes to creating a more resilient financial system.”⁸⁴

Axel Weber, Former President of the Deutsche Bundesbank

4.1 Reform Efforts in the United States

Since the beginning of the financial and economic crisis, the U.S. government has engaged in an effort to close regulatory loopholes to make the financial system more resilient. To prevent a reoccurrence of the financial crisis, regulation needs to cover all participants and products in the financial markets (“no place to hide”). The Dodd-Frank Act addresses a wide range of issues, including consumer protection, and incentive structures (compensatory schemes, corporate governance, rating agencies). To strengthen crisis resilience, the Dodd-Frank Act establishes higher capital and liquidity requirements, stricter regulation and supervision of securities and derivatives (in particular over-the-counter derivatives, OTC) as well as hedge funds, and enhanced regulation of credit rating agencies.⁸⁵

The Dodd-Frank Act establishes comprehensive regulation of the derivative markets, which is shared by the CFTC and the SEC. While most of the details are yet to be determined by the regulators, the Act features two important improvements OTC to the status quo: All transactions are subject to transparency requirements and many products will be centrally cleared in the future.⁸⁶ The reform thus addresses an important problem the crisis had revealed: the opacity of exposures in OTC derivatives. As there was no central marketplace where

trading occurs with OTC, risk monitoring was left to the counterparts of the transactions. As a consequence neither market participants nor regulators really knew the exposures and interconnectedness in the market—and thus could not judge and hedge the risks sufficiently.⁸⁷ As a further innovation, the Dodd-Frank Act subjects hedge funds and private equity funds to more government oversight, namely increased reporting and registration requirements. Funds with assets greater than \$150 million are required to register with the SEC, which entails disclosing their financial data, implementing compliance policies, and undergoing periodic SEC inspections. If the SEC deems funds too risky, they can be put under supervision by the Fed.

The so-called Volcker Rule intends to limit risky activities especially in the field of proprietary trading, hedge fund, and private equity activities. Designed by the former Federal Reserve Chairman Paul Volcker and endorsed by the Obama administration, the rule generally restricts (with certain exemptions) all banking entities, including affiliates or subsidiaries, from engaging in proprietary trading and hedge fund and private equity sponsorship. To make the securitization market for mortgages and other debt more transparent and accountable and to disincentive excessive risk-taking behavior, the Dodd-Frank Act further requires that 5 percent of securitization risk be

retained by the parties involved in securitization.⁸⁸

The Act also addresses the issue of liquidity and capital requirements. The Collins Amendment directs the responsible bank regulators to establish minimum leverage and risk-based capital requirements for insured depository institutions, depository institution holding companies, and non-bank financial companies that are supervised by the Federal Reserve.⁸⁹ This amendment creates the statutory basis on which the rules of Basel III can be implemented—if consistent with the amendment. Otherwise, a new rule will be required.⁹⁰ Basel III is the new global regulatory standard on bank capital adequacy and liquidity that members of the Basel Committee on Banking Supervision (Group of 10) agreed on in late 2010, of which the U.S. is a member.

This most recent of the three Basel Accords was developed in response to the regulatory deficiencies the global financial crisis had revealed. It introduces new regulatory requirements on bank liquidity and bank leverage as well as strengthens bank capital requirements.⁹¹ The Basel Committee on Banking Supervision (BCBS) stressed: “The objective of the Basel Committee’s reform package is to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy.”⁹² The new capital buffers and general capital standards proposed by the Basel III Accord requires banks to hold more and higher quality of capital than under the previous (Basel II) rules. The new liquidity and leverage ratios are meant as a no-risk-based measure in order to supplement the risk-based minimum capital requirements for banks thus ensuring that in case of crisis, adequate funding is maintained. In September 2010, Treasury Secretary Timothy Geithner called the new capital standards under Basel III “a major milestone in the process of global financial reform,” that would substantially reduce the risk of another massive financial crisis.⁹³ However, the success or failure of Basel III will depend on the willingness of major jurisdictions such as the U.S. to implement it. While the U.S. has shown much greater willingness to adhere to the new rules, unlike in the case of Basel II, only time will tell whether this will be the case.

A further cause of the crisis tackled by the Dodd-Frank Act is the issue of rating agencies. The crisis revealed three problems: 1. regulatory and market dependence on ratings; 2. conflict of interest deriving from the business model of the rating agencies; and 3. the quality of ratings. The rating agencies contributed considerably to the financial crisis: Their initially favorable ratings were crucial to the successful bundling and sale of subprime residential mortgages and similar debt obligations. The crisis showed that these initial ratings were overly optimistic. When the problems in the sector became apparent, rating agencies downgraded their ratings, entailing an almost collapse of the market for structured products.⁹⁴ The Dodd-Frank Act thus put in place various measures to improve internal controls and rating accuracy, and removing regulatory reliance on ratings.⁹⁵ It substantially expands the scope of regulation and accountability of Nationally Recognized Statistical Rating Organization (NRSRO). These agencies issue ratings that the SEC then allows other financial firms to employ for regulatory purposes. To curtail conflicts of interest, NRSROs are now required to segregate their sales and marketing personnel from their credit rating operations. To reduce the revolving door problem, NRSROs are required to report to the SEC if an employee leaves the agency for a company previously rated by that NRSRO. Addressing the former lack of internal control, the Act obliges NRSROs to have a compliance officer to monitor policies, procedures, and rules. Furthermore, NRSROs have to establish and document internal policies and procedures for determining credit ratings. The Act also addresses the question of liability by subjecting rating agencies to penalty provisions of the Securities Exchange Act, which allows for the prosecution for misconduct. To make this possible, the Act requires NRSROs to report all ratings, including withdrawn ratings, to the SEC. The SEC in turn has to establish rules allowing assessment of the accuracy and comparability between different NRSRO’s ratings. Finally, the Act calls on the SEC to submit a report to Congress within twenty-four months, resolving the inherent conflict of interest associated issuer-pay models.⁹⁶

The Dodd-Frank Act also addresses the issue of bonus payments but does not go as far as its European counterparts. While the Act did not set

concrete limits for bonuses for example, it directed regulators to curb pay plans that encourage excessive risk-taking. Late March 2011, seven agencies, including the Fed, the OCC, and the FDIC, proposed a rule for large financial services companies to report on their incentive pay systems for executives and for financial firms to defer as much as half of bankers' bonuses for at least three years. The rule would apply to institutions with assets of \$50 billion or more governed by the federal banking regulators and the SEC, to firms regulated by the NCUA with a \$10 billion threshold, and to Federal Home Loan Banks with \$1 billion or more, which are regulated by the FHFA.⁹⁷

While there is strong support for reforms in the wider public, many larger regulatory reform proposals have encountered vehement resistance from the financial industry. While the financial sector is not monolithic in its interests—there are large differences between small and large institutions, saving banks and investment banks, for example—they have some interests in common: They all fear increasing costs for their businesses. Congressional Republicans have answered to these worries, proposing several pieces of legislation to amend or repeal parts of Dodd-Frank. One proposal, for example, would repeal the Dodd-Frank disclosure requirements on how much companies are paying their CEOs compared to their median employees (Burdensome Data Collection Relief Act). Another proposal would revoke Dodd-Frank's liability clause for credit-rating agencies in the case of inaccurate ratings (Discussion Draft to Repeal Section 939G of the Dodd-Frank Wall Street Reform and Consumer Protection Act).⁹⁸

Overall, the Dodd-Frank Act addresses many problems that led to the financial and economic crisis: the opaqueness of financial markets, in particular in the shadow banking segment (for example transparency of over-the-counter derivatives); incentive structures that induced risk-taking behavior (rating agencies and compensatory schemes); and insufficient amount and quality of capital and liquidity (liquidity and capital requirements), to name just a few. While it is too early to judge the effectiveness of the Act as most requirements still have to be translated into concrete rules, it is safe to say that the initiated reforms are incremental rather than an overhaul of the existing regula-

tions. It remains to be seen whether this will suffice.

4.2 Reform Efforts in the European Union

Since the fall of 2008, the European Union has spent a good part of its legislative efforts drafting and developing tighter regulations to deal with the aftermath of the global financial crisis. As in the United States, the new guidelines address a wide range of issues such as leverage and capital requirements, OTC derivatives, alternative investment funds, and rating agencies.

