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A Value-based Approach to Financial Regulation

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This document was written by Aldo Caliari on behalf of the CIDSE Resources for Development Working group. Its common long term objectives are to increase and sustain resources available for southern-driven development and to increase the decision-making voice of countries whose development is most affected by global policies.

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INTRODUCTION

In 2007 the US financial system experienced a financial crisis that would, one year later, acquire global proportions and affect the global economy.

Four years after the fall of Lehman Brothers, which is taken as the beginning point of the 2008-09 Great Recession, the resumption of growth of output in 2010 seemed to herald a recovery. Yet the world economy continues to face the aftershocks of the crisis. Some indicators are the acuteness of the Eurozone sovereign debt and banking crisis, with most European economies on the brink of a recession if not suffering one already, as well as the continuation of tepid growth in the United States. But the risks are greater compared to the 2008 crisis because emerging economies, such as China, Brazil and South Africa, that then acted as the "engine of growth," today face more precarious conditions.

From a broader perspective that looks beyond growth of output, it is clear that the crisis never subsided. If one looks at joblessness, the International Labor Organization reports that 50 million jobs need to be created just to reach the pre-crisis level of employment, and this while 80 million new people are expected to enter the workforce in the coming two years.[1] More importantly part of that unemployment is at risk of becoming structural as the crisis continues with those affected out of work for so long that they are not likely to re-enter the labor force.

The Human Rights situation is also deteriorating. The High Commissioner for Human Rights said in 2009 that the global economic and financial crises "have a disproportionate impact on the livelihoods of the most vulnerable and already marginalized groups of society. They undermine access to work, affordability of food and housing, as well as of water, basic health care and education."[2] This is a statement that still rings true. There was an effort at the height of the crisis to forestall cuts in social spending. However after some ephemeral positive trends, a recent study found that 91 of 128 countries surveyed have introduced, or are on course to introduce, cuts in social spending, as part of austerity measures.[3] A notable casualty are labor rights and guarantees, which are under fire in several advanced countries as a result of so-called "structural reforms" being imposed ostensibly to respond to the crisis.[4]

Inequality has also worsened during the crisis. A boom and bust cycle like the current one has negative impacts on inequality because the poorest segments of the population are less able to cope with fluctuations in the economic cycle.[5]

The ongoing nature of the crisis shows that the efforts to reform the financial system are failing. The most prominent effort to reform financial regulation was arguably the launch of Summits of the G20. The G20 is an informal body that brings together members of the G8 plus 12 more countries, including 9 "emerging market" economies. It was created in 1999 in response to the 1997 East Asian financial crisis. Its goal was to "ensure broader participation in discussions on international financial affairs among countries whose size or strategic importance gives them a particularly crucial role in the global economy." G20 Finance Ministers met regularly until November 2008 at which point, in the heat of the emergency, it began meetings at a Heads of State level that have continued since. At the 2009 Summit in Pittsburgh, Heads of State declared the G20 to be "the premier forum for our international economic cooperation."

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[1] ILO 2012.

[2] HCHR 2009.

[3] UNICEF 2011.

[4] L20 Statement.

[5] Coppel 2012.

In the United States, the crisis prompted financial reform legislation. The "Dodd-Frank Wall Street Reform and Consumer Protection Act" was passed in final form by the US Congress in July 2010 and signed into law (enacted) in the same month. In Europe, the crisis also resulted in a financial reform agenda that, though fragmented into a number of legislative proposals that are at different stages of deliberation and adoption, is also moving forward.

INTERNATIONAL FINANCIAL REGULATION: CIDSE'S ROLE

CIDSE has been monitoring these and other financial regulatory processes in its advocacy. As an international alliance of Catholic development agencies, we approach the subject, as all areas of our advocacy, from the rich ethical and value-based tradition embodied in Catholic Social Teaching (CST) and Catholic Social Thought and our dialogue and cooperation with our partner organizations across the globe. (See Box 0).

> BOX 0 - CIDSE experience in advocating on issues of international financial regulation.
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> In the late 1990s, CIDSE was one of the pioneer organizations calling for a currency transaction tax. More recently, in "The FTT for people and for the planet: Financing Climate Justice" (June 2011) CIDSE advocated the imposition of financial transaction taxes not just on the grounds of the revenue they could generate, but also as a way to stabilise financial markets.
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> In 2002, CIDSE was one of the agencies involved on the *International Conference on Financing for Development*, and has continued to be in its follow up process. The outcome document of that conference, the Monterrey Consensus, was the first global consensus endorsing the need for a comprehensive and integral approach to all areas of development finance and to the structural reform of the international financial and monetary system.
>
> In 2009, CIDSE carried out advocacy around the *World Economic and Financial Crisis and its Impacts on Development*, convened by the United Nations. In "From Collapse to Opportunity: Development Perspectives on the Global Financial Crisis" (April 2009) CIDSE provided analysis and recommendations addressed to this conference.
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> Since 2008, when the G20 convened for the first time at Summit level in response to the crisis, CIDSE has been actively monitoring the implementation of the financial regulation agenda. (Some statements addressed to G20 Leaders over the last few years can be found at http://www.cidse.org)
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> In October 2011, CIDSE took on the issue of speculation in commodity derivatives markets volatility in a paper "Food Price Volatility: Consequences and Impacts on the Right to Food", which called for specific regulatory tools in financial markets with the purpose of limiting food prices.

CIDSE believes that all actors in society should have a say in the design of economic policy and rules, including financial ones. Indeed the Church teaches us that: "In the economic and social realms, too, the dignity and complete vocation of the human person and the welfare of society as a whole are to be respected and promoted. For man is the source, the centre, and the purpose of all economic and social life."

Consistent with this, CIDSE promotes a shift from the current economic paradigm's focus on growth of output to one that focuses on human well-being. This is not only important from an ethical perspective, it is also good economics. Reforms of economic policies that neglect human well-being are, sooner or later, bound to prove their unsustainability.

The crisis has also prompted gestures on the part of public authorities in the direction of addressing the relationship between ethics and financial regulation. Meeting in London, G20 Leaders signaled the "desirability of a new global consensus on the key values and principles that will promote sustainable economic activity," supporting discussion on a "charter for sustainable economic activity" as had been championed by German Chancellor Ms Angela Merkel earlier that year.[6] That same year, at the L'Aquila Summit, G8 Leaders endorsed the "Lecce framework,"[7] which referred to "Common Principles and Standards for Propriety, Integrity and Transparency," in the financial sector.

Although such initiatives proved to be short-lived in the agendas of the forums promoting them, they are indications of the political relevance of inquiries in the direction pursued in this paper. The reflections in this paper serve as input and benchmarks for judging the value of those and future initiatives of the same kind, which our network certainly encourages.

The following principles and teachings are relevant to the task of assessing financial regulation from a value-based perspective:

- The need to place human dignity at the centre of economic life
- The Common Good
- The principle of subsidiarity
- Just distribution of wealth
- The social function of private property
- The Preferential Option for the Poor
- Care for the Earth

In our assessment, application of these CST principles and values to the regulation of the financial sector translates into four simple guidelines that should be used to practically assess any reform proposal. Financial sector regulation should:

1. Place the financial sector at the service of a real economy

… that is geared to the achievement of human rights, human well-being, the common good and sustainable development

The basic rationale for the regulation of the activities of financial markets is the principle mentioned above: human beings are the source, the centre and the purpose of all socio-economic life.[8] The common good is the total of all those conditions of social living – economic, political, sociological and cultural – which make it possible for women and men to readily and fully achieve the perfection of their humanity. Financial regulations, as acts by the public authority whose legitimacy derives from its acting for the common good, [9] should also embody this pursuit. The principle of Care for the Earth calls for new models of economy that embody care for the environment in a responsible way, so as to pass it on to future generations. Benedict

[6] Group of 20 2009, para. 21.

[7] Group of 8 2009, para. 27.

[8] The Church in the Modern World, $ 63. In Catechism of the Church it is said "Economic life is not meant solely to multiply goods produced and increase profit or power; it is ordered first of all to the service of persons, of the whole man, and of the entire human community.", # 2426.

[9] The Catechism of the Catholic Church, # 1902.

XVI stated "The environment is God's gift to everyone, and in our use of it we have a responsibility towards the poor, towards future generations and towards humanity as a whole."[10]

A purely growth-oriented paradigm requires an unsustainable level of economic activity. As financial regulation is presently embedded in, and is subservient to, such an unsustainable paradigm, a change of the whole economic paradigm is needed. Financial regulation should be redirected into promoting support for alternatives that will lead toward improved quality of life and reduce the unsustainable drain on natural resources, as well as creating decent jobs and guaranteeing a livelihood. Respect for the human rights of victims of the financial crises is paramount for any approach to sustainable and equitable economic development based on the active participation by the people concerned. Thus, policies that opt for the poor to prevent future crises should embrace a commitment to providing comprehensive protection and implementation of all human rights - civil and political rights and also economic, social and cultural rights. Human rights standards have been internationally agreed across geographical and cultural borders and they legally bind governments to 'respect, protect and fulfill' human rights in their actions.

Finance should be a pillar that supports this new paradigm, rather than the primary force driving the economy. Developments in the financial sector should also be scrutinized from this perspective. Many financial innovations in the past decades have been in the interest of only a few, and the profits of the financial industry, while yielding little benefit - and sometimes creating risks - for society as a whole.

Furthermore, pre-crisis economies also neglected to address the responsibility for the impacts of our behaviour in our "economic" life on others. Self-interest is, admittedly, a driver of economic progress. But interdependency is a fact of economic life and moral considerations are still relevant. The responsibility for that morality lies with individuals in their choices, companies in their standards of behaviour, and governments in their role as regulators.

2. Prevent financial crisis

… To the greatest possible extent, while making them less frequent and severe, with particular attention to sparing their negative impacts to the poorest and vulnerable

In CST, the preferential option for the poor calls for special attention to the needs of the poorest.[11] The Church has also called for a just distribution of wealth, by teaching that "the riches that economic-social developments constantly increase ought to be so distributed among individual persons and classes that the common advantage of all… will be safeguarded…"[12] In a more recent pronouncement, Pope Benedict XVI has advocated that political action is required for such redistribution, warning that "grave imbalances are produced when economic action, conceived merely as an engine for wealth creation, is detached from political action, conceived as a means for pursuing justice through redistribution."[13]

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[10] Charity in Truth, # 48. He also called therein to "recognize our grave duty to hand the earth on to future generations in such a condition that they too can worthily inhabit it and continue to cultivate it," and refers to a "covenant *between human beings and the environment." (# 51).*

[11] Rerum Novarum # 5. 1891. "[T]he poor must be speedily and fittingly cared for, since the great majority of them live undeservedly in miserable and wretched conditions."

[12] The Reconstruction of the Social Order, # 57. See also The Struggle Against Poverty: A Sign of Hope in Our World, Pastoral Letter of the Canadian Episcopal Commission for Social Affairs, 1996 ("The fight against poverty through redistributive policies [should be] at the top of national priorities.").

[13] Charity in Truth, # 36.

Financial crises disproportionately affect the poorest and most vulnerable, while often widening income inequality, as low-income earners tend to be less prepared to cope with macroeconomic volatility than the top income earners. Cuts in public support to services such as water, housing, health and food, also threaten the internationally recognized rights of those that are most dependent on those services. Regulation can limit excessive risk taking and leveraging that leads to crises. But, as shown by historians, recurrent financial crises are a feature of financial markets.[14] It might be unrealistic to expect that regulation can prevent crises, but it is certainly a duty of regulators to make them less frequent and severe. Moreover, it is certainly possible for financial regulation to mitigate the impacts that financial crises have on the poorest segments of society, for instance by properly safeguarding the public revenue on which assistance to the poorest depends.

