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The Danger of Divergence:
Transatlantic Cooperation on Financial Reform

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Report Co-Chairs

Sharon Bowles, MEP, Chair - Economic and Monetary Affairs Committee, European Parliament
Senator Chuck Hagel, Chairman, Atlantic Council
Senator Mark Warner, U.S. Senate Committee on Banking, Housing, and Urban Affairs

Report Rapporteur

Douglas J. Elliott, The Brookings Institution

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© October 2010

Production and Dissemination Funded By:
ML Resources, LLC, Washington, DC

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Foreword

Two years ago this month, the financial crisis changed dramatically from a brewing but still uncertain storm into a full-blown tempest. As the rapid-fire failures of major financial institutions forcefully accelerated what grew to be the worst global recession since the Great Depression, it became the single topic dominating world attention. In response, governments around the globe worked with unprecedented fervor and cooperation to initiate the most sweeping changes to the regulation of financial markets and institutions in many decades.

The US has already set a framework to address the root causes of the crisis and one is methodically emerging in Europe. Yet we cannot take the completion of reform for granted. The most difficult work remains; regulators must write the rules that will implement the legislation and there will be many devils lurking in those details on both sides of the Atlantic. As the immediacy of the crisis fades, even though its effects are still very much with us, the case for reform gets harder politically. It is essential, therefore, that the highest levels of leadership remain focused and intent on the goal of creating a global financial system that is strong, stable, and safe.

We have co-chaired "*The Danger of Divergence: Transatlantic Cooperation on Financial Reform*" because we believe strongly that transatlantic leadership and cooperation on financial reform is essential to ensure that the high standards of economic governance the United States and Europe both strongly support are adopted globally. This valuable report calls for re-energized transatlantic leadership in defining the global financial architecture, spells out the serious consequences of uncoordinated action, and presents concrete options for policymakers to make this a reality. As legislators we are keenly aware that passage of new law is only the beginning of implementation, and we are committed to participating in the remainder of the implementation process, including at the international level. We strongly endorse this important contribution to the continuing debate on one of the defining global challenges of our time.

...we cannot take the completion of reform for granted.

...we believe strongly that transatlantic leadership and cooperation on financial reform is essential...

This report has benefitted greatly from the views of a distinguished group of individuals that participated on the Thomson Reuters – Atlantic Council Financial Reform Task Force. We are grateful to the members of this group for their time, energy, and enthusiasm for engaging in this process. Frederick Kempe and Alexei Monsarrat of the Atlantic Council, and Paula Dobriansky and Kate Friedrich of Thomson Reuters deserve great thanks for their work to conceive, develop, and organize this effort. Finally, we want to commend Douglas Elliott of the Brookings Institution, who served as task force member and report rapporteur, for his excellent work in interviewing the task force members and producing a truly exceptional piece of work that is at once accessible to non-experts and sophisticated enough to serve policymakers and financial leaders.

Signed,

Sharon Bowles, MEP, Chair - Economic and Monetary Affairs Committee, European Parliament

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Introduction

Two years after the collapse of Lehman Brothers sparked a meltdown of the global financial system, we are at a crucial point that calls for us to step back and examine our progress in the effort to redesign the rules governing global financial markets. The immediacy of the crisis has passed, allowing for clearer analysis of the manifold causes and an evaluation of how the reforms that have been put in place match up with those causes. At the same time, the urgency of the process has not yet entirely dissipated and it is not too late to fill in any holes or to resolve conflicts created by differing approaches around the world.

It is good that real progress has been made. Comprehensive legislation has passed in the US and major pieces of legislation have passed in Europe, with more on the way. However, regulators have many important decisions to make, particularly in the US, and the remaining legislative agenda in the European Union (EU) includes critically important items. As the financial crisis recedes, there will be forces pushing for at least some essential reforms to be put off, watered down, or abandoned.

This is in part because of remaining disagreements over the best rules for the financial system; no legislation is ever perfect and the same issues that fueled such intense debate in crafting the current solutions will now be shifted to the more opaque world of regulatory action. This is set against a fundamental and profound change in the approach to financial markets. After all, it was not so long ago that *deregulation* was the order of the day. This latter point is a reminder that financial regulation is a work in progress that will necessarily evolve over time. We need the right initial framework and processes to maximize the chance that future changes are helpful and not harmful.

There has been a great deal of progress and global partnership in laying the foundation for managing the worst of the fallout that has plagued the global economy since 2007. The process is by no means complete, but the attention to the challenge and the level at which it has been addressed is truly significant. Leaders of the Group of Twenty (G-20) met four times in 14 months – and will meet for a fifth time in November – on a single, all-consuming issue. They moved rapidly, establishing the G-20 as the manager of the global response, and acted together to stem the cascading financial chaos that unfolded over 2008 and 2009 (see Appendix C for a summary of the relevant action steps endorsed by the G-20).

This is set against a fundamental and profound change in the approach to financial markets. After all, it was not so long ago that deregulation *was the order of the day.*

This report focuses on defining the major issues for transatlantic cooperation in their global context, analyzing the effects of proposed rules on the US and European economies, including the impact on the real economy and especially the business sector, and outlining concrete recommendations for policymakers. To do this, the report addresses the following questions:

- What core principles should guide any recommendations on financial reform?
- How do financial systems and market roles differ globally?
- Was this just a "North Atlantic Crisis" requiring only a North Atlantic solution and that can be ignored elsewhere?

- What are the institutional processes of the US and European governments that drive decisions on financial regulation?
- How is international coordination being organized?
- What were the causes of the financial crisis?
- What is being done on each side of the Atlantic to fix the causes of the crisis?
- What transatlantic regulatory conflicts need to be resolved and what differences are acceptable?
- How will regulatory reform affect the economy?
- How can financial reform efforts best be improved or extended?

The Atlantic Council, in partnership with Thomson Reuters, assembled a task force of experts from academia, think tanks, and the private sector, as well as government representatives, to discuss financial market reform and the state of transatlantic cooperation. Task force members provided information and perspectives on the issues covered in the report.

The views expressed in this report are inspired by conversations with the rapporteur and do not constitute a consensus view from the task force or a view from its individual members. Nor do the views expressed here necessarily represent the views of the Atlantic Council or Thomson Reuters.

Executive Summary

Transatlantic leadership is essential to complete the process of global financial reform. The good news is that the trend of transatlantic cooperation is clearly quite positive compared to pre-crisis days. For example, the degree of international controversy over Sarbanes-Oxley was vastly higher than the relative comfort with the Dodd-Frank regulatory reform bill recently passed in the US. Current reform efforts are also addressing serious failures in regulatory cooperation, including a failure to consult effectively across borders about systemic risks and to exchange detailed information about such risks and the maintenance of substantially different capital standards for banks in the US versus the rest of the world.

Yet there is a great deal left to do, and leadership from the US and Europe is especially important now, since, surprisingly, the easiest work of the G-20 may be behind it. As countries begin to concretely define their regulatory plans, it becomes harder to paper over some very real differences that were obscured by the urgency of managing the crisis. Yet, the need for cooperation is similarly at its highest. This report is timed to encourage continued emphasis on the need for international cooperation and, crucially, to urge the transatlantic community to continue leading this effort.

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We offer a number of suggestions to improve the process and outcome of financial reform, listed below. These are explained in greater detail in the Recommendations section.

Finish the key regulatory reforms

There are a large number of issues that remain to be completed, including the writing of a substantial number of regulations. The Dodd-Frank bill alone has hundreds of rule-makings that are the province of many different regulatory bodies. In addition, there are some major outstanding issues that can only be handled either by international bodies, or domestically within the US or EU member states. It is essential to maintain momentum on these reforms.

- Finalize the Basel III accord without sacrificing its strength
- Design reforms to achieve the necessary safety at the lowest economic cost
- Jointly engage major Asian countries and other emerging markets in financial reform
- Harmonize the regulation of financial market infrastructure
- Fix the housing finance system in the US
- Address the underlying macroeconomic, social, and political causes of the crisis
- Stay focused on key unresolved structural issues

Resolve transatlantic conflicts

There are a small number of conflicts between the US and EU that are particularly troublesome. These tend to center around different underlying beliefs in the purpose

of government, the market, and regulation. It is best to address them head-on. It is unlikely this will change the underlying beliefs of either side, but an honest conversation about the conflict is the only way to find solutions that mitigate differences.

- Demand that consistent global accounting standards be applied by all parties
- Find compatible approaches to regulating hedge funds and private equity funds
- Coordinate approaches to credit rating agencies

Repair the supervision process

There is also a subset of issues that both sides agree are essential, but that are fundamentally vexed questions. Unfortunately, these also happen to be areas that are most likely to lead to another crisis if not resolved.

- Improve banking supervision and hold regulators accountable
- Create effective rules for dealing with cross-border banks that run into trouble

Enhance the processes for global cooperation

The coordination processes at the international, transatlantic, and bi-lateral levels are present, but vary greatly in quality and content. There is a strong need to deepen, better structure, and better coordinate a number of these efforts.

Engage Congress and the EU Parliament more deeply in international discussions of reform

- Establish better forums for discussions of transatlantic financial reform issues among all parties
- Define a clear, robust future for the G-20, linked to existing multilateral institutions
- Coordinate macroprudential policies globally
- Coordinate carefully any significant changes in taxation of financial institutions or transactions

The Core Principles

Certain core beliefs underlie the analysis and recommendations in this report:

- Financial reform is crucially important
- Global cooperation is indispensable to effective financial reform
- Coordination between the US and Europe is essential to achieving that cooperation
- Financial protectionism must not reverse economic gains of recent decades

Financial reform is crucially important

There is a great deal of work still to be done on financial reform and it is critical that governments and regulators do not falter now. The financial crisis underlines the need for major reforms to the operations of financial institutions and markets and to the regulatory approaches that were to have protected the system from such a catastrophic failure. Thankfully, this has been a priority of the G-20, the EU, and the various nations hosting the world's major financial centers.

There is clear evidence that major financial crises can do tremendous harm to the world's economy, even outside the key financial centers. Not only was this true of the latest crisis, which spurred the worst recession in much of the world since the Great Depression, but studies by the International Monetary Fund (IMF) and others have shown that recessions following severe financial crises tend to be much worse, and longer lasting, than normal "business cycle" recessions.[1] Therefore, it is critical to get financial regulation right and thereby substantially reduce the frequency and severity of financial crises.

At the same time, regulation is always a balancing act. Societies have created financial markets for a reason and increased safety must be gained without creating an unreasonable drag on the economy that would make credit or other financial services excessively difficult or expensive to obtain.

Efficient financial systems have been major contributors to global economic progress and prosperity; it would be a counterproductive and unacceptable outcome to lose some of this benefit by unnecessarily hobbling the financial system.

Finally, it should be noted that regulation cannot avoid all future financial crises. Systems run by humans will always be subject to bubbles that burst painfully. However, good regulation can provide the guideposts for financial firms, consumers, and governments that will make financial crises substantially less frequent and much less damaging to the larger economy.

Global cooperation is indispensable to effective financial reform

Failure to coordinate financial reform appropriately across borders would create two evils and miss one opportunity. The greatest potential danger from differing national regulatory regimes is the threat of "regulatory arbitrage," which refers to actions taken by private sector financial market participants to side-step stringent regulation by moving activities to geographies or financial

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1 See Reinhart and Rogoff (2009).

...the nations that have the least stringent regulation may find themselves hurt the worst in the long run...

sectors that have the lowest regulatory burden. This can reduce the level of regulation to the lowest common denominator or even spur a race to the bottom.

Ironically, the nations that have the least stringent regulation may find themselves hurt the worst in the long run, but the spillover effects are severe enough that all countries are well-advised to cooperate to avoid weak regulation anywhere. The second danger is that of financial protectionism, discussed later.

On the positive side, global cooperation in financial reform can improve stability for everyone by encouraging the emulation of best practices and the exchange of crucial information about the activities of financial institutions and sectors. A good flow of data may allow problems to be spotted before they become truly troublesome.

Important as global cooperation is, we must acknowledge, however, that not everything in financial regulation needs to be consistent across borders. There are genuine differences in financial and economic systems that can make the right answers differ across countries. Further, we must leave room for countries with different political and social philosophies to try their own approaches without imposing one global ideology of financial regulation. Regulatory differences even have some benefits, in allowing a competition among ideas and in providing a level of "biodiversity" that makes it harder for a financial epidemic to sweep across borders. The key, therefore, is to recognize which aspects of regulation have substantial cross-border implications and to avoid the problems and risks created by significant inconsistencies in the regulation of these areas. As this report will lay out, there are many critical aspects of the financial system that do indeed require a global consistency of approach.

Finally, the desirability of consistency and coordination cannot become a hurdle used by the recalcitrant to stop action across the globe. Sometimes we will need to move forward even when a full consensus is impossible to reach. Similarly, individual countries or groupings of countries must retain the right to dissent and take a different path when they strongly disagree with the correctness of an approach. However, this should truly be a last resort for those areas where global cooperation has clear value and ought to be a right that is exercised very infrequently. Nor should a strong philosophical belief serve to create an automatic exemption from incentives and disincentives created by the world financial community to encourage adequate capital levels or other safety measures.

Transatlantic cooperation will be critical to achieving this global coordination

It is essential that the US and Europe cooperate to promote financial reform. Most of the world's financial transactions take place within our collective boundaries and most of the world's financial assets reside there. Further, the financial markets in our countries are generally recognized as the most sophisticated in the world and were long considered the best regulated. Equally importantly, our countries have a shared vision, that strong private financial institutions and markets will lead to more durable and broadly shared economic prosperity than other, usually more statist, models.

The summaries that follow of financial reform choices made by the US, the EU, and individual European countries show more good news than bad regarding the current state of transatlantic cooperation on financial reform. Nonetheless, there are conflicts already and much that remains to be fleshed out could generate further conflicts. A common transatlantic view on key financial reform issues would form a strong basis for global cooperation and carry much more weight in convincing emerging market countries than if we speak with different voices. Divergence would distract our energies from the common cause, making it harder to achieve optimal financial reform even within our respective borders.

Financial protectionism must not reverse economic gains of recent decades

Unnecessary barriers to capital flows and the provision of financial services across borders must not be allowed to creep in under the guise of financial reform. The globalization of financial services has helped spur the rapid growth of emerging market countries and bolster the growth rates of mature economies. The removal of trade barriers in this realm has lowered the cost of capital for businesses and made it easier for individuals to fund homes and other large purchases. It would be a pity if conscious or unconscious protectionism were to reverse these gains.

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Differences in Financial Systems and Views of the Market

One cause of divergent approaches to financial reform is the simple fact that countries start with differing financial systems, which arise in part from differing conceptions of the proper role of financial institutions and markets and of the intersection of the state with finance. In both cases, there are some fairly broad differences between the US and Europe as a whole, particularly the smaller role of banks in the US and a preference for a lesser state role in finance. However, European countries differ among themselves quite considerably in these regards as well. Emerging economies usually have even larger roles for banks and for the states than is true in Europe. They also tend to have considerably less sophisticated capital markets and even banking systems than do the traditional financial powers in the US and Europe. Appendix A provides a primer on this issue.

These differences in financial systems have significant implications for financial reform. For example, many of the reforms proposed for the capital markets are of substantially greater significance in the US and UK, while bank-centered reforms matter more in Europe and outside the US generally. One way this has shown up is in a difference in the degree of caution shown in making changes. US concerns about potentially harming capital markets inadvertently as part of the reform process has lain behind objections to bans on short-selling or the imposition of a financial transactions tax. Some continental European countries have urged greater caution in the pace and degree of change in capital requirements for banks, since disruptions of bank lending could seriously harm their economies. As another example, the Volcker Rule in the US, which limits the scope of banks by forbidding proprietary trading, makes much more sense in a US historical context than it does for countries in the rest of the world that are comfortable with a very wide role for banks.

The role of the markets

There are also important philosophical differences between countries about the appropriate role markets should play in society. Financial markets at their best are highly efficient avenues for allocating investments to enterprises that will best generate wealth and jobs and provide the foundation for a strong economy. However, they can also produce side-effects that governments choose to address differently. First, they are prone to volatility. Rightly or wrongly, many people blamed large rises in commodity prices in 2008 on excessive speculation associated with the primacy of the markets. Second, markets do not have a natural mechanism to take account of certain societal goals. As a result, some governments prefer allocation mechanisms that require greater state guidance. Third, they are viewed by many as vulnerable to manipulation by speculators in times of crisis. Fourth, some believe that the increasingly central role of financial markets, and speculation encouraged by them, have led to an excessively large financial sector that drains human and other resources from the rest of the economy. This could lead to a “hollowed out” economy that is overly reliant on services for growth.

These differing philosophical views have practical implications for financial reform. Those who want to limit excessive speculation, and the potential for manipulation of markets, tend to favor financial transactions taxes to discourage speculation and limitations on short-selling and the purchase of credit default swaps, among other proposals. Those who focus more on the benefits of markets tend to oppose these ideas for fear that they will make markets smaller and less efficient.

A “North Atlantic Crisis”?