A number of initiatives have been proposed by the European Commission, yet not all have actually been passed at the time of writing. In fact, the reforms were split into a significant number of legislative texts, contrary to the approach chosen in the U.S. with the comprehensive Dodd-Frank package. As early as 2009, a first set was finalized, including a harmonization of deposit insurance regimes, registration of credit rating agencies, and a first revision of the Capital Requirements Directive CRD II. A further initiative is the Directive on the Administration of Alternative Investment Funds, which seeks to regulate fund managers and hedge funds in order to improve transparency and stability. Further initiatives that have been agreed upon include the Third Agreement of the Capital Requirements Directive (CRD III), the Bank Supervisory Package, and the Undertakings for Collective Investments in Transferable Securities (UCITS) directives in summer 2010.⁹⁹ With the CRDs, the EU has so far complied with the Basel requests in terms of required cash reserves for banks via the Basel III process, in demanding that banks maintain higher levels (and higher quality) of capital reserves as a cushion against ill-gone investments. Basel III has called to quadruple the current reserves, and certain German banks have fought this consistently, thereby successfully managing to delay the implementation date. It is hence very likely that the current CRD will be revised in order to make compliance to Basel III provisions obligatory in the EU.

Regarding the derivative market, the European Commission, based on recommendations of the De Larosière Report, adopted two Communications in July and October 2009 to ensure efficient, safe, and sound derivatives markets. The Commission issued a

legislative proposal that was aimed at improving transparency on the derivatives markets, introducing a reporting obligation for OTC derivatives and a clearing obligation for eligible OTC derivatives. It also included measures aimed at reducing counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, rules for trade repositories and central counterparties (CCPs), as well as rules on the establishment of interoperability between CCPs.¹⁰⁰ As Rainer Masera observes, these proposals “are in principle consistent with the Dodd-Frank Act.”¹⁰¹

In order to tackle the negative role compensation schemes play in encouraging risky investment behavior by executives, the European Union has issued a set of comprehensive new rules: to issue bonuses in non-cash instruments such as company shares, to link bonuses more closely to salaries, and to establish a “claw-back” mechanism whereby bonuses cannot be collected for several years in a row, to prevent current business practices resulting in a future meltdown. Starting in 2011, the European Union has agreed to set a fixed limit to bankers’ bonuses altogether—no more than 30 percent (20 percent for larger bonuses) can be paid out immediately; everything else must be linked to longtime performance.¹⁰²

Furthermore, to prevent investment banks from creating investment vehicles in the full knowledge that the latter are designed to fail (Goldman Sachs comes readily to mind), the European finance plan will oblige the originators of all asset-backed securities to retain at least 5 percent of the securities they created for themselves.¹⁰³ The companies are thus incapable of denying at least partial ownership, which ought to create an incentive to underwrite securities more carefully. The EU has also issued new guidelines to administer the marketing, capital, liquidity, and overall structure requirements for all hedge funds.¹⁰⁴ The EU has further addressed the issue of derivatives trading and depositor banking, but does not aim at separating both as the Volcker rule attempts in the Dodd-Frank Act. So far, the EU regulators have only opted for increased transparency by moving derivatives trading more out in the open to public stock exchanges where they are to be processed and traded by clearing houses required to comply with much stricter governance rules. Furthermore, newly

founded trade repositories are supposed to collect data on the status of derivatives contracts in order to allow regulators a better insight into potentially risky deals.¹⁰⁵

Given that all three major rating agencies—Moody’s, Fitch’s, and Standard & Poor’s—are considered to have engaged in corrupt practices (such as giving triple A ratings to investments they were fully aware had been designed to fail), the EU aims at subordinating rating agencies under closer scrutiny by the European Securities and Markets Authority as well as allowing for unsolicited ratings by other, more independent agencies. In April 2009, a Credit Ratings Agency Regulation (1060/2009) was adopted, which, among other things, contains an obligation for rating agencies to register and defines requirements to improve regulatory standards and oversight, following a proposal by the Commission in 2008. As early as the European Council meeting in June 2009, the Heads of State and Government called upon the Commission to come forward with proposals for a centralized system of supervision of Credit Rating Agencies (CRAs) at EU level. In response, the European Commission proposed that the European Security Markets Authority, one of the newly created European supervisory authorities, should have direct supervisory powers over credit rating agencies. This is in line with the recommendations from the De Larosière group, which made the case for centralized EU supervision of CRAs in its report. The European Parliament had also requested centralized supervision for CRAs at the moment of the negotiation of the CRA Regulation.¹⁰⁶

European regulation of Credit Rating Agencies is likely to develop further. From November 2010 to January 2011, the European Commission held a public consultation in order to gain input for a forthcoming Commission proposal dealing with potential remaining risks emerging from the role and functioning of Credit Rating Agencies. In its consultation, it drew particular attention to the over-reliance on credit rating by financial market participants, the high degree of concentration in the rating market, the absence of civil liability of credit rating agencies in the existing CRA Regulation, and conflicts of interest due to the remuneration models used by CRA.¹⁰⁷ A further legislative proposal may hence come up in the

year 2011.

All in all, the majority of the measures adopted can be regarded as market-shaping because they either regulate activities or financial institutions that were previously unregulated in the EU and its member states (for instance Credit Rating Agencies or Alternative Investment Funds Managers).¹⁰⁸ Or they imposed heavier requirements on financial entities that had been regulated prior to the crisis. Examples are the higher capital requirements for banks.

Throughout the negotiation processes on European legislation, differences emerged among the member states. A number of member states, among them mostly the UK, Ireland, Luxembourg, and occasionally Nordic countries, criticized that the EU's regulatory responses were overly prescriptive and potentially protectionist. In most cases, the initial legislative proposals were in fact amended. As a general rule that seems to apply for all legislation passed under the co-decision procedure, changing coalitions of member governments have tried to limit the transfer of competencies to the EU level as well as the respective "costs" of regulation for their country's financial sector. But as the political scientist Lucia Quaglia pointed out, the mere fact that "the rules were proposed in the first place suggests that the balance of regulatory power has shifted in favor of the market-shaping coalition and that a less market-friendly regulatory approach has at least temporarily gained ground."¹⁰⁹ Also, as a counter-weight to prevailing national concerns, the European Parliament has, in many points successfully, introduced stronger European logics into the debate on European regulation and surveillance.



ADDRESSING MORAL HAZARDS

05

ADDRESSING MORAL HAZARDS: ELIMINATING “TOO BIG TO FAIL”

“Addressing the ‘too big to fail’ problem is perhaps the most challenging remaining legacy of the crisis.”¹¹⁰

Mario Draghi, Governor of the Bank of Italy

5.1 Reform Efforts in the United States

To stabilize the financial system during the crisis, the Fed engaged in historically unprecedented levels of emergency lending. For example, in spring 2008, the Fed supported the takeover of Bear Stearns by JPMorgan Chase, putting up emergency funding to prevent a systemic collapse of financial markets. According to Fed chairman Ben Bernanke, “with financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence.”¹¹¹ Bernanke further argued that “moreover, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability.”¹¹² While the Fed thus prevented a breakdown of the financial system, its actions were highly controversial and immediately concerns arose that other banks might begin to count on the Fed for bailouts (moral hazard). Former Treasury Secretary Henry Paulson underlined: “Moral hazard is something I don’t take lightly,” referring to the belief that when the government steps in to rescue a private company, it encourages other companies to engage in risky behavior.¹¹³ The Fed and the Treasury therefore took a different course with regard to Lehman Brothers. While the government had been able to facilitate the takeover of Bear Stearns, a similar rescue of Lehman proved impossible because a deal to sell the investment bank could not be completed. Furthermore, Lehman was judged as not systemically important for financial markets. The consequences of this decision are well

known. Shortly after, the government again stepped in to save the insurance company AIG and the two mortgage lenders Fannie Mae and Freddie Mac. It is now commonly agreed that a lack of rules for orderly liquidations of large failing financial institutions contributed to the severity of the financial crisis.

The two government sponsored enterprises (GSE) Fannie Mae and Freddie Mac are a prime example for a moral hazard aggravated by implicit governmental guarantees, which earned them excellent ratings. Designed and mandated by the government to facilitate housing finance and foster homeownership, also among minorities and lower income classes, they purchased mortgages from banks and other originators, which lend directly to homeowners, bundled them to ABS and sold them on the financial markets. Thereby, they increased the demand and subsequently the price of mortgages on secondary markets, which in turn led to lower interest homeowners had to pay for their mortgages on primary markets. Through the high volume of high-risk mortgage purchases and guarantees, they contributed considerably to the financial crisis. During the financial crisis, what was once an implicit government guarantee became an explicit one: Fannie Mae and Freddie Mac were rescued by the government taking over control in September 2008.

