

The Financial Industry in the New Regulatory Landscape

by
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The financial market outlook and risks as well as the impact of regulatory reforms on the financial sector were the topics discussed at the October 2011 OECD Financial Roundtable. Concerns about the current situation in financial markets were centred on the sovereign debt and banking crisis in Europe and its repercussions in other parts of the world. Many participants felt that policy makers had not been doing enough to address the crisis and that bold action and ‘circuit breakers’ to stop the negative feedback loops were needed to restore market confidence. Regarding regulation, while the financial industry broadly expressed support for Basel III reforms, some elements like the SIFI surcharge were criticised. The industry was also sceptical regarding the benefits of separation of banks’ businesses (Volcker rule, Vickers proposal) and broadly rejected the EU proposal of a financial transaction tax. While policy makers regarded some of the industry’s regulatory concerns as valid, they stressed the aim of regulatory reforms to make the financial sector safer, thus making downsizing of a certain kind of financial intermediation unavoidable. But the right balance needs to be found in terms of the extent and the timing of regulatory reforms; downsizing in the current situation should perhaps be encouraged less quickly in some cases.

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I. Market outlook and risks

1. General outlook

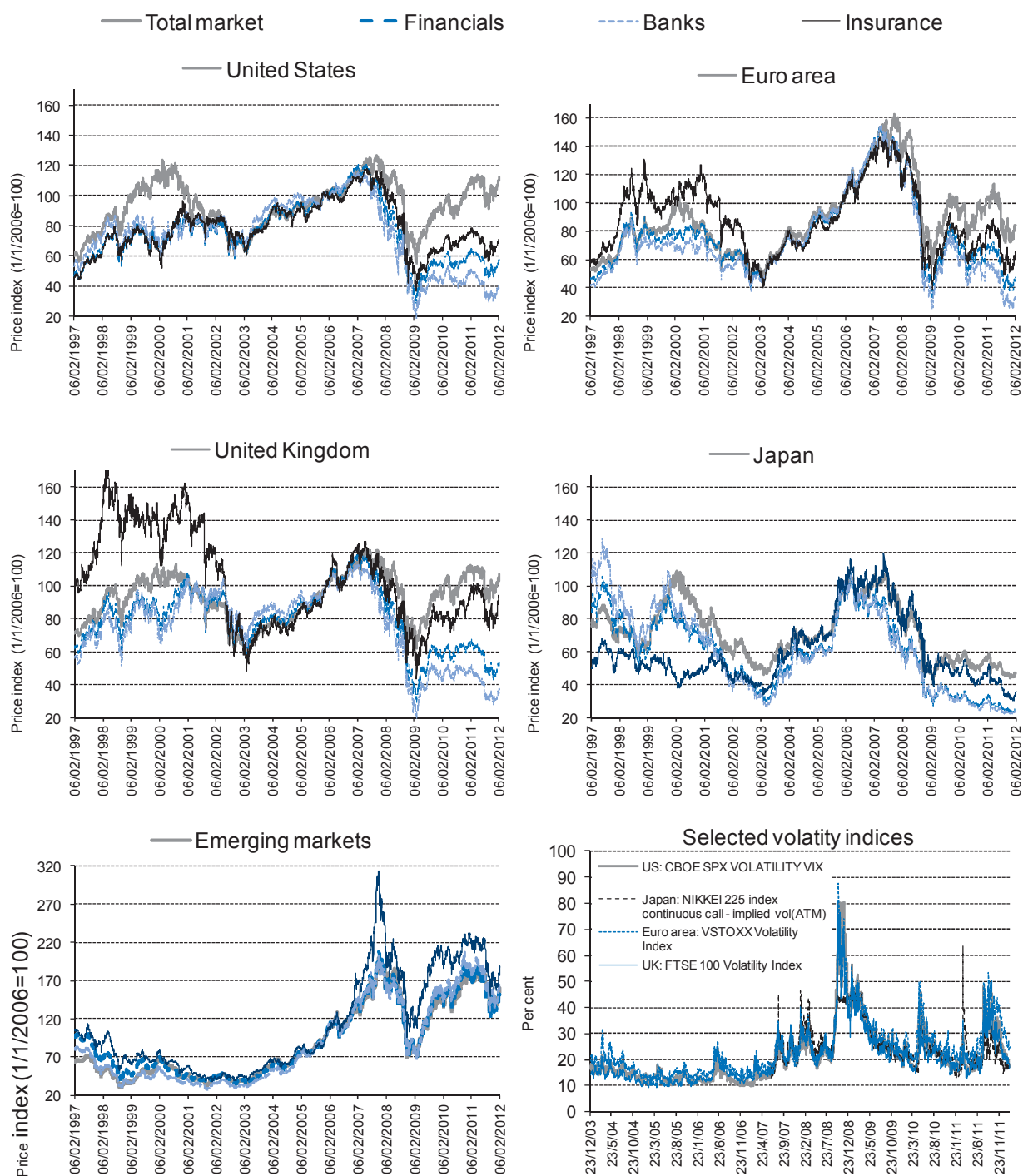
Uncertainty over the economic recovery and policies to address cyclical and structural weaknesses, especially in the financial sectors, had been strongly reflected in financial markets particularly since August 2011 (Figure 1). The accumulation of negative events (the Japanese earthquake and tsunami, the surge in commodity prices, the turmoil in the Middle East) had tested the resilience of already fragile economies early on in 2011 and the rather fast, policy driven recovery of the most severe post-war financial and economic crisis had come to a halt in many countries. Emerging markets, which had held up rather well during the crisis, were also affected, albeit less strongly, as many of them had to put in place policies to cool their overheating economies: to curb inflation, prevent the build-up of asset price bubbles and stem capital inflows. As a consequence, most forecasters have been lowering their growth expectations.¹

Against this backdrop, many participants of the OECD Financial Roundtable conveyed a gloomy view on the current outlook, driven by extreme policy uncertainty and a lack of confidence, mainly due to the political stalemate of finding a convincing solution to the European sovereign debt crisis. However, some extent of ‘political paralysis’ was also noted for the US, where dragged-out negotiations and last-minute decision on lifting the deficit ceiling in August 2011 were regarded as attempts “to play brinkmanship” with the US economy. The US sovereign rating downgrade² led investors to reassess their notion of sovereign risks (realising that even large triple A issuers are not immune against downgrades) and had negative repercussions on already weakened European sovereigns. Investors, preparing for the worst, were searching for ‘safe havens’ (including the hoarding of cash) or were hedging their bets by shorting while earning appropriate, risk-adjusted yields became more difficult in a very low-interest rate environment (Figure 2).

In this context it is worth noting that, while stock market prices in the US and in other parts of the world plummeted after the US downgrade in August, demand for US bonds increased and their yields declined, indicating that investors continued to perceive US treasuries as a safe haven investment, lacking alternatives in a highly uncertain environment. At the same time, US money market funds pared down their European exposure and added to European banks’ funding problems. As indicated by the observed increase in these banks’ recourse to the Eurosystem’s deposit facility, they had already been suffering from their peers’ mounting distrust. Class action lawsuits against financial institutions (with a potential value of USD 200 bn related to mortgage origination in the US) have added to the ‘toxic’ economic-financial feedback loops. In this environment participants also felt that states had lost their important role in and capability of providing safety (financial and otherwise) and reduce the risk that individuals are exposed to.