There is a strong view from a number of emerging economies that the financial crisis was purely a North Atlantic one that had major spill-over effects on their own economies, but was not in any way caused by them. There is obviously considerable truth in this. As a result, it is critical that we not be seen to be preaching to the rest of the world as we attempt to persuade them to join us in reforming the financial system.

Life would be simpler if we really could just fix the problems in our part of the world and allow the emerging economies to proceed as they were before. Unfortunately, this would lead to a serious risk of the kind of regulatory arbitrage described earlier and laid out in more detail later in this paper, as well as a substantially more fragile financial system. Many aspects of finance are now global and the role of the emerging markets will grow ever bigger, making it imperative that there is good cooperation on those issues that transcend borders.

Further, our possession of the most sophisticated financial markets made us the “canary in the mine shaft” warning of a series of quite serious problems that need to be fixed. The large emerging markets will almost inevitably develop much more sophisticated financial systems than they have now. If they ignore the lessons we have learned, it will come back to haunt them, and us. No one could afford, for example, a Chinese “lost decade” comparable to what Japan experienced some years back when its own financial system crashed.[2]

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The transatlantic community must find the way to both “lead by example” and to use our persuasive powers to convince the leaders of the emerging economies that it is in their own interests to join us in financial reform. Doing this effectively, of course, requires that we also listen seriously to their own thoughts and concerns and modify the reform project appropriately.

2 It should be noted that, although the role of the US and Europe in creating the financial crisis was clearly substantially greater than the role of Asia, certain analysts do ascribe some responsibility to the Chinese trade surpluses and to the Japanese policies that led to the “yen carry trade”.

Differences in Decision-Making Processes Across the Atlantic

The US and Europe have markedly different decision-making processes which affect the timing and structure of financial reform. In addition to the basic differences in process, described in Appendix B, a number of task force members described two political realities about the EU that they felt were important. One, they noted that legislatures on both sides sometimes show a very parochial focus on local issues which can complicate international cooperation. In contrast, the European Commission has historically tended to show great respect for international norms, perhaps because it is composed of staff from so many different nations who have to work together on a permanent basis or because it has been required to forge consensus across all the EU nations.

Some task force members also observed that there is a tension within the EU between the handful of nations that host globally significant financial centers and the larger number that do not. There is a concern that the nations that do not have their own major markets are not fully cognizant of the ramifications of actions that may appear to improve financial safety, but that either have damaging side-effects or which harm economic efficiency and growth too much to be worth the safety gain. (Of course, the nations without significant financial centers may feel that those who do have them are too prone to listen to the industry's lobbyists and do not always take account of the knock-on effects on other countries.) It should be noted that the US has similar conflicts between Congressional representatives of states with major financial centers and those without.

International Coordination Processes

The US and Europe use multiple channels to coordinate their regulatory reforms, including:

- Summits of the G-7/8 and G-20 nations
- Permanent multi-lateral organizations
- Direct talks between the US and EU institutions
- Bilateral discussions between the US and individual European nations

The resulting cooperation has been good, resulting in a substantial parallelism of approach, but some serious challenges will now arise as countries make more specific plans, even as the enthusiasm for cooperation wanes as the immediacy of the crisis fades.

There are many channels for transatlantic and global coordination of policies relevant to the financial sector. Cooperation through these channels was quite effective at the height of the crisis, as all countries focused on stopping the precipitous plunge in financial market confidence and valuations which was threatening a potential second depression. Unfortunately, the level of cooperation since the crisis abated appears to have declined significantly, although that cooperation is still quite significant, especially compared to pre-crisis days.

Transatlantic, and indeed global, cooperation on financial matters takes place in four principal ways:

The Group of Twenty (G-20). For some years now, the most powerful countries in the world have coordinated certain major policies through an informal club of governments that have met as the G-5, G-7, G-8, and now the G-20. Until recently, G-7 Finance Ministers meetings (and to a lesser degree the G-8 leaders meetings) were the principal mechanism for coordinating global economic policies. The sudden storm of the financial crisis, which affected major emerging economies as well as the G-7, made it clear that the G-7 could no longer retain its status as the de facto global coordination group.

The G-20 includes the large majority of the world's economic power, although there are certainly significant countries that are outside even that extended grouping. The G-20 has met since 2008 at the level of heads of government and has guided critical decisions about how to respond to the financial crisis during the Washington, London, Pittsburgh and Ottawa summits between 2008 and 2010 and established working groups to engage the more complex issues.

The work of the G-20 to date (see Appendix C) has formed the backbone for the global response to the financial crisis. However, some task force members expressed serious concern about the future cohesiveness and political will of the group. As noted above, the urgency of the crisis has passed, removing the "common enemy" that the group rallied to defeat. The remaining issues are the toughest and require the greatest amount of high level political "push" in order to complete.

Permanent multi-lateral organizations. The Basel Committee, the Financial Stability Board, and the Bank for International Settlements, which hosts those two entities, are among the important multi-lateral organizations that focus on the financial system. The G-20 further bolstered the roles of the Basel-based organizations by explicitly

delegating specific responsibilities to them in the wake of the financial crisis. For example, the G-20 heads of government specifically mandated the Basel Committee, with support from the FSB and BIS, to create more stringent capital requirements, which they are doing through the Basel III process. The IMF also has financial stability functions, not only in terms of monitoring economies and warning of potential financial crises, but also by providing emergency liquidity support for nations that are enveloped by financial crises. Each of these organizations therefore provides governments and central banks on both sides of the Atlantic with avenues to communicate and coordinate fiscal, monetary, and regulatory responses.

Direct talks between the US and the EU institutions. Various high-level Administration and Fed officials from the US talk to equivalent officials from the European Commission, Council of Ministers, and European Central Bank. Less frequently there will be discussions with key members of the European Parliament. Congress, for its part, maintains some sporadic dialogue with EU officials, including those from the Parliament, which has now set up its own office in Washington.

Substantially more frequent and detailed discussions are held at the level of senior civil servants, and occasionally their immediate political superiors, through the EU-US Financial Markets Regulatory Dialogue (FMRD), which has a relatively informal organization. The original core member organizations on the US side included the Treasury, the Fed, and the SEC, although this has expanded to the CFTC and the National Association of Insurance Commissioners (in lieu of a federal insurance regulator, which does not exist in the US). The core member on the EU side has been the Commission, although here too other organizations have been included in particular discussions. The FMRD has been used both to conduct periodic comprehensive reviews of regulatory progress and also to deal with specific conflicts that arise. The FMRD appears to have been instrumental in helping to achieve a high degree of familiarity of officials from both sides with each other and encouraging strong parallelism in the regulatory responses on the two sides of the Atlantic. Where problems exist, or could exist, it provides a good avenue to work out solutions, although its informal and non-public nature obscures its exact role.

It is worth mentioning that one of the ways in which US and EU policymakers have been able to bridge gaps is to allow each side to proceed with somewhat different rules, but provide mutual recognition of institutions that are based in each other's countries or to treat them as equivalently regulated. For example, the credit rating agency rules in the EU have a provision for accepting US-based institutions based on such equivalence, under certain conditions.

Bilateral national talks. There are many discussions between the US government and those of various European countries. Doubtless, there have been constructive discussions on common positions regarding multi-lateral negotiations, such as the Basel III process; however, there has been little scope for direct bilateral agreements during this global crisis.

It should also be acknowledged that there has been a considerable sharing of views across the Atlantic via the extensive volume of writing and speeches by policymakers and policy analysts. Although this method lacks the specificity of direct talks, the creation of a common intellectual framework for viewing the crisis and proposed solutions has been a considerable help in ensuring harmonized actions. Similarly, the ability of civil servants to talk together early in the policy process, before sides have hardened their positions and created political barriers to agreement, has clear value.

Given these multiple, overlapping channels of communication and coordination, it would be difficult to blame structural issues as the main cause of the drop-off in effective coordination as the crisis abated. We do make a number of suggestions in this report on how the processes might be improved, but the larger problem seems to be a decline in the political will to work together and reach compromises for common goals as the urgency of the immediate crisis ebbed. However, it must be emphasized that there was an extraordinarily high level of cooperation during the heart of the crisis which was bound to fall off as the urgency faded somewhat and countries encountered the devils that lie within the details of regulatory reform. Further, there are diverging national interests in key specifics of financial regulation, given the substantial differences in financial, economic, and social systems that exist even among the relatively similar countries on the two sides of the Atlantic.

Causes of the Crisis

Knowing how to prevent a future crisis depends heavily on understanding past crises. Explanations of the recent terrible crisis fall into four broad categories:

- Macroeconomic and overarching social and political factors
- Flawed incentives and structures in financial institutions and markets
- Failed government regulation and interventions in the financial markets
- A severely reduced focus on risk after decades of favorable market conditions

Virtually all of the specific factors being blamed are indeed culprits – the argument is generally over the distribution of the blame between them. Clearly, we should fix the known problems, even if there are arguments as to how important each one was. On the other hand, there is a danger of over-reacting if each problem is treated as an extreme danger, given the long list of fixes that are needed. Nonetheless, as discussed in detail in a later section, it would be well worth giving up a little growth in normal years to forestall periodic severe recessions induced by financial crises.

Policymakers, regulators, and market participants on both sides of the Atlantic are focused on trying to fix the financial system and its regulation to prevent or mitigate future crises of the disastrous magnitude of the one from which we are still exiting. The large majority of proposed reforms are based around fixing problems that became evident in this crisis, although a few of the proposals are aimed at eliminating vulnerabilities that caused minor problems this time but could be more important in the future. Unfortunately, using the recent crisis as our guide is not as clean-cut as one might hope, since there are many different interpretations of the key causes of the crisis.[3] For simplicity, these explanations can be grouped into four broad categories:

Macroeconomic and overarching social and political factors. Many observers believe that excessively loose monetary policy, closely coupled with global trade and investment imbalances, caused, or considerably exacerbated, the crisis. Some add fiscal profligacy to the list while still others suggest that politicians may have been drawn to take a benign view of excessive leverage because it provided another way to support consumption by the average worker in a period when wage increases were low.[4]

Although there may be considerable truth in many of these explanations, these factors mainly lie outside the scope of this report, which focuses on reform of financial regulation rather than wider economic policy decisions. However, there is one clear area of overlap, pertaining to various suggested mechanisms to "lean against the wind" by introducing anti-cyclical measures or at least reducing the inherently pro-cyclical aspects of the financial system. These include both the creation of councils of regulators to identify overall developments that could lead to increased risks of bubbles or other financial imbalances and also the establishment of methodologies to increase or decrease capital requirements

3 See Bailey et. al. (2008), Elliott and Baily (2009), Calomiris (2009), Wallison (2010), Rajan 2010.

4 Raghuram Rajan is a noted advocate of the latter point.

It was not just the private sector that sowed the seeds of the crisis, flawed government policies were also at fault.

or loan loss reserves in an attempt to dampen the highs and lows of credit cycles.

Flawed incentives and structures in financial institutions and markets. Policymakers, along with the media and the general public, have focused principally on problems on Wall Street and its counterparts in The City and other major financial centers. Greed, arrogance, and even the stupidity of financial executives has been a major theme in the popular press although more sophisticated analyses have tended to focus less on personalities and more on the incentives that led the financial industry to take excessive risks.

Four sets of incentive problems particularly stand out:

Banker bonuses. Financial executives generally receive the great bulk of their compensation in the form of discretionary bonuses that are tied to annual profits. This creates a financial incentive for investment professionals at these firms to take positions that generate short-run profits in most years even if they are prone to occasional disastrous years in which all the "profits" are given back.[5] Similar incentives affect the CEO and other senior executives, although this is mitigated by their large holdings of company stock.

Excessive leverage/insufficient capital. Top executives in the banking industry were pushed by numerous incentives to take on more asset risk with less capital and more debt. A similar pattern occurred in regard to liquidity management, with cheaper, but riskier, short-term funding sources increasing significantly in importance. As noted, compensation was so high in good years that it discouraged a real focus on the potential for bad years. Further, stock market investors rewarded risk taking while bond market investors did little to push back, partly due to the expectation that the government would not allow failures of major institutions.

Business model focused on origination to distribute. Key parts of the financial markets developed in ways that gave the originators and structurers of credit products the incentive to create packages of investments with considerably more risk than they appeared to have on the surface. For example, the "originate to distribute" model of mortgage banking produces incentives for financial institutions to make loans that are quite risky, as long as the risk is not obvious and they will appear to perform well in the short run. If a lender can make a loan and then package it together with other loans and sell it on in securitized form at a profit, then there is a strong temptation to loosen lending terms in order to maximize the volume on which intermediation profits can be earned. This has been blamed as a key factor driving the vast quantity of excessively risky subprime loans made at the height of the housing bubble. A similar logic led Wall Street to create ever more complex bundles of risky investments that they could sell on in the form of Collateralized Debt Obligations (CDO's) or other securities.

Credit rating agency conflicts. Credit rating agencies have an inherent conflict of interest in their business of rating securitized products which gave them an incentive to hand out excessively high ratings. For decades, the rating agencies have been paid by the issuers of securities and not by the investors who rely on the accuracy of the ratings, since charging investors runs into a severe "free rider" problem because ratings information is easy to obtain and to pass on. This conflict seemed manageable for corporate bond ratings, since the volume of issuance was determined largely by borrowing needs rather than the level of the credit ratings. After all, the agencies had a long-term business interest in maintaining the credibility of their ratings, which is their main selling point. However, the size of the securitization market is heavily dependent on the ability to obtain "AAA" ratings, since a large segment of the investor base will not buy securitizations with lesser ratings, unlike corporate bonds where there is a robust market for all levels of creditworthiness. Therefore, the rating agencies found themselves with a strong financial incentive to issue their top ratings, which would result in a large volume of issuances on which they could charge fees. Many observers believe that the rating agencies became far too lax in their ratings methodologies as a result of this perverse incentive and that Wall Street firms put great effort into taking advantage of, and encouraging, this laxness.

Failed government interventions in the financial markets. It was not just the private sector that sowed the seeds of the crisis, flawed government policies were also at fault. In the most extreme form, some conservative commentators paint the crisis as essentially the result of the bursting of a massive housing bubble in the US which then had disastrous knock-on effects, given the centrality of housing in the financial markets and the economy as a whole. These critics believe that excessive government encouragement of home

5 The compensation question is much more complicated than this. Please see Elliott (2010c) for a primer on financial compensation issues.

ownership and the use of flawed structures to achieve this were the major factors behind the housing bubble.

This extreme version of the argument almost certainly goes too far. It gives too much weight to the housing bubble, while ignoring many other market and economic excesses, ignores private sector incentives unrelated to government actions, and ignores global problems that were unrelated to the US housing bubble. Nonetheless, government incentives in the US were clearly a major contributor to the crisis.

Fundamentally, US government policy has strongly encouraged home-ownership for decades, including through favorable tax treatment of mortgages and of capital gains on house sales. This emphasis became even stronger under Presidents Clinton and George W. Bush, as a result various government actions helped produce ever higher homeownership rates in the US. It is clear, in retrospect, that the rates became unsustainably high. There are, after all, many people whose economic and other circumstances make homeownership too risky or unwise, given the mortgage debt load that would be required.

One of the more powerful ways in which the US aided housing was by allowing Fannie Mae and Freddie Mac to borrow with an implicit government backstop and to do so in an unsound manner, with too little capital and too little diversification.[6] In addition to the risks created for the financial system from having these extreme cases of "too big to fail" institutions, the government directed their activities in a manner intended to ensure that they provided particular help to certain riskier classes of borrowers. Some observers have argued strongly that the way in which this was done was a major support for the unsound lending practices that arose during the housing bubble. Many of these same observers contend that the large banks were forced in a similar risky direction by provisions of the Community Reinvestment Act.[7]

The US government, along with others, is also often blamed for creating serious "moral hazard" issues by appearing to stand behind the largest financial institutions, come what may. If creditors of these institutions believe that they will be rescued by the government if disaster strikes, then they lose much of their incentive to differentiate between riskier and less risky borrowers. The existence of moral hazard would help to explain why banks and other financial institutions were able to lever up and otherwise increase their risk-taking without suffering any serious increase in the borrowing costs demanded by investors. Given the highly levered nature of financial institutions, such a rise in borrowing costs would have been a strong disincentive to take excessive risks, since it would crimp profits significantly.

Finally, poor government regulation and supervision have been identified by many as exacerbating the crisis. Although the private sector must take primary blame for its own mistakes of judgment and excessive risk taking, it is the role of regulators to spot systemic risk arising from these choices. To the extent these problems were spotted, regulators were quite ineffective in stopping the risky actions. For example, regulators did little to force the industry to bolster what turned out to be quite insufficient levels of capital. Nor did they step in to use their authority to halt risky types of mortgage lending. For that matter, important parts of the financial sector were allowed to develop with little or no regulation, such as in the area of derivatives and in the growth of the "shadow banking" sector.