3. Promote the just distribution of wealth and income

… including the alignment of risk and rewards for financial market actors and protection of fair compensation for workers

In 'The Church in the Modern World' it is argued: "To satisfy the demands of justice and equity, strenuous efforts must be made, without disregarding the rights of persons or the natural qualities of each country, to remove as quickly as possible the immense economic inequalities, which now exist and in many cases are growing and which are connected with individual and social discrimination."[15]

While the Church does not deny the importance of the markets, it "demands that the market be appropriately controlled by the forces of society and by the State, so as to guarantee that the basic needs of the whole of society are satisfied."[16] Indeed, financial wealth, as a form of private property, is not exempt from the Church's teaching that "Private property is not an absolute and unconditional right, but must be exercised for the common good, and the Pope calls on public authority to ensure this."[17]

In 'On Human Work,' the Church refers to the principle of the priority of labour over capital as a "principle that has always been taught by the Church."[18] This is in evidence when the Church highlights the fundamental role of just wages,[19] but also when it refers to employment and the right to work.[20]

Financial regulations in line with CST should ensure a proper functioning of the market, where actors who take risks bear the full consequences of their decisions. Financial regulations must also be used to actively safeguard against market excesses that foster the growing gap in income and wealth inequality, and that harm employment and workers' income.

[14] Reinhart and Rogoff 2009.

[15] Church in the Modern World, # 66.

[16] Centesimus Annus 1991, # 34.

[17] Development of People, # 23-24.

[18] On Human work, # 12.

[19] See On Human Work, # 19. ("In every system, regardless of the fundamental relationships within it between capital and labor, wages, that is to say remuneration for work, are still a practical means whereby the vast majority of people can have access to those goods which are intended for common use".).

[20] On Human work, # 18. ("When we consider the rights of workers in relation to the "indirect employer," that is to say, all the agents at the national and international level that are responsible for the whole orientation of labor policy, we must first direct our attention to a fundamental issue: the question of finding work, or, in other words, the issue of suitable employment for all who are capable of it.").

A fair distribution of wealth and income requires tackling the financial opacity provided by offshore jurisdictions, which allow profit-shifting and illicit financial flows. Opacity in finance ranges from bank secrecy practices to all kinds of vehicles that enable secrecy, including accounting rules and practices, and corporate governance and reporting standards.[21]

4. Be the result of transparent and accountable processes

… that allow for all those affected in society to participate, while respecting subsidiarity

The Church has said that "It is necessary that all participate, each according to his position and role, in promoting the common good. This obligation is inherent in the dignity of the human person."[22] Furthermore, it is prescribed that "citizens should take an active part in *public life.*"[23]

Government is the main way by which people cooperate in order to achieve the common good. The principle of the common good has, therefore, important implications for the level of participation in the development of financial regulation. Far from supporting the belief that financial regulation is a matter for a few secluded experts, the teachings of the Church underscore the need to balance the views of those experts with as broad as possible an array of alternative views coming from different backgrounds (consumer, labour, gender, environment, development voices etc.—especially those from the South). Alternatives, approaches, should be openly debated as, the more diverse the debate, the more likely that the right choices on financial regulation will be adopted.

Participation has another dimension in the current economy. The presence of cross-border mobile capital flows has made it necessary to resort to international bodies for the development and/or coordination of some types of regulation. In 'The Reconstruction of the Social Order Encyclical', the Church articulated the principle of subsidiarity by saying that: "it is an injustice and at the same time a grave evil and disturbance of right order to assign to a greater and higher association what lesser and subordinate organizations can do."[24] This, far from endorsing a *laissez faire* approach to regulation,[25] means that each matter should be first handled at the level of government or association –including the Nation State— that is closest to the individual, as long as this is feasible. At the same time, read *a contrario sensu*, the subsidiarity principle calls for resort to greater forms of association to address matters that exceed the boundaries and capacities of lesser organizational forms. The implication is that when it comes to financial regulations that will not work if pursued by a Nation State alone, cooperation within a higher associational form – intergovernmental cooperation of various sorts – will be necessary. The need for participation in design and operation of financial regulation should be read in conjunction with that of subsidiarity to ensure that participation is not deprived of impact, or pre-empted by actions (or omissions) of international structures, not accountable to those affected.

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[21] See CCFD-Terre Solidaire 2011, whose research shows that many activities of MNC and banks are artificially concentrated in secrecy jurisdictions 20% for the 50 biggest European companies and 26% for the 12 biggest banks in the European Union.

[22] The Catechism of the Catholic Church, # 1913.

[23] Ib. 1915.

[24] The Reconstruction of the Social Order, # 79.

[25] That subsidiarity should not be interpreted as laissez-faire endorsement to regulation is further clarified in Charity in Truth, # 58: "*The principle of subsidiarity must remain closely linked to the principle of solidarity and vice versa*, since the former without the latter gives way to social privatism."

ISSUES, APPROACHES AND ASSESSMENT

1. Too big to fail (TBTF)

In 2008, both in the US and in Europe, trillions of dollars of public funding were spent on bailouts of large financial institutions that were seen as the culprits of the financial crisis. Such bailouts in some cases still continue. In the case of Europe, the amount of money spent in public bailouts since 2008 is equivalent to 30 per cent of European GDP.[26] This placed the spotlight on the so-called "too big to fail" problem.

Customarily, when a firm becomes insolvent, it files for bankruptcy and then follows a predetermined process for the distribution of assets among the creditors, including options for dissolution and/or transfer of ownership of the company's assets. In contrast, when financial firms, especially big ones, fail, this failure is seen as having the potential to trigger a cascade of failures in other financial firms and even other sectors of the economy.

Without a mechanism for resolving failing big financial companies in an orderly way that does not disrupt critical banking activities, the government has no alternative but to rescue them using public funding. When this happened on a massive scale in 2008, there was massive public outrage at the perverse outcome – namely that a number of firms that had taken excessive risks in order to boost unsustainably high profits were supported with public resources. This situation becomes more objectionable when the deficits created by financial rescues are to be financed by budget cuts or regressive taxation whose impacts are borne disproportionately by those most in need.

The Central Bank Governor of the UK, Mr. Mervyn King, argues that the implicit taxpayer subsidy is at the heart of the profits made by the financial sector.[27] Similar opinion was voiced by the European Commission:

"There is evidence that the financial sector has been more profitable than the non-financial sector over the last two decades. This is not problematic as such if higher profit is related to high productivity. However, the high profitability of the sector could result from certain sector specific characteristics. For example, the financial sector is different from other sectors in respect of the existence of an (implicit or explicit) safety net which, combined with banking regulation may enable some institutions to enjoy economic rents…."[28]

Banks are not merely passive beneficiaries of this situation. Some authors go as far as saying that banks have an active strategy to grow in size and interconnectedness, as a way to bolster the "implicit safety net" and the increased profits that come with it.[29]

It is important to emphasize that the government might be put in a situation of having to bail out firms not just when they are too big to fail (TBTF), but also when they are deemed "too complex" or "too interconnected" to fail. While these characteristics are not always correlated with size, often big firms become more interconnected or complex as they grow –sometimes as

[26] European Commission 2010, p. 2.

[27] King, Mervyn 2010. "Banking: From Bagehot to Basel, and Back Again." The Second Bagehot Lecture, Buttonwood Gathering, New York City.

[28] European Commission, "Issues Note on Financial Sector Taxation." August 2010.

[29] Kane, Edward 2010. Extracting Nontransparent Safety Net Subsidies by Strategically Expanding and Contracting a Financial Institution's Accounting Balance Sheet. Boston College. ("Even in financial-center countries, authorities have been slow to confront the complex ways in which any large financial organization can expand its access to implicit safety net subsidies... by increasing its portfolio size, balance-sheet complexity, or geographic footprint.").

the principal means of growing-- in size.[30] (In the rest of this paper, TBTF is used to refer interchangeably to companies that are too big, interconnected or complex).

The prospect of a bailout also subverts attempts to steer the financial sector away from speculative transactions designed to boost profits, and into supporting credit for productive, real economy activities. If the first firms in line for a bailout are those that owe an oversized balance sheet to speculative trading, chances are that those who receive public support will be the same actors who profited from the boom times, furthering the redistribution of wealth upwards. Some measures to separate essential banking services (such as deposit-taking and creation of credit for small and medium companies) from investment banking, have a profound implication that goes beyond the attempt to avert bailout.[31] They are practical means to provide incentives for a banking sector more aligned with sustainable economic activities.

Another problem with bailouts is that, while the consequences of not bailing out companies would be bad (perhaps an economy-wide collapse), bailouts undeniably erode market discipline leading to a system more prone to crises in the future. The existence of a credible resolution mechanism is critical, not only to avoid bailouts when an institution fails but, also, to the success and effectiveness of measures to prevent the kinds of excessive risk-taking that may cause a crisis. The perception that some firms are exempt from a resolution process creates moral hazard and incentivizes the taking of excessive risks by rendering ineffective market discipline to limit such behavior.[32] It should be stressed that this is the case even when legal prohibitions for bailouts exist, as long as the bankruptcy-style process cannot credibly be implemented without the disruption of banking functions essential to the public or to the system.

Bailouts, without countervailing regulation, also lead to a financial sector that is becoming more concentrated and less diverse, which aggravates the TBTF problem by reducing the incentives to make bankruptcy a credible threat to insolvent firms. Over the last 15 years, the assets of the largest 5 financial institutions in the US have grown from 17 % of GDP to 63 % of GDP. The share of all banking industry assets held by the top 10 banks rose from 24% to 44% and 58% in the years 1990, 2000, and 2009, respectively.

When calculating risk of big firms, rating agencies assume that the government will continue to back up such firms with public funding when the need arises, fostering further consolidation of the financial sector. This assumption is reflected in a rating premium for big firms as compared to small ones. Such rating boost continues to exist in the US, even after passage of the recent

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[30] See Finance Watch 2012, p.4 (showing that banks that grow in size tend to so on the basis of increases in trading and derivatives activities, and at the expense of their loan books).

[31] See more on these measures under 1.2.

[32] A recent IMF Discussion paper refers to the dangers in the current situation: "Confidence in financial systems is still highly dependent on explicit and implicit central bank and government support. Moral hazard has increased, in part as sectors have become more concentrated, while financial systems are still prone to stress and turmoil. Measures are needed to restore proper incentives and market discipline. Governments need to rethink how to reduce the threat that large financial institutions pose to systemic stability, including through reduced complexity, better capital structures, and, possibly, restrictions on their scope and activities." Claessens, Stijn, Ceyla Pazarbasioglu, Luc Laeven, Marc Dobler, Fabian Valencia, Oana Nedelescu, and Katharine Seal 2011. Crisis Management and Resolution: Early Lessons from the Financial Crisis. Staff Discussion Note. March 9. See also FSB 2010 ("Absent credible steps to reduce the likelihood of bail-outs, [Systemically Important Financial Institutions] funding costs will reflect the expectation of official support, leading SIFIs to engage in higher risk activities that distort the allocation of capital and make future crises more likely.")

financial reform whose ostensible objective was to stop bailouts in the future.[33] The rating boost to big firms exacerbates the plight of the smaller banks that bear a disproportionate burden of the credit-quality problems and are unlikely to attract much-needed fresh capital from investors and depositors due to their weak financial position. In the US, for instance, a new wave of mergers and acquisitions of smaller banks has further reduced the number of firms operating in the sector. By reducing the number of participants in the market, particularly the smaller, local and regional financial institutions that were more accustomed to relationship lending, levels of credit to small and medium size entrepreneurs are likely to be cut. Given the fact that such entrepreneurs are the biggest source of jobs, their reduced access to credit exacerbates, in turn, the unemployment crisis.

The whole social contract that underpins a country's budget may be *de facto* overturned in a matter of hours in order to respond to a perceived threat, making a mockery of the participatory processes that one would expect as a standard of good governance in democratic societies. While bailouts represent the diversion of huge resources into unexpected ends, the emergency situation created by a threat of collapse leads to decisions made in haste, and bypassing of the existing mechanisms for public participation.

In some countries the cost of the bailout has been repaid fully by banks, in some cases with profits,[34] leading some policymakers to argue that taxpayers have been left "better off." Surely this line of argumentation misses the real point. The fact that an injection of capital has been repaid does not mean taxpayers took no risk in providing it. The argument also does not address the increased moral hazard on the recipients and the systemic risk increased by such moral hazard. It is important to underscore government's willingness to provide loans to the private sector is a legitimate policy option and not *a priori* wrong, but there should be an open and public debate on what sectors will be favored and on what basis. The guidelines promoted in this paper should definitely be considerations in such debate. Government activity should reward support to socially desirable activities, rather than reckless risk-taking.