Although the problem of moral hazard and TBTF is widely acknowledged, the Dodd-Frank Act disappoints in this regard. Neither does the Act bail in large institutions, nor does it sufficiently address GSEs. The Act does not propose a limit for the size of large

banks and thus does not break up any of the institutions, from which emanate currently the largest risks—Bank of America, JP Morgan Chase, City Group, Wells Fargo, Goldman Sachs, and Morgan Stanley. Efforts to reduce their systemic risks, for example by introducing a bank levy, have been heavily diluted.¹¹⁴

Resolution Fund and Resolution Authority: While there was a special resolution regime (so-called conservatorship) for depository banks that hold FDIC insured deposits, this mechanism was not available to investment banks. In its White Paper, the Obama administration underlined that the government should be given the “tools it needs to manage financial crises [...] We propose: A new regime to resolve nonbank financial institutions whose failure could have serious systemic effects.”¹¹⁵

To tackle the “too big to fail” problem, the Dodd-Frank Act establishes an orderly liquidation process (“resolution authority”) for systemically important institutions. The FSOC plays a central role in this process, as it can place a company under the receivership of the FDIC, which then carries out its orderly liquidation. For this process, the FDIC cannot draw on an ex ante resolution fund but has to borrow money from the Treasury. If the FDIC, after dismantling an institution, does not retrieve enough funds to amortize its liabilities to the Treasury within sixty months (five years) or the negotiated time-frame, it will have to recover the shortfall from assessments on large financial companies with total consolidated assets of \$50 billion or more.¹¹⁶ Also, the Act requires large, complex companies (both bank and non-bank financial companies) to periodically submit plans to the Federal Reserve for their rapid and orderly shutdown should the company fail (“funeral plans,” also called “living wills”). The FED and FDIC have to approve of the plans. If firms fail to submit acceptable plans, they will have to face higher capital requirements and restrictions on growth and activity, as well as divestment. The Senate voted against an amendment that would have broken up the largest banks by imposing caps on the deposits they can hold and their capital assets.¹¹⁷

The House bill of the Dodd-Frank Act had planned a \$150 billion resolution fund to cover the government’s cost of unwinding a failing financial firm; the

Senate bill had also originally incorporated a \$50 billion Systemic Resolution Fund. The fund, which was to be paid for by fees levied against large financial institutions (see also discussion on bank fee), was intended to protect taxpayers from expensive future bailouts. However, senators eventually overwhelmingly opposed this provision, which did not make it into the final version of the bill. Many, including the Treasury, had warned that pre-paying for the fund would create new moral hazards by curtailing the consequences of the bank failure. Instead, the Act now authorizes regulators to borrow the needed funds from the Treasury to be paid back later.¹¹⁸

Bank Fee: On 14 January 2010, the Obama administration proposed a Financial Crisis Responsibility Fee (FCR) to recover intervention costs incurred during the financial crisis under the \$700 billion Troubled Assets Relief Program (TARP). The fee was to be in place for ten years, longer if necessary, until the costs of TARP were fully recovered. This fee was thus decidedly backward-looking. Only the largest firms (banks, thrifts, insurance companies, and U.S. holding companies of those entities) with assets of more than \$50 billion and that profited from TARP would have been subject to an annual levy. U.S. companies would be taxed based on their worldwide consolidated assets, foreign entities only on their U.S. assets. Covered liabilities would have to be reported by regulators, the fee would be collected by the IRS, and revenues would be used to reduce the federal budget deficit.¹¹⁹ About sixty entities would have qualified for taxation under the FCR, according to the Treasury, thus 99 percent of the banking sector would have been unaffected. Treasury Secretary Geithner wanted to achieve two goals with the fee: putting a premium on risk-taking behavior and reducing the government deficit. The FCR fee was estimated to raise \$90 billion over a ten to twelve year period. Contrary to the IMF’s proposal, the administration did not propose a rainy day fund for future financial crises. The administration feared that such a fund could amplify the “too big to fail” problem and promote rather than prevent taxpayer bailouts of failed financial institutions (moral hazard).¹²⁰

The administration’s proposal ran into strong opposition from lawmakers, particularly Republicans.¹²¹ While the Treasury Secretary eloquently lobbied for

the administration's proposal, skepticism remained strong. In the end, the proposal was removed from the financial regulatory overhaul bill, the Wall Street Reform and Consumer Protection Act. Only days before the final vote, it became apparent that the bill would not pass, particularly in the Senate, unless the bank levy was taken out. Instead, the Obama administration needed to make a compromise with Republicans, who strongly opposed the bill. Sixty votes are necessary to make a proposal filibuster-proof. Not only did the Democrats not have this majority, it was also clear that not all of them would vote for the proposals. To win over the necessary Republicans to secure the bill's passage, the Obama administration sacrificed the bank levy.

Mid-February 2011, the Obama administration retabled the Financial Crisis Responsibility Fee, albeit dramatically curtailed in its scope. Under the new plan, the bank levy would collect \$30 billion over ten years to recoup the costs of bailing out troubled financial institutions during the financial crisis. The fee would be applied to banks and financial firms with consolidated assets over \$50 billion. The proposal was part of Obama's 2012 fiscal budget plan. According to the Treasury Department "the financial crisis responsibility fee is intended to recoup the costs of the TARP program as well as discourage excessive risk-taking, as the combination of high levels of risky assets and less stable sources of funding were key contributors to the financial crisis."¹²² So far, however, the bank levy has not found enough political support.

Placing the Fed under greater political scrutiny: The Fed has been harshly criticized for its pre-crisis monetary policy as well as its crisis management and emergency lending. Congress therefore wanted to place the Fed under closer political scrutiny. While the Dodd-Frank Act makes the Fed the key authority in the regulatory and supervisory structures, it also requires more transparency of its activities. The preliminary House bill had given the Government Accountability Office the power to conduct continuing periodic audits of a wide range of issues beyond the Fed's financial crisis response. The original Senate bill was a watered down version. The government would only have been required to conduct a one-time audit of the Federal Reserve's emergency

response programs. Both proposals were highly controversial as they entailed greater political pressure on the Fed. The Dodd-Frank Act struck a compromise: The GAO must audit the governance of the Fed within twelve months of the passage of the Act and will also have authority in the future to audit the Fed's assistance programs. Furthermore, the Fed is required to provide greater transparency, including on emergency and discount window lending. Before engaging in crisis lending, it also has to obtain the Treasury Secretary's approval. In addition, it must provide Congress with a report that justifies the exercise of its authority and describes the material terms of the assistance.¹²³

Overall, the Dodd-Frank Act does not deal sufficiently with misplaced government guarantees, inducing moral hazards, the most glaring example being the GSEs. Furthermore, as the Act shied away from an ex ante charge on systemically relevant institutions, these will have to bear their own losses, but not the costs their failure would create for the markets in general.¹²⁴

5.2 Reform Efforts in the European Union

In the European Union, TBTF problems are seen in a different way than in the United States. The economists Morris Goldstein and Nicolas Véron point out: "Because the continent is composed of independent, generally centralized nation-states with strong cross-border financial linkages, national governments have been encouraged to favor the emergence of a strong and autonomous national financial sector that could successfully compete with its neighbors. Thus, the inclination is generally to protect and foster 'national banking champions.'"¹²⁵ Indeed, European policy-makers have been very much inclined to prevent the takeover or disappearance by forced domestic consolidation or by nationalization (such as Hypo Real Estate in Germany or Northern Rock and Bradford & Bingley in the United Kingdom). Bank failures are regarded as serious political disasters and therefore the European consensus is to avoid them at all costs, often with historical references to the 1930s.

During the European Council meeting on 15-16 October 2008, the Heads of State and Government agreed to take all necessary steps to preserve the

stability of the financial system and support major financial institutions. All the while, they strongly emphasized that these measures needed to be taken concurrently with measures protecting the taxpayers. But the subsequent rescues showed that the government's initial use of ad hoc measures to bail out individual banks to contain the crisis did not provide sufficient scope for an appropriate response to systemically relevant banks in distress. For example, the German government stepped in on 6 October 2008 to avoid the collapse of Germany's second largest mortgage lender, Hypo Real Estate (HRE). In an attempt to prevent a bank run, the German government announced it would guarantee all personal bank deposits in the country. After the worsening of the crisis in fall 2008, the Bundestag passed a law creating the Special Fund for Financial Market Stabilization (known by its German acronym, Soffin), a bank bailout package of nearly €500 billion. Along with €400 billion to guarantee banks' loans, it also contained €100 billion for re-capitalization. This fund was used to shore-up Hypo Real Estate with nearly €52 billion, to partially nationalize Commerzbank after its purchase of Dresdner Bank, as well as spending €13 billion to bailout HSH Nordbank in February 2009, among others.¹²⁶

The U.S. and EU both have been criticized for their plain reluctance to break up any bank whose sheer size implies a potential threat to the financial system. European regulators have, however, devised another possible approach to the matter: Recently the European Commission proposed giving regulators the power to block new products (such as derivatives) and artificially limit trading risks at financial institutions that would need "extraordinary public support" during a crisis because they were so large. Also the (European-led) Financial Stability Board is supposed to identify financial institutions that are so big, so (market) important, and so interconnected globally, that their failure would cause a significant rift in the global financial system—and consequentially subject the identified banks to tougher monitoring. Part of this would be an official requirement posed by the Board that those systemically important financial institutions (SIFIs) and in particular global SIFIs (G-SIFIs) come with "higher loss absorbency capacity to reflect the greater risks that these institutions pose to the global financial system."¹²⁷

The EU also discussed a bank levy to recoup the costs of the financial crisis and to curb excessive risk-taking behavior. Michel Barnier, EU Commissioner for Internal Market and Services, emphasized: "The financial sector needs to contribute to the costs of financial stability. This should be one of the building blocks in our effort to set up a crisis management framework in Europe."¹²⁸ But while competencies on financial regulation are shared between the national and the EU level, the power over tax legislation is almost entirely national.