A severely lessened focus on risks after decades of favorable market conditions. Another, complementary, explanation of the financial crisis focuses on the behavioral aspects of finance. All of the entities in the financial and housing markets are run by human decision-making. As such, they are prone to periods of excessive optimism and excessive pessimism. A significant literature has developed studying the ways in which the waves of optimism or pessimism can lead to bubbles and crashes. In this context, it is not surprising that a quarter century of favorable financial market conditions would lead to quite excessive optimism that would be reflected in a near-universal failure to fully observe risks and a tendency to minimize the importance of those risks that were not ignored altogether. It is worth remembering that the US stock market bottomed out in 1982 at a level of 800 on the Dow and went up by a factor of close to twenty times over the next quarter of a century. Most other financial and real estate investments did exceptionally well over that period, as long as they were held through the relatively brief downturns. Similarly, the economy as a whole did so well for much of that period that the term "the Great Moderation" was coined to describe how favorable government policies and benign markets had tamed the worst aspects of the business cycle.

In this favorable environment, it is easy to see why virtually every group became lax about risk. Wall Street and its

6 They were limited by law to operating in the mortgage markets and, indeed, within certain segments of this market.

7 See Pinto (2010), Wallison (2010), Calomiris (2009) among others.

Avoiding periodic severe recessions would be well worth a little slower growth in normal years.

foreign counterparts loaded up on risky investments, regulators and rating agencies remained more conservative than Wall Street but not nearly as vigilant as they should have been, policymakers encouraged or allowed risky actions, and individuals collectively took on considerably too much risk in both the housing and equity markets.

These four broad views of the principal causes of the crisis can lead to quite different policy recommendations. If the core causes were related to bad macroeconomic and "big picture" policy choices, then there is less need for financial reform altogether; rather the focus should be on overall economic management. Similarly, if perverse government interventions in the housing and financial markets were the central cause, then the main lesson is not to intervene in those ways. On the other hand, if incentives in the financial markets were the key drivers of the disaster then there are a large number of specific actions that need to be taken to fix known weaknesses. The final theory, that crises of some magnitude are inevitable in the long run due to human weaknesses, would suggest that measures need to be in place to minimize the frequency and severity of these crises. This latter theory is complementary to the others, primarily underlining the importance of safety measures rather than allocating the blame between financial markets, regulators, and government policymakers.

In practice, governments on both sides of the Atlantic appear to be responding to all of these theories of the origins of the crisis, by attempting to tackle every one of the problems described above. On the one hand, this is clearly the broadly sensible approach. We should fix the known problems, even if there are arguments about how important each one was. On the other hand, there is a danger of over-reacting if each problem is treated as an extreme danger, given the long list of fixes that are needed.

Government leaders need to find the right balance, fixing problems without creating onerous burdens on financial markets that are increasingly critical to the world economy. The regulated financial system could be made extremely safe at the expense of massively increased credit costs and a shift in much of the activity to unregulated financial intermediaries. It is true that some reforms may be essentially "free" because the activities that are discouraged were not producing true economic value. Unfortunately, however, most reforms require finding the right trade-off between increased safety and reduced economic performance during "normal" years. Done right, this would still be a net gain to the economy, since the long-term costs of severe crises are very high, not to mention the short-term devastation of people's lives. Avoiding periodic severe recessions would be well worth a little slower growth in normal years.

Approaches to Financial Reform on Each Side of the Atlantic

This section of the report reviews the actions being taken on each side of the Atlantic to fix the financial system. For each of the key areas, the issues are briefly described, followed by the actions already taken and the proposals under serious discussion in each of the US and Europe. European actions are broken down between EU-level decisions and those taken at the national level.

The US and Europe have both taken major steps forward to fix their financial systems. Areas of regulatory reform include:

- Derivatives
- Securitization
- Credit rating agencies
- Compensation and corporate governance
- Capital and liquidity requirements
- Consumer protection
- Proprietary trading
- Financial taxes
- Hedge funds and private equity funds
- Expanding the perimeter of regulation
- Limitations on the size and scope of banks
- Ability to intervene with troubled financial institutions
- Management of systemic risks
- Reorganization of regulatory bodies
- Accounting rules
- Market integrity

Interestingly, a comparison of the fixes with the underlying problems shows that reforms are more often aimed at problems caused by the private sector than at mistaken government policies or poor supervision. It should also be noted that some of the specific problems, such as those created by securitization structures of egregiously complex nature, have ceased to be pressing issues as investors have simply stopped accepting them.

Matching the regulatory changes or proposals shown here to the underlying causes just discussed reveals an interesting conclusion: reform proposals by the different governments are aimed largely at fixing problems caused by bad incentives for financial institutions and executives or a generally excessive relaxation about financial risks. Fewer of these actions are focused on the larger macroeconomic and social causes or on the mistakes governments and regulators made — they are focused more heavily on the key private sector participants in the crisis.

For example, although the G-20 has called strongly for a rebalancing of world economies and trade flows, little has actually happened except for an attack on budget deficits in the EU that was forced by financial market pressures more

...reform proposals by the different governments are aimed largely at fixing problems caused by bad incentives for financial institutions and executives or a generally excessive relaxation about financial risks.

than G-20 urgings. Similarly, a large majority of US analysts acknowledge that Fannie Mae and Freddie Mac were central to the financial crisis, but proposals to reform those entities are only now being put together and will likely not be adopted for years.

Derivatives

Derivatives are financial instruments whose value is derived from the value of some underlying instrument. For example, wheat futures are a derivative whose ultimate value depends on the price of a physical purchase of wheat at a future point in time, allowing farmers and wheat buyers to hedge their risk that wheat prices might move adversely between now and harvest time. Most derivatives are relatively straightforward products whose principal users are hedging existing risks. However, the financial crisis was significantly exacerbated by the excessive complexity of some newer types of derivatives, the opacity of the markets for many derivatives, the counterparty risks created by the manner in which most derivatives were cleared, and, some would argue, by the excessive use of derivatives such as credit default swaps (CDS) for speculative purposes rather than hedging. Generally, each of these problems ties to bad incentives, (such as the alleged ability of major derivatives dealers to profit from their information advantages in an opaque market), or to an excessive relaxation about risks, (such as made extremely complex structures seem reasonable), or, often, to both bad incentives for the structurers and insufficient risk aversion at the buyers.

Governments on both sides of the Atlantic have focused on improving the derivatives market by reducing counterparty credit risks, increasing the transparency of transactions and positions, and more carefully regulating derivatives dealers.

There is a clear consensus among governments around the world on the need to tackle the opacity of some derivatives markets by pushing as much business as possible onto regulated trading venues and report all trades to a trade repository to improve efficiency and transparency. In broad terms, there is agreement to move standardized derivatives (sometimes more precisely defined as "clearing eligible" derivatives) onto regulated trading venues such as exchanges, Multi-Lateral Trading Facilities (MTF) and the newly defined Swap Execution Facilities (SEFs) and to ensure these trades are cleared using a central clearing house[8] to substantially reduce counterparty credit risk. However, there remains an appropriate use for non-standard derivatives, albeit with a requirement for greater safety margins of capital and collateral. A full range of derivatives allows parties to customize their transactions to the unique risks presented by the underlying deal; limiting parties to standard derivatives increases the likelihood that hedging activities will not perfectly match risks, which may increase transaction costs, reduce liquidity and diminish the proper allocation of capital and risk within the market.

There is a divide between those policymakers and analysts who wish to place limits on the ability of speculators to enter into derivatives transactions and those who do not. The particular focus of the dispute is on CDS, which, in simplest form, are contracts that provide protection to the purchaser if the issuer of a bond becomes insolvent or forces a restructuring of their debt. Those in favor of limitations on speculation compare naked positions in CDS, those where the purchaser does not own the underlying bond, to the purchase of a fire insurance policy on someone else's house. This has particular salience in a panic, where a CDS purchaser would have a financial incentive to commit the equivalent of arson by adding to the panic or by blocking all actions short of an involuntary restructuring. On the other hand, most market participants see naked positions in CDS as playing the same constructive role as short selling of stocks or other financial instruments. They provide liquidity, making the markets function more smoothly, and allow the market price of a bond to better reflect the balance of optimistic and pessimistic views.

US actions

The Dodd-Frank bill makes many important changes to the regulation of derivatives, including:

- Requiring derivatives to be traded on an exchange or Swap Execution Facility, with some exceptions.
- Increasing capital requirements for banks that trade derivatives over the counter.
- Requiring derivatives to be cleared through a central clearinghouse where reasonably possible.

8 In an over the counter derivatives trade, A sells to B and the two parties maintain their obligations to each other until the contract ends, creating credit risk between them. A central clearinghouse steps between the two parties, buying from A and selling to B. As a result, the continuing obligations are between A and the clearinghouse and B and the clearinghouse. A does not need to worry about credit risk to B or vice versa. Instead, the credit risk is now between each party and the clearinghouse. Clearing houses are run so as to be highly creditworthy and they themselves manage their counterparty risk by requiring collateral ("margin") from each counterparty which is increased or decreased daily based on market movements. The daily adjustment considerably reduces the credit risk, although it does not eliminate it. In addition, members of the clearinghouse must also agree to share in losses, if necessary, within certain limits.

- Imposing collateral requirements on counterparties when derivatives are not centrally cleared.
- Forbidding commercial banks from trading derivatives except on foreign exchange or interest rates, although other members of the corporate family may do so.

The US dealt with one thorny issue by providing a wide exemption for commercial users of derivatives who are hedging their underlying business risks. In general, these companies do not have to buy their derivatives on exchanges or regulated trading venues, do not have to agree to central clearing (although they can still choose to insist on it), and may put up whatever collateral is agreed with the other side of the transaction.

Regulators have been mandated to make many important determinations, such as defining which derivatives may still be traded over the counter. The Treasury Department, for example, has been given the authority to determine whether to exempt foreign exchange swaps and forwards from central clearing requirements.

EU actions

The Commission put forth a formal legislative proposal in September of this year building on the derivatives portions of three consultation papers.[9] The proposal is broadly consistent with actions being taken in the US. They include:

- Requiring derivatives to be cleared through a central clearinghouse where reasonably possible.
- Harmonized regulation across Europe of central clearing houses.
- Rules for the interoperability of the many clearing houses spread across different EU countries.
- Mandatory reporting to trade repositories.
- Extension of market abuse rules to derivatives transactions.

As with the US legislation, most non-financial institutions using derivatives are exempted from the various requirements. This is done on a somewhat wider basis than in Dodd-Frank. Derivatives used for a legitimate hedging transaction are excluded completely from the requirements for a non-financial firm. In addition, derivatives trading by these firms beyond that directly related to hedging will still be exempt below certain substantial thresholds.

Later this year, the Commission will present proposals to amend the Markets in Financial Instruments Directive (MIFID). Consultations leading up to this revision have focused on such questions as the right requirements for more trading of derivatives on exchanges or multi-lateral trading facilities and better disclosure and reporting.

Selected European national actions

Germany has established regulation to stop speculators from taking "naked" positions in certain credit default swaps. Forthcoming Commission proposals will also address this, which is likely to mean that national actions such as Germany's would then be aligned with EU action.

Transatlantic tensions

There is a great degree of parallelism in the EU and US approaches. In fact, the Commission's proposal of September 2010 includes the following clear statement on this score:

> "As already indicated above, this initiative is part of a larger international effort to increase the stability of the financial system in general, and the OTC derivatives market in particular. Given the global nature of the OTC derivatives market an internationally coordinated approach is crucial. It is therefore important that this proposal takes into account what other jurisdictions intend to do or have already done in the area of OTC derivatives regulation to avoid the risk of regulatory arbitrage.
>
> In this context, this proposal is consistent with the recently adopted US legislation on OTC derivatives, the [Dodd-Frank] Act. The Act has a broadly identical scope of application. It contains similar provisions requiring the reporting of OTC derivative contracts and the clearing of eligible contracts. Furthermore, it puts in place strict capital and collateral requirements for OTC derivatives that remain bilaterally cleared. Finally, it puts in place a regulatory framework for trade repositories and upgrades the existing regulatory framework for CCPs. Similarly to the Commission's proposal, the Act foresees the further elaboration of a number of technical rules."

The high degree of parallelism arose in significant part because there has also been a great degree of consultation across the Atlantic. Policymakers in both the US and Europe clearly recognize the importance of getting derivatives

9 These include consultations on the Market Abuse Directive, derivatives market infrastructure, and short selling and credit default swaps.

regulation right and of ensuring that the global markets for these products function smoothly.

That said, this is too large, important, and complex an area for there to be an absence of transatlantic tensions. For example, the US has been concerned that various infrastructure operations critical to these markets, such as the clearing houses and trade repositories, may be regulated in a way that entrenches national champions in various European countries or puts EU financial institutions in a privileged position compared to US-based organizations. It appears that the final Commission proposal essentially avoids such problems, but it will not be entirely clear until critical technical details are worked out. For its part, the US requires that collateral for US customers be held in the US, a requirement that could be viewed as a modest trade barrier, while the Commission is not proposing a parallel requirement. Other issues could arise as the details are worked through, but the signs are quite hopeful for transatlantic harmony is this area.

Securitization

Flawed securitizations contributed to the financial crisis in three main ways. First, the separation of origination and ownership functions sharply reduced the incentives of the original lender to maintain conservative underwriting standards and thereby helped lead to risky loans that created large investment losses for the buyers of the securities. Second, an excessive reliance by investors on credit ratings combined with lax procedures at rating agencies to encourage investment banks to invent overly complex, opaque securities that allowed the securitization of yet lower quality loans. Third, that complexity and opacity made it very difficult to value the securities once the market lost confidence in their creditworthiness, substantially contributing to the market panic about the viability of important financial institutions. The problems with securitization that arose in the crisis generally fit snugly with theories that emphasize bad incentives and/or an excessive decline in risk aversion. In addition, the underlying problems with the housing market that damaged so many securitizations have causes that extend into broader macroeconomic and social areas and into the realm of failed government interventions.

This is another area where there is a broad consensus globally about policy goals. The focus has been on requiring better information to be provided to buyers, obliging buyers to demonstrate due diligence, requiring the retention of a portion of the securities by the issuers ("skin in the game") to provide more incentive to maintain underwriting standards, and enhancing regulation of rating agencies, described separately below. In addition, as with derivatives, financial markets have essentially stopped buying the overly complex forms of securitizations and are unlikely to resume purchases in any large volume.

US actions

The Dodd-Frank bill increased information requirements for securitizations, required issuers to retain 5% of the risk on securitizations (except on high-quality mortgage securities), and placed new regulatory and legal burdens on rating agencies, as described later. Many of the important details have been left to regulators, such as when a mortgage security will be exempted from the skin in the game requirement and what specific data issuers will have to provide on securitizations.

EU actions

The EU has adopted legislation providing for better disclosure of information by issuers, the requirement for buyers to demonstrate their due diligence or face higher capital charges, and the requirement for issuers to retain 5% of any securitization. Further, it has created substantial levels of regulation on credit rating agencies that would affect securitizations, as explained in the next sub-section.

Transatlantic tensions

This is another area of relatively low conflict, with any tensions arising primarily from fairly technical arguments.

Regulation of credit rating agencies

Credit rating agencies have taken much of the blame for the spectacular failure of major sections of the securitization market. Buyers of securitizations relied excessively on credit ratings, often to the point of failing to do their homework adequately, or at all. Investors particularly valued the top (AAA) rating, which they generally viewed as signifying the same very low level of credit risk as represented by AAA-rated corporations. This over-reliance became very dangerous when combined with conflicts of interest that gave rating agencies the incentive to use methodologies that were too lax, plus the simple fact that the securitization market for many types of loans was quite new by historical standards and therefore not as well understood as corporate bond markets were.

Several policy actions are available to tackle the basic conflict of interest created by the fact that issuers of securities, who want high ratings, are currently the ones who pay the agencies. Some in Europe showed interest in establishing a government-affiliated rating agency to provide non-conflicted ratings, although this proposal has dropped away in the face of substantial opposition. The US is experimenting with the idea of randomly assigning the first rating agency for a new security. Beyond trying to tackle the conflict of interest directly, the US has substantially increased the legal liability facing the rating agencies, in hopes of encouraging higher standards out of the rating agencies' own self-interest. Further, the US is trying to remove regulatory and legal mandates for investments to be at certain rating levels from one or more of the major rating agencies. Beyond those actions, the US, broadly speaking, is trying to reduce the importance of credit ratings, as outlined below.

US actions

Dodd-Frank changed the legal liability standards for rating agencies to make them more like the liability for securities underwriters, although without moving all the way to that high standard. It also calls for the random assignment of the rating agency which provides the initial rating for a new security, unless regulators find a better solution to the conflict of interest problem in the near-term. Finally, as noted, credit ratings are being removed from legal standards for investments, wherever possible.

EU actions

The EU established new rules for the rating agencies through legislation that passed in April 2009. Implementation is targeted for September 2010. In June 2010, the European Commission proposed amendments to the 2009 rules which would centralize the EU's oversight of rating agencies in the new European Securities Market Authority.[10] (This would be parallel to the SEC's central authority over rating agencies in the US.) This authority would have the power to request information, launch investigations, and perform on-site inspections. Further, all issuers of securitizations would be required to provide the same information to all rating agencies, to make it easier for those other agencies to provide their own ratings. (This information provision feature may prove moot as it is not clear that rating agencies will be looking to provide unsolicited, and therefore unpaid, ratings.)