Figure 1. Equity markets had plummeted, driven by financials, and volatility was high

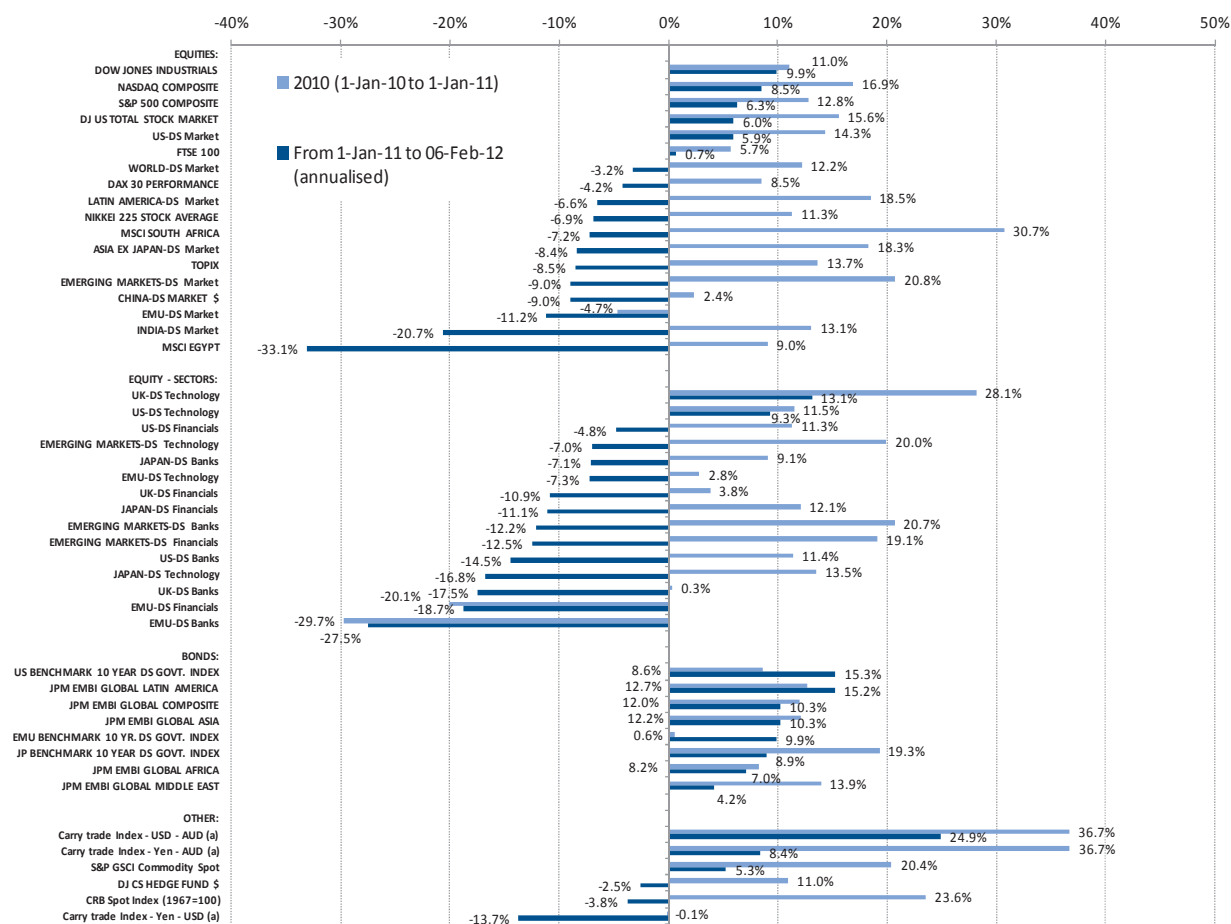
Selected equity indices, DS total markets and sectors (1/1/2006=100), and volatility indices



Source: Thomson Reuters Datastream.

Figure 2. After the market reversal, “places to hide” are harder to find for investors

Selected investment alternatives, percentage changes over period, annualised, in US dollar terms



Notes: a) The carry trade return index is calculated based on the assumption of one-month investments in the respective currencies, borrowing in yen, applying 1-month eurodollar interest rates and central exchange rates, without taking into account bid/ask spreads and transaction costs.

Source: Thomson Reuters Datastream.

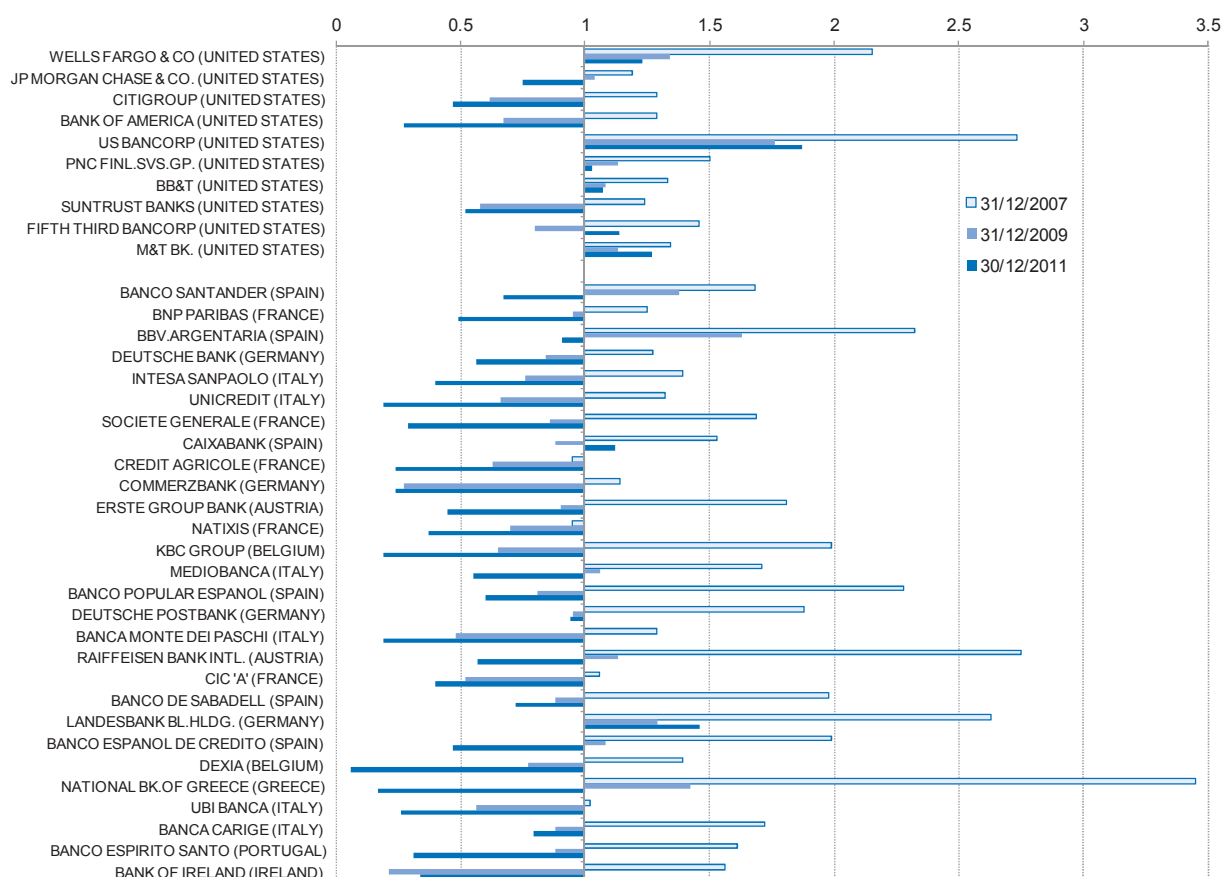
2. Banking sector outlook

While the banking sector has been severely affected by these negative feedback loops, industry representatives expressed a lack of confidence in the ability of policy makers to break these vicious cycles. Moreover, there was also a lack of confidence in bank supervisors and banks' risk management capabilities as trust in these had been undermined during this crisis. And as banks have been nationalised or otherwise bailed out by governments, investors are also wary about politicisation of the banking business. Furthermore, participants also pointed out that costs of new regulations are weighing on banks. While it was felt that the new Basel III rules (see section II below) are being phased in over a reasonably long period of time and would eventually contribute to a more stable financial system, it was pointed out that markets are reacting immediately by anticipating and pricing in the future costs of regulation that institutions will have to face. Banks' share valuations are down and market-to-book value ratios are below one for many banks in particular in Europe (Figure 3) where, participants argued, another major

bank default cannot be excluded. As there is also high uncertainty regarding the valuation of banks' capital, regulators were asked to make efforts towards finding a 'common language' regarding accounting rules and evaluation of risk. However, the latter may be difficult because in the current environment of uncertainty risk cannot be properly quantified.

Figure 3. Investors are wary of the health of banks' balance sheets

Market-to-book value of largest US and euro area banks (sorted by market value)



Source: Thomson Reuters Datastream and author's calculations.