The European Commission proposed to create a European Bank Resolution Fund in May 2010.¹²⁹ The proposed fee, which would be shouldered largely by fifteen big listed banks in Europe, is forward-oriented rather than making ex post payments. The Commission's report argued that a financial stability fee would have a "double dividend," meaning that it would raise revenues (between €13 and 50 billion depending on the rate of tax imposed) and improve market stability by putting a price on risk-taking behavior.¹³⁰ But the Commission also concedes the risk of moral hazard, if a rainy-day fund for future bank collapses was introduced. It therefore emphasized that "resolution funds must not be used as an insurance against failure or to bail out failing banks, but rather to facilitate an orderly failure."¹³¹ Only some member states are supportive of a European solution for bank rescues. It is hence unlikely that the Commission proposal will be adopted. For instance, France pushed for a European bank rescue fund during its European Council Presidency in the second half of 2008. Differing roles of the banking sectors in the national economies and diverging financing needs of the banks make it unlikely that a common stance will be found—even for the seventeen euro-zone member states. Some member states whose banking sectors do not face important recapitalization or restructuring needs refuse to share in the costs of other member states by creating a pan-European solution. A more feasible European option would hence be the introduction of national bank levies—albeit with a certain degree of coordination, not only on taxation levels and the actual tax base, but most importantly to avoid double taxation.



WHAT REMAINS TO BE DONE

06

CONCLUSION: WHAT REMAINS TO BE DONE

“It’s important to recognize that the U.S. and Europe are in broad agreement on the importance of putting in place more conservative restraints on risk-taking, more conservative capital requirements [for banks] and bringing transparency and disclosure to the derivatives market.”¹³²

Timothy Geithner, U.S. Treasury Secretary

Undoubtedly, financial re-regulation and improved supervision alone will not be able to prevent future crises. Other highly important issues to be tackled are global macro-economic imbalances and large government debts. However, as malfunctioning financial markets can trigger economic crises with widely-felt negative effects far beyond the borders of individual countries, better regulation (rules) and oversight (regulatory agencies and regulatory architecture) are equally important building blocks for a safer world economy. As the financial markets continuously change, new products are developed and new actors enter the scene, regulation and oversight have to be adapted continuously. A reform every fifty years certainly does not suffice. Reforms are well underway in both the United States and the EU.

Overall, the U.S. was quicker in adopting changes. The timing can be explained by different legislative processes and policy priorities: In the EU, the reforms were split into a significant number of legislative texts, contrary to the approach chosen in the U.S. with the comprehensive Dodd-Frank package. While the EU struggled to consolidate its members’ positions—in particular with regard to financial market regulation and crisis resolution schemes—most of the U.S. regulatory reform took place on the federal level. Furthermore, the mid-term elections in the U.S. in November 2010 posed considerable time pressure on legislators to find a compromise, while their EU

counterparts were preoccupied with the sovereign debt crisis of several of its members.¹³³

With regard to the meaningfulness of reforms, however, the jury is still out as reform implementation is pending in many areas. On substance, each side lags behind in some issues and leads in others. For example, in the field of curtailing risky investments, the U.S. is in the lead with the Dodd-Frank Act’s Volcker rule restricting U.S. banks from investing their core capital in risky business such as hedge funds, plus requiring more transparency, etc., as depicted in the previous section. The EU also lagged behind with regard to cross-border crisis resolution schemes a result of the close interconnectedness of sovereign defaults and systemically important banks at risk. The U.S., on the other hand, has not sufficiently dealt with implicit government guarantees for GSE such as Fannie Mae and Freddie Mac and the incentive structures on the mortgage market.¹³⁴ Controls regarding American bankers’ bonuses remain more or less nonexistent while the EU has implemented comparatively strict rules.

The Case for Transatlantic Cooperation

While the analysis has clearly shown that cross-border cooperation on regulatory issues is not easy even within the European Union with its integrated financial market and established multi-level decision-

making system, a case can still be made for a transatlantic approach to the regulatory agenda.

First, an objective should be to create a level playing field and to avoid regulatory arbitrage and a distortion of competition between the European and the U.S. financial markets. Stronger cooperation is not only necessary during the design of new rules and regulations to prevent regulatory arbitrage. More cross-country supervisory cooperation is required to spot risks on the international markets.

Second, the U.S. and the EU together should attempt to advance risk-minimizing standards and functioning surveillance and crisis-resolution structures. This is necessary because financial market actors that are too big to fail frequently operate in several countries—and functioning solutions for crisis resolution and burden-sharing still need to be found. Former IMF head Dominique Strauss-Kahn rightly pointed out: “One reason locally reasonable but globally myopic initiatives are on the rise is that regulators so far have been unable to agree on a convincing burden-sharing mechanism when cross-border conglomerates run into problems. [It] is a formidable challenge, the place where the fact of national-level fiscal authority and bankruptcy law collides with the reality of global banking.”¹³⁵ Indeed, as recent cases in the financial crisis have shown, governments will try to limit the potential liability of their own taxpayers, while institutions approaching bankruptcy will transfer assets home. If, for instance, a large European bank operates in the U.S.—or vice-a-versa—transatlantic cooperation on the remedies is key. In the longer term, global rules, procedures, and possibly resolution authorities should be envisaged.

Increasing globalized activities of financial market actors and the multipolarity of global finance with a rising role of emerging economies as major centers of financial activity¹³⁶ make the case for global solutions with a prominent role for the G20 format, the International Monetary Fund, the Financial Stability Board, and the Bank of International Settlements, including the Basel Committees. These bodies have gained a stronger role since the G20 summit of 2008 outlined a large agenda for post-crisis reform. The U.S. and the EU, if allied in a close coalition for better regulation and supervision, can play a key role in

pressing for progress in the international governance institutions. The transatlantic partners have a forum they could use more intensively to find a pre-consensus on key issues: the EU-U.S. Financial Markets Regulatory Dialogue.

A third reason for transatlantic cooperation is the fact that the financial crisis cannot only be explained by deregulation of finance and excessive risk-taking. Rather, macro-economic imbalances have been held accountable for triggering the crisis. Some observers such as the lawyer and political scientist Aldo Caliari argue “global imbalances and financial deregulation actually fuelled each other, leading to worse consequences than either of those two factors would have produced.”¹³⁷ It is hence no coincidence that the G20 have, in recent years, added the reduction of global imbalances to their political agendas and have charged the IMF with monitoring activities in this field. While current economic developments may have a rebalancing effect between the major players, the U.S. and China, it is more likely than not that this issue reappears on the global economics and finance agenda in the rather near future. Close cooperation between the U.S. and the EU is likely to be beneficial to advancing process in sensitive global governance issues.

ABBREVIATIONS

ABS	Asset-backed security	FDIC	Federal Deposit Insurance Corporation
AIG	American International Group	FED	Federal Reserve
BCBS	Basel Committee on Banking Supervision	FHFA	Federal Housing Financing Agency
CCP	Central Counterparty	FIO	Federal Insurance Office
CDS	Credit Default Swaps	FSOC	Financial Stability Oversight Council
CDU	Christian Democratic Union (German party)	FTC	Federal Trade Commission
CEBS	Committee of European Banking Supervision	G20	Group of Twenty
CEIOPS	Committee of European Insurance and Occupational Pensions Committee	GAO	Government Accountability Office
CESR	Committee of European Security Regulators	GSE	Government Sponsored Enterprise
CFPB	Consumer Financial Protection Bureau	G-SIFI	Global Systemically Important Financial Institution
CFTC	Commodities Future Trading Commission	HRE	Hypo Real Estate
CRA	Credit Rating Agency	IMF	International Monetary Fund
CRD	Capital Requirements Directive	NCUA	National Credit Union Administration
EBA	European Banking Authority	NEC	National Economic Council
EC	European Commission	NRSRO	Nationally Recognized Statistical Rating Organization
ECB	European Central Bank	OCC	Office of the Controller of the Currency
ECOFIN	Economic and Financial Affairs Council	OTC	Over-the-Counter Derivatives
EIOPA	European Insurance and Occupation Pensions Authority	OTS	Office of Thrift Supervision
EP	European Parliament	SEC	Security and Exchange Commission
ESA	European Supervisory Authority	SIFI	Systemically Important Financial Institution
ESMA	European Securities and Markets Authority	SWP	German Institute for International and Security Affairs
ESRB	European Systemic Risk Board	TARP	Troubled Assets Relief Program
ESRC	European Systemic Risk Council	TBTF	Too Big to Fail
EU	European Union	UCITS	Undertakings for Collective Investments in Transferable Securities
FCR	Financial Crisis Responsibility Fee		

NOTES

1 Stormy-Annika Mildner is Member of the Board of Directors of the German Institute for International and Security Affairs (SWP); Daniela Schwarzer heads the Research Unit European Integration at SWP. We greatly thank our Bosch Fellow Edna Drezka for her support and input into this paper as well as our interns Marja Freudenberg and Hannah Petersen for their enthusiasm and hard work, which helped to complete this report.