Given the differences with the US approach, which is less interventionist, the EU is exploring how to create a framework for "equivalence" for US and Canadian rating agencies, or for those of any other nation where this is relevant.

Selected European national actions

France's National Assembly passed a bill in June that gives its securities regulator oversight powers over rating agencies. The bill is awaiting Senate action.

Transatlantic tensions

The US and EU approaches differ substantially here. The US added relatively light new requirements on the agencies, combined with attempts to reduce the regulatory use of ratings. On the other hand, the EU imposed a number of specific requirements that will affect day-to-day activity by these firms.

The big transatlantic issue is that the major rating agencies are global, operating at least as much in the US as in Europe. In addition, the securities being rated are usually offered globally or are traded globally after initial issuance. Therefore, restrictions placed by the EU need to be consistent with US legal and market requirements and vice versa, otherwise the agencies will effectively be forced to deal with contradictory legal mandates. As noted, this could be addressed to a large extent by the EU granting equivalence to US and Canadian regulated rating agencies, without requiring exactly the same regulation.

Compensation and corporate governance at financial institutions

Most observers believe that perverse compensation incentives, combined with lax corporate governance, significantly contributed to the financial crisis. There is a broad consensus that the minimum level of reform must be to ensure that compensation structures do not unnecessarily encourage excessive risk-taking. Policymakers around the world are mandating or encouraging the deferral of a greater portion of bonuses, an increase in the part of the deferrals which is put into company stock, and the creation of mechanisms to "claw back" bonuses that, in retrospect, were based on overly optimistic accounting or excessive risk-taking.

Policymakers are generally supplementing this with moves towards greater transparency in corporate governance, particularly compensation decisions. For example, the US

10 Much of this paragraph is drawn from an "Alert Memo" from the law firm of Cleary Gottlieb, dated June 11, 2010, which summarizes the EC's Communication of June 2010.

is requiring that firms allow their shareholders a non-binding vote on executive compensation processes.

Thus far, policymakers have chosen not to place absolute limits on compensation of financial executives, despite strong popular support for such actions.[11] In fact, with the exception of a one-off tax in the UK, governments have shied away from taxing "excessive" bonuses, much less prohibiting them. Most policymakers are not confident that they know how to set appropriate limits and worry that they will severely damage their nation's financial industries if they scare away the top talent.

US actions

The Federal Reserve has issued guidelines for banks on best practices in compensation and has indicated already that a number of banks will need to change their existing approaches or be forced to do so by the Fed.

The FDIC has proposed a modification of its deposit insurance premium rates to increase those rates for banks which encourage excessive risk taking through their compensation programs.

Dodd-Frank mandated non-binding shareholder votes on compensation approaches and made some other changes to how Boards of Directors operate.

EU actions

The revised Capital Requirements Directive (CRD 3), which was passed in July 2010, includes very significant remuneration restrictions for financial institutions operating in the EU, particularly but not exclusively banks. The remuneration rules will take effect in January of 2011. The Parliament essentially insisted on much more specific rules than had been proposed originally by the Commission, in exchange for ratifying the entire CRD 3, which the Commission and Council viewed as containing critical revisions to capital requirements for trading assets and more complex securitizations.

The new rules limit bonuses for bankers to an amount "proportional" to salaries, with the details of this test to be determined by the Committee of European Banking Supervisors later in 2010. No more than 30% of the bonus funds can be paid up-front in cash, a figure reduced to 20% for senior bankers. Between 40 and 60% of the bonus must be deferred for a minimum of three years and must be subject to a clawback if they were based on investment performance that was reversed during the deferral period. At least 50% of the total bonus must be deferred in a form that would count as contingent capital or represents company shares. Limitations on bonus amounts for bailed out firms were added as well.

The European commission presented two recommendations on remuneration principles in April 2009, followed in June 2010 with a much more sweeping "green paper" on "Corporate governance in financial institutions and remuneration policies" with comments requested by September 1, 2010. Some of this paper's proposals are essentially subsumed in the provisions included in CRD 3, but most would be complementary to these actions. These cover a wide range of issues about the roles of Boards of Directors, external auditors, internal risk management personnel, supervisors, and the nature of appropriate remuneration policies.

Selected European national actions

The UK imposed a one-off tax on bankers' bonuses above a certain level for last year's bonuses. This appears not to have resulted in much of a reduction in bonuses and therefore served in the end as a revenue source more than a behavioral modifier, whatever the original intent.

Transatlantic tensions

The EU is putting in place substantially more restrictive remuneration policies than is the US. In essence, the US approach is to use regulatory pressure to ensure that banks set compensation policies that follow best practices as much as possible and, at a minimum, do not encourage excessive risk-taking. The EU, on the other hand, is aiming to establish hard and fast rules that will be applied across the board and which are significantly more stringent than the US best practices. The European Parliament has been the strongest proponent of this, perhaps most directly reflecting the high level of voter anger about banking remuneration.

There is a real possibility that US, or even Asian, remuneration packages will become significantly more attractive to top bankers and traders than those available to workers in The City or other financial centers in the EU. This could lead to a shift in financial market share away from the EU as other markets find it easier to attract and retain top talent. Arguably, this is a form of economic competition that is healthy, allowing different nations to take alternative approaches which eventually allow global best practices to develop. However,

11 A few US financial institutions that had received extraordinary aid under TARP were forced to obtain approval from the US government for the specific compensation levels of their top executives. However, these were determined on a case by case basis and not subject to an absolute limit.

it seems quite possible that excessive differences between the approaches on the two shores of the Atlantic could create unnecessary disruptions of the existing financial system.

Capital and liquidity requirements/Basel III

There is a strong consensus that banks must hold higher levels of capital and that more of the capital must be in the strongest form, tangible common equity.[12] In addition to capital, banks clearly need to hold more liquidity than they did before the crisis, in order to provide assurance that they can pay their bills and repay maturing debt even in the middle of a market-wide crisis of confidence. Creating more stringent capital and liquidity requirements would mitigate a number of causes of the crisis that fell into the general categories of perverse incentives (since higher requirements would reduce the ability to over-lever) and a general apathy towards risk, which had created a tolerance for excessively low capital and liquidity levels.

With a few exceptions, stricter capital and liquidity requirements are being negotiated through the "Basel III" process, run by the Basel Committee on Banking Supervision (Basel Committee) with assistance from the Financial Stability Board (FSB) and the Bank for International Settlements (BIS). In addition, tightening of capital rules for trading positions at banks have already been agreed through a similar process coordinated earlier by the Basel Committee.

The international community has recognized for several decades that it is important for bank capital standards to be harmonized around the world. Capital standards may be the single most powerful tool to protect nations from a banking crisis, since capital represents the buffer available to absorb losses due to mistakes or bad luck, however these arise. At the same time, capital is expensive, so regulators must balance considerations of safety against the desire to maintain affordable lending rates. Sometimes regulators in one country will set lower capital standards, either in principle or in practice, giving their industry a substantial competitive advantage against other banks around the globe. The first set of capital standards agreed by the Basel Committee, known now as Basel I, was established in 1988 in part to counter what was seen as predatory actions by Japanese banks that appeared to be taking advantage of lower capital requirements. These provisions were considerably expanded and comprehensively refined and revised a few years ago to fix a number of flaws that had become apparent. The revised rules are known as Basel II and have become the law of the land in most financial centers. Some additional changes were put in place after the financial crisis, in particular to substantially increase the capital set aside against trading activities. These revised rules are sometimes referred to as Basel IIa.

The Basel rules are voluntary standards agreed by the nations participating in the Basel Committee, plus many other nations that choose to adopt the same rules. Since they are voluntary, they do not take effect unless national regulations and laws are altered as needed and many nations choose to modify the international rules to at least some extent when they implement them.

The Basel III proposals are too complex to be fully summarized here, and some important decisions have yet to be made, but the key elements are as follows[13]:

Total capital levels will be increased. The Committee recently recommended an increase in the minimum level of qualifying common equity from 2% of risk-weighted assets to 4.5% with an additional 2.5% conservation buffer. Limitations on dividends and compensation levels will apply for those banks that achieve the 4.5% common equity level but do not have the full conservation buffer. Regulators may choose to reduce this buffer in the event of a financial downturn, in order to dampen the effects on the economy. Total "Tier 1" capital, which includes some softer forms of capital alongside common equity, will need to be held at an 8% minimum level. These various new capital levels will be implemented over a six-year phase-in period starting in January of 2013.

More of the capital will have to be in the strongest form and some weak forms of capital will no longer count at all. Tangible common equity will become a higher proportion of the minimum requirements; certain weaker forms of capital, such as traditional subordinated debt instruments, will be eliminated from capital calculations, while some others will continue to count as capital.

Risk-weighted asset calculations will be tightened. The Basel accords have always relied on an adjusted calculation for the size of a bank's assets which weights each type of asset by its riskiness. These risk weightings will generally be raised, due to a large variety of technical changes, which means banks will appear larger and need commensurately more capital.

12 See Elliott 2010b for a primer on bank capital.

13 See Elliott 2010d for a primer on the Basel III proposals.

A "leverage ratio" will be added, over time. In addition to the core tests of capital in relation to risk-weighted assets, a new simpler test will be added. A minimum level of capital to total assets, without risk-weighting, will be introduced as a "safety net" to ensure that the risk-weightings are not distorted by mistakes or gaming of the system. The US banks are already subject to such a test, making this a lesser adjustment for them than for the European and Japanese banks which have built themselves taking careful account of the Basel risk-weightings. The leverage test will be phased in, becoming truly binding in 2018.

New liquidity tests will be added. The previous Basel accords did not establish globally harmonized liquidity requirements, an aspect that is now perceived as a clear weakness, in light of the strong role of illiquidity as a factor sapping confidence, indeed creating panic, during the financial crisis. However, it proved too difficult to design these new tests in an acceptable form in time for implementation alongside the other Basel changes. Instead, the new liquidity tests will be implemented starting three and six years after the other Basel III measures begin to apply and they may be refined or even substantially altered before then.

The Basel Committee, in consultation with the BIS, FSB, and IMF, has already announced most of the key agreements necessary to flesh out the original proposals. However, a few items remain to be decided prior to the Seoul meeting of the G-20 heads of government in November of 2010.

US actions

Dodd-Frank largely left the issue of capital levels to the regulators, to be coordinated through Basel III. However, at the instigation of Senator Collins, several important steps were taken on capital. First, the existing minimum regulatory capital ratios must be treated as minimums going forward, serving as a floor. This may not have much effect, given the clear intent in Basel III of substantially raising the requirements. Second, certain softer forms of capital, known as "trust preferred securities," will cease over time to count as forms of capital for all but the smaller banking groups.

EU actions

The EU is coordinating closely with the Basel Committee, with the clear intent to embed the ultimate Basel III proposals in a new Capital Requirements Directive, as it has done with Basel II and with the Basel IIa changes to capital requirements for trading books. (The latter was included in a new Capital Requirements Directive, known as CRD 3, which was passed in July 2010. The capital changes will be effective at the end of 2011.)

Transatlantic tensions

One of the continuing sources of friction in transatlantic discussions of financial reform is that the US never did implement Basel II for its commercial banks, despite having been a very active participant in the negotiations to create that accord. (The SEC did adopt Basel II for US investment banks, but this ended up having the unfortunate side-effect of encouraging additional leverage at these institutions as they headed into the crisis.) However, the Obama Administration has assured its partners that Basel III will be implemented in the US in a timely manner and this does appear likely to be the case, given the quite different political circumstances now compared to the time when Basel II was debated in the US.

Policymakers and policy analysts on both sides of the Atlantic generally support the basic goals of the Basel III proposals. However, there are some serious transatlantic differences in how best to gain these benefits. For example, the US strongly supports the addition of the simple leverage test in order to ensure that banks do not have excessive levels of total assets even if these assets are invested in categories that are viewed as relatively safe. This view stems from skepticism about the ability and willingness of banks and regulators to precisely assess asset risk. Opinion within the EU is more split, but some nations have grave doubts about the application of a strong leverage test and fear that it could cause significant economic harm if it encourages European banks to shrink their balance sheets unnecessarily and therefore contract their credit provision. They want the leverage test to be used as one non-binding guideline or, failing that, for any binding limit to be set quite low. The compromise announced in July by the Basel Committee puts off the introduction of the leverage test and sets it tentatively at a level that appears low to the strongest advocates of the leverage test, but will still make it a universal test.

There are also arguments about the new steps to reduce the role of softer forms of capital, which, as a general matter, comprise a larger portion of capital at European banks, particularly in certain countries, than is true in the US. Here, too, compromises were reached in the July and September Basel Committee meetings, including the agreement to include some of the softer forms up to relatively low limits and to allow government support to count for a long transitional period.

The differences in opinion matter because it is critical that the final Basel III accord strikes the right balance between safety and economic efficiency and is applied globally in a relatively uniform manner that minimizes the risk of damaging regulatory arbitrage. The compromises reached in Basel appear quite hopeful in terms of uniform application on the two shores of the Atlantic, but there is still room for differences to develop. Some technical decisions remain which could matter, plus the Basel agreements do not take effect until enshrined in national law and regulation. There are likely to be some divergences between how the Basel III accord is implemented in various countries.

Consumer protection

A major problem in the US crisis was that many consumers were offered mortgages and other loans that were inappropriate for their circumstances and often not understood by the borrowers. In some cases, mortgage brokers, the initial lenders, appraisers, and sometimes the borrowers themselves were complicit in legally or morally fraudulent activities. For example, many mortgages were made where borrowers were allowed to assert their income and asset levels without having to provide documentation, a practice which practically begged for fraud to occur. In other instances, borrowers were lured with very low “teaser” mortgage rates that were bound to increase sharply after a few years, rendering the loan insupportable at the borrower’s current income level. This created an almost inevitable default, unless house prices rose to allow a refinancing, perhaps with a new teaser rate.

Although they played a lesser role in the crisis, consumer advocates have also been quite concerned about perceived abuses related to credit cards and to bank fees of various kinds.

As with many of the other areas of reform, the issues around consumer protection mostly pertain to bad incentives and a failure to pay adequate attention to risk. Of course, those analysts focused on larger social issues and perverse government interventions as causes of the crisis will find some support here as well, as it is possible that government regulation and enforcement would have been tougher if there had not been a strong desire to “democratize” credit and also to increase homeownership.

Consumer protection problems were clearly a more major issue in the US than in Europe, which probably explains why enhanced consumer protection was a major part of Dodd-Frank, but has not received the same emphasis in Europe. In addition, consumer protection reforms in Europe would take place at the national level, rather than at the level of the EU.

US actions

Dodd-Frank created a new Bureau of Consumer Financial Protection (BCFP) that has taken over most of the consumer protection functions that previously resided within the safety and soundness regulators such as the Federal Reserve Banks and the Federal Deposit Insurance Corporation (FDIC). These regulators were perceived to have done a very poor job in the run-up to the crisis, which is a principal reason this was taken out of their hands going forward. In addition, the BCFP has been given quite broad powers to tackle “deceptive”, “unfair”, and “abusive” practices by financial institutions. States are being encouraged to aid in this in two ways. First, they are required to make their own regulations at least as strong as the national ones (although this may not always be possible to judge objectively) and state attorneys general are given the authority to bring cases to enforce the federal consumer protection mandates, which is a highly unusual extension of state prosecutorial powers into federal law.

The ultimate effects of the creation of the BCFP will depend heavily on choices made by that bureau, which is one reason why there is already a major political fight over who will be the first director.

EU actions

Consumer protection in this area generally does not fall in the remit of the EU, but is governed at national level.

Transatlantic tensions

There do not appear to be any major conflicts in this area. EU financial institutions with operations in the US would have to obey US consumer laws, which differ from those in Europe, and the same would be true in the other direction. However, this is already the case and financial institutions seem able to manage the process of obeying the relevant laws and regulations. So far, proposed consumer protection actions do not seem likely to generate significant trade barriers.

Proprietary trading and investments at banks

Commercial and investment banks lost large sums of money on their investments during the financial crisis, which had knock-on effects on the rest of the financial system by contributing to doubts about the solvency of the banks. A portion of these losses came from "proprietary investments". This is an ill-defined term that attempts to describe speculative activities taking place at banks that are not closely tied to serving customers in some manner. It is relatively easy to be sure that an activity is proprietary in this sense when it takes place in a unit that a bank has denoted as such. However proprietary investment also takes place within most parts of a bank that make investments. Unfortunately, it can be extremely hard to decide what is proprietary and what is not. For example, regulators want banks to maintain substantial investment portfolios for the purpose of covering unexpected liquidity needs. Such investments should generally be highly creditworthy and quite liquid, so that they can be sold quickly at a price near their book value if funds are needed. In the run-up to the crisis, much of the liquidity portfolios at banks came to be invested in AAA-rated asset-backed securities, which were perceived to be safe and liquid. They were attractive, since they paid interest rates significantly higher than high-quality corporate bonds. Should these have been viewed as proprietary investments rather than liquidity investments? There is no objective answer to this question.