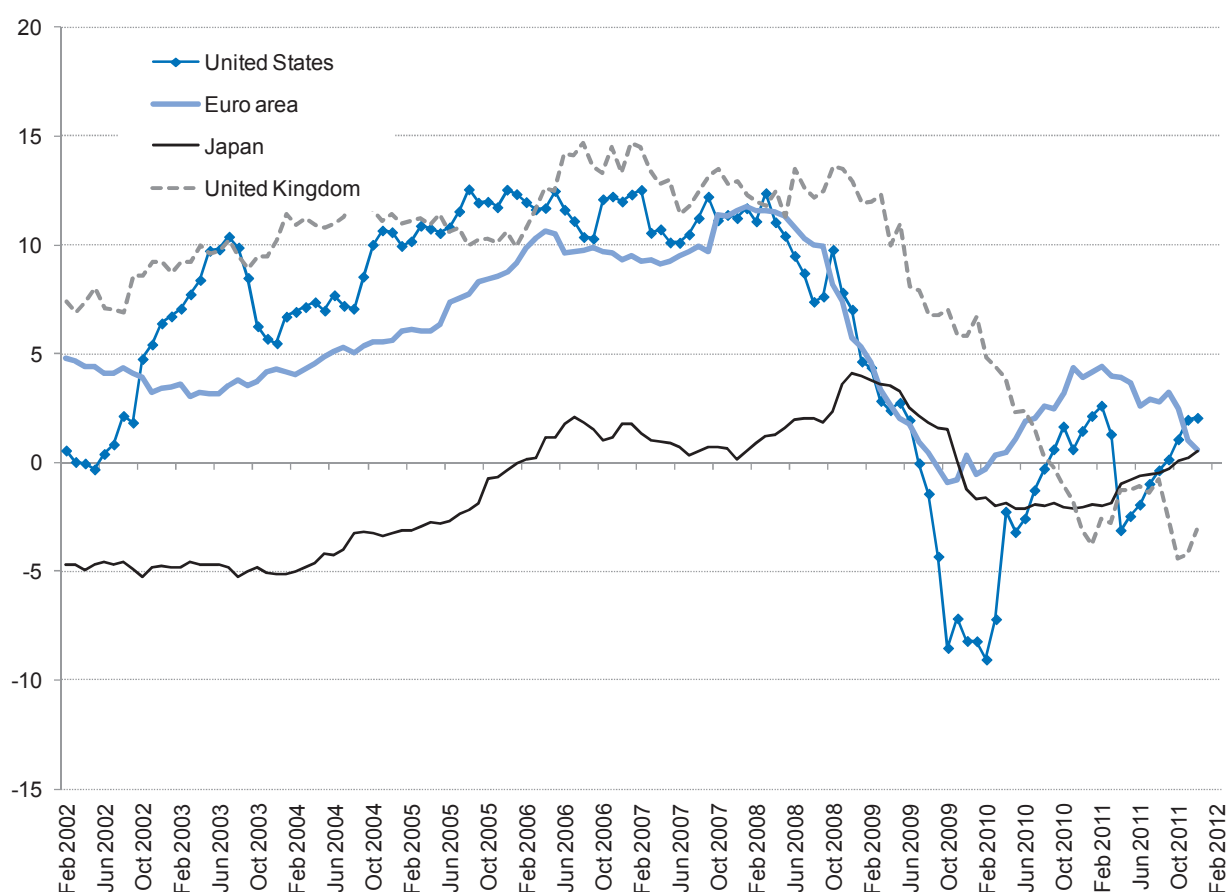
In this situation, it has become more difficult for banks to raise capital, and capital markets have become dysfunctional and highly volatile. This is creating another negative feedback loop that is reinforced when banks are forced to realise losses by selling depressed assets – which in the current situation of broad-based deleveraging and lack of demand has become rather difficult. Consequently, banks are hoarding liquidity, are not lending or only at very onerous conditions, thereby squeezing the funding of SMEs and other dynamic parts of the economy (Figure 4).

However, some participants also suggested that this negative outlook should be somewhat qualified and put in perspective given the fact that banking sectors play a different role in and differ widely across various countries, also within the EU, and are thus affected differently. The European economy is about 75-80% bank financed, while this share is about 25% in the US. It was argued that many, mainly US investors have

been cornering European banks indiscriminately, assuming they all operate in the same way and in the same regulatory environment, but this is not true, also for ‘cultural’ and historical reasons. Bad prophecies may be self-fulfilling and no bank is safe in the case of a bank run, even if such a run would not be justified by fundamentals. France was cited as an example where banks have continued financing SMEs throughout the crisis, and these banks also have not had problems with mortgage lending so far. Stricter regulations and the fact that their lending decisions are based on borrowers’ longer-term solvability (*i.e.* based on their expected income) rather than on their current asset valuation (as is often the case elsewhere) also saw French banks suffer very little during several real estate crises over the past 50 to 60 years.

Figure 4. Bank lending has declined and remains weak

Bank loans to the non-financial private sector, year-on-year percentage changes



Source: Thomson Reuters Datastream.

3. The role of policy

Participant clearly saw a role for policy to restore confidence and growth which has to be the basis for any recovery. Policy makers need to show leadership in order to decide on and implement the necessary measures that can stabilise markets; immediate action is required. The problem is that the notion of a risk-free rate provided by government bonds has been lost and needs to be restored (where sovereigns are solvent). There was also a call on the ECB for lowering interest rates, and while central banks have stepped in –

implicitly at least – as lender of last resort, providing liquidity, a clearer message regarding liquidity support for the financial sector would be regarded as helpful. This becomes especially important in a context where market participants are not sure whether implicit government guarantees for global Systemically Important Financial Institutions (G-SIFIs) can be taken as granted in the near term, as regulatory reforms are being discussed that will include resolution regimes and other measures removing or compensating for this implicit guarantee in the future.

There was also strong agreement that further actions to restore credibility will have to come from the governments, not only the central banks. Some strong views were expressed on speeding up fiscal adjustment in Europe (the UK was mentioned as a positive example), liberalisation (especially of labour laws) and lowering or at least not further increasing taxes in order to support growth and avert the threat of another recession. Fiscal adjustment was also seen as necessary to address the longer-term structural problem of unfunded public pension schemes. In the US, large infrastructure investments will be needed to repair and renew the existing stock and thereby support the economy and avoid recession or even depression. High levels of debt were seen as tolerable in the short run and as long as the the US dollar remains the world's main reserve currency, but this window of opportunity may eventually close and long-run fiscal adjustments will be necessary.

4. The situation in Europe: sovereign debt problems

Regarding the situation in Europe, many of the private financial sector participants felt that a haircut in the range of market expectations (about 40-50% as of October 2011) will eventually be necessary for Greek debt, and possibly for Portugal's and to a lesser extent Ireland's. Such debt restructuring would not necessarily imply an exit from the euro or a break-up of the EMU. As history shows, most sovereign crises are closely linked to banking crises, thus it was seen as hard to separate the two in a resolution process. In this context it was pointed out that sovereign defaults would be harder to manage in the future because the new Basel rules will increase the linkages between the sovereign and the banking sector because banks will be given incentives to hold more government debt (especially via new liquidity requirements). Similar effects could be expected from separating bank business and ring-fencing 'traditional' banks assets as proposed in some regulatory reforms (Volcker rule and Vickers proposal, see below). This will make the management of sovereign default more difficult and costly. Thus regulators should encourage banks to hold a more diversified portfolio of assets and not be too highly concentrated in holdings of their own sovereign's debt.

Other participants contested the view of a sovereign debt haircut being necessary, noting that current bailout-packages in place were already providing much relief and pointing to the risks of contagion effects that were hard to control and enormously costly. However, to control contagion it was proposed that these haircuts should be accompanied by measures guaranteeing full financial support for the bigger ones of the problem countries as well as a recapitalisation of the main banks. In this context it was also mentioned that analysis showed that in many cases investors seem not so much worried about the sovereign but rather about the corporate sector in a country affected by the crisis.