2 Acceptance Speech by Federal Chancellor Angela Merkel on Receiving an Honorary Doctorate from the New School in Berlin, 19 February 2010, <http://www.bundeskanzlerin.de/nn_704298/Content/EN/Reden/2009/2009-02-19-rede-merkel-ehrendoktor-wuerde_en.html> (2 April 2011).

3 Quoted in: Darlene Superville, "Strict Regulations Needed to Avoid new Financial Crisis, Obama Says," *Associated Press*, 18 April 2010, <<http://m.freep.com/news.jsp?key=635164&rc=ne>> (1 April 2011).

4 Lucas Papademos, Vice President of the ECB, "Strengthening Macroeconomic Supervision in Europe" (speech presented at the conference on "After the Storm: The Future Face of Europe's Financial System," Brussels, Belgium, March 24, 2009).

5 Quoted in: Ross Levine, "An Autopsy of the U.S. Financial System," *NBER Working Paper* 15965 (2010): 28.

6 Leader's Statement. The Pittsburgh Summit, 24-25 September 2010, <http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf> (1 April 2011).

7 Thomas Cooley and Ingo Walter, "The Architecture of Financial Regulation," in *Regulating Wall Street*, ed. Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (New York, 2011), 35-49, p. 35.

8 Rainer Masera, "Reforming financial systems after the crisis: a comparison of EU and USA," *OSL Quarterly Review* 63, No. 255 (2010), 297-360, p. 332.

9 *Ibid.*, 229.

10 Barry Eichengreen, "Globalization and the Crisis," CESifo Forum 3, Panel 1 (2010), <http://www.ifo.de/portal/page/portal/DocBase_Content/ZS/ZS-CESifo_Forum/zs-for-2010/zs-for-2010-3/forum3-10-panel1.pdf> (30 March 2011).

11 "EU Expert Group Calls for Tightened Financial Supervision," Euractiv, Euro & Finance/ News (2009) <<http://www.euractiv.com/en/financial-services/eu-expert-group-calls-tightened-financial-supervision/article-179770>> (5 April 2011); Financial Supervision in Europe, ALDE background notes, <http://www.alde.eu/fileadmin/docs/documents/Background_notes/FT-ADLE-Supervision-en.pdf> (31 May 2011).

12 Barry Eichengreen, "Globalization and the Crisis," CESifo Forum 3, Panel 1 (2010), <http://www.ifo.de/portal/page/portal/DocBase_Content/ZS/ZS-CESifo_Forum/zs-for-2010/zs-for-2010-3/forum3-10-panel1.pdf> (30 March 2011).

13 Caroline Fohlin, "The Fate of Deutschland AG," AICGS Transatlantic Perspectives, December 2009.

14 See for example: Ross Levine, "An Autopsy of the U.S. Financial System," *NBER Working Paper* 15965 (2010).

15 James Bullard, Christopher J. Neely, and David C. Wheelock, "Systemic Risk and the Financial Crisis: A Primer," *Federal Reserve Bank of St. Louis Review*, 91, no. 5 part 1 (2009): 403-17, <<http://research.stlouisfed.org/publications/review/09/09/part1/Bullard.pdf>> (17 June 2011).

16 Viral Acharya, Thomas Cooley, Matthew Richardson, Richard Sylla, and Ingo Walter, "A Bird's Eye View. The Dodd-Frank Wall Street Reform and Consumer Protection Act," in *Regulating Wall Street*, ed. Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (New York, 2011): 1-32, p. 3.

17 Hans J. Blommestein, Lex H. Hoogduin, and Jolanda J.W. Peeters, "Uncertainty and Risk Management after the Great Moderation: The Role of Risk (Mis)management by Financial Institutions," in *The Quest for*

Stability: The View of Financial Institutions, Surf Study 2010/3, June 2010, <<http://www.suerf.org/download/studies/study20103.pdf>> (2 April 2011).

18 Efraim Benmelech, "The Credit Rating Crisis," *NBER Reporter* 1 (2010) Research Summary, <<http://www.nber.org/reporter/2010number1/benmelech.html>> (14 June 2010); Peter Boone and Simon Johnson, "The Doomsday Cycle," *Vox*, 22 February 2010, <<http://www.voxeu.org/index.php?q=node/4659>> (14 June 2010); Sebastian Dullien and Hansjörg Herr, "EU Financial Market Reform. Status and Prospects," Friedrich Ebert Stiftung International Policy Analysis, May 2010, 4; Edward Altmann, T. Sabri Öncü, Matthew Richardson, Anjoilein Smeits, and Lawrence White, "Regulation of Rating Agencies," in *Regulating Wall Street*, ed. Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (New York, 2011): 443-467, p. 444.

19 *Ibid.*, 3.

20 James Bullard, Christopher J. Neely, and David C. Wheelock, "Systemic Risk and the Financial Crisis: A Primer," *Federal Reserve Bank of St. Louis Review* 91 (2009): 408-409.

21 Hearing of the Subcommittee on Securities, Insurance, and Investment, "Examining the Causes and Lessons of the May 6 Market Plunge," 20 May 2010, <http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=1b8af4cd-f9c2-47d8-8e87-3748a4ad43ca> (28 March 2011).

22 Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner, <<http://lehmanreport.jenner.com/>> (23 May 2011).

23 The Warwick Commission on International Financial Reform, "In Praise of Uneven Playing Fields," http://www2.warwick.ac.uk/research/warwickcommission/report/chapter_5.pdf (17 June 2011), 28.

24 Kenneth Dam, "The Subprime Crisis and Financial Regulation. International and Comparative Perspective," *John M. Olin, Law and Economics Working Paper* 517 (2010).

25 The Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report," January 2011, <http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf> (24 March 2011), xviii.

26 European Commission Communication on European Financial Supervision, 27 May 2009, <http://www.google.de/url?sa=t&source=web&cd=1&ved=0CCIQFjAA&url=http%3A%2F%2Fec.europa.eu%2Fint_ernal_market%2Ffinances%2Fdocs%2Fcommittees%2Fsupervision%2Fcommunication_may2009%2FC-2009_715_en.pdf&rct=j&q=European%20Commission%20Communication%20on%20European%20Financial%20Supervision&ei=gVPaTdkzC8SB0tYnkeEP&usq=AFQjCN Gy9w_hh8BE24xd_y_zs-aDt2icQQ&cad=rja> (23 May 2011).

27 "EU Expert Group Calls for Tightened Financial Supervision," EurActiv, Euro & Finance/ News (2009), <<http://www.euractiv.com/en/financial-services/eu-expert-group-calls-tightened-financial-supervision/article-179770>> (April 5 2011).

28 Sebastian Dullien and Hansjörg Herr, "EU Financial Market Reform. Status and Prospects," Friedrich Ebert Stiftung, International Policy Analysis, May 2010, 4.

29 Quoted in: Edward Wyatt, "S.E.C. Puts Wall St. on Notice," *New York Times*, 19 April 2010, <<http://dealbook.nytimes.com/2010/04/19/s-e-c-puts-wall-st-on-notice/>> (17 June 2011).

30 Ross Levine, "An Autopsy of the U.S. Financial System," *NBER Working Paper* 15965 (2010): 197

31 Joseph Stiglitz, "A Crisis of Confidence," *The Guardian*, 22 October 2008, <<http://www.guardian.co.uk/commentisfree/cifamerica/2008/oct/22/economy-financial-crisis-regulation>> (5 April 2011).

32 The Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report," January 2011, <http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf> (24 March 2011).