In the US, there was a strong movement to limit proprietary investing and trading which ultimately resulted in inclusion of the "Volcker Rule" in Dodd-Frank, as described below. In Europe, there has been less interest in following this path, in large part because of the well-established tradition of universal banking. Concerns about potentially excessive investment risk are instead dealt with through the capital and liquidity requirements in Basel II and III and through supervisory oversight.

US actions

The Volcker Rule provisions in Dodd-Frank require commercial banks and their affiliates to cease their proprietary trading and investing activities over a period of several years, but leaves significant leeway for regulators to decide what is meant by "proprietary." One area where the law is fairly clear is that banks are forbidden to continue owning significant stakes in hedge funds and private equity funds and are not allowed to provide major support in other ways to these funds, including using the group name with their funds.

EU actions

There have been no significant EU actions to limit proprietary trading and investment, other than sharp increases to capital requirements for trading books resulting from Basel IIa and prospective changes under Basel III.

Transatlantic tensions

There are concerns among European banks that the technical implementation details on the Volcker Rule may inadvertently limit their operations outside the US, while US regulators have some concern that non-US affiliates of US banks may end up inappropriately taking on proprietary trading exposures. However, these concerns do not rise to the level of the major transatlantic conflicts in other areas and can hopefully be resolved by intelligent implementation of the rules.

Special taxes on financial institutions or markets

Many observers, and some governments, have suggested special taxes related to the financial system. Multiple reasons have been given for special taxation, including:

- Recoupment of support given to the financial system
- Raising funds for potential future support
- Deterring excessive bonuses
- Discouraging speculative trading
- Shrinking a bloated financial sector

In addition, two generally unstated reasons clearly are major factors as well: governments need money and banks are wildly unpopular at the moment, fueling a public desire for punitive actions.

The two major types of taxes under consideration are direct levies on financial institutions and financial transactions taxes that apply to purchases and sales of financial instruments. The latter are particularly aimed at reshaping the financial system to have less speculation and fewer short-term trades in general.

US actions

President Obama has proposed a "Financial Crisis Responsibility Fee" of 0.15% on the size of a bank's non-deposit liabilities. The size was chosen to bring in roughly enough over ten years to recoup the taxpayers' likely

ultimate loss on the Troubled Asset Relief Program, which was estimated at the time of the fee proposal as being about $90 billion. It is unclear whether Congress will pass such a fee. If it does, there is a high probability that the details, and perhaps amount, will be altered substantially.

EU actions

The EU is in discussions on financial taxation, but has not thus far put forward a concrete proposal.

Selected European national actions

Britain, Germany, and France have indicated the intention to add special taxation for the financial sector. The UK has specifically put forward a plan to raise about 3 billion pounds a year for the general coffers. Germany just proposed legislation for an industry-funded system for an orderly restructuring and – if necessary – resolution of failing credit institutions. France is planning to add a tax, but has not settled on the exact approach.

Transatlantic tensions

There are considerable differences in view among the different governments around the world, but there is not a clear US versus EU conflict on this issue.

Alternative investment managers

Hedge funds, private equity funds, and other "alternative" investment vehicles have been regulated only very loosely until recently. In the US, securities regulation has historically focused heavily on protecting retail investors while intervening much more minimally in transactions involving institutions or wealthy people. Hedge funds and private equity funds have been established in a manner that keeps them exempt from most securities regulation by marketing only to limited numbers of sophisticated investors, defined primarily by their institutional status or wealth. Alternative investment managers were usually quite lightly regulated in Europe as well, for broadly similar reasons.

Alternative investment managers were not generally major players in the recent financial crisis, except sometimes through their associations with larger financial institutions, such as was the role of the Bear Stearns hedge funds that helped start the disastrous decline of that institution. Hedge funds did lose large sums of money on many occasions, as other investors did, but those losses seldom had significant systemic implications. In that sense they mostly functioned as they were supposed to do – they were investment vehicles for people who could afford to lose the money.

However, many policymakers are concerned about these investment vehicles for several reasons. First, tighter regulation of investment banking activities raises even more strongly the possibility that hedge funds will take on banking-like roles with considerably less regulation than faced by banks. One major hedge fund, for example, was already known before the crisis, (and the resulting increased regulation), to be interested in taking over the more profitable aspects of the banking industry while preserving its status as a lightly regulated set of hedge funds. For instance, it and some other hedge funds were already acting much like securities underwriters in certain offerings by agreeing to buy significant chunks of Initial Public Offerings at a discount, with the understanding that they would sell much of their positions on to other investors.

Second, the sheer size of these funds and their increasing interconnections with regulated financial institutions creates the potential for one or more funds to become systemically significant, meaning that it could be the domino knocking over other important parts of the financial system in the event of a disaster. If leverage in the system could again be a major problem, it seems odd to supporters of greater regulation to ignore the role of highly levered hedge funds. Similarly, if incentive structures that encourage excessive risk are an issue, there is an argument for regulating hedge funds carefully, given their historic fee structures which give a clear incentive for managers to take substantial risks.[14]

Third, policymakers in some European countries have been concerned for some time that hedge funds and private equity funds encouraged unfortunate social trends, such as reductions in the size of workforces.

US policymakers very largely hold to the view that hedge funds represent relatively low systemic risk while European policymakers tend to be much more concerned about the risks described above.

US actions

Under Dodd-Frank, the US is maintaining a relatively light touch. Large and medium-sized funds will have to register with the SEC, but only by providing relatively simple information. The very largest fund groups could potentially be determined to be systemically important, in which case the Fed and other regulators would be able to apply much

14 In addition to their base fees, many funds charge 20% of the annual profits above an initial hurdle rate and do not return those incentive fees if losses occur in future years, although they do have "high watermark" tests that mean new incentive fees are not earned until such losses have been recovered.

stricter regulation. However, it appears unlikely that this would occur anytime soon or very frequently if it does occur. There will also be better tracking by regulators of information about these funds' activities to the extent that they engage in derivatives or other trading that is affected by the moves towards greater transparency, but this is simply an effect of the larger regulatory effort and not aimed at hedge funds.

EU actions

The EU, many of whose members were already suspicious of these fund managers, has proposed substantially increasing its regulatory control. The Commission proposed a draft law in 2009, which was followed in May 2010 by proposed revised versions from the Parliament and the Council. There are significant differences between the Parliament's and Council's version, but both would retain the Commission's original intent to create substantial new regulatory controls on hedge funds and, to a lesser extent, private equity funds. Requirements would be created in regard to:

- Valuing fund assets and liabilities using independent parties
- Depositing funds and securities with regulated financial institutions
- Avoiding the encouragement in remuneration procedures of excessive risk-taking
- Disclosing substantially more information to investors, regulators, and other stakeholders
- Abiding by leverage limits set by national or EU regulators
- Marketing to investors in the EU only according to new EU limitations
- Marketing non-EU funds to EU investors according to strict new limits

Transatlantic tensions

The US and the EU are taking fundamentally different approaches to regulating hedge funds and private equity funds. This disparity becomes a transatlantic issue because the US is the home of many of the largest global alternative investment management groups. US firms and policymakers fear that the EU restrictions may make it quite difficult to raise money in Europe. US firms would have two avenues to marketing broadly in the EU. First, they could submit to EU regulation. Unfortunately, many US funds managers view the EU regulations as imposing unacceptable burdens on alternative funds managers, including both leverage and disclosure requirements that are seen as too harsh. In addition, there may be some technical difficulties in complying. Second, US funds managers could obtain permission from one EU country to market their funds and then use an EU "passport" to market to other EU countries.

However, many US observers believe that the proposals would make it extremely difficult to actually use the "passport" route. Failure to fix such problems could create barriers to trade in these management services. For their part, the EU Parliament and Council argue that the restrictions in their proposed versions of the law are reasonable and workable. Compromises are currently in the works that may solve the transatlantic conflicts, but it will be difficult to judge until the work is completed.

Expanding the perimeter of regulation

Core financial institutions in the US and Europe are regulated much more closely than general corporations and receive quite significant government support, such as access to deposit insurance funds and to the central bank as lender of last resort. Therefore, a key issue in any major revamp of financial regulation is to determine where to place the perimeter of financial regulation. The clear movement after the recent crisis, as is usually the case after any major financial crisis, is to expand the perimeter out further. For example, investment banks were in a middle ground in the US, where they did face significant regulation, but were generally much freer to operate as they wished than was true of commercial banks. In exchange, they were generally not viewed as having access to the Federal Reserve as a lender of last resort. This differentiation proved unviable in the last crisis and the large investment banks have all become subsidiaries of commercial bank holding companies. Similarly, alternative investment managers are facing increased regulatory burdens, particularly in Europe. The US goes further and provides catch-all authority for regulators to pull certain institutions inside the perimeter of close regulation even if they are not technically organized in a way that would subject them to this normally.

US actions

Dodd-Frank includes the following:

- The Financial Stability Oversight Council, advised by the Fed, is authorized to subject systemically important financial institutions that are not banks, or even bank holding companies, to regulation quite similar to that

imposed on systemically important banks. This requires a super-majority vote.

- All systemically important financial institutions are to be held to higher regulatory standards. The form and degree of this is largely left up to the regulators.
- Institutions that converted to bank holding companies in response to the crisis, such as the parent companies of the major investment banks, may not exit the Fed's oversight by converting to another institutional form. (This is referred to colloquially as the "Hotel California" clause, as an homage to a rock song of some years ago that described a hotel which you could never leave.)

EU actions

None of note to date. In general, EU countries have not had financial institutions with large market shares that were not banks, insurers, pension funds or other closely regulated entities, with the exception of alternative investment management companies, described earlier.

Transatlantic tensions

There do not appear to be significant transatlantic conflicts in this area.

Limitations on the size and scope of financial institutions

There has been a great debate around the globe about "Too Big to Fail" (TBTF) financial institutions, as well as about the overall size of the financial sector relative to the economy. Virtually everyone agrees that it is unfortunate that the largest financial institutions are too big for governments to allow them to fail in the middle of a severe financial crisis, because the blow to confidence and the direct impact on other financial institutions would be too dangerous to risk. However, there are a wide range of views about how best to eliminate or mitigate the problem.

One way to ameliorate the problem is to make it easier and less painful to resolve a troubled financial institution. This complex subject is discussed in its own sub-section below. Other proposals include: putting an absolute limit on the size of financial institutions; empowering regulators to break up institutions whose size imposes excessive systemic risks on a case-by-case basis; and limiting the range of permitted activities to reduce the size and riskiness of banks.

The US and European responses to this problem vary quite significantly. A key reason for this is that the largest US banks are substantially smaller as a percentage of the total system than is true for individual European nations, despite the continuing consolidation of the US industry. This pulls in two different directions, of course. On the one hand, this has lessened US policymakers' incentives to impose size limitations compared to the pressure on the Europeans, since limits are less critical in a less concentrated market. On the other hand, imposing meaningful size limitations in the US would be considerably easier than in individual European countries where the largest banks dominate. These US and European differences are enhanced by the much greater importance of banks in the European financial system, compared to the US. US banks are a significantly smaller part of the economy, largely due to the existence of a robust capital market which serves as an alternative source of credit for large corporations. Europe is developing stronger capital markets, but remains far more bank-centric.

US actions

Dodd-Frank modestly tightens existing limitations on the size of commercial banking groups. Similar to existing rules, there will be a severe limitation on the ability to grow by acquisition once a bank surpasses a 10% limit on their liabilities as a portion of the total banking system. However, those that are already larger than this are not being reduced in size and they and others are permitted to grow organically. In addition, the regulators are given the power to force a systemically important financial institution to divest activities which are believed to contribute excessive systemic risk. In practice, though, this provision appears likely to be used only in extreme circumstances.

There were proposals to reimpose some of the Glass-Steagall limitations as a way of re-separating investment banking and commercial banking activities, but policymakers generally concluded that this was no longer feasible in the modern financial system. (For example, the difference between a "loan" and a "security" has become extremely blurry, hampering one of the key ways of distinguishing between investment and commercial banking.) Instead, a more limited form of division was imposed through the Volcker Rule, described earlier, which will force banks to cut back significantly on their proprietary investment activity.

EU actions

The EU has not directly addressed this with any legislative proposals. However, some of the regulatory changes that are being discussed to deal with troubled or potentially troubled institutions might indirectly lead to actions in this area. In particular, the "living wills" concept discussed below could conceivably lead regulators to force a divestiture of certain activities if they appeared to create too much risk.

Selected European national actions

The UK has created a commission to examine the problem of institutions that are "Too Big to Fail". They will consider size and scope limitations as part of the range of options.

Transatlantic tensions

Should the EU, or a major component country such as the UK, decide to deal with "Too Big to Fail" concerns by breaking up their largest banks or placing severe restrictions on their activities, it could create a species of regulatory arbitrage by spurring a shift in market share to other financial centers. (This, of course, is the opposite of traditional regulatory arbitrage where one country gains market share by setting soft rules that appeal to financial institutions.) US opponents of the Volcker rule contend that this will happen in the opposite direction as proprietary trading activities move to European banking centers. In addition to this overall point, there is scope for quite substantial technical problems, which could in the worst case create some trade barriers, to the extent that banking activities are limited in one jurisdiction but not in others.

Ability to intervene or resolve troubled financial institutions and markets

The crisis demonstrated that many countries did not have well-designed sets of tools for regulators to intervene when systemically important institutions became endangered. For example, the US did have well-developed powers to intervene with commercial banks, but lacked any real ability to step in when investment banks or non-bank financial institutions hit the wall. This proved very troublesome when Bear Stearns, Lehman, and AIG hit the wall. (Of course, it must be noted that there is a limit to what can be accomplished through such tools. The FDIC has taken very large losses, both in absolute and percentage terms, despite its strong powers to intervene with the banks it insures.) For its part, the UK did not have an effective deposit guaranty program, which proved to be a significant problem when Northern Rock and Bradford & Bingley fell apart.

On top of this, virtually no country had an existing set of effective tools to intervene to supply capital to their largest financial institutions in order to avoid a potential meltdown of the system. In almost all cases, it was necessary to create programs from scratch, such as the TARP program in the US or the UK's capital injection program that partially inspired it.

The creation of "living wills" is one of the ways in which policymakers hope to improve their ability to intervene when trouble strikes, as well as to rein in the complexity of large financial institutions. Sometimes also known as "funeral plans," these are formal documents that banks would be required to create detailing how they suggest that they, or some of their subsidiaries, would be unwound in the event of problems. If these can be set up clearly and effectively, they would allow regulators to be prepared and to move very quickly in a crisis. If the living wills were publicly available it would provide the further advantage of reducing confusion among creditors and other interested parties as to what would happen when a bank flounders. There is a strong consensus on both sides of the Atlantic in favor of living wills, although there are differences of opinion to be sorted out about how to operationalize the concept. It is also not clear how effective the idea will be – some supporters have great hopes for it while others view it as a positive step, but one of somewhat limited benefit.

There are a host of questions that would need to be answered to make these plans an effective part of regulation. This starts with the most basic question as to what kind of trouble is being envisioned. The exact genesis of a crisis could have a major effect on whether and how a particular subsidiary should be unwound. For example, AIG could most likely have sold off several of its healthy insurance subsidiaries quite quickly and effectively if the group's problems had been idiosyncratic and not part of the greatest financial crisis since the Great Depression. In practice, the last financial crisis rendered this approach unviable in a short timeframe. There are a number of other questions, such as what information should be made public and how binding the plans should be in the event of an actual crisis.

US reforms in regard to intervention in troubled financial institutions are relatively straightforward, as described below, but Europe's situation is different. Understandably, it is very complicated to blend national and EU-wide resolution authorities, especially since one immediately encounters the vexed question of how to split the cost of

any rescues or insurance payouts. The US spreads these costs nationally with no one seriously suggesting a regional approach, but European countries are loath to sign up for bills that may be generated by the actions of other countries.

US actions

Dodd-Frank authorizes the Financial Stability Oversight Council, with advice from the Fed, to declare a non-bank financial institution to be systemically significant. Such a declaration would give the Fed the ability to regulate that financial institution in a manner quite similar to how it regulates bank holding companies that are considered to be systemically significant. In effect, this first brings the non-bank under rules similar to those for any bank holding company and then goes further to allow regulatory actions that pertain only to systemically significant institutions. The latter include the ability to force divestiture or wind-down of any activities that are deemed to represent an excessive systemic risk.

The bill also authorizes the use of special resolution procedures for systemically important non-bank financial institutions. If a non-bank runs into trouble, the Secretary of the Treasury, in consultation with the President and with the concurrence of a super-majority vote of the other relevant regulators, can inform a special panel of bankruptcy judges that the particular non-bank is systemically important and in need of a special resolution procedure. If the judges agree on the systemic importance, then the FDIC would be given authority to resolve the troubled institution in much the same way that it is allowed to resolve troubled banks. In general, this gives it the authority to quickly make final decisions on what to do with the financial institution and on allocating losses among the various parties. Judicial review is allowed only under quite limited conditions that generally pertain to ensuring that the FDIC acted under appropriate authority. Congress instructed the FDIC to use the special resolution authority as a liquidation method rather than a method of aiding an institution that will continue forward.