On a more positive note, it was pointed out that the overall government debt-per-GDP ratio in the Eurozone is lower than in the US and in Japan, and if European politicians agree to join their efforts the current problems can be overcome. Steps in the right

direction are being taken, like the enhancement of the EFSF that should be enabled to intervene in primary and secondary markets, extend credit lines and perhaps create a bank recapitalisation facility. A need was seen for a pan-European banking resolution mechanism to deal with failing banks across the EU.³ These steps could then lead to the creation of a future European Monetary Fund which over time and within the proper fiscal and economic integration would be able to introduce common Eurobonds. More generally, there was broad agreement that stronger fiscal integration in the Eurozone will be necessary in order for the Euro to become a more sustainable currency.

II. Assessment of financial sector regulatory reforms

1. *Basel reforms, G-SIB proposal and general considerations*

Shortcomings in regulatory capital and other requirements in the Basel II system that were brought to the fore during the crisis⁴ led the Basel Committee to revise its Basel II framework.⁵ At the core of the Basel III reforms⁶ are higher minimum capital requirements and liquidity requirements expressed in a liquidity coverage ratio and a net stable funding ratio. Proposals also include additional capital charges for global systemically important banks (G-SIBs)⁷ as well as resolution regimes for systemically important financial institutions (SIFIs)⁸ to address the “too big to fail” problem. The new framework also revises the way risk-weighted assets (RWA) are calculated, for example adding charges for counterparty credit risk⁹ that are likely to double under the new regime, increasing RWA. The costs of these revisions, the industry claims, have been largely underestimated by the Basel Committee.¹⁰

Nevertheless, the Roundtable discussion showed there was broad support by the industry for the new Basel capital and liquidity rules in general. However, participants felt that some elements need to be redesigned or better balanced. Representatives from the banking industry strongly expressed their views against the planned G-SIB surcharges and against expressly designating such status to certain banks. There was no case for such surcharges: these were seen not only as unhelpful as they would increase moral hazard (by officialising too-big-to-fail status) and distort markets in favour of these banks, but there were also fundamental flaws and inconsistencies (circularity) seen in the SIFI surcharge methodology.¹¹ If regulators deem restrictions on size and business models of banks necessary at all, targeted legislation would be preferred to such surcharges.

Some national regulators have gone beyond the Basel reforms. For example, the Swiss regulators were among the first to sizeably increase capital charges for their big, systemically important and globally active banks.¹² Outside the OECD, China has imposed tougher and more differentiated rules for different categories of banks.¹³ In the United States, as part of the financial reforms proposed in the Dodd-Frank Act,¹⁴ the “Volcker-rule” imposes restrictions on banks’ proprietary trading. In the United Kingdom, the reform proposals by the UK Banking (“Vickers”) Commission¹⁵ contain three innovative key elements: (i) Ring-fencing retail banking from investment banking (and requiring that boards of retail and riskier parts of banks be separate and that any transactions across the ring-fenced units be done at arm’s-length to ensure reduced cross-subsidisation); (ii) the requirement that the loss absorbing capacity of banks depends on equity, and this should be much higher than current Basel standards require; and (iii) measures to improve competition in banking. Some argue that further reforms should also include restrictions on wholesale funding and better risk control for the entities ‘outside the ring fence’ (investment banking) as their business is likely to get riskier as banks strive to generate returns.

While some policymakers may expect that such national topping of global regulatory rules may create a push and incentive for other regulators to follow suit,¹⁶ participants at the Roundtable generally thought that such ‘gold plating’ of general rules should be avoided. Topping up the Basel requirements by some countries may in the end be dangerous as it would lead to beggar-thy-neighbour effects on banks and other countries. The timeline for the implementation of the reforms should be adhered to, and globally consistent standards should be favoured over national or EU-specific (CRD IV) norms. For example, deviations in CRD IV from the Basel rules that favour European over other banks should be abandoned.

There was also a plea to the official sector to recognise the progress banks have made in improving their capital, liquidity and risk management. Banks have also substantially changed their compensation practices,¹⁷ creating better, risk-compatible incentives. Banks also accept and support better, more intensive and intrusive supervision – as opposed to regulation – and the industry is also much in favour of an intensified dialogue with regulatory and supervisory agencies that should have sufficient resources to conduct that dialogue on a high-level basis. The industry is also in favour of a serious peer review at the national level to ensure consistent and high-quality implementation of the Basel standards, and the G-20 should refocus on the consistency of implementation of regulatory standards more generally.¹⁸

2. Impact of reforms on the economy and the banking sector

The Basel Committee itself has undertaken an assessment of the macroeconomic effects of the Basel reforms in 2010,¹⁹ also of its long-term positive growth effects, stemming mainly from reducing output costs related to banking crises,²⁰ and so has the banking industry.²¹ These estimates have been revised in light of the G-SIBs surcharge as well as resolution regimes. Regarding the impact assessment of new regulation, lawmakers were seen as not putting enough focus on the overall long-term effects of the new regulatory framework. In a more comprehensive approach, the industry estimates that the net cumulative impact of financial reforms will lower GDP in major economies by 3.2% by 2015, the equivalent of about 7.5 million jobs foregone.²²

Besides these effects on GDP, reforms will also have an impact on the structure and business models of the financial industry. Recent studies by industry consultants have looked at the return impact of new regulations, estimating that Basel III would reduce an average bank’s return on equity (ROE) by about four percentage points in Europe and about three percentage points in the United States.²³ For the top 13 global banks firms, ROE would be reduced to about seven percent (from previously 20 percent).²⁴ However, as banks adapt their business strategies,²⁵ these impacts are likely to be mitigated.²⁶ While the authorities have been stressing the overall positive effects of the Basel III reforms, some have recently warned about unintended consequences for cost of capital, funding patterns, interconnectedness, and risk migration.²⁷

In the Roundtable discussion it was pointed out that many banks have already started to change their structure in response to expected regulatory changes. Low-margin businesses are being and will be further reduced. Due to stricter regulatory capital requirements banks in the US and Europe are estimated to need some additional USD 1.5 trillion capital over the next five years.²⁸ This capital can be raised by retained earnings or share issuance, but the latter is difficult as expected lower returns make the sector less attractive for investors. Thus banks will have to reduce the size of their balance sheets to meet the required capital ratios, at least in the short run. In order to restore returns to

levels required by investors it was argued that banks would need to double or triple their profit levels – and have taken steps in this direction by cutting costs, increasing revenues or increasing capital efficiency. Many of these measures would imply higher borrowing costs and a cutback in lending, also in the extension of longer-term loans, including those for infrastructure. Stricter regulations were also said to have permeated banks' management that have begun to make decisions with the aim to fulfil regulatory requirements (also because this is what markets are judging them for) rather than oriented by a comprehensive long-term strategy.

It was also pointed out that Basel III may cause 'collateral damage' that should be avoided. The new liquidity requirements are leading to a 'race for deposits' whereby banks are also taking away customers from pensions funds, (life) insurers and mutual funds. Thus not only the banking but also the asset management industry is suffering due to these reforms, and there is less money to be invested not only in banks, but also in corporates and sovereigns. This, it was argued, leads to 'beggar thy neighbour' behaviour with negative side effects on other industries that are also highly pro-cyclical. In addition, Solvency II was seen as coming at the wrong time pushing insurance companies to sell off their stocks (*i.e.* also being pro-cyclical).²⁹

While policy makers regarded some of the industry's regulatory concerns as valid, the aim of regulatory reforms was to make the financial sector safer, thus downsizing of a certain kind of financial intermediation is unavoidable. However, there are questions of finding the right balance regarding the extent and the timing of such reforms, and whether the downsizing in the current situation should be encouraged less quickly.