33 Timothy Geithner and Lawrence Summers, "A New Financial Foundation," *Washington Post*, 15 June 2009, <<http://www.washington->

- post.com/wp-dyn/content/article/2009/06/14/AR2009061402443.html> (17 June 2011).
- 34 Mario Draghi, Keynote at the Peterson Institute for International Economics – Bruegel Conference on “The Transatlantic Relationship in an Era of Growing Economic Multipolarity,” Washington, DC, 8 October 2010.
- 35 Morris Goldstein and Nicolas Véron, “Too Big to Fail: The Transatlantic Debate,” Bruegel Working Paper 2011/3 (2011): 3-4, 21.
- 36 Gerald P. Dwyer, “Regulating Systemic Risk,” *Federal Reserve Bank of Atlanta*, December 2009, <http://www.frbatlanta.org/cenfi/pubscf/vn_reg_systemic_risk_1209.cfm> (15 March 2011).
- 37 David Singer, “Uncertain Leadership. The U.S. Regulatory Response to the Global Financial Crisis,” in *Global Finance in Crisis. The Politics of International Regulatory Change*, ed. Eric Helleiner, Stefano Pagliari, Hubert Zimmermann (London, New York, 2010): 93-107.
- 38 Kenneth Dam, “The Subprime Crisis and Financial Regulation. International and Comparative Perspective,” *John M. Olin, Law and Economics Working Paper* 517 (2010).
- 39 Quoted in: “Obama fordert schärfere Finanzmarkt-Regulierung,” *Wirtschaft*, 26 February 2009, <www.wirtschaft.ch/Obama+fördert+schaerfere+Finanzmarkt+Regulierung/374837/detail.htm> (17 June 2011).
- 40 Timothy Geithner and Lawrence Summers, “A New Financial Foundation,” *Washington Post*, 15 June 2009, <<http://www.washingtonpost.com/wp-dyn/content/article/2009/06/14/AR2009061402443.html>> (17 June 2011).
- 41 Kenneth Dam, “The Subprime Crisis and Financial Regulation. International and Comparative Perspective,” *John M. Olin, Law and Economics Working Paper* 517 (2010).
- 42 Department of the Treasury, Financial Regulatory Reform, “A New Foundation: Rebuilding Financial Supervision and Regulation,” June 2010, <http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf> (17 June 2011).
- 43 Chairman Chris Dodd (D-CT), “Summary: Restoring American Financial Stability – Discussion Draft,” Senate Committee on Banking, Housing, and Urban Affairs, <http://banking.senate.gov/public/_files/FinancialReformDiscussionDraft111009.pdf> (17 June 2011).
- 44 Thomas Cooley and Ingo Walter, “The Architecture of Financial Regulation,” in *Regulating Wall Street*, ed. Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (New York, 2011): 35-49.
- 45 “Dodd-Frank Wall Street Reform and Consumer Protection Act,” <<http://www.opencongress.org/bill/111-h4173/show>> (31 May 2011); Pepper Hamilton LLP, “The Dodd-Frank Act and the Insurance Industry,” 10 March 2011, <http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2036#_edn2> (17 June 2011).
- 46 U.S. Treasury, Financial Stability Oversight Council Created under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Frequently Asked Questions,” October 2010, <<http://www.treasury.gov/initiatives/Documents/FAQ%20-%20FinancialStabilityOversightCouncilOctober2010FINALv2.pdf>> (17 June 2011).
- 47 Rainer Masera, “Reforming financial systems after the crisis: a comparison of EU and USA,” *OSL Quarterly Review* 63, no. 255 (2010): 297-360, p. 308.
- 48 Daniel K. Tarullo, “Financial Regulatory Reform,” (Speech presented at the U.S. Monetary Policy Forum, New York, 26 February 2010).
- 49 Davis Polk, “Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on 21 July 2010,” <http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf> (18 March 2011).
- 50 Rainer Masera, “Reforming financial systems after the crisis: a comparison of EU and USA,” *OSL Quarterly Review* 63, no. 255 (2010): 297-360, p. 308.
- 51 Dodd-Frank Wall Street Reform and Consumer Protection Act, <<http://www.opencongress.org/bill/111-h4173/show>> (31 May 2011).
- 52 The White House, “Fact Sheet: Reforms to Protect American Credit Card Holders,” 22 May 2009, <http://www.whitehouse.gov/the_press_office/fact-sheet-reforms-to-protect-american-credit-card-holders> (19 March 2011).
- 53 The Financial Services Roundtable, “Comparison of H.R. 4173 with the Senate Financial Stability Bill,” 1 June 2010, <<http://www.fsround.org/policy/pstatements/pdfs/RegulatoryReformComparisonChart.pdf>> (30 June 2011).
- 54 Steffen Kern, “U.S. financial market reform: The economics of the Dodd-Frank Act,” *Deutsche Bank Research EU Monitor* 77, 28 September 2010, <http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000262857.pdf> (17 June 2011).
- 55 Pepper Hamilton LLP, “The Dodd-Frank Act and the Insurance Industry,” 10 March 2011, <http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2036> (18 March 2011); Viral Acharya, John Biggs, Hahn Le, Matthew Richardson, and Stephen Ryan, “Systemic Risks and the Regulation of Insurance Companies,” in *Regulating Wall Street*, ed. Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (New York, 2011): 241-301.
- 56 Victoria McGrane, “GAO: Implementing Dodd-Frank Could Cost \$2.9 Billion,” *Wall Street Journal*, 28 March 2011, <<http://blogs.wsj.com/economics/2011/03/28/gao-implementing-dodd-frank-could-cost-2-9-billion/>> (17 June 2011).
- 57 “Who Will Rescue Financial Reform?” *New York Times*, 27 March 2011, <<http://www.nytimes.com/2011/03/28/opinion/28mon1.html>> (28 March 2011).
- 58 Edward Wyatt, “9 Senators Seek to Delay Debit Card Fee Changes,” *New York Times*, 15 March 2011, <<http://www.nytimes.com/2011/03/16/business/16debit.html>> (28 March 2011).
- 59 “Bipartisan Coalition of Senators: Stop and Study Proposed Debit Card Rule,” 15 March 2011, <http://tester.senate.gov/newsroom/pr_031511_debitfees.cfm> (17 June 2011).
- 60 “U.S. Consumer Bureau Funding Would Drop 40 Percent under Republican Plan,” *Bloomberg*, 15 February 2011, <<http://www.bloomberg.com/news/2011-02-15/house-republicans-target-consumer-protection-bureau-funding-in-budget-bill.html>> (16 March 2011).
- 61 Ibid.
- 62 H.R.557 Consumer Financial Protection Oversight Act of 2011 (Introduced in House), 8 February 2011.
- 63 Edward Wyatt and Ben Protess, “Foes Revise Plan to Curb New Agency,” *New York Times*, 5 May 2011, <<http://www.nytimes.com/2011/05/06/business/06consumer.html>> (17 June 2011); “Congressional Pressure Intensifies for CFPB Reform,” *Financial Reform Watch*, 6 May 2011, <<http://www.financialreformwatch.com/2011/05/articles/us-congress/congressional-pressure-intensifies-for-cfpb-reform/>> (17 June 2011).
- 64 “Who Will Rescue Financial Reform?” *New York Times*, 27 March 2011, <<http://www.nytimes.com/2011/03/28/opinion/28mon1.html>> (17 June 2011).
- 65 Phil Mattingly and Carter Dougherty, “U.S. Consumer Bureau Funding Would Drop 40 Percent Under Republican Plan,” *Bloomberg News*, 15 February 2011, <<http://www.bloomberg.com/news/2011-02-15/house-republicans-target-consumer-protection-bureau-funding-in-budget-bill.html>> (30 March 2011).
- 66 Kevin Drawbaugh, “Rep Frank vows fight over GOP attack on Dodd-Frank,” *Reuters*, 10 February 2011, <<http://www.reuters.com/article/2011/02/10/us-financial-regulation-frank-idUSTRE71989920110210>> (17 June 2011).
- 67 “Obama boost to CFTC, SEC faces Republican fire,” *Reuters*, 14 February 2011, <<http://www.reuters.com/article/2011/02/14/usa-budget-regulators-idUSN149736520110214>> (March 31 2011).
- 68 “SEC Budget Still up in the Air,” *Thompson*, 1 March 2011, <<http://www.thompson.com/public/printpage.jsp?id=3374&pageid=news->

brief> (17 June 2011).

69 Testimony before the Subcommittee on Financial Services and General Government, Committee on Appropriations U.S. House of Representatives by Chairman Mary Schapiro, U.S. Securities and Exchange Commission, 15 March 2011, <http://appropriations.house.gov/_files/031511SECFY12BudgetTestimonyFINAL.pdf> (17 June 2011).