Each systemically important financial institution would be required to create a living will that would explain in detail its corporate structure, which invariably encompasses hundreds or thousands of subsidiaries, along with a plan for unwinding those institutions in the event of trouble, including a clear discussion of which parties would be paid in which priority. Regulators have been empowered to determine how these living wills should work.

EU actions

The European Commission has published two "Communications" on cross-border crisis management in the banking sector and on options for bank resolution funds. These discuss a large variety of ideas for dealing with the complex problems posed by cross-border financial crises. The Commission will publish an action plan in October 2010 on crisis management, which they indicate will lead to specific legislative proposals for a complete set of tools for prevention and resolution of bank failures.

Selected European national actions

Germany just proposed legislation for an industry-funded system for an orderly restructuring and – if necessary – resolution of failing credit institutions. Belgium recently enacted legislation governing measures that can be taken when the situation of a financial institution threatens the stability of the system. The UK and Sweden have also proposed or enacted legislation related to this area.

Transatlantic tensions

It is not yet clear if there will be a divergence between the US and the EU on resolution procedures, since the US is further along than the EU in specifying its changes. However, it will be extremely important that the approaches be coordinated. The dominant banks in many countries are global institutions, making it very messy to unwind or otherwise resolve them, especially if the different major markets have different rules about how to do this. One of the issues would be that of divvying up the cost of any state support for backing global activities. In addition, there would be a host of serious technical problems that could arise.

Management of systemic risks posed by market cycles

The financial crisis burned into nearly everyone's mind the importance of watching out for future bubbles or other major financial imbalances. These are almost always associated in the financial sector with a phase in the credit cycle that involves loosened credit standards and substantially higher leverage throughout the system.

There is a strong consensus across the Atlantic that entities need to be set up, or very substantially strengthened, to watch for developing problems. Further, there is general agreement that certain tools ought to be used to dampen the natural credit cycles, both on the upswing and on the way down. For example, the Basel Committee is honing

proposals to encourage higher levels of capital to be held during upswings in the credit cycle, in order to discourage excess lending and to build the capital base to absorb the likely hit when loose credit standards create losses. Capital requirements would be loosened on the downswing to avoid forcing banks to cut back on their lending as a result of large capital losses. Similarly, the committee is looking at anti-cyclical loan loss provisions, meaning that the reserves created for expected loan losses would be higher during upswings, or at the very least level across the cycle rather than declining in the "good times" as they tend to do now.

US actions

Dodd-Frank did not address this issue in any detail, other than to create the FSOC and to empower it to monitor the system as a whole. Regulators already have the ability to increase capital requirements above the statutory minimums and may also reduce them to those minimum levels if regulation had previously set them higher. US regulators also have considerable authority to set accounting rules for banks, such as loan loss provision rules, although in recent times they have tried to stick with Generally Accepted Accounting Principles (GAAP) whenever possible.

EU actions

The creation of a European Systemic Risk Board will give the EU a body with the clear responsibility for monitoring systemic risks and for advising EU organizations and national regulators about those risks and how best to deal with them. However, the ESRB will initially have little ability to directly regulate the systemically important European financial institutions, as this will largely remain a national responsibility for now.

Selected European national actions

National regulators in EU countries will likely follow the lead of the Basel Committee in putting into place and using the various counter-cyclical tools being considered, such as dynamic capital requirements. Spain already has dynamic loan loss provisioning, which many observers believe served to somewhat dampen the credit cycle there. (Of course, other factors led to a massive housing bubble which hurt banks very badly when it burst, so it is difficult to prove the point.) In June, France's National Assembly passed a bill that, among other things, established a systemic risk council. The bill is awaiting Senate action.

Transatlantic tensions

This area remains somewhat unformed and the new regulatory bodies are only starting to be put into place, so it is difficult to tell whether there will be transatlantic conflicts going forward. We should do our best to avoid or resolve such conflicts because our financial cycles, and even business cycles, are synchronized enough that global coordination is imperative in many cases.

Expansion and reorganization of regulatory bodies

Regulatory bodies around the world largely failed to spot the looming financial crisis or to effectively intervene in its early stages when the damage might have been lessened. As a result, many countries have chosen to reorganize their regulatory structure in significant ways. Unfortunately, there does not appear to be a strong pattern that would tell us which types of structures work best, since there are examples of major regulatory failures under various structures. Given this, the structural reforms tend to be quite specific to each country's circumstances.

The US, which almost everyone can agree has too many different regulators, is nonetheless keeping the number of major regulators constant, principally as a result of political constraints which make it difficult to eliminate existing bodies. The one casualty is the Office of Thrift Supervision, which was deemed to have performed quite poorly. However, the creation of the Bureau of Consumer Financial Protection brings the count back to the original number. A number of countries in Europe have made changes. For example, the UK concluded that the earlier separation of the Bank of England from its role as banking supervisor was a mistake and is reuniting most of those functions under the Bank's auspices, while separating the consumer protection piece into its own independent agency.

The EU is in the process of taking another substantial step towards the creation of union-wide bodies by following through on the recommendations of the de Larosiere report. New EU-wide regulatory authorities will coordinate supervision of banks, of securities firms, and of insurers. In addition, there will be a European Systemic Risk Board to coordinate the EU's response to signs of bubbles or other significant market imbalances. In all cases, one of the most critical issues will be the division of responsibilities and powers between the EU-wide bodies and the national regulators. Given the EU's history, it seems highly likely that

the powers of the new EU-wide bodies will be significantly enhanced over time.

US actions

Dodd-Frank made several changes to the regulatory entities for banking:

- The Office of Thrift Supervision is being merged into the Office of the Comptroller of the Currency.
- A new Bureau of Consumer Financial Protection is being established, as described earlier.
- An overall council of regulators (the FSOC) is being created, with most detailed actions being delegated to the Fed.

EU actions

As described above, four new EU-wide bodies are being created:

- European Systemic Risk Board
- European Banking Authority
- European Securities and Markets Authority
- European Insurance and Occupational Pensions Authority

Day to day supervision and any decisions having a fiscal impact remain with national supervisors. The EU-wide bodies will focus on coordination, advice, and suggestions related to best practices. They will play a key role in EU policy development, taking over the roles of the current advisory and regulatory committees. Finally, they will also arbitrate disputes between national supervisors.

Selected European national actions

The UK is merging most of the Financial Services Authority back into the Bank of England, from which it was taken out roughly a decade ago. The consumer protection part of the FSA will remain as a separate body. France, for its part, has merged its insurance and banking supervisory authorities. Belgium put in place a new law that gradually introduces the “twin peaks” model of one integrated financial services regulator for safety and soundness issues and one for consumer protection.

Transatlantic tensions

This is essentially a national/European question. Policymakers in one jurisdiction do not have a strong stake in how their counterparts are organized elsewhere, as long as the regulation works effectively.

Accounting standards

The US uses a set of accounting rules that differ markedly from those used in Europe and much of the rest of the world. This makes it more difficult to set uniform quantitative requirements around the world, such as the capital requirements being set under Basel III. There are efforts underway to merge the two standards, but they are making slow progress.

The US currently uses a set of accounting rules known as Generally Accepted Accounting Principles (GAAP), set by the Financial Accounting Standards Board (FASB) under authority from the SEC. International Financial Reporting Standards (IFRS), corresponding to the former International Accounting Standards (IAS), are set by the International Accounting Standards Board (IASB).

The rules differ not just in their technical details, but also in some critical aspects of their approach to accounting, which is part of what has made it so difficult to meld the two. As a general matter, International Financial Reporting Standards are principles-based, meaning that companies have the obligation to faithfully follow the principles without being bound to quasi-legalistic rules. On the other hand, although GAAP is also based on underlying theoretical principles, it requires firms to follow very specific rules. Each approach has its benefits. Principles-based accounting provides the flexibility for companies, and their auditors, to choose the most informative accounting for specific items. It also makes it difficult for companies to deliberately mislead while technically complying with specific rules. On the other hand, rules-based accounting ensures a greater uniformity across companies and eliminates much of the flexibility that an unscrupulous company might use to mis-state performance. In addition, GAAP has a greater emphasis on carrying assets, and even liabilities, at their market values, while IFRS affords financial institutions more flexibility to smooth changes in market values. “Mark to market” accounting has the benefit of forcing more realistic valuations in many circumstances, but also creates distortions when markets over-react in one direction or the other. There are other differences as well, including in many areas that are less relevant to banks.

FASB and the IASB are in continuing talks on common standards. The G-20 has mandated the boards to arrive at common rules by 2011, although there is some considerable doubt about whether this deadline will be met. Recently FASB proposed some changes to its mark to market accounting rules that were viewed by many outside the US as moving the accounting standards further apart rather than closer together.

There are also concerns that the governance structure of the IASB may not be of the necessary quality for the important role that it has, as it does not create a clear framework of accountability to the IASB's ultimate stakeholders. This problem is echoed by the body's difficulty in attracting sustainable funding.

Transatlantic tensions

There is a long-standing conflict on international accounting standards despite strong agreement on both sides of the Atlantic that we need one set of international standards, with perhaps some modest national flexibility. Some Europeans ascribe the problem to US unwillingness to give up elements of sovereignty while some Americans point to what they believe are inadequacies of governance at the International Accounting Standards Board and certain differences in accounting principles that they think are too important to compromise on.

Effects on the Real Economy

Financial reform efforts in the aggregate are likely to slow economic growth modestly in "normal" years as the price for buying substantially greater stability. Done right, this price is worth paying, since the severe recessions that follow the worst financial crises wreak terrible and long-lasting damage. Quantitative analyses from the Basel-based regulatory groups and from academics and think tankers back this conclusion, although some industry bodies have produced considerably more dire estimates that indicate reform would come at too high a price. Financial reform is critically important, but cost-benefit analyses such as these must remain a key part of regulatory decision making.

Financial reform efforts are intended to produce a more stable financial system with less severe and less frequent crises. Virtually everyone accepts that the actions to achieve this will make credit and other financial services at least marginally more expensive and less available. The belief of policymakers, shared by the author, is that the benefits in the long run of avoiding devastating financial crises, and associated recessions, will more than pay for the modest reduction in economic performance in "normal" years. (This assumes that the final regulatory packages are well-conceived, as appears broadly to be the case.)

There is a pressing need for considerably more and better analyses of the likely economic effects of the reforms. A great divide exists today between the banking industry's various analyses, which predict major economic costs at a level which would not appear to be warranted by the benefits, and the relatively sparse academic literature, which almost universally suggests substantially lower reductions in economic performance, at levels that appear to be worth suffering in exchange for greater safety. It is clear from discussions with policymakers around the world that they place little credence in what they see as considerably exaggerated industry analyses.

There is a pressing need for considerably more and better analyses of the likely economic effects of the reforms.

In fact, the Basel Committee and its partners released two extensive quantitative analyses in mid-August 2010 evaluating the likely economic effects of the Basel III changes. One report looked at the long-term costs and benefits and concluded that the benefits of avoiding the most severe financial crises outweighed the burden on the economy of greater safety requirements. Under extremely conservative assumptions, the benefits modestly outweighed the costs. More realistic assumptions showed quite considerable net gains.[15]

The other report examined the transitional impacts assuming a two to four year transition period starting at

15 It is worth noting that even the more optimistic assumptions assumed that two of the major adjustment mechanisms for the banking industry would provide no benefit, which is quite conservative. The financial industry was assumed not to reduce its operating expenses in response to profit pressures and equity investors were assumed to ignore the fact that the banking industry would be safer and less volatile, attributes that normally cause them to reduce their demanded return on stocks.

the planned implementation date of 2012. It concluded that there would indeed be net costs during the transition period, which would peak shortly after the end of the two or four year transition and would gradually be recovered, in line with the report on longer term consequences. The report calculated effects a fraction of the size of the impact suggested by the IIF's draft interim report.[16]

There has not yet been time to hear detailed industry rebuttals of these analyses, which will likely follow. However, the consistency of the Basel Committee's reports with the views of disinterested analysts makes it very likely that policymakers will accept the key conclusions of the committee. Thus, the reports provide further momentum for agreement to be reached in time for the original late 2010 deadline for an accord.

16 The report quantified the cost by translating the revised requirements into net changes in the industry's total ratio of core Tier 1 capital (essentially tangible common equity) to risk-weighted assets. If the total effect were equivalent to an increase in capital of one percentage point, then the economy would likely be slightly less than 0.2% smaller at the worst point than it otherwise would be. The effect was roughly linear, so that a two point change in Tier 1 capital ratios would have twice the effect and a three point change three times the effect, etc.

Recommendations

This report makes the following recommendations.

Finish the key regulatory reforms

- Finalize the Basel III accord without sacrificing its strength
- Design reforms to achieve the necessary safety at the lowest economic cost
- Jointly engage major Asian countries and other emerging markets in financial reform
- Demand that consistent global accounting standards be applied by all parties
- Harmonize the regulation of financial market infrastructure
- Fix the housing finance system in the US
- Address the underlying macroeconomic, social, and political causes of the crisis
- Stay focused on key unresolved structural issues

Resolve transatlantic conflicts

- Find compatible approaches to regulating hedge funds and private equity funds
- Coordinate approaches to credit rating agencies

Repair the process of supervision

- Improve banking supervision and hold regulators accountable
- Create effective rules for dealing with cross-border banks that run into trouble

Enhance the processes for global cooperation

- Engage Congress and the EU parliament more deeply in international discussions of reform
- Define a clear, robust future for the G-20, linked to existing multilateral institutions
- Coordinate macroprudential policies globally
- Coordinate carefully any significant changes in taxation of financial institutions or transactions

Maintain political momentum to finish the key regulatory reforms quickly

As the most dramatic effects of the crisis fade from the public mind – and therefore policymakers' priority lists – it is vital to maintain the political will to make tough choices on regulatory reform. The US and EU both have emerging distractions, including mid-term elections, hard choices on fiscal policy, and lingering sovereign debt worries. It is essential for political leaders to remind the public that

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Finalize the Basel III accord without sacrificing its strength

The Basel III proposals are a critical element of the regulations necessary to minimize future crises. It is important that the strength of the agreements reached already in Basel is retained. There are four risks still to be faced. First, there is a small chance that the G-20 governments could backtrack on the commitments made by the central bankers and regulators in Basel, particularly if the economy takes a nose-dive in the next two months. Second, there remain a number of technical details to be worked out and there is some room for the basic structure to be weakened by these implementation decisions. Third, some very important decisions have been deferred for several years, particularly on the liquidity tests and key aspects of how the leverage test will work. These are critical areas and we must guard against the possibility that crucial reforms will drop away, or be gutted, as the urgency of the last crisis fades. Fourth, national governments and regulators will be the ones to determine how Basel III is implemented in each country. There is a history of cheating around the edges, or at the very least, inconsistencies in implementation between countries. These should be avoided as much as possible.

Design reforms so that they achieve the necessary safety at the lowest economic cost

Most financial reforms come with a price tag. It is critical that cost-benefit analyses be conducted to ensure that added safety margins really are worth the costs, as has been done with Basel III. For example, higher capital requirements from Basel III will clearly add expense and reduce credit availability to some extent, but careful quantitative analyses demonstrate that the benefits from avoiding severe damage from future financial crises more than pay for the loss of economic growth in "normal" years. This same balancing act must be present in deliberations on other significant financial reforms around the globe. As part of these calculations, it is critical that the cumulative effect of all significant relevant actions be considered. Certain actions might be worthwhile in isolation, but could prove excessive in combination with other steps.

One way to reduce the cost of increasing safety margins while retaining most of the benefits is to allow adequate transitional arrangements, as the Basel Committee intends to do. The task force believes that this is laudable, as long as the transition periods are not so extended, or the scope so broad, that the core changes are gutted.

Some members of the task force suggested that cost/benefit analyses be reviewed every few years, given continuing economic and financial changes. This is generally a good idea as long as great caution is used to ensure that this did not become a back-door way of weakening standards in the next financial upswing when greed may come to outweigh fear again.

Jointly engage major Asian countries and other emerging markets in financial reform

There is a very real danger that major emerging market countries will view the global financial reforms as optional. Many task force members have observed a disturbing passivity in the approach of the major emerging market countries to international financial reform, particularly the Basel III process. This could mean that these countries are not planning to take the resulting guidelines seriously, but rather to pick and choose the parts that they find attractive. (After all, these countries tend to believe that the financial crisis was created in the US and Europe and to be skeptical that many of the lessons learned actually apply to their own banks.) Given the growing importance of financial centers in these nations, which is likely to increase even further in the future, problems of regulatory arbitrage could become severe over time.

US and EU policymakers and senior officials should coordinate their approach to key Asian economies. This could include utilizing the US-EU Summit process – including the Transatlantic Economic Council, which has the mandate to address major transatlantic strategic policy issues – to ensure a harmonized approach that has high level political support. The FMRD, which has proven to be a flexible and

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The danger of not working together is stark.

effective means of engagement, could also be utilized to build common positions at the senior officials level.