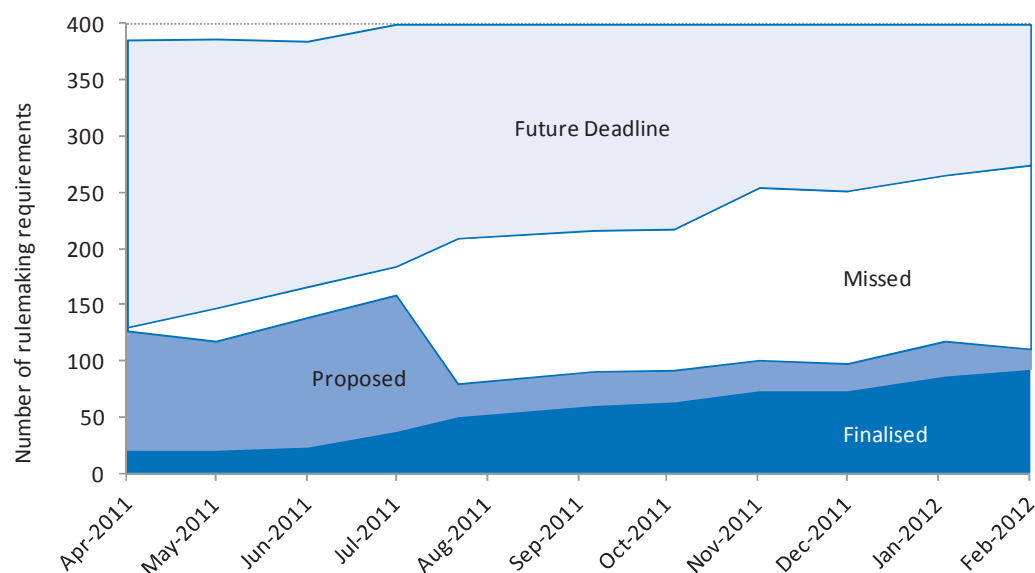
3. Regulatory uncertainty about liquidity and leverage regulations

Delays and uncertainties regarding the implementation of regulations at the national level may be problematic. While scheduled delays may be justified to smooth the transition to new rules or as measures of regulatory forbearance in an exceptionally difficult economic and market environment, unscheduled delays create regulatory uncertainty and impede the financial industry from making early and proper adjustments and setting in place sound and long-term business plans. Moreover, authorities' procrastination may increase reform fatigue and raise resistance to reforms. Complaints in this regard have often been heard in the context of the US reforms, noting that the Dodd-Frank Act³⁰ contains many conditional rules that require further analysis and more detailed specifications before they can be finalised and implemented, and that they get diluted during such procedures and in the political process (Figures 5, 6 and Table 1).

Concerns about regulatory uncertainty had already been raised by the financial industry in previous Roundtable discussions.³¹ Also at this Roundtable participants felt that there is still large uncertainty regarding the actual implementation of the various reform proposals. This uncertainty is weighing on the industry and investors and is counteracting monetary and fiscal stimuli that authorities have been putting in place. This was felt especially with respect to the new liquidity regime. While the industry welcomes that regulators are allowing a long enough monitoring and observation period before taking further steps in this new and difficult area, it is impeding banks in making longer-term business decisions and to decide what their future structure and business model should be. Furthermore, not knowing the details of the new liquidity regulation would render any quantitative impact study (QIS) result incomplete and unreliable.

Figure 5. Implementation of new regulation takes time

Dodd-Frank rulemaking progress by month

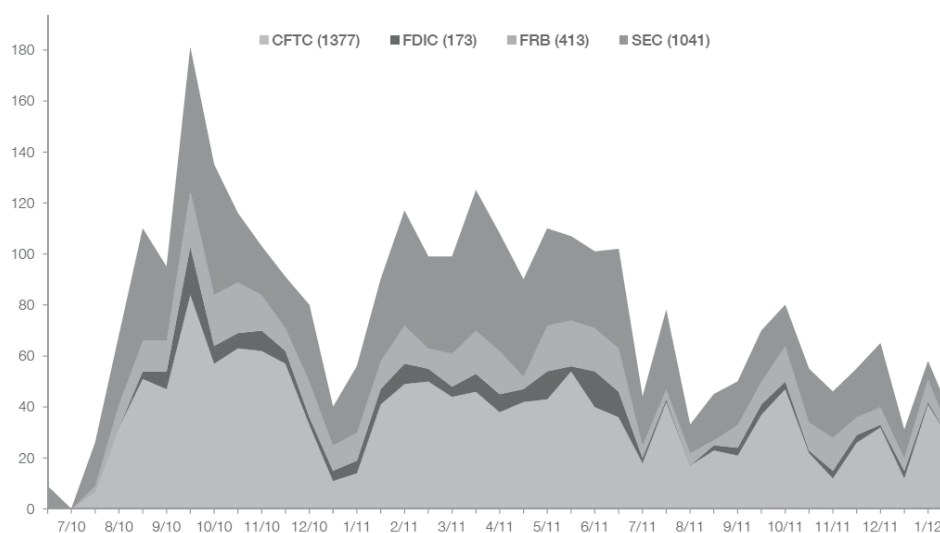


Notes: Values refer to number of rulemaking requirements; rulemaking counts are based on estimates and require judgment. The Progress Report only includes rulemakings explicitly required by the Dodd-Frank Act. Many discretionary rulemakings will be needed to implement Dodd-Frank's mandates.

Source: Davis Polk Regulatory Tracker; Davis Polk (2011, 2012).

Figure 6. Implementation of new regulation requires consultation efforts

Regulators' meetings with outside participants over time, as of 15 January 2012



Note: CFTC: Commodity Futures Trading Commission; FDIC: Federal Deposit Insurance Corporation; FRB: Federal Reserve Board; SEC: Securities and Exchange Commission. Reportedly there have been at least 2800 meetings with these regulators since 1 July 2010; the more than 200 joint meetings are counted separately for each participating regulator.

Source: Davis Polk (2012); Dodd-Frank Progress Report (January).

Table 1. Implementation of new regulation is costly

11 federal agencies' reported new funding resources associated with the implementation of the Dodd-Frank Act
In US dollar, fiscal years 2010 through 2012 (estimates)^a

Agency / Year	2010	2011	2012	Total over years
Federal Reserve ^a	7,300,000	77,500,000	..	84,800,000
CFTC	0	15,400,000	77,000,000	92,400,000
FDIC ^a	2,345,000	40,860,000	..	43,205,000
FHFA	0	3,800,000	4,350,000	8,150,000
FTC	0	0	0	0
OCC	0	34,850,000	235,000,000	269,850,000
SEC	0	23,525,000	108,982,000	132,507,000
Treasury	0	10,393,000	5,525,000	15,918,000
CFPB	9,200	142,825,000	329,045,000	471,879,200
FSOC	0	7,435,000	7,885,000	15,320,000
OFR	0	33,890,000	74,468,000	108,358,000
Total of agencies	9,654,200	390,478,000	842,255,000	1,242,387,200

a) FDIC and the Federal Reserve report on a calendar year basis. The figures for these two agencies reflect calendar years 2010 and 2011 estimates. At the time of the review, estimates were not available for calendar year 2012.

Legend: Federal Reserve: Board of Governors of the Federal Reserve System; CFTC: Commodity Futures Trading Commission; FDIC: Federal Deposit Insurance Corporation; FHFA: Federal Housing Financing Agency; FTC: Federal Trade Commission; OCC: Office of the Comptroller of the Currency; SEC: Securities and Exchange Commission; Treasury: Department of the Treasury; CFPB: Consumer Financial Protection Bureau; FSOC: Financial Stability Oversight Council; OFR: Office of Financial Research.

Source: Government Accountability Office (GAO) (2011).

While the short-term Liquidity Coverage Ratio (LCR) was seen as conceptually correct, it was regarded as too conservative in its assumptions, too narrow in its definition of liquid assets and as creating 'perverse' incentives to hold more and more government paper that has become riskier. Therefore, it was seen as positive that these issues would be looked at again, but many more studies would need to be done – by regulators as well as the banking industry – on the industry-specific impact of this regulation. To correctly assess the effects, more clarity would also be needed about the future role of central banks and predictability in their provision of liquidity.

The long-term Net Stable Funding Ratio (NSFR) was regarded as problematic and as needing considerably more analysis. While maintaining long-term liquidity is important, it should be put in the context of the Basel principles regarding risk management and be embedded in a Pillar II approach, letting banks decide their liquidity requirements based on their business. Similar criticisms were raised regarding the proposed leverage ratio, the definition and implementation of which was seen as surrounded by much uncertainty. The fact that regulators would give this topic further consideration was welcome.