Regulatory approaches

In the US, the centerpiece of the Dodd-Frank Act's approach to preventing the buildup of systemic risk is a newly-created council, the Financial Stability Oversight Council (FSOC), and the creation of a special regime for the resolution of systemically important firms. The purpose of the FSOC[35] is to focus on identifying, monitoring and addressing systemic risks posed by large, complex financial firms as well as products and activities that spread risk across firms.

The Orderly Liquidation Authority for systemically important firms means that, in principle, the Federal Deposit Insurance Corporation can safely unwind failing nonbank financial firms or bank-holding companies that are insolvent and would, subject to normal bankruptcy rules, generate systemic risk. During liquidation, no taxpayer funds can be used and shareholders and creditors would have to take losses. Each of the companies is required to keep and submit to the

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[33] For instance see Moody's 2012. See also Ötker-Robe, İnci, Aditya Narain, Anna Ilyina, and Jay Surti 2011, p. 6, showing how bigger financial institutions in the US have faced lower funding costs than their smaller counterparts.

[34] The expression "net fiscal costs" would refer to the cost minus the repayment received back from the financial firms.

[35] The Financial Stability Oversight Council (FSOC or "the Council"), is a council comprising all regulators (chaired by the US Treasury) and charged with monitoring and responding to systemic risks posed by large, complex companies, products and activities. It can decide to extend the Fed jurisdiction to individual non-bank financial companies that may pose a threat to US financial stability.

Council a plan for a "rapid and orderly resolution in the event of material financial distress or failure," which has been called, in popular parlance, a "living will."

More than the US, the European Union has relied on new institutions charged with strengthening supervision of systemic risk. The lack of an entity in charge of macro-prudential oversight at the European level was, in fact, the main justification for establishing the European Systemic Risk Board. The body is similar to the US's FSOC in the sense that its members are existing regulators—in this case, among others, the Governors of European Central Banks and the European Central Bank. A vexing aspect of achieving orderly resolution of systemically important firms is that posed by the large number of financial firms that operate cross-border, which would entail the need to deal with a number of different insolvency regimes in case of failure. At the request of the G20, the Financial Stability Board has been working since 2009 on cross-border resolution of financial institutions. As a step towards this goal, in 2011 it issued the "Key attributes of effective resolution regimes for financial institutions." In it the FSB recommends that countries seek convergence of their resolution regimes by incorporating the tools and powers in that document into their domestic regimes "in order to facilitate the coordinated resolution of firms active in multiple countries."[36] The FSB also adopted a methodology for determining firms that are global and systemically important financial institutions, with the purpose of tagging them for tougher measures such as the preparation of "resolution plans" and additional capital requirements. However, the list comprises only 29 firms,[37] and it captures the firms deemed systemically important at a particular point on time.[38] In spite of the apparent objectivity of the criteria for determination, the exercise has fallen prey to political horse-trading among countries where the different firms are based. It is true, though, that the FSB recognized this as a non-taxative list, encouraging national regulators to extend the treatment to other firms as they deem fit, and also that the FSB is working on similar criteria for domestic systemically important financial institutions.

In Europe, given the existence of the common market, domestic and cross-border resolution are intimately linked. Since 2001, a Directive on Credit Institutions Reorganization and Winding-Up has been in force. This Directive introduced a "single entity regime."[39] The checkered functioning of this Directive, however, illustrated the daunting character of the task of trying to implement a cross-border resolution regime. For instance, the existence of this directive was not enough to enable orderly resolution of Fortis, a relatively small Dutch-Belgian-Luxembourg financial services company. Thus, the European Commission has been working after 2008 towards a common framework for crisis management of the financial sector. After missing the June 2011deadline it had set for adoption of a legislative proposal for bank recovery and resolution, the European Commission issued a proposal for a Directive in June 2012.

The proposed regime contains, as in the case of the US, a presumption that common bankruptcy (termed "insolvency" in the European case) is the regime that should be applied to failing banks, but there should be special regimes for dealing with systemically important financial institutions. For a resolution to proceed, therefore, one of the conditions that need to be met is that purposes of ensuring continuity of critical functions, avoiding significant adverse effects on financial

[36] FSB 2011.

[37] FSB 2011a.

[38] The list is supposed to be updated every year, thus even in the best case, it is bound to miss firms that become systemically important in between, something not to be ruled out given the dynamism that asset portfolios may exhibit in such firms.

[39] Single-entity regime, also referred to as the "universal approach," is that where home country authorities apply an insolvency proceeding to a bank incorporated in their jurisdiction and all its branches in other countries. The opposite is the separate-entity, also referred to as territorial approach, to insolvency.

stability, or others specified in the legislation, could not be achieved through application of common insolvency proceedings.[40] The Commission subscribes to the principle that resolution costs should be borne in principle by shareholders and creditors, but also calls for resolution funds to be established in member states as a contingency in case some other costs need to be incurred, for instance, for establishing a "bridge bank." This is not very different from the US approach, where the principle of shareholder and creditor losses is adopted but the FDIC is empowered to use public funding for the resolution, subject to certain conditions.

The European Commission's approach falls short of a common resolution authority for the European Union. While recognizing that this would be better, the Commission stated it would be difficult "in the absence of a harmonised insolvency regime and of a Single European Supervisory authority for those entities." This explains why the Commission's latest proposal is more along the lines of "a coordination framework based on harmonised resolution tools."[41] Under this framework the home resolution authority would lead the process of resolution and colleges of resolution authorities would be established to deal with the resolution of a cross-border institution.

1.1. Strengthening supervision of systemic risk

One shortcoming of the responses that rely excessively on regulators to spot and give early warning of systemic risk threats, is that they place too much trust on the capacity and will of regulators who have failed in the past to act – the FSOC is, after all, just a re- grouping of existing regulators. The fact that the Fed, a body highly suspect for its role previous to the financial crises, is given a predominant role in several major decisions in the Council, does not help assuage such concerns. Additionally, it is feared that cumbersome procedures and bureaucratic hurdles will compromise the FSOC.

The Pan-European authority seems to be in an even worse position. Serious doubts remain about the ESRB's ability to implement its decisions, even assuming it has will and capacity to act. Although the ESRB is empowered to issue warnings of systemic risk and recommend remedial actions, the actions ultimately have to be implemented by the respective national authority. In this regard, the ESRB has been invested with no binding authority. The legislation states it has been conceived "as a 'reputational' body with a high level composition that should influence the actions of policy makers and supervisors by means of its moral authority."[42]

1.2. Winding down TBTF institutions orderly and without taxpayer loss

The difficulties in resolving large and complex cross-border institutions reveal the need for significant international cooperation to be successful. The existing regimes assume that cooperation for cross-border resolution can be done through the home jurisdiction. This is implicitly so in the US (where one could presume the Orderly Resolution Authority would be unwinding any US-based company that operates beyond US borders), and explicitly in the European regime being considered.

Reliance on the home country authority, as the leader of the process, may make it difficult to overcome disputes that are common between home and host(s) states when cross-border firms fail. The less clear the rules on how to resolve such disputes, the greater the potential for a

[40] European Commission 2012, Arts. 26 and 27.

[41] European Commission 2010. Communication on Common Financial Sector Crisis Management Framework. October.

[42] European Commission 2009. Proposal for a Regulation of the European Parliament and of the Council on "Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board." Brussels, September 23.

resolution that will be unsuccessful, disorderly and/or will use more taxpayer funds from different jurisdictions than would be desirable. The Basel Committee on Banking Supervision has identified some of the key issues that represent an obstacle. One of them, perhaps the most important, is that the probability of a government applying measures that seek to protect local interests and stakeholders. This is likely because it faces public and policy pressure to allocate financial resources in a way that reduces the burden for its own taxpayers.[43] The assessment of comparative burdens is complicated because, in a cross-border crisis, there are different perceptions of the impact of failure of a cross-border institution and the willingness or ability of different authorities to bear their share.[44] Such an assessment will also be affected by whether the jurisdiction is the home country of the financial institution or group or, if a host, whether the institution operates through a branch or subsidiary. [45] It will also be affected, for host countries, by asset maintenance, capital or liquidity requirements that may be imposed on branches or subsidiaries.[46]

The disputes are almost unavoidable because there is a mismatch between the interests of the home supervisor – to supervise the financial company – and the interest of the host supervisor – to protect financial stability in its jurisdiction. The home country may want to confine the costs of a possible recapitalisation to the bank's home operations and national depositors, a problem that is more acute in the case of large banks in small countries.

The European Commission noted the tendency of Member State authorities to ring-fence national assets of a cross-border group and apply national resolution tools at the level of each entity instead of seeking a resolution across the whole group.[47] The problem is that such ring-fencing of local assets may often hinder rather than help resolve a problem in a cross-border group.[48]

The decisions of the resolution college would need to be implemented by each competent national authority but would then be binding. At least this transpires from a provision in the directive prescribing that, where national authorities disagreed, the European Banking Authority should mediate such disputes, and make final determinations and enforcement, should an agreement not prove possible.[49] This appears fairer than leaving such decisions to the home resolution authority. But it remains to be seen whether the mechanism can operate as swiftly as required without being outrun by real time events. Needless to say, the mechanism falls short from a centralized resolution authority and its teeth will be just as strong as the teeth of the European Banking Authority itself. [50]

1.3. Reducing size and complexity of TBTF institutions

Relying on monitoring of systemic risk to prevent future crises has limitations. Only limited hopes can realistically be placed on resolution regimes, especially for cross-border resolutions. Measures that would reduce the size and complexity of financial firms need serious consideration

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[43] BCBS Cross Border Bank Resolution Recommendations 2010.

[44] Ibid.

[45] Ibid.

[46] Ibid.

[47] European Commission 2009, 8.

[48] European Commission 2009, 8.

[49] European Commission 2012. Art. 83.6.

[50] This is, however, a more centralized mechanism than that voiced by the Commission in 2010 where it explicitly stated that the group resolution scheme would not be binding, even saying that "national authorities that disagreed with the scheme would not be prevented from taking independent action where they considered that necessary for reasons of national financial stability." European Commission 2010.

as a first line of prevention. Simpler institutions are definitely easier to regulate. However the large and transnationalised financial industry argues that by forcing a smaller and more fragmented financial sector, the economy will lose the contribution that such companies make based on economies of scale and diversification. If they existed these advantages would need to be traded-off against the instability that such large companies generate. But to begin with, these claims have been found to be bogus. Economies of scale seem to disappear after institutions reach some USD 100 million in assets.[51] The diversification effects have most often been linked to the capabilities of cross-border institutions to evade regulation and taxation measures in different jurisdictions, which is not necessarily a desirable way to bring down costs. Ultimately, it is unclear whether even cost reductions achieved in this way have benefitted the real economy, or simply contributed to the outstanding increase in profits and gains by the financial sector and its highest ranks.[52]

In the US, the recent legislation shied away from other measures such as imposing caps on the size of financial firms. Instead, the Financial Stability Oversight Council can order companies of more than USD 50 billion in assets, or other companies designated "systemically important" by the Fed and deemed a "grave threat to the financial stability of the United States," to reduce their size (for example, by terminating one or more activities) or restrict their activities. The legislation also created an Office of Financial Research, inside the Council, to monitor and study threats to systemic risk. The Office of Financial Research is also charged to report periodically to Congress. One important function of this Office would be to provide early warnings.

There are also some limits to concentration. Banks that as a result of a merger or acquisition would grow to hold more than 10 per cent of the aggregate consolidated liabilities of all financial companies are barred from consummating such an operation. However, the Fed can authorize such banks to proceed with the operation when the acquired bank is in default, or in danger of default, is receiving assistance from the FDIC, or when the operation would result only in a "de minimis" increase of its liabilities. It is worth noting that a federal law enacted in 1994 already restricted any bank from holding more than 10 per cent of the nation's deposits and, yet, several of the largest banks had been granted waivers from that requirement or used loopholes to evade its intent.