70 Commission's Communication for the Spring European Council, "Driving European Recovery," 4 March 2009 (COM 2009), 114, <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0114:FIN:EN:PDF>> (17 June 2011).

71 Communication from the Commission, "European Financial Supervision," 27 May 2009, (COM 2009), 252 final <http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf> (17 June 2011).

72 "EU Leaders Back Financial Supervision Overhaul," *EurActiv*, 19 June 2009, <<http://www.euractiv.com/en/financial-services/eu-leaders-back-financial-supervision-overhaul/article-183341>> (17 June 2011); "Commission Tables Banking Supervision Plan, Faces Criticism," *EurActiv*, 28 May 2009, <<http://www.euractiv.com/en/financial-services/commission-tables-banking-supervision-plan-faces-criticism/article-182687>> (2 April 2011).

73 "EU-Finanzmarktaufsicht beschlossen," *Wirtschaftsblatt*, 2 December 2009, <<http://www.wirtschaftsblatt.at/home/boerse/binternational/eu-finanzmarktaufsicht-beschlossen-400095/index.do>> (17 June 2011).

74 "Bundesbank vs. EU-Finanzaufsicht," *EurActiv Finance & Growth*, 13 November 2009, <<http://www.euractiv.de/finanzplatz-europa/artikel/bundesbank-vs-eu-finanzaufsicht-002374>> (2 April 2011).

75 Council of the European Union, Press Release, 2981st Council Meeting, Economic and Financial Affairs Brussels, 2 December 2009, <http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/cofin/111706.pdf> (17 June 2011).

76 Press Release, "Commission Adopts Legislative Proposal to Strengthen Financial Supervision in Europe," Brussels, 23 September 2009, <<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1347>> (17 June 2011).

77 European Parliament, Press Release, "EP adds bite to EU financial watchdog rules," 2 September 2010, <<http://www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20100902IPR80950>> (17 June 2011).

78 Association des Banques et Banquiers, Luxembourg, Financial Services, "Additional Legislative Proposal to Complete the Framework for Financial Supervision in Europe," 19 January 2011, <<http://www.abbl.lu/news-publications/news-archive/other-news/financial-services-additional-legislative-proposal-complete-framework-financial-superv>> (17 June 2011).

79 "Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010," *Official Journal of the European Union*, 15 December 2010, <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF>> (17 June 2011).

80 "Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC," *Official Journal of the European Union*, 15 December 2010, <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0048:0083:EN:PDF>> (17 June 2011).

81 *European Union Law blog*, <<http://eulaw.wordpress.com/tag/european-securities-and-markets-authority/>> (5 April 2011).

82 "European Supervisory Authorities," Centrum für Europäische Politik (CEP) 2011, <<http://www.cep.eu/en/analyses-of-eu-policy/financial-services/eba/>> (4 April 2011).

83 "Holpriger Start für die EU Finanzaufsicht," *Euractiv Finance & Growth*, 3 February 2011, <<http://www.euractiv.de/finanzplatz-europa/artikel/holpriger-start-fr-die-eu-finanzaufsicht-004313>> (2 April 2011).

84 Axel Weber, "Financial Stability and Banking Regulation in Germany and Turkey" (introductory remarks at the Central Bank of Luxembourg

Conference on Institutional Responses to the Crisis and Thoughts on Issues, Luxembourg, 3 November 2009).

85 Daniel K Tarullo, "Financial Regulatory Reform," (Speech by Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, at the annual U.S. Monetary Policy Forum, University of Chicago Booth School of Business, New York, February 26, 2010).

86 KPMG, "Dodd-Frank Act: Regulation of Over-the-Counter Derivatives (Title VII)," *Regulatory Practice Letter* no. 10-13 (2010), <<http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/regulatory-practice-letters/Documents/rpl-1013-otc-derivatives.pdf>> (17 June 2011)

87 Viral Acharya, Or Sharchar, and Mari Subrahmanyam, "Regulating OTS Derivatives," in *Regulating Wall Street*, ed. Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (New York, 2011): 367-425, p. 367.

88 "Factbox: Major U.S. Financial Regulation Reform Proposals," *Reuters*, 9 June 2010, <<http://blogs.reuters.com/financial-regulatory-forum/2010/06/09/factbox-major-u-s-financial-regulation-reform-proposals/>> (28 March 2011); Baird Webel et al., "Financial Regulatory Reform and the 111th Congress," *CRS Report for Congress*, R40975, March 2010; "Factbox: Highlights of U.S. Dodd-Frank Wall Street Reform Bill," *Reuters*, 8 November 2010, <<http://www.reuters.com/article/2010/11/08/us-financial-regulation-sifma-doddfrank-idUSTRE6A73MR20101108>> (17 June 2011).

89 Raymond Gustini and Lloyd H. Spencer, "The Dodd-Frank Act implementation of the Collins Amendment," Nixon Peabody LLP, 8 September 2010, <http://www.nixonpeabody.com/linked_media/publications/Global_Finance_Alert_09_08_2010.pdf> (17 June 2011).

90 Rainer Masera, "Reforming financial systems after the crisis: a comparison of EU and USA," *OSL Quarterly Review* 63, no. 255 (2010): 297-260, p. 311.

91 "Basel III," Bundesministerium der Finanzen (2011), <http://www.bundesfinanzministerium.de/nr_39808/DE/BMF__Startseite/Service/Glossar/B/022__Basel__III.html> (April 6, 2011).

92 "Strengthening the Resilience of the Banking Sector - Consultative Document," Bank for International Settlements, December 2009, <<http://www.bis.org/publ/bcbs164.htm>> (6 April 2011).

93 U.S. Department of the Treasury, "Secretary Geithner Testimony before the House Financial Services Committee," 22 September 2010, <http://financialservices.house.gov/Media/file/hearings/111/Treasury_Testimony092210.pdf> (17 June 2011).

94 Edward Altman et al, "Regulation of Rating Agencies," in *Regulating Wall Street*, ed. Viral Acharya et al. (New York, 2011): 443 – 467.

95 "Dodd-Frank Wall Street Reform and Consumer Protection Act: Credit Rating Agency Provisions" in *Regulating Wall Street*, ed. Viral Acharya et al. (New York, 2011): 443 – 476.

96 Davis Polk and Wardwell LLP, "Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010," 21 July 2010, <http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf> (4 April 2011); Dechert LLP, "Dodd-Frank Measures Affecting Credit Rating Agencies," August 2010, <http://www.dechert.com/library/Finance_and_Real_Estate-08-10-35-Dodd-Frank_Measures_Affecting_Credit.pdf> (4 April 2011).

97 U.S. Securities and Exchange Commission, "Incentive-based Compensation Arrangements," (2011), <<http://www.sec.gov/rules/proposed/2011/34-64140.pdf>> (31 March 2011).

98 "Dodd-Frank Implementation Faces Strong Congressional Opposition," in *RegBlog*, 30 March 2011, <<http://www.law.upenn.edu/blogs/regblog/2011/03/dodd-frank-implementation-faces-strong-congressional-opposition.html>> (17 June 2011).

99 European Commission Statement, "Mitteilung der Kommission an das Europäische Parlament, den Rat, den Europäischen Wirtschafts- und Sozialausschuss und die Europäische Zentralbank. Regulierung der Finanzdienstleistungen für Nachhaltiges Wachstum," KOM (2010) 301, 2