4. Financial intermediation and related issues

A natural, intended consequence of new regulations that aim at making banks safer and less leveraged will be a reduction in banks' lending capacity. Overall, participants expected the banking sector to shrink considerably and therefore felt that new forms of

financial intermediation should be encouraged to close the financing gap in the economy. Such a shift would not happen rapidly but over the next five years or so in the US and Europe. This shift, it was argued, required not only structural changes in the banking sector, but also in the government sector that had to support such a shift in terms of the tax, legal and regulatory framework and perhaps also explicitly support SME and other growth-oriented financing. Such new intermediation can also be supported by allowing (a further increase in) banking and other financial services activities by non-financial corporations (like post offices and large corporates). It was also underlined that new, safer forms of securitisation should be promoted. In addition, measures to foster long-term savings would be needed – an effort in which the OECD could also take a leading role. Tax incentives (*e.g.* favouring long-term over short-term savings) could be one of the measures proposed.

Banks may become less and less relevant, and the shadow banking sector will be able to make its contribution to new lending. Pension funds, to match their long-term liabilities, could very well engage in long-term investments in a favourable regulatory environment. There were calls for abandoning mark-to-market accounting where appropriate in order to allow institutions like insurance companies to invest again for the long-term and to help financing growth. For financing long-term investment and infrastructure, public-private partnership models, including banks, should be encouraged, and for specific areas that are not or underserved by commercial banks, mandated lending could be imposed on these entities. There is also evidence that high-net-worth individuals are, mostly via their family offices, starting to engage in the lending business. But if the shadow banking sector is to play a more important role in lending, the claim was made that the risk management capabilities of these new lenders need to be scrutinised in order not to create new sources of instability. Thus governments will have to think about how and to which extent the shadow banking sector needs to be regulated especially as its share in financial intermediation can be expected to increase.

In fact, enlarging the perimeter of financial regulation to include “shadow banking” activities was an item on the reform agenda initiated by G-20 leaders in response to the crisis,³² and is, in principle, also supported by the banking industry.³³ Such activities may pose systemic risks, in particular those stemming from maturity and liquidity transformation, imperfect credit risk transfer and leverage. In April 2011, an FSB task force presented initial recommendations for discussion for strengthening the oversight and regulation of the shadow banking system, *i.e.* the “credit intermediation involving entities and activities outside the regular banking system.”³⁴ Having agreed on these recommendations in July and having set in place a monitoring process to assess the size and developments of non-bank credit intermediation, the focus is henceforth on gauging the case for further regulatory action in five areas identified by the task force, looking at indirect regulation (banks’ interactions with and exposure to shadow banking entities), direct regulation of money market funds and other shadow banking entities, as well as the regulation of securitisation and of activities related to securities lending/repos.³⁵ These efforts seem all the more important as new regulations may push current banking activities into the shadow banking system.

5. Resolution and ring-fencing

The industry is supportive of cross-border resolution regimes and the use of bail-in techniques in such procedures in order to reduce loss of value in failing firms and avoid systemic effects. The industry’s own proposals³⁶ are generally very much in line with those by the FSB, even though it was felt that the latter could be more ambitious by

setting up a timetable for necessary changes in national legislations and proposing an international convention. Regulators should now act quickly to implement these reforms.

Bail-ins via the conversion of debt into equity (via contingent convertible bonds – CoCos) as currently used and proposed were seen as having worked well in the past and have helped in the preservation of banks, and would be an effective tool to resolve banks more or less completely. While the economics of the instrument were seen as rather simple,³⁷ the legal technicalities of these debt-to-equity conversion instruments are exceptionally difficult.³⁸ The issue is that large globally active banks are not single entities but very complex corporate groups, and in case of resolution numerous issues involving several jurisdictions need to be tackled with. Therefore such resolution needs to be addressed at a global level and needs some form of international agreement.³⁹

Participants saw that at the current juncture major risks are coming from the various efforts to ring-fence capital, liquidity, and business in national markets. It was argued that forcing banks into a national, one-line and undiversified business model would tend to concentrate risk and make the banking sector potentially more unstable and less profitable. The first type, ring-fencing by national areas, may occur as a result of the combination of liquidity regulations and resolution regimes. Even though final decisions in these areas have not been taken yet this raises concerns among the banking industry.

The other type of ring-fencing, separating banks' business lines, as proposed by the recent Vickers report⁴⁰ (and supported by the OECD Secretariat⁴¹) is also seen with great concern by the industry. While the primary argument (besides others like lowering risk) for the Vickers proposal is that the separation should aid bank resolution, it was criticised that the case for this to work had not been made in the report. This bank separation proposal was seen as a tighter version of the US regime under Regulation W⁴² that has been in place for US banks over the past 15 years, and, it was argued, is known not to work. The main argument put forward for such a regime is that in case of default one can keep the deposit-taking part of the bank and let the rest go bankrupt without major impact – but the default of Lehman, an investment bank, has shown that this argument would not hold. It was also noted that Northern Rock, the UK bank that was nationalised in a rescue operation, was a traditional mortgage lender without an investment banking arm. Furthermore, in the UK this separation proposal would not be too helpful for resolution as it would apply mainly to G-SIBs that are already designated as necessary to be saved. It was also pointed out that there is a 'toxic' combination between Vickers and Basel III liquidity requirements that would leave the non-deposit taking part of a commercial bank with a liquidity problem, compounded by the LCR rules. Therefore, it was argued, the Vickers-Basel interaction will make it extremely difficult or even impossible to implement these projects.

Many private sector participants also argued that such bank separation would bring greater instability rather than diminish it as it would reduce the capacity of larger institutions to balance their business lines in their own books, and reduce the lending capacity of the industry. Furthermore, it was pointed out that the savings and loan (S&L) crises of the 1980s and 1990s had their origins in a narrow banking model, and that there was no evidence that the demise of the Glass-Steagall Act⁴³ led to this crisis: the excessive mortgage lending in the build-up to the subprime crisis could also have happened under a Glass-Steagall regime. Regulatory failure (like the failure in the US to regulate the mortgages underlying structured products) was seen as one of the main culprits of the crisis, but there is no structural solution to that.

There was, however, some support among the private sector participants for the bank separation proposal. Banks had been using customer deposits to speculate on their own behalf and did not pay for the risk they were taking. If these ‘gambling’ parts of banks were exposed to a credible risk of failure (involving winding down the institution concerned), the pricing of risk and thereby risk-taking should become more adequate. Banks should not be acting like hedge funds unless their deposit business is separated out and risk of failure becomes real as these entities would not (and should not) be supported by the government. While the official sector regarded the discussions about ring-fencing as useful, the conclusion was that further deliberations may be needed.

6. *Financial sector taxes*

Various taxes have been levied on the financial sector in response to the crisis, mostly to finance current or future financial sector rescue measures, but also with a view to address failures in the way markets function and increase financial stability.⁴⁴ These taxes have been mainly targeting assets, liabilities, and bonuses, and some of them were introduced on a temporary basis only.⁴⁵ Financial transactions taxes (FTT) were part of the discussions,⁴⁶ but have so far not been introduced comprehensively. However, following an initiative by the French and German governments, the European Commission had proposed to introduce a tax on securities and derivatives trading at the EU level as of 2014,⁴⁷ but this project has met strong objections and is unlikely to go forward as planned by its proponents. G-20 leaders have been discussing possibilities to introduce a financial transaction tax at a more global level.⁴⁸

Participants at the Roundtable pointed out that taxes and levies as currently proposed would weigh on the industry and reduce lending. They would, depending on their form (transaction taxes in particular), reduce market liquidity and eventually reduce the returns for investors like insurance companies and pension funds that are already operating in a very low interest rate environment. The negative impact on liquidity was of great concern because of the currently already very low level of liquidity in most markets. Also, if the tax were not to be introduced on a more global level this would certainly have broader ramifications: much of the trading would migrate to tax-free places, on and off-shore, because financial transaction taxes are some of the most easily evaded taxes in the world and their imposition would thus be futile.