Another important tool in the US legislation is the so-called "Volcker Rule": a requirement that banks not engage in proprietary trading, or invest in hedge funds or private equity funds. This provision intends to ensure that firms cannot bet on high risk vehicles while relying on the subsidy guarantee provided for deposit-taking institutions. In this way, the possibilities that a subsidy intended to protect depositors may end up providing support to high risk activities would be limited. However, this requirement was adopted with significant exceptions: banks will be able to keep hedge funds and private equity fund units in-house; they are allowed to invest up to 3 per cent of bank capital in them; and to engage in proprietary trading of their own to hedge the bank's risk, for market-making purposes or to facilitate clients' needs (see also provisions that prohibit Federal assistance for deposit-taking institutions that engage in derivatives dealing, B.3. on derivatives). These exceptions might ultimately risk undoing the merits of the Volcker rule.

One critical design flaw of the rule, as conceived by the law, allows hedging banks to take on not only specific, but also aggregate portfolio positions. Hedging a full portfolio might not be very different from the bets banks engage in to boost their profits, with the same risky consequences.

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[51] Haldane, Andrew 2010. ("Economies of scale appear to operate among banks with assets less, perhaps much less, than $100 billion. But above that threshold there is evidence, if anything, of diseconomies of scale.")

[52] More on the question of whether large and complex banks play a useful role in Caliari, Aldo 2010 and 2009.

Furthermore, judging whether certain positions are taken for market-making reasons, or in order to boost the bank's own profits will be hard to do.

In the European Union, the possibility of imposing caps on bank size has not even entered into the legislative proposals so far and neither have the restrictions on "proprietary trading" called for in US legislation. However, the issue has been slowly creeping onto the European agenda mainly due to the continuing crisis faced by banks throughout the economic zone.

In early 2012, the European Commission appointed a High Level Expert Group tasked with reviewing whether structural reforms of the EU banking sector are needed. The group should, in particular, pay attention to activity restrictions, size limits and structural separation of certain activities. In 2011, the UK coalition government appointed a five-member Commission chaired by Sir John Vickers, the former chairman of the Office of Fair Trading, which was tasked to examine the structure of the UK banking sector, and look at structural and non-structural measures to reform the banking system and promote competition. The terms of reference of the Commission specifically refer to recommendations on "Structural measures to reform the banking system and promote stability and competition, including the complex issue of separating retail and investment banking functions."[53] The Commission's report, issued in September 2011, called for ring fencing banks undertaking retail activities –especially taking deposits – from risky investment operations. The ring fence called for means economic and operational separation and that the ring fenced banks should not be dependent on the rest of the group and should be separately capitalized. This recommendation is among those that the UK government decided to implement.[54]

2. Bank Capital requirements

The main significance of capital requirements is that they represent the main buffer that banks have to absorb losses in the event that transactions go wrong. The form of capital most capable of providing such a buffer is common equity, as it is the only one that can be entirely devoted to absorb losses.[55] As a general rule, the higher the proportion of equity capital that a bank is required to hold, relative to its volume of transactions, the more constrained the bank becomes in undertaking such (lending or investment) transactions through leverage. By reducing the ability of banks to use leverage, capital adequacy standards can limit risk-taking that may lead to instability in the system and ultimately to crises. Capital requirements are also important because they shape the incentives determining the types of activities that banks will be more willing to engage in. All things being equal, banks seeking to maximize profits will be more willing to engage in activities for which they are required to hold less capital, than those for which they are required to hold more capital.

National regulators have traditionally set the capital requirements for the financial firms. But since the late 1970s, a regime for international cooperation in the determination of capital requirements has been established by successive agreements called "Basel Agreements." This is because the committee that developed them, Basel Committee on Banking Supervision (BCBS), is housed by the Bank for International Settlements in the city of Basel. The BCBS is a body with limited representation, tasked with developing and implementing banking standards.[56] Although

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[53] Independent Banking Commission Terms of Reference.

[54] UK Treasury 2011.

[55] As opposed to debt or deposits, the bank has no contractual obligation to return equity to shareholders.

[56] Since 2009, the BCBS has expanded its membership which now is constituted by representatives from the following governments: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi

the Basel agreement is not a treaty, the trend has been towards increasingly broader implementation of it[57] through the adoption of domestic legislation or regulation by member countries.

The original Basel Agreement required that banks hold a specified level of capital as a proportion of risk-weighted assets. Basel II, issued in 2004, allowed for two approaches to measure capital: the Standardized Approach and the Internal Ratings Approach. The Standardized Approach required countries to rely on external credit assessments – usually provided by credit rating agencies whereas the Internal Ratings-Based Approach would allow banks, under certain conditions, to use their own internal risk assessment systems for the determination of the risk weight of assets. The crisis was seen as evidence of the inadequacies of the Basel I and II agreements. So in December 2010 the BCBS issued version III of the Basel agreement and several decisions.

Regulatory approaches

The US Dodd-Frank legislation left the determination of the capital requirements to the regulators. This was done in the expectation that the regulator would follow, or at least strongly rely on, the Basel III agreement. In the EU, the Capital Requirements Directive (CRD) made the Basel II mandatory for firms in the EU. The CRD was revised in 2009 and 2010 and it is expected that a fourth version (CRD IV) will be issued to make Basel III applicable to firms operating in the EU.

2.1. General issues with the Basel frameworks

Basel III would represent some significant changes over the Basel II approach. (See Box 1 next page). At the same time, it continues to rely on internal risk management techniques to be implemented by the banks themselves. Just like its predecessors Basel III will fail to live up to the promise of keeping the system more stable and less prone to crises.

The adoption of a higher proportion of common equity capital requirements, the most loss-absorbent form of capital, is welcome. But the equity capital requirements are still a lot lower than they should be to overcome the incentives firms face to use excessive leverage.[58] Essentially this means that banks can game the system when stating the risk-weight of their assets. By claiming that certain assets are less risky, banks can get away with keeping less capital than they might otherwise have had to. The head of JP Morgan, Mr. Jamie Dimon, said last year that to reach the higher capital requirements under Basel III he intended to "manage the hell out of [risk-weighted assets]."[59] Lately, the industry has even coined the expression "risk-weighted optimization" to refer to the techniques used to manipulate risk weights so that lower capital amounts are required. The internal monitoring of risk-weighted assets valuations by banks, puts a great burden on regulators to understand and eventually challenge highly intricate risk–management frameworks. Indeed, it is an incident in JP Morgan that most vividly illustrates the potential for manipulation of internal risk models.

Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

[57] In 2006 a survey found that Basle II agreement was at some stage of introduction in 82 countries (number that included countries in all regions of the world).

[58] Compare Basel III targets with, for instance, the 20 per cent equity that some Bank of England officials have argued for in Miles, Yang and Marcheggiano 2011, 40.

[59] Braithwaite, Tom 2011.

Box 1 - Key aspects of capital requirements under the Basel III agreement

- *Common equity*: the minimum capital that should be available in the form of common equity ranging from 2 % to 4.5 % cent of risk-weighted assets.
- *Capital conservation buffer*: a capital conservation buffer - which is destined to absorb losses in periods of severe financial stress - is created and set at an additional 2.5 %, that also has to be met with common equity, making the required minimum of common equity capital 7% of risk-weighted assets.
- *Additional countercyclical buffer*: A countercyclical buffer is, subject to national conditions, also to be implemented.
- *Liquidity requirements*: Two main forms of liquidity requirements are established: a liquidity coverage ratio and a net stable funding ratio. The liquidity ratio is the requirement that banks keep a certain portion of cash or liquid instruments available to survive a scenario of 30 days of acute stress. The net stable funding ratio is geared to ensure that banks have sufficiently stable sources of funding.
- *Leverage ratio*: This ratio is a supplementary ratio designed to keep a check on leverage. As opposed to the other ratios, this one is measured as a proportion (3 %) of total, not risk-weighted, assets.
- *Increased requirements for Systemically Important Financial Institutions (SIFIs):* Stricter capital requirements apply to SIFIs.

Internal risk-management systems rely generally on "Value-at-Risk" (VaR) measures. Value-at-risk indicates the losses in a given period that a company may suffer given a certain level of confidence. In May 2012, JP Morgan Chase disclosed USD 2 billion losses by its trading desk, losses that continued to rise due to the continuation of the market trends it had bet against and the impossibility to unload some of the assets without triggering further losses. Prior to revealing such losses, JP Morgan changed its model for Value-at-risk, for reasons that are still unclear. The reported VaR of the trading desk, after that revision, was of USD 67 million. Now JP Morgan has gone back to the original model and reviewed the trading desk's first-quarter VaR to USD 129 million. Even the higher of these two figures was a lot smaller than the actual loss suffered. The most significant point is that a bank is allowed to make these very wide differences, presumably based on different variables in the calculation, when reporting a measure that should be key for the regulator to understand the bank's capital situation.

Because of the lassitude allowed in risk-weighted assets, the most promising reform in Basel III is the introduction of a "leverage ratio" (3 per cent) which, unlike other capital measures, is calculated on the basis of total, rather than risk-weighted, assets. This makes the calculation less susceptible to gaming. Unfortunately the ratio has been set rather low. In the case of Europe, latest proposals for the text of the Capital Requirements Directive IV have made this leverage ratio optional.

The ratio is not entirely exempt from gaming. In the case of exposures to derivatives, for instance, accounting rules determine whether the ratio will give an accurate picture of leverage. Under US accounting rules, firms are required to report net derivatives exposure, where international standards (which are also applied in Europe) require firms to report derivative exposures on a gross basis. The difference can be significant, especially for the few banks that are the largest players in the derivatives markets.[60] Reporting derivatives exposures on a net basis helps the respective banks to dramatically downplay their total assets and, consequently, their leverage. In spite of attempts at harmonizing reporting rules, as recently as June of 2012 the

[60] See Financial Times Lex Team 2011 for an estimate at the end of 2011 was that reporting derivatives on net, rather than gross, basis would have swollen the balance sheet of the five largest US banks by a 40 per cent.

Financial Stability Board reports little progress: "After considering the comments of stakeholders the [International Accounting Standards Board and the Financial Accounting Standards Board] decided to maintain their current different offsetting accounting models but to improve and converge related disclosure requirements."[61]

In addition to the critiques that can be made about its inadequacy to actually prevent build up of systemic risk, the Basel framework can be criticized in its lack of consistency with ethical requirements that one might want to see in a banking capital requirements framework. The Basel agreements are all one-size-fits-all solutions, designed with a market logic in mind. In this sense, they do not necessarily enable flow of credit to productive activities, or to those with the most desirable social purposes. The consideration of risks does not address environmental or human rights issues. The potential of capital requirements to serve as a regulatory tool to incentivize credit to certain sectors or activities that need to be privileged is unfulfilled. Furthermore, they might enter into conflict with the prescriptions of the Basel agreement.

Of course, implementation of the agreement to the letter does not need to be the case, particularly given its "soft law" nature. The European case quoted above – dropping some of the requirements established by the Basel Committee—while not an example that should be promoted, shows that countries have the leeway to depart from the Basel Committee's prescriptions if they so want.

2.2. Capital surcharges for TBTF institutions

As mentioned above, capital requirements surcharges for SIFIs are an important measure to deter excessive risk-taking by large financial institutions. In this regard, the US legislation, also expecting guidance from the Basel Committee, agreed on capital surcharges for such institutions but left that extra surcharge at the discretion of the regulator.

Unfortunately, the decision by the Basel Committee has been disappointingly low. The surcharges can, in the best of cases, reach an extra 3.5 per cent.[62] In the opinion of one analyst, the expected capital surcharges for systemically important firms are unlikely to prove a sufficient incentive for reducing size or activities, and are particularly insufficient if they are not accompanied by more structural responses to "too big to fail."[63] In light of the rating subsidy that such firms enjoy it would have been necessary, at the very least, that they actually offset it. It is also important to highlight that, following the intention of the Basel Committee, these surcharges would apply to the limited number of firms considered to be systemically important (See B.1). However, it is possible for national regulators to decide to apply surcharges to companies they deem systemically important (even if the Basel Committee does not).