- June 2010, <http://ec.europa.eu/internal_market/finances/docs/general/com2010_de.pdf> (3 April 2011).
- 100 "Internal Market, Financial Markets Infrastructure," European Commission, <http://ec.europa.eu/internal_market/financial-markets/derivatives/#proposals> (2 April 2011).
- 101 Rainer Masera, "Reforming Financial Systems After the Crisis: a Comparison of EU and USA," *OSL Quarterly Review* 63, no. 255 (2010): 297 – 360.
- 102 "EU Agrees Bank Bonuses Limit Deal," *BBC on the web*, 30 June 2010, <http://www.bbc.co.uk/news/10468718> (7 April 2011).
- 103 Hungarian Financial Supervisory Authority, "Presidency Conclusions of the Brussels European Council 18/19 June 2009," <http://www.pszaf.hu/en/left_menu/eu_international/otherEU/eucouncil_090618_19.html> (6 April 2011).
- 104 The European Commission, "The Single Market," (2011), <http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm> (7 April 2011).
- 105 Steven Hill, "Happy 2011: Europe's Year of Reining in the Banks," *Social Europe Journal*, 18 January 2011, <<http://www.social-europe.eu/2011/01/happy-2011-europe%E2%80%99s-year-of-reining-in-the-banks/>> (17 June 2011); Clifford Chance, "Regulation of OTC Derivatives Markets. A comparison of EU and US initiatives," 16 September 2010, http://www.cliffordchance.com/publicationviews/publications/2010/09/regulation_of_otcderivativesmarkets-.html (17 June 2011).
- 106 Karel Lannoo, "What Reforms for the Credit Rating Industry? A European Perspective," *ECMI Policy Briefs* no. 17, 13 October 2010, <<http://www.ceps.eu/book/what-reforms-credit-rating-industry-european-perspective>> (17 June 2011).
- 107 European Commission, Rating Agencies, <http://ec.europa.eu/internal_market/securities/agencies/index_en.htm> (17 June 2011).
- 108 Lucia Quaglia, "The 'old' and 'new' politics of financial services regulation in the European Union," Research Paper of the European Social Observatory (Brussels: OSE, April 2010): 11.
- 109 *Ibid.*, 13
- 110 Mario Draghi, Keynote at the Peterson Institute for International Economics – Bruegel Conference on "The Transatlantic Relationship in an Era of Growing Economic Multipolarity," Washington, DC, 8 October 2010.
- 111 Quoted in: Tracy Alloway, "Bond 37638WAA9 and the Bear Stearns Bailout," *Financial Times*, 6 April 2010, <<http://ftalphaville.ft.com/blog/2010/04/06/195571/bond-37638waa9-and-the-bear-stearns-bailout/>> (17 June 2011).
- 112 Quoted in: "Bernanke Defends Bear Stearns Bailout," *CBS News*, 17 April 2009, <<http://www.cbsnews.com/stories/2008/04/03/business/main3991713.shtml>> (17 June 2011).
- 113 Quoted in: Martin Crutsinger, "Paulson Says Lehman Bailout was Never an Option," in *ChicagoDefender.com*, 15 September 2008, <http://www.chicagodefender.com/article-1882-paulson-says-lehman-bailout-was-never-an-option.html> (17 June 2011).
- 114 Matthew Richardson, Roy C. Smith, Ingo Walter, "Large Banks and the Volcker Rule," *Regulating Wall Street*, ed. in Viral Acharya, et. al. (New York, 2011): 181-212.
- 115 Department of the Treasury, "A New Foundation: Rebuilding Financial Supervision and Regulation," *Financial Regulatory Reform*, June 2010, <http://www.financialstability.gov/docs/regs/FinalReport_web.pdf> (31 March 2011).
- 116 Davis Polk and Wardwell LLP, "Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010," 21 July 2010, <http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf> (4 April 2011).
- 117 Covington & Burley LLP, "Systemic Risk Regulation and Orderly Liquidation Authority of Systemically Important Firms," Advisory Dodd-Frank Act, 21 July 2010, <<http://www.cov.com/files/Publication/f3cacf02-b81e-4484-9543-cc561077f388/Presentation/PublicationAttachment/1053ae45-096f-4d35-bae3-d0100fd40789/Dodd-Frank%20Act%20-%20Systemic%20Risk%20Regulation%20and%20Orderly%20Liquidation%20of%20Systemically%20Important%20.pdf>> (17 June 2011); Thomas J. Fitzpatrick IV and James B. Thomson, "An End to Too Big to Let Fail? The Dodd–Frank Act's Orderly Liquidation Authority," *Federal Reserve Bank of Cleveland*, 1 May 2011, <<http://www.clevelandfed.org/research/commentary/2011/2011-01.cfm>> (17 June 2011).
- 118 *Ibid.*
- 119 The White House, "Financial Crisis Responsibility Fee," 7 May 2010, <<http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn>> (17 March 2011).
- 120 Stormy-Annika Mildner, "It's Payback Time. The United States and Germany Are Debating a Financial Institution Fee," AICGS Transatlantic Perspectives, May 2010.
- 121 The President's Proposed Fee on Financial Institutions Regarding TARP: Part 2, Senate Finance Hearing, 4 May 2010, <<http://finance.senate.gov/hearings/hearing/?id=8e5b624f-5056-a032-52e9-12425ef455f8>> (22 March 2011).
- 122 U.S. Treasury, Fact Sheet: Administration's Fiscal Year 2012 Budget, 14 February 2011, <<http://www.treasury.gov/press-center/press-releases/Pages/tg1061.aspx>> (17 June 2011).
- 123 Davis Polk and Wardwell LLP, "Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010," 21 July 2010, <http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf> (4 April 2011); Steffen Kern, "U.S. Financial Market Reform. The Economy of the Dodd-Frank Act," Deutsche Bank Research (2010), <http://www.fpdc.com/DB/TreasuryPulse/PDF/DB-Research_%20US_Fin_Mkt_Reform_092810.pdf> (17 June 2011).
- 124 Viral Acharya, et al., "A Bird's Eye View. The Dodd-Frank Wall Street Reform and Consumer Protection Act," in *Regulating Wall Street*, ed. Viral Acharya, et. al. (New York, 2011): 1-32.
- 125 Morris Goldstein and Nicolas Véron, "Too Big to Fail: The Transatlantic Debate," *Bruegel Working Paper* 2011/3 (2011): 6.
- 126 Stormy-Annika Mildner and Mark Prentice, "Germany's Social Market Economy, Old Wine in Old Bottles? How the Social Market Economy Influenced the Management of the Economic Crisis," in *Germany's Founding Pillars at 60: Future Challenges and Choices*, AICGS German-American Issues 10 (Washington, DC: American Institute for Contemporary German Studies, 2009): 7-20.
- 127 Financial Stability Board, Press release 20.10.2010, Ref no: 45/2010,7 (April 2011)
- 128 Quoted in: "EU: Bank Levy Could Raise up to 50 Billion a Year," *Euractiv*, 7 April 2010, <<http://www.euractiv.com/en/financial-services/eu-bank-levy-could-raise-50-billion-year-news-421200>> (1 April 2011).
- 129 Communication from the Commission to the European Parliament, the Council, the European Social and Economic Committee and the European Central Bank, *Bank Resolution Fund*, Brussels, COM(2010) 254 final, 26 June 2010, <http://ec.europa.eu/internal_market/bank/docs/crisis-management/funds/com2010_254_en.pdf> (1 April 2011).
- 130 "Commission Services Issue an Analysis of the Main Innovative Financing Options," Press Release Rapid, 6 April 2010, <<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/405>> (17 June 2011).
- 131 Quoted in: "EU Proposes 'Preventive' Bank Levy," *Euractiv*, 26 May 2010, <<http://www.euractiv.com/en/financial-services/eu-proposes-preventive-bank-levy-news-494501>> (17 June 2011).
- 132 Quoted in: "U.S. and Germany Emphasize Common Ground on Financial Regulation," *DW World*, 27 May 2010, <<http://www.dw-world.de/dw/article/0,,5623688,00.html>> (17 June 2011).
- 133 Nicolas Véron, "EU Financial Regulatory Reform: A Status Report,"

Bruegel Policy Contribution, Issue 2010/11 (December 2010): 6, <http://veron.typepad.com/files/bruegelpolicycontribution_dec10_eufinreform.pdf> (17 June 2011).

134 Rainer Masera, "Reforming financial systems after the crisis: a comparison of EU and USA," *OSL Quarterly Review* 63, no. 255 (2010): 297-360, p. 308.

135 Dominique Strauss-Kahn, "Nations Must Think Globally on Finance Reform," *Financial Times*, 18 February 2010, <<http://www.ft.com/intl/cms/s/0/ffccb0aa-1c2b-11df-86cb-00144feab49a.html#axzz1PYLwX9SY>> (17 June 2011).

136 Nicolas Véron, "EU Financial Regulatory Reform: A Status Report," *Bruegel Policy Contribution*, Issue 2010/11 (December 2010): 6, <http://veron.typepad.com/files/bruegelpolicycontribution_dec10_eufinreform.pdf> (17 June 2011).

137 Aldo Caldari, "Transatlantic Cooperation for Post-Crisis Financial Reform – To What End?" Herinrich Böll Stiftung (2011) <http://www.networkideas.org/featart/jun2011/Aldo_Caldari.pdf> (17 June 2011).

AICGS

1755 Massachusetts Ave., NW
Suite 700
Washington, D.C. 20036 – USA
T: (+1-202) 332-9312
F: (+1-202) 265-9531
E: info@aicgs.org
www.aicgs.org

AMERICAN INSTITUTE
FOR CONTEMPORARY
GERMAN STUDIES

THE JOHNS HOPKINS UNIVERSITY

Located in Washington, D.C., the American Institute for Contemporary German Studies is an independent, non-profit public policy organization that works in Germany and the United States to address current and emerging policy challenges. Founded in 1983, the Institute is affiliated with The Johns Hopkins University. The Institute is governed by its own Board of Trustees, which includes prominent German and American leaders from the business, policy, and academic communities.

Building Knowledge, Insights, and Networks for German-American Relations