While this may trigger some understandable sensitivity to the idea that the US and EU and "ganging up," this should not dissuade Brussels and Washington from talking through their positions and ensuring they effectively convey a common message on the issue. Nor does such a discussion preclude genuine engagement with emerging economies. Naturally, this needs to be a genuine dialogue – transatlantic voices will be more persuasive, and better results will be achieved, if emerging market inputs are solicited and truly taken into account in formulating policy proposals.

The danger of not working together is stark. For example, Chinese banks, some of which are among the largest in the world now when measured by market capitalization, are likely to follow the path Japanese banks trod several decades ago by transforming from domestic banks into global ones. If Chinese banks in future years were to operate under less stringent capital and other regulations that were designed for domestic Chinese conditions, we could repeat the experience of those Japanese banks. They used their regulatory and other competitive advantages to expand into overseas markets where they took significant market shares. Unfortunately, they often made bad loans or charged substantially too little for the risks they took, which helped to lead to the severe financial problems they faced when the boom years ended in their domestic market and their overseas mistakes came home to roost. (Naturally, the under-pricing damaged their competitors as well by encouraging the softening phase of the credit cycle.) The world could ill afford a Chinese "lost decade", with all of the negative ramifications for the world economy.

Even if Chinese or other emerging market regulators avoided melt downs among their own banks, this kind of regulatory arbitrage could put great pressure on the banks in other financial centers that were operating under more stringent rules. Unfortunately, banks under competitive stress have historically tended to take on excessive risks, either by finding a way to "game" the existing rules to mimic the less stringent environment of their foreign competitors or by reaching for profits in various ways that entail hidden risks.

It is unacceptable that FASB and the IASB are taking so long to harmonize their rules.

Demand that consistent global accounting standards be applied by all parties

One cannot achieve uniformity of regulation without using comparable accounting figures. It is unacceptable that FASB and the IASB are taking so long to harmonize their rules. Admittedly, there are quite major differences between the philosophies and specific rules of these two approaches which are making this harmonization slow and difficult. Nonetheless, governments must find a way to ensure more rapid progress. Although it is important to allow accountants the autonomy to determine the most accurate ways of measuring income and balance sheet items, experts cannot be allowed to be dogmatic when accounting harmonization is critical to achieving crucial public goods. For example, imposition of a leverage test in Basel III would be much less useful if, as has been widely reported, the two accounting standards can show balance sheet sizes that differ by a factor of two.

Governments should not prescribe accounting answers, but it must be made clear to those in charge of the standards that agreement on harmonization must be reached within a few years or governments will reorganize standard-setting bodies to ensure that the next set of accounting leaders will reach agreement.

In the short term it may be necessary to allow US regulators to require an adjusted version of GAAP while the rest of the world uses an adjusted version of IFRS, where the required adjustments bring the two standards much closer to each other on the points most relevant to calculating capital ratios. However, this is not an acceptable solution for the medium and long-term.

Harmonize regulation of financial market infrastructure

Regulation of the plumbing of global financial markets must be harmonized. Plumbing is not sexy, but it makes itself very

Governments should not prescribe accounting answers, but it must be made clear to those in charge of the standards that agreement on harmonization must be reached within a few years…

Plumbing is not sexy, but it makes itself very obvious when it stops working.

obvious when it stops working. Governments and regulators in all of the major financial centers are moving towards a significantly greater role for exchanges or regulated trading venues, clearing houses, trade repositories, and other entities that specialize in the infrastructure of finance. The global nature of the markets that use these bodies makes it imperative that regulators coordinate their approaches, even though harmonization may require that national institutions face real global competition. There are three dangers if countries or regions go in different directions.

The first and greatest risk is that regulatory arbitrage sets in and encourages a race to the bottom in standards. For example, clearing houses can compete with each other by lowering the amount of margin that they require or by accepting an increasingly wide range of collateral, rather than just cash. Strict margin and collateral requirements will be more expensive for users than lax ones, providing an incentive to loosen standards in order to gain market share. This incentive will be magnified considerably by the knowledge that these institutions will be "Too Big to Fail." (Realistically, governments are not going to be able to force financial market participants to shift to using these entities without providing an implicit guaranty every bit as real as the US found was the case with Fannie Mae and Freddie Mac.)

Second, there is already the risk of financial protectionism. Some members of the task force fear that various requirements being suggested by EU organizations could end up blocking non-EU clearing houses and trade repositories from much of the European market. The final rules should be written to protect legitimate EU interests in safety and efficiency while maintaining the ability for foreigners to participate.

Third, the failure to adequately coordinate the details of infrastructure requirements and functions could lead to a significant loss of efficiency in financial markets. Plumbing is not glamorous, but when it does not work, everyone notices. The same is true with the plumbing of the global financial system.

Regulators should accept, on principles of mutual recognition, regulation of market participants by foreign regulators as long as such regulation occurs on a comparable, comprehensive basis. While each regulator should retain control of which foreign regulations it accepts as being sufficient for the various regulated platforms, mutual recognition would allow regulators to channel their resources more efficiently and minimize the likelihood that participants would be subject to duplicative and/or conflicting requirements.

Fix the housing finance system in the US

It is now time to fix the housing finance system. There were legitimate reasons why the US has done little so far to fix the overall structural problems[17], but the time has come to press forward, as both Congress and the Administration have pledged to do. This is more than a national issue. Investment in US mortgage loans and related securities is a major cross-border activity and we have seen how a US housing crisis could affect the entire world in a very negative way.

Address the underlying macroeconomic, social, and political causes of the crisis

Task force members recognized that larger economic and social factors played key roles in the last crisis and are likely to do so in future crises. Detailed recommendations lie outside the scope of this paper, which focuses on regulation, but it is clear that governments around the world should accelerate efforts to end the imbalances that continue to endanger our economic and financial systems. Several members suggested that it would also be helpful to work towards a reduction in the incentives for excessive leverage that are created in most tax systems through a preferential treatment of debt as compared to equity.

Stay focused on key unresolved structural issues

Some important regulatory problems are exceedingly difficult, and have therefore been put off, but these issues must be dealt with while there remains some political will. There are several unresolved issues of critical importance to the world financial system including:

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17 The Administration and Congress believed that the time was not ripe to make the necessary major changes while the housing market remained in a terrible crisis. Further, there was a danger that including reform of Fannie Mae, Freddie Mac, and other key housing entities in the larger financial reform bill would have killed the effort altogether.

- Reducing or eliminating the risks from financial institutions that are "Too Big to Fail".
- Finding the right balance in compensation approaches at financial institutions.
- Fixing corporate governance issues in the financial sector.

It is important that countries do not simply give up on talking with one another and go their own way. It may be necessary to try different approaches, but the channels of communication must stay open and everything that can reasonably be done to avoid coordination problems ought to be done.

Resolve major outstanding transatlantic conflicts

As discussed earlier, the US and EU have left key work undone domestically, and this is true internationally as well. Having addressed most of the comparatively easy issues, it is now time to dig into the hardest. Again, this is substantially a question of political will to find creative ways to manage systems that operate under somewhat different philosophy.

Find compatible approaches to regulating hedge funds and private equity funds

The differing tacks of the US and the EU could easily create problems and economic inefficiencies unless compromises can be found. The key is to allow the EU to apply its regulations effectively while allowing US and other non-EU funds significant leeway to operate differently without giving up all access to the EU market as investors or fundraisers. This, of course, is easier said than done, but stands a much better chance if high-level governmental officials on both sides devote time and resources to solving this problem. Fortunately, there are substantial signs of compromise in the works, which we should encourage.

Coordinate approaches to credit rating agencies

There is a similar problem with regard to rating agencies, although it appears to be more tractable. The EU is establishing substantially tighter regulations on the operations of the rating agencies than the US is requiring. Since the rating agencies are global organizations, and many of the securities being rated are also offered on a global basis, it would be problematic if the EU imposed requirements that contradicted US law or regulation or vice versa. One way around this is the idea being considered by the EU of treating US regulation as equivalent for this purpose, under certain conditions. Another would be careful, detailed coordination across the Atlantic to align specific US and EU requirements.

> *There has been too little focus on the mistakes that regulators made during the run-up to the financial crisis and in the crisis itself.*

Repair the supervision process

Improve banking supervision and hold regulators accountable

There has been too little focus on the mistakes that regulators made during the run-up to the financial crisis and in the crisis itself. Banking and financial market supervisors were often lulled into the same false sense of security as were the financial market participants, and indeed almost all groups in society. Further, they often allowed financial institutions to enter into major activities that were ill-understood by supervisors. For example, regulators allowed the development of very large bank exposures to securitization and derivative activity that the regulators understood very poorly and that some banks themselves did not understand much better. Similarly, capital requirements were calculated using internal bank models that, in retrospect, were clearly much too optimistic and reliant on historical data that simply did not extend back very far.

There is no one area where supervisors failed, rather they were drawn into the same kinds of mistakes as the banks were, but at one remove. The key is to ensure that regulators are independent, empowered appropriately, understand both their roles and how the banks are actually operating, and are held accountable for failures of supervision. There is no magic bullet to end all problems from weak supervision, but we must remain focused on minimizing future problems in this area.

More and stronger regulation must go hand in hand with better supervision. This will require:

- More, knowledgeable, and better paid, supervisory personnel. Governments must recognize that they are competing with the compensation and prestige of the private sector when attracting talent. They should not

We do not have an effective system for dealing with failing financial institutions that have major cross-border activities.

be penny wise and pound foolish, but must allocate the necessary resources.

- Better mechanisms to hold regulators accountable for their choices. There is a sense among many observers that individual regulators have seldom been held responsible for their mistakes.
- Better information sharing among supervisors both within and across borders. This will be especially important in regard to macroprudential policy and large cross-border financial institutions.
- Greater transparency in dealings between supervisors and those they regulate, although there will always be good reasons to keep certain information and decisions confidential.

Create effective rules for dealing with cross-border banks that run into trouble

We do not have an effective system for dealing with failing financial institutions that have major cross-border activities. Task force members, and many other observers, have identified harmonizing resolution regimes as a critical, but extremely difficult issue. Governments must continue to push forward on this and not give in to either despair about the difficulty of agreement or to complacency about the acceptability of current ad hoc approaches. Detailed EU proposals are due in October – the EU must be both creative and tough-minded in tackling the political difficulties that could hinder offering an effective solution. In the US, much of the work has been left in the hands of regulators. They must coordinate closely with their counterparts in Europe and Japan. Nor should emerging markets be ignored. Although they do not boast a large degree of cross-border activity at present, they will doubtless do so over time.

The bankruptcy process for Lehman was relatively smooth in the US, but a disaster in its effects on non-US stakeholders. The problems with foreign deposits of Iceland's banks forced uncomfortable, and often unfair, ad hoc rescues in other European countries. There were even challenges in dealing with banking groups that split their activities between the Netherlands and Belgium, two countries that cooperate closely. One can only shudder when considering how a Citigroup failure might have been handled.

These problems matter. The recent financial crisis was considerably exacerbated by uncertainties as to how governments could and would respond when major institutions became troubled. Faced with that uncertainty, many creditors and investors pulled away from the risky institutions. Much of the market panic was a reflection of sentiment that important institutions might be dealt with in a manner that would create losses for the investors, often in unexpected ways. In a future crisis, where sovereign creditworthiness could additionally be a concern, it would also be helpful for investors and voters to understand how the costs of any unwinding or rescue of a major global financial institution would be split.

One member suggested the bold step of setting a goal of harmonizing resolution approaches within 10 years by identifying differences in resolution mechanisms in the major financial centers and creating a Basel Committee-type process to reach an accord.

Remove unnecessary legal restrictions on international cooperation by regulators

National rules can sometimes make international regulatory cooperation difficult. National regulators often operate under quite strict rules about their decision-making and about what information they can share with each other. These rules are codified in law or in rules of administrative procedure that were often written well before international cooperation became a serious issue. Apparently it was only in 2008, for example, that the Office of Management and Budget in the US changed the rules of administrative procedure to allow regulators to take international cooperation explicitly into account as one factor in making decisions. Wherever possible, governments should free their regulators to share information and impose common rules and procedures, without being halted by outdated statutes or procedures.

The bankruptcy process for Lehman was relatively smooth in the US, but a disaster in its effects on non-US stakeholders.

Enhance the processes for global cooperation

Engage Congress and the EU parliament more deeply in international discussions of reform

The two legislative branches were identified by many task force members as forces that sometimes seriously hindered transatlantic cooperation in financial reform. This is not surprising, as both institutions were designed to focus on local voter interests, particularly in the case of the US Congress. In the case of the EU, there are also issues related to the evolving role of the European Parliament, which recently acquired a significantly greater level of power than it previously held and needs to be better integrated into global policy formulation as a result.

Task force members suggested that forums need to be established, or enhanced, to enhance communication between the members of the relevant committees in the legislatures on the two sides of the Atlantic and between the committees and other interested parties from across the ocean, both governmental and private. This should include:

- Utilizing the Transatlantic Legislators Dialogue (TALD) to cover major economic and finance issues.
- Deepening contact through Congressional Delegation visits designed to build relationships between legislators and to familiarize members of Congress and Parliament with the major financial institutions, centers, and regulators in our territories.
- Initiating an ongoing process for greatly increased staff level discussions of key areas of common interest.

A small secretariat in the legislatures should be created to coordinate these efforts, including the meetings and other information exchanges.

There are already some modest coordination mechanisms in place; organizations like the Atlantic Council help facilitate contact and engagement, but larger-scale and more formal mechanisms would bear considerable fruit.

Define a clear, robust future for the G-20, linked to existing multilateral institutions

Transferring key roles from the G-7/8 to the G-20 was a necessary move, given the lack of representation in the G-7/8 of many emerging market powers. The expansion was necessary both to ensure that a wider range of voices were heard, but also to enhance the legitimacy of the outcomes by making it clear those voices were included in the debate.

At the same time, there are several significant concerns with the G-20 process. We pair these below with associated recommendations.

Losing focus and momentum. As discussed above, as the crisis recedes, the impetus to make hard choices fades. With the relatively easy decisions already made, the hardest work is left to do. Yet the group lacks a good mechanism to ensure that financial and regulatory issues remain in the forefront of consideration when other items come to seem more pressing. (This has been an ongoing criticism of the G-8 process as well.)

- **Recommendation: The G-20 should commit to completing its financial work before taking on significant new issues.** The agenda for the G-20 Korea Summit will already include development issues. Leaders should make clear that completing the work of financial regulation takes precedence over other issues.

Too unwieldy a process for actual decision-making. Compounding this problem, the size and radically different economic governance frameworks within the group of countries makes it hard for all the nations to agree on any contentious issue. This forces the serious, substantive discussions to other fora or simply leaves them unresolved.

- **Recommendation: An informal steering group should set the agenda and drive decision-making.** The process for deciding the composition of such a group would be difficult, but it is essential if any real decisions are to be made. A possible system would be to have the group comprise the past, present, and future presidencies, along with a rotating schedule of three other members.

Inadequate coordination channels. The group needs to improve coordination with the IMF, the Basel-based institutions, and other multi-lateral standards-setting bodies. One of the most critical questions in this regard is simply to decide on roles for the different organizations that overlap as little as possible while still allowing each to fulfill its missions.

- **Recommendation: Establish a small secretariat for technical coordination issues.** While the G-20 should remain an informal coordinating body, a modest apparatus to help coordinate on-going work would improve its effectiveness without sacrificing its flexibility.

Attempting to "lean against the wind" with countercyclical banking regulation in one country, or even one region, will be much less effective than coordinated actions across the major financial centers.

Although these and other options should be considered, the task force acknowledges that much of the "problem" is inherent in reaching consensus among 20 nations with differing political and economic systems and viewpoints. There is no returning to the old, "great power" days when a handful of countries stitched up deals among themselves.

Coordinate macroprudential policies globally

Regulators around the world must work together to avoid, or minimize the effects of, financial bubbles. They should work through the Basel Committee and in other appropriate forums, to find ways to reduce the pro-cyclicality of financial institutions and markets. The Basel III proposals already include ideas for the reduction of this pro-cyclicality which are worth exploring further. In addition, a key aspect of macroprudential supervision in each country will clearly be to reduce the risks from boom and bust cycles in the credit and other financial markets.

This must be coordinated globally. Credit cycles and business cycles are increasingly synchronized around the world as a result of burgeoning trade and freer capital flows in recent decades. Attempting to "lean against the wind" with countercyclical banking regulation in one country, or even one region, will be much less effective than coordinated actions across the major financial centers. This is not to say that every country must act exactly as the rest do, or wait for a complete consensus before acting. There will often be good reasons for diverging policies that reflect differing economic conditions. However, we strongly encourage a global flow of regulatory information and frequent consultations among macroprudential regulators in the major countries in order to maximize the level of coordination.