Important areas of disagreement remain between the US and the EU concerning the nature of the capital to be used to meet such higher capital ratios. It is becoming increasingly clear that banks will be allowed to comply with higher capital ratios via so-called contingent capital instruments. These are hybrid instruments that would, upon determination by the regulator, convert debt-holders' stakes in a bank into loss-absorbing capital.

In principle, the Basel requirements apply only to banks. The US legislation empowers the regulator to demand higher capital requirements also from non-bank financial companies that are designated as systemically important. It may be problematic to develop such a list, particularly given the moral hazard implications. Nevertheless, the issue of monitoring the capital

[61] FSB 2012. Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability, 21.

[62] Bank of International Settlements, 2011.

[63] Cornford, 2010.

requirements of non-bank SIFIs is an important one that has not been tackled by the European Union to date.

3. Derivatives

Derivatives are financial assets whose value depends upon that of an underlying asset, such as a commodity, a stock, a bond or a currency. This value of the underlying asset can be derived in many ways. A straightforward example is, for instance, a derivative whose price depends on the value that a stock is expected to have at a future time –a "forward." But derivatives such as credit default swaps could also be linked to the probability of default on a certain bond.

Derivatives can be infinitely varied, as there is no limit to the forms that contractual parties to derivatives might decide to give to their agreement. Yet, a number of contracts have reached a certain degree of standardization such that they can be traded in regulated exchanges (even if this is not always the case). Other derivatives are traded Over the Counter (OTC), that is, by private agreement between the parties. The size of over-the-counter (OTC) derivatives market has increased from $91 trillion in 1998 to some $605 trillion in 2008.

By helping different actors in the real economy to hedge their risks, derivatives can play a useful function in society. The typical case is a farmer wishing to lock in a future price for his/her harvest, or airlines wishing to lock in a certain price for the fuel they will need in their flights. In both cases the users can increase the predictability of future income or expenses, thus allowing better planning and security in their operations.

However, derivatives, especially in the deregulated environment of the decade preceding the financial crises, became the subject of widespread abuse. As a result, derivatives most often have contributed to increased opacity in the functioning of financial markets and growing risks in the economy. Speculation facilitated by derivatives has had detrimental effects on growing price volatility for a range of commodities from food staples to oil and metals. Over-the-Counter derivatives have proliferated with a variety of purposes that are often not linked to any social value but simply boost profits for the companies using them by hiding the true risk of certain assets or enabling tax avoidance. Given the praxis, therefore, it is debatable whether their role as risk mitigation tools can outweigh their role in increasing risks, especially for poorest consumers, producers and traders.

Derivatives contribute to the opacity and complexity of financial operations that make the orderly resolution of large financial companies more difficult without resort to taxpayer funds. The opacity and complexity of derivatives markets results in a web of cross-exposures among large and complex financial institutions and the rest of the system, which is very difficult to evaluate, inhibiting the feasibility and credibility of a bankruptcy-like remedy. This is because the collapse of a company would mean the partial, or total loss, of the value of the derivatives held by other institutions in the system that have the said company as a counterparty, rendering the knock-on effects unpredictable and contributing to panic reactions by market players.

During the recent crisis, for instance, derivatives markets were responsible for the threatened collapse of American Insurance Group (AIG) leading to the US government's decision to bail out the institution. American Insurance Group, then the world's biggest insurer, was found to be at risk of default on massive derivative transactions that had gone wrong. Since many of these transactions were insuring risk in Collateralized Debt Obligations[64] and pools of risky assets (that deteriorated during the crisis and were widespread throughout the system), the possibility of

[64] Collateralized Debt Obligation is a pool of assets and/or mortgage backed securities with loans, bonds or other financial assets as the underlying.

default on those contracts was deemed as carrying catastrophic consequences. So the government decided to err on the side of caution and bail out the company. In a highly interconnected and opaque environment, the mere suggestion that a large company might default, given the inability of investors to understand how the counterparties to their derivatives might be affected, is enough to trigger a broad-based loss of confidence that, in turn, can trigger a collapse.

This opacity is also an amplifier of the impacts when a financial firm fails, as in the case of Lehman Brothers. Once a financial crisis is underway, derivatives fuel contagion. The largest companies, and those with highest volume of OTC derivatives trading, closely overlaps, as over 80% of derivatives are controlled by JPM Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley.[65]

OTC derivatives also allow for excessive risk-taking via under-collateralized transactions. Because these transactions happen bilaterally, rather than in exchanges, traders can post less collateral and set lower margins than they would be required to otherwise. One estimate put the percentage of bilateral derivatives without collateral at nearly 23%. It is not known how much collateral is posted for the remainder of bilateral transactions.[66]

Derivatives enable speculation that has driven up the prices and the price volatility of food and energy commodities. Several independent analyses consider the enactment of the Commodity Futures Modernization Act in 2000 as a critical juncture in the process of enabling speculators to drive up price of these commodities. This legislation, as described by Gosh, "effectively deregulated commodity trading in the United States, by exempting over-the-counter (OTC) commodity trading (outside of regulated exchanges) from CFTC oversight. Soon after this, several unregulated commodity exchanges opened. These allowed any and all investors, including hedge funds, pension funds and investment banks, to trade commodity futures contracts without any position limits, disclosure requirements, or regulatory oversight."

There are also clear instances where the use of derivatives has been traced to a number of non-desirable purposes while offering no useful contribution to society or real economy users:

- In 2010, credit default swaps were blamed for worsening the Greek debt crisis when it emerged that the Greek government had used derivatives to hide the true value of its budget liabilities.
- These instruments are the source of risk, the extent of which is still to be determined, in the debts of a number of US municipalities and national governments with large sovereign debt burdens, such as Italy.
- In the US, the use of credit default swaps was key to the mechanism that allowed banks to sell investors pools of securitized mortgages of low credit quality as assets of top-rated credit quality.
- In 2011, a pilot audit of Mopani Copper Mines Plc (a copper and cobalt mining company owned in 73 % by Swiss-based company Glencore) found it to be engaging in use of derivatives trades to shift profits out of Zambia in order to minimise its tax bill in the country.[67]
- In a 2008 study the OECD found that aggressive tax planning involves, among other instruments, derivatives, and that this tax planning was sometimes carried out for clients but was also undertaken for the banks themselves. Many of these tax planning solutions were "designed to generate tax losses that are separate from the mainstream of the taxpayer's

[65] DEMOS 2010, Biggest Banks, Riskier Banks.

[66] Estimate by ISDA, quoted in Wellink, Nout 2010.

[67] Christian Aid 2011.

business activities and shelter unrelated income; and they often lack economic substance independent from the tax benefits. …some aggressive arrangements are designed to obscure the real economics of the transaction."[68]

Regulatory approaches

The main reforms agreed by the G20 in this area are intended to ensure that standardized derivative contracts are traded on public exchanges (or electronic trading platforms) and cleared through central counterparties.

Requiring derivatives onto public exchanges and to be centrally cleared is a way of increasing transparency in the market. The increased transparency also facilitates competition in price and better prices for users by making it more difficult for bank dealers to charge the higher prices they might do in an environment of less disclosure. Public trading and central clearing also forces the posting of margin and collateral for those transactions, reducing the overall leverage built in the system, and allowing regulators to spot risks more easily. Collateral to back the transactions has to be monitored on a frequent basis –daily, in some cases. This is not necessarily done when the transactions are carried outside of a clearinghouse.

Central clearing also facilitates multilateral netting of the positions in the transactions, better enabling regulators to understand the risks different actors bear. The obligation to clear derivatives trades safeguards against some risks that were otherwise borne by dealers and users, and contributed to uncertainty in a crisis situation. Bilateral transactions were carried out with limited quantity or quality of collateral, making complex cross-exposures to other dealers uncertain.[69] The obligation to centrally clear transactions guarantees that cross-exposures will be recorded, netted out on a multilateral basis. To absorb losses they will count with the benefit of posted margins and clearing funds. But margin requirements also serve the function of making it harder to speculate. Margin requirement is a percentage that traders have to post as collateral in their account for the derivative transactions they are conducting. The higher the margin requirements, the harder it is to maintain an open position in a contract, without cash or good collateral to back it up. Derivatives that are not centrally cleared should still be reported and should be subject to higher capital requirements. The purpose of this is to also enable appropriate monitoring of these transactions and provide disincentives to engage in them.

The G20 also agreed that regulators "should have, and use formal position management powers, including the power to set ex-ante position limits." [70] Position limits for traders make speculation more difficult and increase its costs. Position limits curb the ability of speculators to post contracts for the pure purpose of betting, or getting exposure to the underlying commodity.

All of the above requirements have, in general terms, been adopted in the US reform legislation. In the EU, the legislative process is ongoing through several separate but related tracks. In September 2010, the European Commission adopted a legislative proposal on the Regulation on OTC Derivatives, which contains broadly similar requirements for derivatives clearing as the US legislation. In March 2012, a proposal was adopted by the European Parliament and remains to be accepted by the European Council. A separate piece of legislation, the Markets in Financial Instruments Directive, addresses the trading venues and market participants, and is currently being reviewed by the European Parliament.

[68] OECD 2008. Chapter 9.

[69] Wellink, Nout 2010, quoting a report estimating that 23 per cent of bilateral trades were not collateralized while for the remaining 77 per cent the extent of collateralization was unclear.

[70] Group of 20 2011.

In the European context it is also relevant to mention the Directive on Market Abuse, which aims to prevent market manipulative behaviors. The European Commission is also preparing proposals for reform of this directive. It is likely that the Directive will require transaction reporting of clearly specified OTC derivatives for market abuse detection purposes to be developed in conjunction with CCPs and trade repositories.

However positive many of these proposals are, caveats need to be made regarding their effectiveness in addressing the issues surrounding derivatives. In most cases the effectiveness is also contingent on the regulators' willingness to implement them. This is not a moot point. Mobilized by the financial industry, US lawmakers opposed to the Dodd –Frank Act have used tactics to intimidate the regulators, grilling them in public hearings, introducing bills to downsize them, or cutting their budget, even before the ink on the Act was dried. The financial industry has also resorted to challenging some rules via lawsuits.

3.1. Scope of application

The obligation to move trades to public exchanges covers "standardized" derivatives contracts. Many OTC derivatives are, essentially, non-standardized and custom-made to the needs of a specific client. These contracts will be subject to lesser obligations and will continue to be carried out on a bilateral basis. However, it is often not clear when a contract needs to be standardized or not. The "needs" of the client being met by such an instrument might simply be a device to achieve some undesirable purposes, or might achieve needs that can also be achieved with standardized contracts, but a non-standard form is used just to avoid the public exchanges.

US and EU rules also exempt derivative transactions where one of the parties to the transaction is a so-called end-user. End-users or "non-financial counterparties" in the EU are non-financial entities that use derivatives to hedge real risks ("commercial risks" in the US legislation). This exception is aimed to prevent end-users from being overburdened by regulatory requirements or the costs of margin and collateral.

But, as the EC warned in its proposal for legislation on Derivatives, there is a risk that non-financial counterparties take systemically important positions in OTC derivatives. Also, a financial counterparty could easily circumvent the obligations set out in the Regulation by establishing a new non-financial entity and directing its OTC derivative business through it.[71] It is easy to see how the purposes of the legislation could be thwarted, by allowing exceptions for exactly the riskiest types of derivatives, if the regulators define "commercial risk" too broadly. For instance, a letter addressed to the CFTC by the Commodity Markets Oversight Coalition states:

> "Commercial risk" should not include risk that is purely financial in nature, including balance sheet risk. We reject the assertion that "commercial risk" is essentially any business-related risk other than risk associated with the movement of physical commodity prices. Such an interpretation would imply that the risk management needs of purely financial market participants are "commercial" in nature."[72]

In defining who are the "dealers" subject to the oversight, there is also potential for a more or less strict notion. In the US, an initial proposal by the regulator would have subjected dealers carrying a volume of transactions above USD 100 million in the course of a year to its oversight entities, the regulation finally approved raised that threshold significantly, to USD 8 billion.