Furthermore, it was pointed out that about 400 years⁴⁹ of experience with the stamp duty on share transactions in the UK have shown that this tax has not eliminated speculation on the London Stock Exchange; new, non-taxed instruments were devised against the stamp duty (*e.g.* contracts for differences⁵⁰) to circumvent taxation of the transfer of the title. Thus speculation persisted even in the presence of the stamp duty as this tax was evaded and speculation took place in a different form. It was also argued that taxing retail investors investing in mutual funds should be avoided; a tax between financial professionals only may be more easily to accept.

7. *Market regulation and market infrastructure*

In line with a call by the G-20 to improve the OTC and commodity derivatives markets,⁵¹ regulators have proposed or introduced reforms to achieve stability and transparency on these markets, to standardise OTC derivative contracts, report them to trade repositories and, as far as possible, transfer OTC trades onto exchanges (or electronic trading platforms, where appropriate) and have them cleared through central counterparties (CCPs) with enhanced margining rules.⁵² Many markets participants have

criticised the rules because they would raise their costs due to higher (cash) collateral requirements.⁵³

While clearing through CCPs should reduce the aggregate counterparty market risk, some observers, including regulators, have also pointed out problems of concentration in a few CCPs that will compete on margins and will create another class of too-big-to-fail entities incurring systemic risks. Furthermore, some of the Basel III proposals regarding derivatives would create incentives for risk concentration in a smaller number of counterparties.⁵⁴ And, as derivatives trading is highly concentrated and dominated by a few G-SIFIs which have the means to design derivatives in a way that they may be exempt from exchange trading, OTC trades are likely to remain very important.⁵⁵ Regarding implementation, the FSB noted that uneven implementation of OTC reforms may create room for regulatory arbitrage,⁵⁶ and is seeking to harmonise the approaches co-ordinating the work of BCBS, CGFS, CPSS and IOSCO that have been working on a common set of rules. Efforts are now underway at the G-20 level that implementation proceeds expeditiously.

In line with these on-going discussions, Roundtable participants expressed great concern that CCPs could become ‘mega-SIFIs’ and far more systemic than any other financial institution. It was underlined that currently no jurisdiction has any regime in place to deal with the failure of such a clearing house. So far the resolution of clearing houses has been ignored on the implicit assumption that failure would not happen. Such an ‘ostrich’ strategy may be justified given that clearing house failures were very rare events in the past, but this no reason for complacency and it will not work in the future when CCPs become truly global and systemic.⁵⁷ Therefore, global efforts will be needed to start thinking about how to deal with the failure of CCPs. In this sense, the conclusions of a recent CPSS/IOSCO report⁵⁸ urging each clearing house only to think about these issues are not sufficient to address the problem.

While it was agreed that there will be a need for stronger safeguards and controls in place to make failure very unlikely, some concerns were raised about the cost of large amounts of collateral immobilised in clearing houses, a problem to which a well-balanced solution needs to be found.

In general, the industry expressed support for enhanced regulation of financial markets during the Roundtable discussions, because improved market governance was seen as important for restoring confidence and stability. The strengthening of MiFID rules⁵⁹ currently underway in Europe was welcome for creating better functioning and more orderly financial markets, but it was still seen as short of what would be needed for the buy side, the asset management industry. Given its leadership in setting standards for and improving corporate governance, it was noted that the OECD could also play a role in fostering market governance.

NOTES

1. See the OECD Interim Economic Assessment, 8 September 2011, and the November 2011 Economic Outlook, at www.oecd.org/oecdEconomicOutlook; and OECD composite leading indicators, at www.oecd.org/std/cli. This assessment is also supported by the IMF World Economic Outlook (IMF, 2011a) and the Global Financial Stability Report (IMF, 2011b) and their January 2012 updates.
2. On 5 August 2011 Standard & Poor's downgraded the US credit rating by one notch from triple A to double A plus, the first ever downgrade of the US by a leading rating agency, noting that the long-term outlook for the US remained negative and that it could lower the rating further to double A within the next two years if there were less spending reduction than that agreed to under the debt ceiling deal (of the same week), a rise in US interest rates or deterioration in the trajectory of US debt.
3. It was also pointed out that unfortunately all relevant 'rescue' institutions like IMF and EFSF had been designed explicitly not to be able to provide direct support for the banking sector; such a possibility would have made financial sector rescue operations like in Ireland much easier and effective; discussions to give the IMF, equivalent to the World Bank's IFC, the possibility to intervene in financial institutions directly were seen as going in the right direction.
4. See also Blundell-Wignall *et al.* (2008, 2009) for a critique on elements of the Basel II framework.
5. BCBS (2011a). For a long-term impact study see also Angelini *et al.* (2011) where long-run positive effects stem from reduced output volatility (rather than the reduction of financial crisis costs which are not taken into account).
6. The new Basel III framework is laid out in BCBS (2010).
7. As proposed by the Basel Committee (BCBS, 2011b), a progressive Common Equity Tier 1 capital charge ranging from 1% to 2.5%, depending on a bank's systemic importance, may be imposed on banks' risk-weighted assets (RWA), with an additional 1% surcharge if such banks materially increase their global systemic importance. These surcharges ("loss absorbency requirements") will be introduced in parallel with the Basel III capital conservation and countercyclical buffers, between 1 January 2016 and end of 2018, becoming fully effective on 1 January 2019. Global systemic importance of banks is to be assessed by an indicator that measures size, interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity of institutions.
8. FSB (2011c) proposes policy measures empower authorities to resolve SIFIs without systemic disruption and without exposing the taxpayer to the risk of loss. These measures include, among others, (mandatory) Recovery and Resolution Plans (RRPs; "living wills"), bail-ins (creditor-financed recapitalisation), removing obstacles to resolvability (arising from complex firm structures and business practices), and cross-border cooperation agreements. In case such resolution regimes are credibly put in place, they will eliminate the implicit government guarantees for SIFIs and may lead to higher financing costs (upward risk adjustment) and lower (or zero) support ratings for such institutions.

9. The main changes regarding counterparty-credit risk (CCR) in the Basel III framework (BCBS, 2011a) concern increased capital charges that take into account positive correlations of probability of default of counterparties with general market risk factors (adding a capital buffer based on a stressed VaR), correlations between large financial entities (GSIFIs), exposure to central counterparties (previously considered as risk-free), and credit-valuation adjustments (CVAs; see below). See, e.g., Blundell-Wignall and Atkinson (2011) for a short overview of reforms in the Basel III framework regarding derivatives and counterparty risk.
10. Lambe (2011).
11. These views are also expressed in the IIF's comments (IIF, 2011c) on the consultative Basel Committee document on G-SIB surcharges (BCBS, 2011b). In these comments the Institute emphasises its "fundamental objection", noting that designating groups of firms as potentially systemic and applying capital surcharge to these "will only increase the moral hazard and market distorting effects arising out of such firms being seen as 'special' and potentially too big to fail". The Institute also identifies "fundamental flaws" in the methodology and recommends "that further consultation be made with the industry." See also the other comments received by the BCBS on the consultative document, at <http://www.bis.org/publ/bcbs201/cacommments.htm>. Regarding other reforms like the proposed resolution regime for SIFIs the Institute is more supportive (IIF, 2011d).
12. Commission of Experts (2010). Banks are, however, allowed fulfil these sizeably higher capital requirements by issuing hybrid, contingent convertible ("CoCo") bonds (also called bail-in bonds).
13. Abandoning unified regulation of the global Basel rules, China's Banking Regulatory Commission (CBRC) will impose tougher regulations on banks by classifying the whole evaluation system to seven big categories and 13 regulatory indicators. A formula set for each indicator will let banks determine their capital requirement and, by a similar formula, the differentiated reserve requirement ratios for banks. The new rules are expected to "better reflect banks' real conditions" and be "thus more market-oriented and much fairer." See "Chinese Version of 'Basel III' to Differentiate Regulations on Banks", *Caijing.com*, at <http://english.caijing.com.cn/2011-03-04/110656717.html>.
14. U.S. Congress (2010).
15. ICB (2011).
16. Such hopes were expressed by some policy makers and commentators with regard to regulations concerning separation of bank business in via the Volcker rule.
17. See also IIF (2011g).
18. For example, the joint effects of various regulations such as Basel III and Solvency II should be examined more closely, see IIF (2011b).
19. MAG (2010). This report estimates, in a central scenario, that increasing bank capital to required levels would lower GDP by 0.22% from the baseline after 35 quarters, with annual growth 0.03 percentage points below baseline, followed by a GDP recovery towards the baseline. Similar results were obtained by the OECD (OECD, 2010; Slovik and Cournède, 2011).
20. BCBS (2010).