Coordinate carefully any significant changes in taxation of financial institutions or transactions

It is tricky to make substantial financial taxes work effectively without international coordination. The G-20 finance ministers rejected any global move on taxation of financial institutions at their Seoul summit in the spring of 2010. However, many nations, and the EU as a whole, are considering imposing such taxes on their own. This report has focused on financial regulation and not taxation, but the structure of any such national or regional tax needs to take account of issues similar to those raised by regulations that have global ramifications. For example, a significant tax on financial transactions that was implemented in only one country or region could well be circumvented by moving trades to other jurisdictions. Attempts by the taxing jurisdiction to prevent this movement could result in an escalating series of restrictions that would inadvertently attack free trade in financial services, doing considerable harm.

To be clear, this is not to express an opinion about whether to add special taxes for the financial sector. However, any such taxation must be constructed carefully to take account of international ramifications. Ideally such taxation would be coordinated across the financial markets.

Conclusions

The recommendations presented here are designed to strengthen the leadership of the transatlantic community in the global effort to reform the financial system. In painting the broad landscape of the major issues, the report necessarily omits many details. Yet even in doing so, the fundamental points become clear:

Transatlantic cooperation is essential for financial reform to work at the national, transatlantic, and global levels.

- Reform is not inevitable. There is a long road ahead before the relevant groups nail down the details of reform, and there is an urgent need to stay politically focused at high levels to complete the work.
- The G-20 is an essential part of this process, and the United States and Europe (as a group and as individual states) need to lead by example in making the case to the emerging economies that a strong, stable, and safe financial system can only be realized if we all cooperate.

It will take a long time before the effects of the financial crisis are behind us, and there remains a danger of divergence as countries respond to their domestic needs. It is the responsibility of governments to meet those needs, but it also their duty to ensure that they anchor their economies within the global system. This requires strong, visionary leadership for years to come.

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Appendix A

Financial systems

A key role of financial systems is to aggregate funds from savers/investors and allocate those funds to worthy projects. There are four principal avenues for allocating funds:

- Banks
- Non-bank financial institutions
- Capital markets
- Governments

Banks are at the heart of virtually every financial system. In most capitalist countries they are the principal providers of credit, but they also offer the infrastructure, transaction services, and liquidity that allow capital markets and many non-bank financial institutions to function. Given their importance, a large portion of financial reform efforts are focused directly on the banks and the impact of the reforms is likely to be greatest for bank-centric systems.

However, the role of banks differs quite significantly around the world. The US probably has the least bank-centric financial system. Commercial banks there are direct providers of only about one-third of the credit used by the economy. Much of the rest comes from the capital markets and from non-bank financial institutions, although the US government has long played a critical role in certain sections of the credit market, particularly in housing. US officials have traditionally seen the lesser role of banks as a broad positive, since if problems directly hit the banks, there would be room for the capital markets and other financial sectors to step up their credit provision. (Of course, the recent crisis has underlined the potential for interactions among the sectors that can freeze credit provision across the board.)

Most continental European nations have much more bank-centric systems. European banks provide roughly three-quarters of their economies' credit and capital markets are correspondingly significantly smaller and less developed. However, there are differences within Europe. In particular, the UK, which hosts Europe's largest financial center by some distance, has more developed capital markets and a proportionately smaller role for banks. In a number of European countries, such as Germany and France, banks associated with, or owned by, local or national governments play quite significant roles in the financial system.

Finally, emerging economies generally have even larger roles for the banks and much less developed capital markets. Even the financial instruments used by banks tend to be less sophisticated at this stage of their development, which will lessen the impact of a number of the reforms that are focused on more complex instruments. Further, the major banks are often directly owned by the state. Sometimes a major role for the state-owned banks is to allocate credit to state-owned corporations, rather than private enterprises.

There is a related dimension of difference among banking systems. Most countries outside the US use a "universal banking" model in which banks play a wide range of roles in the financial system. In the US, these roles have historically been broken up between "commercial banks", which focused on taking deposits and lending, "investment banks", which focused on securities issuance and capital markets activities, and various non-bank financial institutions that offered credit cards, credit to small businesses, or focused on other sectors. Japan had a similar system, reflecting the US military occupation after World War II and consequent US influence on Japan's post-war restructuring of its economy.

Appendix B

Differences in decision-making processes

United States

In the US, the President and his Administration, (also known as the Executive Branch), generally shape the key proposals in critical policy areas, as was certainly true with financial reform. However, Congress represents a fundamentally equal branch of government which can refuse to follow the Administration's lead, by turning down proposals in their entirety or very substantially modifying them or even going in an entirely different direction. This is less of an issue at times like the present where the President is of the same party as the majorities in each house of Congress, but even under those conditions Congress can and will exert its independent influence.

Congress' influence is not only overt, but also exhibits itself when an Administration chooses to offer plans that already reflect the known inclinations of Congress. For example, it seems fairly clear from conversations with policymakers that the Obama Administration would have liked to propose more consolidation of regulatory bodies as part of financial reform but concluded that this was politically infeasible. The most obvious example of this was the failure to propose merging the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), a move that would have generated little opposition because it is supported by a large majority of policy analysts and is a matter of indifference to the public. Unfortunately, the two bodies are overseen by two different sets of committees within Congress and there was no good organizational compromise that would have been acceptable to both sets.

Congress also tends to put much less emphasis on international cooperation than the Executive Branch does. The US constitution intentionally made Congress responsive to local interests while the Executive Branch's need to coordinate with foreign nations pulls in the other direction.

Europe

European nations, on the other hand, generally have a much closer alignment of the Executive and Legislative branches than does the US, whose system is based at heart on the equality and independence of the two branches. The typical European political systems are parliamentary ones where the national administration is created directly by the majority in parliament, which makes it much easier to coordinate policy between the two branches of government. This can allow the government to make even large changes quite quickly, if the prime minister can hold his or her own party together.

However, decisions which need to be made at the level of the European Union, as is the case with most of financial reform, run into a different, and rather difficult set of institutional constraints. First, there is the basic question of determining when the decisions should be taken at the EU level. In the case of regulatory reform, EU nations have largely accepted the need for EU-wide standards. Second, the EU system has its own system of checks and balances, one with three entities sharing the power to create laws. The European Commission (Commission) represents the European interest. European civil servants operate this branch, under the direction of their politically appointed masters, led by the members of the Commission itself. The Commission proposes legislation and has many attributes of an Executive branch. The European Parliament (Parliament) is directly elected by the voters. Finally, the Council of Ministers (Council) represents the governments of the individual member nations. The Parliament and Council have staff of their own, in addition to benefiting from the advice of the Commission. These European institutions differ from national governments, in that the Commission is not the result of a parliamentary majority and the Parliament and Council are not characterized by stable political or ideological majorities and minorities. Instead, a majority has to be found in both parts of the legislature on the basis of specific facts and circumstances applicable at the time.

In regards to the EU's "internal market", which includes virtually everything related to financial reform, there is a "co-decision" process. The Commission has a "monopoly of initiative," meaning that it must be the first of the three bodies to propose new laws on financial reform. After that, Council and Parliament offer revisions and bargain among themselves, with the Commission acting as a kind of broker, until they reach agreement on final legislation. This co-decision process is one reason why some of the proposed reforms take a long time to come together, due to differing visions among the three institutions. Once agreed at the EU level, EU legislation needs to be transposed into the national law of the member states of the EU in order to come into practical force. The exception to this is for EU-level regulations which can be directly applied.

Appendix C

Financial commitments of the Washington, London, Pittsburgh, and Ottawa G20 Summits[18]

FINANCIAL REGULATION

1) We are committed to take action at the national and international level to raise standards together so that national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage. We call on the FSB to report on progress to the G20 Finance Ministers and Central Bank Governors in advance of the next Leaders summit.

FSB ESTABLISHMENT

2) We agreed to the establishment of a new Financial Stability Board (FSB) a successor to the Financial Stability Form (FSF).

3) FSB members have committed to pursue the maintenance of financial stability, enhance the openness and transparency of the financial sector, implement international financial standards and agree to undergo periodic peer reviews, using among other evidence IMF / World Bank FSAP (Financial Sector Assessment Program) reports. The FSB will elaborate and report on these commitments and the evaluation process.

INTERNATIONAL COOPERATION

4) The FSB should collaborate with the IMF to conduct early warning exercises (EWE) to identify and report to the IMFC and the G20 Finance Ministers and Central Bank Governors on the build- up of macroeconomic and financial risks and the actions needed to address them.

5a) Implement immediately the FSF principles for cross-border crisis management and that systemically important financial firms should develop internationally consistent firm-specific contingency and resolution plans. National authorities should establish crisis management groups for the major cross-border firms and a legal framework for crisis intervention, as well as improve information sharing in times of stress.

Develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future.

6) Establishment of the remaining supervisory colleges for significant cross-border firms by June 2009.

7) Support continued efforts by the IMF, FSB, World Bank, and BCBS to develop an international framework for cross-border bank resolution arrangements.

8) Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.

PRUDENTIAL REGULATION

9) Prudential regulatory standards should be strengthened once recovery is assured. The national implementation of higher level and better quality capital requirements, counter-cyclical capital buffers, higher capital requirements for risky products and off balance sheet activities, as elements of the Basel II capital framework, together with strengthened liquidity risk requirements and forward-looking provisioning, will reduce incentives for banks to take excessive risks and create a financial system better prepared to withstand adverse shocks.

10) Strengthening Oversight and Supervision

11) Guidelines for harmonization of the definition of capital should be produced by the end of 2009.

12) The FSB, BCBS and Committee on the Global Financial System (CGFS), working with accounting standard setters should take forward implementation of the recommendations published to mitigate procyclicality, by the end of 2009, including a requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate.

13) The BCBS should review minimum levels of capital and develop recommendations in 2010.

14) The BCBS and authorities should take forward work on improving incentives for risk management of securitization, including considering due diligence and quantitative retention requirements by 2010. Securitization sponsors or

18 Extracted from text prepared by the Government of Korea

originators should retain a part of the risk of the underlying assets, thus encouraging them to act prudently.

15) The BCBS and national authorities should develop and agree on a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions by 2010.

16) Risk-based capital requirements should be supplemented with a simple, transparent, non-risk based measure which is internationally comparable, properly takes into account off-balance sheet exposures, and can help contain the build-up of leverage in the banking system.

We support the introduction of a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability, the details of the leverage ratio will be harmonized internationally, fully adjusting for differences in accounting.

17) All major G-20 financial centers commit to have adopted the Basel II capital framework by 2011.

18) BCBS to review guidelines for processes for measurement of risk concentrations in 2009 to ensure they are timely and comprehensive.

19) Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to re-examine their internal controls and implement strengthened policies for sound risk management.

20) Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts.

21) The Basel Committee should study the need for and help develop firms' stress testing models, as appropriate.

22) Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate.

23) The appropriate bodies should review the differentiated nature of regulation in the banking, securities and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements.

24) Authorities should monitor substantial changes in asset prices and their implications for the macroeconomy and the financial system.

25) National and regional authorities should also review business conduct rules to protect markets and investors.

26) We will amend our regulatory systems to ensure authorities are able to identify and take account of macro-prudential risks across the financial system including in the case of regulated banks, shadow banks and private pools of capital to limit the build up of systemic risk.

We will ensure that national regulators possess the powers for gathering relevant information on all material financial institutions, markets and instruments in order to assess the potential for failure or severe stress to contribute to systemic risk. This will be done in close coordination at international level.

We call on the FSB to work with the BIS (Bank for International Settlements) and international standard setters to develop macro-prudential tools and provide a report by autumn 2009.

27) All firms whose failure could pose a risk to financial stability must be subject to consistent, consolidated supervision and regulation with high standards.

Our prudential standards for systemically important institutions should be commensurate with the costs of their failure. The FSB should consider possible measures including more intensive supervision and specific additional capital, liquidity and other prudential requirements.

The IMF and FSB will produce guidelines for national authorities to assess whether a financial institution, market or an instrument is systematically important by the next meeting of Finance Ministers and Central Bank Governors.

28) Hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on leverage, necessary for assessment of the systemic risks they pose individually or collectively. Where appropriate registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management.

We ask the FSB to develop mechanisms for cooperation and information sharing between relevant authorities in order to ensure effective oversight is maintained when a fund is located in a different jurisdiction from the manager. We will, cooperating through the FSB, develop measures that implement these principles by the end of 2009. We call on the FSB to report to the next meeting of Finance Ministers and Central Bank Governors.

29) Supervisors should require that institutions which have hedge funds as their counterparties have effective risk management, including mechanisms to monitor the funds' leverage and set limits for single counterparty exposures.

30) We will promote the standardization and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision.

To this end, all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.

We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

31) We will each review and adapt the boundaries of the regulatory framework to keep pace with developments in the financial system and promote good practices and consistent approaches at an international level.

32) We have agreed to improve the regulation, functioning and transparency of financial and commodity markets to address excessive commodity price volatility.

33) All G20 members should commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessment of countries' national regulatory systems.

COMPENSATION

34) In London, Leaders endorsed the Principles on pay and compensation in significant financial institutions developed by the FSF.

The Pittsburgh Summit endorsed the Implementation Standards for the FSB's Principles and called upon firms to implement these sound compensation practices immediately. Leaders tasked the FSB to monitor the implementation of the FSB standards and propose additional measures as required by March 2010.

35) BCBS should integrate FSB principles on pay and compensation into their risk management guidance by autumn 2009.

36) Supervisors should have the responsibility to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary to offset additional risks, apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices.

Supervisors should have the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention.

NON-COOPERATIVE JURISDICTIONS

37) We call on all jurisdictions to adhere to the international standards in prudential, tax and anti-money laundering/countering the financing of terrorism (AML/CFT) areas and appropriate bodies to conduct and strengthen objective peer reviews, based on existing processes, including through the FSAP process.

38) We call on countries to adopt the international standard for information exchange endorsed by the G20 in 2004 and reflected in the UN Model Tax Convention.

39) We welcome the expansion of the Global Forum on Transparency and the Exchange of Information, including the participation of developing countries, and welcome the agreement to deliver an effective program of peer review. The main focus of the Forum's work will be to improve tax transparency and exchange of information so that countries can fully enforce their tax laws to protect their tax base. We stand ready to use countermeasures against tax havens from March 2010.

40) We are committed to developing proposals, by the end of 2009, to make it easier for developing countries to secure the benefits of a new cooperative tax environment.

41) We are committed to strengthened adherence to international prudential regulatory and supervisory standards. The IMF and the FSB in cooperation with international standard-setters will provide an assessment of implementation by relevant jurisdictions, building on existing FSAPs.

42) We call on the FSB to develop a toolbox of measures to promote adherence to prudential standards and cooperation with jurisdictions.

We call on the FSB to report progress to address NCJs with regards to international cooperation and information exchange in November 2009 and to initiate a peer review process by February 2010.

43) We agreed that the FATF should revise and reinvigorate the review process for assessing compliance by jurisdictions with AML/CFT standards, using agreed evaluation reports where available.

We welcome the progress made by the Financial Action Task Force (FATF) in the fight against money laundering and terrorist financing and call upon the FATF to issue a public list of high risk jurisdictions by February 2010.

44) We call on the FSB and FATF to report to next Finance Ministers and Central Bank Governors meeting on adoption and implementation by countries.

ACCOUNTING STANDARDS

45) We have agreed that the accounting standard setters should improve standards for the valuation of financial instruments based on their liquidity and investor's holding horizons, while reaffirming the framework of fair value accounting.

46) Accounting standard setters should take action to reduce the complexity of accounting standards for financial instruments by the end of 2009.

47) Accounting standard setters should take action to strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information by the end of 2009.

48) Accounting standard setters should take action to improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty by the end of 2009.

49) Accounting standard setters should take action to achieve clarity and consistency in the application of valuation and provisioning standards internationally, working with supervisors by the end of 2009.

50) We call on our international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process; and complete their convergence project by June 2011.

51) The IASB's institutional framework should further enhance the involvement of various stakeholders.

52) Regulators and accounting standard setters should enhance the required disclosure in relation to complex financial products by firms to market participants. (By end 2009).

CREDIT RATING AGENCIES

53) We have agreed that for all credit rating agencies whose ratings are used for regulatory purposes, should be subject to a regulatory oversight regime, including registration, consistent with the IOSCO Code of Conduct fundamentals, by the end of 2009.

54) National authorities will enforce compliance and require changes to a rating agencies practices and procedures for managing conflicts of interest and assuring the transparency and quality of the rating process. CRAs should differentiate ratings for structured products and provide full disclosure of their ratings track record and the information and assumptions that underpin the ratings process. The oversight framework should be consistent across jurisdictions with appropriate sharing of information between national authorities, including through IOSCO.

55) BCBS to review the role of external ratings in prudential regulation and determine whether there are any adverse incentives that need to be addressed. (By end 2009). The BCBS is working to address a number of inappropriate incentives arising from the use of external ratings in the regulatory capital framework. National and regional authorities have also taken or are considering ways of lessening undue reliance on ratings in rules and regulations.

A FAIR AND SUBSTANTIAL CONTRIBUTION BY THE FINANCIAL SECTOR

56) IMF to prepare a report for June 2010 Summit with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system.

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