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[71] European Commission 2010. Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, p.7.

[72] Commodity Markets Oversight Coalition 2010. Letter to Commodity Futures Trading Commission. November 1.

In the US case, another important exception is that the US Treasury is empowered to decide whether foreign exchange swaps and forwards should be exempted from the clearing requirements and public trading requirements.

3.2. Position limits, collateral and margin

In the US legislation, the regulator is required to set position limits by market, and by commodity, for all traders. It is not clear that the European legislation will follow a similar approach, so position limits could be made optional.

Even where position limits are mandatory, they may be set at such high levels that they are ineffective to prevent speculative behavior. Critics claim that this is the case for the position limits set by the Commodity Futures Trading Commission in the US.

Collateral and margining requirements are also as effective as the determination of regulators and to the extent that they affect the way of doing business of the speculators. What matters is whether they will be significant – e.g., margins could be set so low that they are irrelevant to attempts to limit position-taking for solely speculative purposes.

3.3. Governance of the clearinghouses

Their obligation to clear trades makes governance regimes for clearinghouses (central counterparties in European legislation) set by regulators very important. In the US legislation, regulators are required to set limits on the voting and ownership rights of dealers in the clearinghouses and exchanges. If regulators fail to generate stringent enough caps, there is a risk that a few banks or dealers could collude to own a clearinghouse, thereby maintaining the dominance of the derivatives transactions that they enjoyed before the crisis.

The clearing obligation also means that risks are concentrated in the clearinghouses. In the US legislation, clearinghouses are among the "financial market utilities" that the FSOC could declare of systemic importance. This in turn enables the clearing institutions in question to enjoy extraordinary discounts and borrower facilities, as well as reserve requirements exceptions. As a result, it is possible that publicly-funded bailouts may be needed to support derivatives bets gone awry. In the European Union, though no similar provision exists so far, the guarantee clearing houses would enjoy is implicitly as effective.

It is also important to keep in mind that clearinghouses are not a silver bullet. There are certain types of derivatives where the market is characterized by large positions held by a few traders, in which case the clearinghouses might not be able to mitigate counterparty risk so well.[73]

3.4. Derivatives betting by publicly-insured deposit-taking institutions

In institutions that take deposits (publicly insured) and engage in derivative transactions, it is difficult to disentangle one activity from the other. It is likely that institutions wherein both activities coexist will be bailed out when risky derivative trades go wrong In turn, such financial firms, knowing this situation are more prone to undertake excessive risks thus creating moral hazard. The interventions of such institutions have a major effect on the market. A few large banks account for 80 per cent of all derivative trades in the US.[74] Not tackling this issue would seriously undermine regulation of trading for speculative purposes.

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[73] Wellink, Nout 2010. Mitigating Systemic Risk in OTC Derivatives Markets, in Banque de France, Financial Stability Review, No. 14, Derivatives – Financial innovation and stability, July.

[74] See Suppan 2011 ("Just four firms (JP Morgan, Goldman Sachs, Bank of America and Morgan Stanley) were counterparties to 96 percent of U.S. OTC derivatives as of December 31, 2009. The EU OTC

There are a number of proposals to separate more traditional banking activities (deposit-taking and credit provision) and investment banking activities. This recommendation was even made by the Pontifical Council for Justice and Peace.[75]The Volcker rule in the US and the proposals of the Vickers Commission in the UK are some examples (See Section 1.)

In addition, in the US legislation, deposit–taking institutions are required to spin off their derivative trading operations, though this rule is subject to a number of exceptions. The section effectively requires most derivatives activities to be conducted outside of banks and bank-holding companies. The exceptions are for derivatives "involving rates or reference assets that are permissible for investment by a national bank" under the relevant legislation. This allows derivatives based on: interest and exchange rates, gold and silver. In a separate provision the law also allows trading of cleared, investment grade CDSs. Finally, trading is allowed through hedging that is directly related to the firms' own activities.

The European legislation does not have provisions related to the spin-off of derivatives trading from publicly insured institutions.

3.5. No option to scrutinize and/or ban undesirable derivatives

As mentioned above, derivatives have been associated with the pursuit of several purposes that, even if legal, are not desirable. Because derivatives will, in all likelihood, continue to pose risks to the system, there is a special duty to scrutinize the reason for engaging in them and ban those that do not pass a reasonable burden of proof on the social ends to be fulfilled by them. But there is no requirement in the legislation that might allow regulators to ban certain derivatives, except for the European Union movement towards banning dangerous derivatives, such as CDSs and naked short-selling.

4. Hedge funds and private equity funds

Hedge funds can be defined as "private pools of funds that invest in traded instruments (both cash securities and derivatives)." In a simpler definition, hedge funds are funds established for the purpose of investing the money of their participating partners. While the lines between hedge funds and private equity funds are blurred, and the lack of exact definitions does not help distinguish them, one could say that private equity funds are also pools of funds that have, generally, a strategy of investing in private – that is, closely held— companies. Oftentimes, the private equity funds achieve higher than average returns by investing in companies, restructuring them and selling them out.

Because hedge funds specialize in highly sophisticated, high-risk investment strategies to achieve above average returns, they usually engage in highly leveraged bets that could carry risks for the entire system. They use various means of leverage, including short positions, and are generally not regulated.

In spite of this contribution to risk, some argue that the 2008-09 Great Recession had nothing to do with hedge funds. They argue that fears about these instruments are ill-placed. Many hedge funds did close during the crisis, so the risks of failure were borne by the contributing investors and they did not need to be bailed out by governments. However, data released by the Fed showed that hedge funds were among the beneficiaries of Fed emergency bailout programs,

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market is similarly, it not as intensively, concentrated in Credit Suisse, Deutsche Bank, HSBC, Rabobank and UBS.")

[75] Pontifical Council for Justice and Peace 2011. Towards Reforming the International Financial and Monetary Systems in a Context of Global Public Authority.

effectively meaning that taxpayers supported profits in these supposedly high risk-high return vehicles for wealthy investors.[76]

Hedge funds contributed to the crisis in other ways as well (See Section 7). They had significant linkages to banks and other financial firms' whose excessive risk-taking they made possible by taking the counterparty positions in risky transactions. Hedge funds were also in many cases housed or owned by banks and other companies.

There is a trend towards hedge funds becoming more solidly embedded in the social security fabric of many countries, as social security responses provided by States come under fire. As a consequence, workers and pensioners have their savings increasingly exposed – in some cases without their knowledge or without understanding the true risks—to these institutions.

Indeed, hedge funds were only supposed to be accessible to high net worth individuals – which also ensured that average consumers were not exposed to the risk – but the access to retail investors has steadily increased. Governments have also increasingly been investing their pension programs money in hedge funds. In the United States for example, in 2004 the Securities and Exchanges Commission (SEC) reported that about 20 per cent of corporate and public pension plans were using hedge funds in 2002, up from 15 per cent in 2001, and the trend was rising. Public pension funds are among the number of entities that, in the last few years have sharply increased the amount of money they put into hedge funds in an effort to boost their returns and diversify their holdings. In Europe, hedge funds have, in practice, been accessible to investors of far more modest means. This was the case in France where funds of hedge funds could be accessed by individuals with a minimum amount of €10,000 and Germany where German investors could buy hedge funds from Deutsche Bank in units of less than €125. The European Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) tightly regulated a number of funds that were widely used by retail investors. But these instruments, with more recent changes to the law, have allowed the funds to go into riskier activities. Hedge funds are also reportedly repackaging their products into vehicles consistent with the UCITS and, thus, capable of being offered to retail investors.

At the same time, the strategies that hedge and private equity funds tend to utilize to boost the returns of their holders usually have, as a downside, activities detrimental for the real economy or with negative impacts on the most vulnerable. These include the leveraged buyout of companies to increase their value by firing workers or reducing their benefits, and the use of commodity derivatives to speculate on food or mineral prices.

Regulatory approaches

US rules now require managers of hedge funds and private equity funds to register with the SEC. They empower the SEC to require hedge funds to report and file records and even conduct on-site inspections of their records. The requirement includes reporting aspects that could be useful for the FSOC to assess threats to systemic risk. While funds managing less than USD 150 million can be exempted from the registration, the SEC is still empowered to demand that they file information necessary for the protection of the public interest.

In Europe, as mentioned, there is a Directive on UCITS that regulated funds available for retail investors which, to some extent, has served as a vehicle for hedge funds. In addition, an Alternative Investment Fund Managers' (AIFM) Directive, approved by the European Parliament in November 2010, focuses on requirements for managers of some hedge funds:

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[76] This support was provided to some hedge funds through the Term Asset-Backed Securities Loan Facility (Talf).

those that are not covered by the UCITS, and as long as their assets are above a threshold the legislation sets at E 100 million.

4.1. Some general issues concerning the regulatory approaches

The coverage of the EU legislation seems, in general terms, lower as funds under the threshold of assets under management are from the outset excluded from the legislation (whereas in the US the regulator is empowered to still make some demands for information).

The EU Directive empowers the Commission to set leverage limits. In principle US regulators do not have similar power. But if the hedge funds are designated as systemically important, then the monitoring of leverage, as well as other aspects of the financial structure that pose risks, could fall under the jurisdiction of the FSOC. Such actions by the FSOC are cumbersome, however, and unlikely to be taken frequently (See B.1) The EU Directive establishes that AIFM does not give the right to market the funds to retail investors. However, it also states that different Member States may add their own requirements, thus making the funds marketable to retail investors. Under this framework, it is therefore possible that countries may issue less constraining requirements than UCITs. As far as the US is concerned, the question of the retail investors seems equally unregulated. There is only a study ordered in the Dodd Frank Act to analyze "the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds."

The use of dubious tax strategies by hedge funds is to some extent addressed in the EU legislation, which prohibits that funds market shares of funds domiciled in third countries, unless such third countries comply with standards in the OECD Tax Convention. The purpose of this provision is to ensure that national tax authorities may obtain all information from the tax authorities of the third country necessary to tax domestic professional investors investing in offshore funds. But the reliance on tax evasion and avoidance strategies that may include use of offshore tax havens by hedge funds based in the EU is not addressed, neither is it clear that the information provided under OECD Model Tax Convention will enable tax authorities to tackle those strategies. In the US, not even the reference to the OECD Tax Convention is found in the legislation. But US-based funds trying to market in Europe will have to comply with this requirement.

5. Credit rating agencies

Credit rating agencies (CRAs) provide ratings for a range of companies and financial assets in exchange for a fee. Institutional investors (such as pension funds, mutual funds) and banks rely on credit rating agencies for the assessment of the risk of assets in their portfolios.

Credit rating agencies may incentivize excessive risk-taking that leads to crises by providing an unwarranted sense of security regarding the quality of certain assets purchased by investors, or leading investors to be less careful in their own assessment of the risks such assets involve. In the lead up to the 2008 collapse, the assessment of credit rating agencies was a key factor allowing the gross underestimation of the risk of financial products such as Mortgage-Backed Securities and Collateralized Debt Obligations. Without the blessing of such ratings there would have been no market for many of the toxic products that were at the heart of the financial crisis.

In many cases, the reliance on CRAs' assessments was due to legally-mandated requirements. In other words, the law would prescribe that only certain securities that were rated as Triple A (the best possible rating) could be the subject of investment by certain funds. Ratings were also a mandatory way for banks assessing the risks of their assets under the Basel II agreement on capital requirements. This was true for banks not relying on internal risk models (See Section 2).

But it was also true for banks using internal risk models to the extent that ratings were realistically the only option that could be applied for rating structured finance products, such as CDOs.

Obviously, there is a degree of uncertainty inherent to any activity that involves predicting future events, such as a default. But the systematic underestimation of the risk of certain products in the lead up to the financial crisis has the spotlight on the CRAs' rules for governance, accountability and conflict of interest.[77] The business model of Credit Rating agencies, which is based on the "issuer pays" principle—that is, the company issuing the securities pays the agency examining them—has a conflict of interest at heart. Companies could shop around to find the agency that would offer the most favorable rating. So CRAs access to business was actually dependent on their ability to keep clients by offering ratings that would satisfy them.