21. IIF (2010). The preliminary results presented in that report conclude that for the United States, the euro area and Japan a full implementation of regulatory reform (as was known then) would lower real GDP growth by about 0.6 percentage points on an annual average over 2011-15, and an average of about 0.3 percentage points over the full ten year period of implementation, 2011-2020. Europe will be affected the most, given its size and significance of the banking system relative to the economy.
22. IIF (2011e). This update to IIF (2010) estimates the economic impact of the reforms to lead to a reduction of 3.2 per cent of real GDP after five years, with employment 7.5 million below baseline after the same time period, equivalent to a 0.7 per cent output loss per year. This impact is well above official sector estimates and is expected to be concentrated on the major mature economies. While the study acknowledges that stability benefits from the regulatory reform should accrue over the longer term, beyond the five years in which the output losses will be concentrated, it argues that such benefits are likely to be overstated given the fact that instabilities can also arise outside the banking sector.
23. Härle *et al.* (2010).
24. Böhme *et al.* (2011).
25. Visalli *et al.* (2011) argue that banks in the US and Europe, in order to face competition from other regions and to secure a sustainable future will need to radically transform their business models.
26. Banks' adjustment in business models, risk management, finance and treasury, IT, and operations can mitigate the effects by up to 40 percent of the ROE impact. Such adjustments may concern not only the product and services mix but also the geographical and legal structure of an institution, as well as spin-offs to or partnerships with "shadow banking" entities (Böhme *et al.*, 2011).
27. Al-Darwish (2011).
28. Visalli *et al.* (2011).
29. Arguments against applying similar approaches (capital requirements, mark-to-market accounting) to industries with different business models like in Solvency II were already put forward at a Financial Roundtable in April 2011, see Bassanini and Reviglio (2011) and the other articles published in that special section on long-term investment and growth in the same issue of Financial Market Trends (vol 2011/1, no. 100); available at www.oecd.org.daf.fmt. Similar arguments have also been raised against simply extending the Basel framework to shadow banks, some of which also act as long-term investors.
30. U.S. Congress (2010).
31. As documented, *e.g.*, in Wehinger (2009).
32. Following up on the Pittsburgh declaration, G-20 Leaders requested at their November 2010 Seoul Summit that the FSB, in collaboration with international standard-setting bodies, develop recommendations to strengthen the regulation and oversight of the "shadow banking system" by mid-2011.
33. IIF (2011a, p.14) states that "the industry strongly supports the work being done by the FSB on 'shadow banking' and non-bank financial intermediation and, in particular, on the identification of potential systemic risks and the appropriate policy responses."
34. FSB (2011b).

35. FSB (2011d).
36. See IIF (2011f).
37. It was mentioned that the economic background of these instrument are set out well in the book by the UK's FSA senior official Thomas F. Huertas (2011) as well as in various papers by the IIF, available at www.iif.com/regulatory.
38. It was mentioned that Clifford Chance has done much work on these issues and that the legal technicalities and difficulties are described in a recent paper (Clifford Chance, 2011).
39. In a related comment it was pointed out that, as the EU is planning to take a lead on bail-ins in the forthcoming resolution directive, the issue of how bail-ins and CoCos interact will become even more complicated. In the same vein, as the UK Vickers report recommends that banks maintain both coco and bail-in capital, the latter can be expected to be subordinated in order to get a pricing benefit for senior debt, with the effect of making bail-in capital almost indistinguishable from CoCos.
40. ICB (2011); see also Section II.1 above.
41. See OECD (2009) and Blundell-Wignall *et al.* (2009), arguing in favour of ring-fencing and banks' business separation, preferably in a non-operation holding company (NOHC) structure.
42. US Regulation W concerns transactions between member banks and their affiliates and implements sections 23A and 23B of the Federal Reserve Act that establish certain restrictions on and requirements for transactions between a member bank and its affiliates.
43. This Banking Act of 1933 contained provisions to separate commercial and investment banking in the US until 1999 when it was repealed by the Gramm-Lech-Bliley Act.
44. See also IMF (2010).
45. For an overview see Schich and Kim (2010).
46. Taxes on OTC derivatives trading have recently also been proposed in an article released by the OECD: Blundell-Wignall and Atkinson (2011) propose a derivatives transaction tax as a possible option that would counter the cross-subsidisation of risk and attenuate the too-big-to-fail (TBTF) problem.
47. The proposal was officially put forward in a Council Directive by the European Commission on 28 September in order to ensure that the financial sector's "fair contribution to public finances and for the benefit of citizens, enterprises and Member States" (EC, 2011). The tax would apply to shares, bonds and derivatives (and not spot, but derivative currency transactions) traded by European investors (financial institutions, not private individuals and non-financial corporations) applying the home country rule (taxable are transactions in which a EU-based seller or buyer is involved). The tax rates of the draft proposal are 0,1% for shares and bonds and 0,01% for derivatives. The tax is expected to raise annual EU-wide revenues of about EUR 57 bn – at an economic cost of an about 0.5% long-term reduction in GDP, according to first impact estimates by the Commission. Levying the tax via electronic platforms applying an accrual rule would mean that high frequency trades would be particularly hit. The intention is to introduce this tax at the EU-wide level; however, there have been some discussions that in case countries like the UK or Sweden are opposed, an introduction at the euro area level only may be envisaged.

48. The G-20 have discussed this at the 2010 summit in Toronto, and preliminary findings of a study (Gates report) on a tax on financial transactions are being presented to G-20 leaders at their September meeting in Washington. The findings show that such a tax (intended for development aid) could generate nearly USD 50bn if applied across the G-20 members.
49. Stamp duty was first introduced in England in 1694.
50. *E.g.* Mizen and Rode (2011), analysing the daily turnover of London equities, find that half of trading in the executable market is related to contracts for difference derivatives, which do not attract stamp duty.
51. In their Pittsburgh summit statement of September 2009, G-20 Leaders agreed that: “All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Noncentrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”
52. In the United States, the Dodd-Frank act requires the clearing and reporting of OTC derivatives and registration with the Commodity Futures Trading commission (CFTC) or the Securities and Exchange Commission (SEC) or both. In Europe, the European Market Infrastructure Regulation (Emir), due to come into effect in April 2013, governs over-the-counter derivatives trading and requires many of these trades to be centrally cleared.
53. Some also pointed out that the rules to move trades on exchanges may affect some (large) corporate prime borrowers (with below average borrowing costs) that may face higher borrowing costs, i.e. the average price for a specific calls of borrowers generated on an exchange. Pension funds in particular have been requesting exemptions (under Emir now granted for pension funds until 2015) arguing that the regulation would threaten their liability-driven investment (LDI) programmes that depend on interest rate and inflation swaps that would have to be cleared centrally, increasing costs.
54. For example, counterparty netting in the calculation of (an otherwise additive across netting sets) Credit Valuation Adjustment (CVA) charge to cover mark-to-market unexpected counterparty risk losses creates disincentives for using a well-diversified set of counterparties; see Blundell-Wignall and Atkinson (2011) and OECD (2011).
55. Blundell-Wignall and Atkinson (2011). OTC trades clearly dominate: only about 4% of all derivatives are currently traded on exchanges, according to derivative statistics from the BIS.
56. FSB (2011a).
57. It was noted that Paul Tucker in a recent speech (Tucker, 2011) saw the reason for ignoring this ‘unspeakable truth’ in the fact that if insolvency of a CCP were regarded as possibility this would imply an unlimited liability that would ultimately fall on all CCP members to which they cannot openly admit for various regulatory reasons (and without endangering their creditworthiness).
58. CPSS/IOSCO (2011).
59. For more information on the Markets in Financial Instruments Directive (MiFID) see http://ec.europa.eu/internal_market/securities/isd/index_en.htm.

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