In spite of their tremendous impact on the market, CRAs ratings are at the same time considered a mere opinion. For their opinions, the agencies have invoked – and have had upheld in courts —freedom of speech guarantees. This not only has been wielded as a defense against government interference or control, but has also allowed them to avoid, in general successfully, the application of standards of liability that apply to expert opinions provided for a fee in other sectors, such as accounting or investment banking.

Regulatory approaches

The G20 countries agreed in 2008 to "exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct."[78] This is a Code of Conduct developed by the International Organization of Securities Commissions (IOSCO) in its revised version of May 2008.[79] In 2010, at the Seoul Summit, they also endorsed a set of principles produced by the Financial Stability Board on "reducing reliance on credit rating agencies."[80]

The US approach, embodied in the Dodd-Frank Act, grants new powers to the SEC to monitor and supervise CRAs. It also establishes a number of procedural safeguards that CRAs must adopt regarding disclosure of information on methodologies (both with the SEC and with investors), requirements on methodologies themselves, disclosure of the performance of methodologies, assumptions in ratings, due diligence, governance requirements (e.g. that a certain number of Board members should not have an interest in credit ratings being assessed), etc.

The European Commission had already started a process towards a reform in the regulation of CRAs in 2008, with the result that by mid-2009 it issued a new Directive. The Directive aimed at increasing oversight of CRAs operating in EU jurisdictions. It required all agencies intending to have their ratings used in EU jurisdictions to submit to registration and supervision in the EU. The regulation covered conflicts of interest, rating analysts, methodologies, disclosure and presentation of credit ratings, transparency, and registration. In fact, many of the measures adopted in Dodd Frank are broadly similar to requirements contemplated in the European

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[77] FSF 2008. ("The CRAs that rate the vast majority of [structured] products rely primarily on an issuer-pays model and the revenues from this rating activity accounted for a fast growing income stream for these CRAs in recent years…. While the issuer-pays model applies to all the products rated by these CRAs, including corporate bonds, the standard conflicts of interest may be more acute for structured finance ratings… The conflicts are exacerbated when CRAs also sell consulting services to entities that purchased ratings.").

[78] G20 2008.

[79] IOSCO 2008.

[80] FSB 2010.

Union 2009 Directive. Both generally incorporate the principles of the IOSCO Code of Conduct. To the extent that in its most recent report of implementation, the FSB comments that "A significant proportion of FSB members have also taken actions to improve CRA practices and procedures, such as the adoption of the IOSCO CRA Code, inclusion in relevant rules/regulations of the requirements for assuring the transparency and quality of the rating process, and providing full disclosure of their ratings track record."

Indeed, this sense of satisfaction with the progress might explain why at the last G20 Summits (Cannes 2011 and Los Cabos 2012) the agenda on strengthening the regulation and supervision of credit rating agencies seems to have all but vanished. In terms of the reduction of mechanistic reliance on CRAs, by contrast, limited progress is reported.

5.1. General issues with the regulatory measures

While the IOSCO Code of Conduct offers some useful principles for ensuring transparency and integrity in the ratings process, it is largely procedural and does not grant regulators more than a prerogative to monitor the implementation of such procedures. There is a risk that the formal implementation of such principles neglects effective changes in incentives that drive conflicts of interest in the rating business.

It is because of this that the attempts to reduce the impact of CRAs in the market by removing references to CRAs in laws and regulations is, in theory, a more useful way of addressing the issues surrounding the role of CRAs. However, progress on this front is very limited and there are structural reasons for this. A measure of this difficulty can be inferred from the fact that the Basel framework for capital adequacy, even after the Basel III reforms are accounted for, still embeds a role for credit rating agencies in determining the risk of certain assets.[81]

Effectively shifting from CRAs to alternative risk assessment measures would demand building capabilities in market participants and regulators, which will take a long time. It is likely that for some participants, especially small firms and investors, attempting to perform due diligence on risk assessments will be such a burdensome task that they might need to rely on CRAs on an informal basis. If that is the case, we might end up with an even worse situation where the CRAs play a "shadow" role even while formal mechanisms appear to not rely on them.

It is therefore all the more necessary to keep the reforms to ensure strengthened supervision and regulation of CRAs on the agenda.

5.2. Conflicts of interest in the CRAS business model

Under the US financial reform legislation, the "issuer-pays model" is, for the moment, left intact. However, the legislation called for a study on how to avoid conflicts of interest generated by the model. In two years, rules have to be issued on the assignment of CRAs to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the product from selecting a preferred agency. This study has to be acted upon within 18 months. There is also a study requested on mechanisms for compensating CRAs so they have incentives to provide more accurate credit ratings. Unfortunately, the deadlines set in the law have so far not been met. The European Union Directive passed in 2009 does not even pretend to address this issue. But further changes to the existing regulations that are currently being debated have raised the possibility of introducing alternatives to "issuer –pays." A new Directive proposed by the European Commission on November of 2011, among other things, would have CRAs rotate so, as a rule, no CRA can rate the same issuer for more than 3 years.

[81] In spite of the fact that the most recent guidelines adopted by the Basel Committee attempt to dilute this role or add safeguards to make it less impactful. See Basel Committee on Banking Supervision 2011.

The same proposal, however, states that the idea of a public rating agency has been abandoned, judging that it would not offer enough guarantees that conflicts of interest can be avoided.

5.3. Standard of liability

An important reform in the Dodd Frank legislation was to weaken the exemption of liability that CRAs used to enjoy for their statements. The legislation now determines that CRAs can be sued for failing to "(i) conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or '(ii) to obtain reasonable verification of such factual elements …from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter."

Again, only the most recent European Commission proposal addresses civil liability. Investors suffering damage as a result of a credit rating on which they have relied to purchase a certain instrument will be able to bring action against the issuing agency if the latter has "committed intentionally or with gross negligence" one of a series of infringements that the legislation lists. These infringements can be, for instance, breaches of the rotation rules or failures to disclose conflicts of interest or circumstance that compromise the ratings.

5.4. Other issues

Two additional points are touched on in the latest European Commission proposal (but have not been the subject of references in US legislation). These are rules to enhance competition among credit rating agencies, and lower barriers to new entrants. The other is a set of extra requirements for sovereign ratings. The CRAs would have to publish a full research report when issuing and amending sovereign ratings, in order to improve transparency and enhance users' understanding. They are also banned from issuing sovereign ratings before close of business or less than an hour before the opening of trading venues in the EU.

6. Financial sector taxation

Financial sector taxation has come back on the agenda of governments as they struggle with mounting public deficits and public indebtedness as a result of the crisis and, in some cases, a direct result of the costs incurred to bail out private financial firms. Observation of the stark contrast between the outsized gains made by financial firms and the sacrifices imposed on the public via budget cuts and layoffs has added to a sense of urgency around reassessing whether the fiscal pressure on the financial sector should be increased.

The taxation of the financial sector has been justified on a number of grounds. Firstly, the taxes on the financial sector can fulfill revenue-raising goals (raising revenue for national and global public goods). In an estimate, at the European level even a financial transactions tax at a minimal rate of between 0.1 per cent and 0.01 per cent would generate income of about Euro 57 billion per year.[82]

Secondly, they are a way to ensure a fairer distribution of the burden of bailouts between public and private sectors. As put by the IMF, one of the objectives that should guide measures to pay for and contain the fiscal costs of future financial failures should be to ensure that the financial sector pays in full for any fiscal support it receives.[83] "Expecting taxpayers to support the sector

[82] European Commission 2011.

[83] IMF 2010, 9.

during bad times while allowing owners, managers, and/or creditors of financial institutions to enjoy the full gains of good times misallocates resources and undermines long-term growth."[84]

Thirdly, depending on their modalities, the taxes can provide a disincentive to activities that involve excessive risk-taking. Providing a disincentive to engage in transactions that generate risk with little benefit for society can be, in and of itself, enough justification for some taxes. CIDSE has consistently promoted a special form of financial transaction tax (FTT) which targeted currency transactions. The type of cross-border trade of currencies targeted by this measure has contributed to amplifying the volatility in currency markets and enabling speculative attacks on currencies.[85]

Finally, taxation can be designed in ways that reduces the incentives for financial firms to become "too big" or "too interconnected" to fail (See section 1).

Regulatory approaches

In the US, a version of the House-approved legislation addressing the Resolution Authority, contained a measure to ensure the financial sector pre-funds potential future bailouts by requiring banks with over USD 50 bn in assets, and hedge funds with over USD 10 bn in assets, to contribute to a fund of USD 150 bn. The Senate version contained a similar measure but envisioned a fund of USD 50 bn, to be paid for by entities with over USD 50 bn in assets, in proportion to the potential benefit they could derive from the fund.

These measures were dropped, along with a measure that would have required banks to pay fees to finance implementation of the law at a cost of USD 19 billion. The law retained the requirements prohibiting the use of taxpayer funds for resolution and states that if this requirement is breached, any expense incurred is to be restored after the fact by ex-post levies on the financial sector.

It should be noted that the taxes were not intended to be a mechanism for reducing the size of the sector, compensate taxpayers for the losses in previous bailouts, or prevent speculative activity. Only the bank levy proposed by President Obama had some anti-speculative elements insofar as the basis for collecting the tax would be the non-insured debt liabilities of the companies.[86]

In the EU, more progress has been made towards introducing a number of special taxation measures on the banking sector, though the scope, extent, and purposes of the measures are rather diverse across countries. In a Resolution of June 2010 the European Council stated "Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk."[87] It also agreed that "The EU should lead efforts to set a global approach for introducing systems for levies and taxes on financial institutions with a view to maintaining a world-wide level playing field and will strongly defend this position with its G20 partners. The introduction of a global financial transaction tax should be explored and developed further in that context."[88]

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[84] Ib.

[85] CIDSE 2009.

[86] A number of proposals targeting financial transactions for special taxes were introduced throughout the year, but not attached to the Dodd-Frank bill. Some examples are the "Let Wall Street Pay for Wall Street's Bailout Act of 2009" introduced by House Representative DeFazio and the "Investing in Our Future Act of 2010," introduced by House Representative Stark.

[87] European Council. Resolution of June 17, 2010.

[88] European Council. Resolution of June 17, 2010.

It is reported that, implementing the European Council agreement, European states already have measures in place that are designed as a tax on the balance sheet or on risk-weighted assets – therefore, intend to operate as disincentives to risky activities.

However, after unsuccessful attempts to adopt a European Commission Directive for an Europe-wide financial transaction tax, it was decided that those in favor will go ahead by using a mechanism called "enhanced cooperation" that allows 9 or more member states to move ahead in a proposal to apply to them.

6.1. General issues

As made clear by the above assessment, the imposition of financial sector taxes has been very uneven among countries and, moreover, prospects for multilateral adoption are dim. However, one interesting finding that seems to emerge from the post-crisis debate is that multilateral coordination on this particular issue may not be as important as claimed. It certainly has not provoked the catastrophic migration of financial sector activity that some forecast. This is not to say that such migration of activity would necessarily be negative – in fact, defenders of the tax have long argued that reducing the most risky financial behaviors is a positive and intended, not a negative, consequence of the taxes.

Moreover, the review of experience showed how many countries actually did already have special taxation measures in place to target financial transactions, or the financial sector, without having triggered the effects that skeptical experts envisioned. Paradigmatically, in a report last year the IMF asserted:

"Unilateral STTs,[89] even if levied on fairly narrow bases, are certainly feasible as witnessed by their use in numerous developed countries. The fact that major financial centers such as the U.K., Switzerland, Hong Kong, Singapore, and South Africa levy forms of STTs indicates that such taxes do not automatically drive out financial activity to an unacceptable extent. Indeed, given the apparent agglomeration effects in financial activity, established financial centers may face a less elastic base than peripheral countries. Other factors than taxes, including regulatory regimes, legal institutions, and clientele location, also impact the cost of transacting in a particular financial center."[90]

It will also be important to assess how much of this tax revenue is devoted to social expenditures, development or climate, versus other potential objectives such as recapitalizing banks or repaying sovereign debt. Except for France that has clearly and constantly championed the use of the revenue for development finance, there are no clear indications so far that the use of the revenue collected will be necessarily guided by specific redistribution or ethical considerations.[91]

[89] The IMF paper adopts the nomenclature of referring to Securities Transaction Taxes (STTs), or taxes on trades of securities.

[90] IMF 2010. Financial Sector Taxation: The IMF Report to the G20. Background Material, p. 176. It is worth noting that, nonetheless, the IMF advises the collaboration in imposing STTs because of challenges from cross-border integration Nonetheless, since increasing cross-border integration of financial markets may otherwise increase the elasticity of the tax base or worsen revenue collection.

[91] See A Bottom Up Approach to Righting Financial Regulation 2012, for a human rights framework view of the tax and how to use its revenue.

7. “Shadow banking”

“Shadow banking “ can be defined as a lightly regulated or unregulated part of the financial system that operates in a bank-like manner, that is, intermediating funds between savers/investors and borrowers. However, what characterizes the shadow banking system is that it transforms funds, such as those of investment banks, which are short term and confidence-sensitive, into assets that are similar to those of commercial banks, that is, illiquid and long-term consumer and commercial credit.

Companies that qualify as part of the shadow banking system include: investment banks, finance companies, money market funds, some hedge funds, special purpose entities and conduits, among other vehicles. While the shadow banking system is not supposed to be publicly insured, as is the business of deposit–taking and credit–providing banks, the many interconnections that were generated between banks and shadow banks made it impossible to keep the distinction in the 2008-09 crisis. Some experts suggest that this will always be the case. As only commercial banks have the capacity to generate coin/currency-like liabilities through deposit–creation, shadow banking entities can only fund themselves through liabilities that have to be, at some point, accepted by a bank.[92]

The IMF recently estimated that cross-border interconnections between banks and shadow banks were in the range of USD 25 trillion,[93] compared to the financial sector at USD 30 trillion. A number of companies stand out as examples of institutions that fit this definition of shadow banking and that the government decided to bailout at the onset of the crisis. Among the investment banks are Goldman Sachs, Morgan Stanley, Merrill, and Bear Sterns. Among the finance companies, GE Capital, GMAC, CIT, AMEX, and Discover.[94]

Analysis of the interconnections among banks and shadow banks also reveals interesting connections with offshore centers. Although the analysis is hampered by data limitations, the IMF states “the rise of offshore financial centers gives the impression of a seemingly dispersed or decentralized global financial architecture with many centers. But the analysis of holdings and cross-border exposures in the funds data reveals a core group of centers or nodes, such as the United States, United Kingdom, Luxembourg, and France, around which the offshore centers are clusters and to which they channel funds sourced globally.”[95]

Regulatory approaches

Recent US financial reform has been very lenient in its treatment of the shadow banking system. For instance, a loophole that allowed industrial loan companies to operate as “shadow banks” before the crisis has not been closed. (See Box 2 next page). Some regulators have taken it upon themselves to tighten requirements for some of the parts of the shadow banking sector, as is the case with the SEC’s agenda to regulate money market funds. Similarly, in Europe, a green paper issued by the European Commission last summer intends to start the process of developing regulations for the sector.

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92 See for a more detailed explanation, Levy Economics Institute 2012.

93 IMF 2010. Powerpoint.

94 Drawing upon Konczal and Date 2010.

95 IMF 2010.

BOX 2 - Benefitting from bank treatment… without following the rules of banks. Industrial loan companies in the US

Among the vehicles operating in the shadow banking sector were the industrial loan companies, thrifts and credit card companies. These companies were deposit-insured entities. Therefore, in principle, companies owning them would have had to submit to the stricter capital requirements of bank-holding companies. However, because of the Industrial Loan Corporations (ILC) exception introduced in 1987, the non-bank companies that owned them were not required to submit to such requirements. This created an opportunity for arbitrage. Investment banks were allowed to operate, with the taxpayers' safety net provided by the Federal Deposit Insurance Corporation (FDIC), but without submitting to the stricter regulation on capital and type of activities that banks were subject to. The ILC exception was key to the high levels of leverage that several of these companies were undertaking at the time of the crisis.

Eight out of the 12 corporate parents of the largest Utah-chartered industrial loan companies, which were enabled by this exception, either failed or received substantial taxpayer support during 2008 and 2009. Thirty percent of all U.S. taxpayer support under the Troubled Asset Relief Program (TARP) has been directed to the parents of these Utah ILCs'.[96]

The US Administration proposed the abolition of the ILC exception in its initial bill submitted to Congress. Therein, the Administration held that "by escaping the Bank Holding Company Act, these firms generally were able to evade effective, consolidated supervision and the long-standing federal policy of separating banking from commerce…. These firms were able to build up excessive balance-sheet leverage and to take off-balance sheet risks with insufficient capital buffers because of the limited consolidated supervision and weaker or non-existent consolidated capital requirements at the holding company level. Their complex structures made them hard to supervise. Some of the very largest of these firms failed during the current crisis or avoided failure during the crisis only as a result of receiving extraordinary government support."[97]

The final legislation, however, failed to dismantle the ILC exception and settled for a study to determine whether it is necessary to do so in order to strengthen the safety and soundness of institutions or the stability of the financial system. It is unclear what the study – which should have been produced within 18 months of the enactment of the law, will say or what actions it will lead to.

But at the Cannes Summit, the Group of 20 Leaders agreed to strengthen oversight and regulation of the shadow banking system and gave impetus for the Financial Stability Board (FSB) to focus on proposals. A first paper with proposals and a work program was released in October 2011 covering: i) The regulation of banks' interactions with shadow banking entities (indirect regulation); (ii) The regulatory reform of money market funds (MMFs); (iii) The regulation of other shadow banking entities; (iv) The regulation of securitisation; and (v) The regulation of securities lending and repos.[98]

[96] Cambridge Winter Center for Financial Institutions Policy 2009. Industrial Loan Companies and Shadow Banking. Research Note.. August. Utah -based ILC parents included Morgan Stanley, Merrill Lynch, Goldman Sachs, Lehman Brothers.

[97] US Department of the Treasury 2009. Financial Regulatory Reform: A New Foundation. Rebuilding Financial Supervision and Regulation, p. 33-34.

[98] Ib.

7.1. Some general issues

Part of the problem in designing and implementing better regulation results from the scarcity of data in a sector that has traditionally been outside the radar for regulators. Rightly, the FSB proposed program includes some important measures on data collection and collation according to consistent standards. But the program proposed by the FSB does not really question the existence of shadow banking entities, or whether they perform desirable functions in the financial system. Nonetheless, it is often the case that shadow banking entities are there for no other purpose than exploiting the regulatory arbitrage generated by their situation as entities less regulated than banks.

C. RECOMMENDATIONS

Financial regulation should guarantee that public resources are protected from having to be used in bailing out banks, and other financial institutions that have become too big, complex or interconnected to be orderly wound down.

Regulation should include controls to ensure that, beyond certain limits, financial institutions do not grow in size, interconnectedness and complexity unless they generate tangible benefits for society as a whole and do not compromise systemic stability. In particular, financial institutions carrying both deposit-taking and investment operations increase interconnectedness and complexity that does not meet such conditions. Taxes, such as those applied on financial transactions, can be designed in ways to manage size, complexity and interconnectedness via setting incentives.

Feasible mechanisms for the orderly resolution of financial firms, regardless of their size, complexity or interconnections, should be in place, including feasible solutions for companies that operate across borders.

Bank capital requirements can be a useful tool to make systemic crises less frequent and severe, and to generate incentives for banks to undertake activities that support socially desirable goals in the real economy. To achieve these purposes capital requirements need to be tailored to the specific realities called for by the social contract in each country and allow for differentiated requirements across types of activity and sector. They should not be subject to manipulation by banks via complex risk-weighting techniques. Capital ratios calculated in relation to total, rather than risk-weighted, assets, accompanied by clear accounting rules to determine the assets that count towards that total, are preferable in this regard.

Derivatives transactions should be carried out in transparent markets and without risk to systemic stability. For this, requirements to trade them in public exchanges, centrally-cleared, with good collateral and margin requirements and complete reporting requirements are crucial. Legislation should also entrust regulators with power to set position limits in order to preclude distortions and volatility on prices of underlying assets, especially commodities.

All derivatives transactions, but especially those whose parties claim they should be exempt from the requirements mentioned above, need to be subject to a careful assessment to assert what desirable purpose they are fulfilling. Absent of such proof, such transactions should be banned.

Hedge funds and private equity funds should be subject to strong reporting requirements in order to ascertain their links to the banking system and ensure they do not need to be bailed out in case of collapse. The steps required for citizens to become investors in these vehicles should be highly regulated to ensure that only those fully aware, and able to understand and bear the risks, are exposed to them. Social security systems should ensure citizens decent retirement options that do not involve being exposed to the excessive risks of hedge funds and private equity. Hedge funds and private equity funds' practices that undermine workers' rights and benefits, as well as other productive assets, should not be permitted, unless justified by a greater good being generated for society.

Where possible, measures need to be implemented to diminish the impact of CRAs via removal of regulations and legislative requirements to resort to them.

CRAs should be subject to strong governance requirements to suppress conflicts of interest and ensure integrity and accountability. For this it is particularly important to ensure CRAs are not exempt of legal liability for damages caused by negligent action or omission. But, in addition, their business model should not be susceptible to conflicts of interest, which calls for prohibiting the issuer-pays model.

The financial sector should pay its fair share of taxes. Taxes on the financial sector should also be designed with the goal of limiting excessive risk-taking and systemic risk. Well-suited to this purpose is a step by step introduction of a general and uniform Financial transaction tax. This should cover all spot and derivate transactions on organized exchanges (shares, bonds, securities and derivatives, including trade of futures and options related to stocks, interest rate securities, currencies and commodities). In the long term the tax should be extended to "over-the-counter" (OTC) transactions directly related to asset prices, in particular to exchange rates and interest rates including derivatives.

Shadow banking vehicles should be defined as: all entities that provide functionally similar services to those of banks, while not being one. They should not operate without license. A license should be granted only if they can show that they exist for purposes that are legal, are not merely to exploit regulatory arbitrages with the regulated banking sector, or enable tax evasion and avoidance. Shadow banking vehicles should be subject to strict reporting requirements to ensure proper and successful monitoring. Such reporting will also enable regulators to track down links with the financial sector that might generate systemic risk. They should be held legally responsible if they fail to stick to the conditions for licensing.

To strengthen transparency, accounting standards should include an obligation for multinationals to report, in every country in which they operate:

- Names of all its companies trading in the country in question;
- Details of its financial performance, including :
  - Sales, both third party and to other group members;
  - Sales, both third party and with other group members;
  - Purchases, split between third parties and intra-group transactions;
  - Labour costs and employee numbers;
  - Financing costs, including facilitation payments, split between those paid to third parties and to other group members;
  - Pre-tax profit;
- Detailed tax charges included in its accounts for the country in question;
- Details of the cost and net book value of physical fixed assets;
- Details of gross and net assets.

This should be part and parcel of follow up to G20 countries' commitment to a *"single set of high quality, global accounting standards"* (Communiqué of Meeting of G20 Finance Ministers and Central Bankers, Busan 5 June 2010), and the International Accounting Standards Board should be challenged regarding its current ability to meet the needs of all stakeholders.

To restore responsibility in the financial sector the information on beneficial ownership of all companies, trusts, foundations, and charities should be made available in a record, in each jurisdiction. Similarly registers of bank accounts must be readily accessible to tax, financial and judicial authorities in every jurisdiction.

To stop impunity for corruption, tax evasion and other financial crimes, effective tax and judicial cooperation should be stepped up. Governments should**:**

- Tighten and implement sanctions against tax evaders and the authors of financial crime;
- Harmonize legal definitions of tax evasion (without watering them down); and
- Keep the list of tax, judicial and regulatory havens (FATF, OECD and FSB lists) updated.

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