Transatlantic consistency?

Financial regulation, the G20 and the TTIP

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The transatlantic integration of financial markets has suffered a serious setback since the crisis of 2007. Sharp market-driven corrections in cross-border banking and finance have had to be digested, especially in European bank exposures in the United States.

Since then, the countries affected have fundamentally overhauled the regulatory framework governing financial markets. Reforms were adopted and implemented primarily by the Group of Twenty (G20), with the main focus on banking regulation and infrastructure institutions.

However, this stricter regulation has led to regulatory divergence. The European Union (EU) and the United States (US) have adopted nearly all the key legislation and enacted the necessary implementation rules. And yet although their objectives and methods are similar, the implementation process has revealed inconsistencies.

Divergent rules on capital, liquidity, derivatives and banking structures are threatening to fragment the financial markets. Only the rules on recovery and resolution are similarly structured.

Interests, institutions and ideas are the main causes of this divergence. Despite the similarity of objectives and methods, the differences in national regulatory interests are sufficiently stark as a result of market diversity and certain vulnerabilities and priorities. This situation is exacerbated by specific institutional factors. There are also discrepancies between some regulatory approaches.

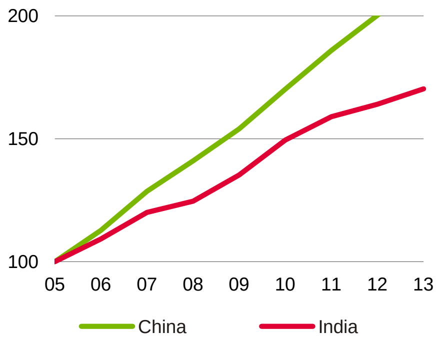
The proposed Transatlantic Trade and Investment Partnership (TTIP) provides a good opportunity to lay strong institutional foundations for regulatory cooperation on financial services as well. An agreement in principle under the TTIP would be the ideal solution here – and is therefore likely to be virtually impossible to achieve. The currently available dialogue channels need to be used.

Responsibility for creating internationally harmonised rules on financial market regulation rests with the G20 leaders. The relevant regulatory bodies continue to need political backing, especially where consistency is concerned. The EU and US should find their way to agreeing a multi-year convergence programme and show leadership in the G20.

Contents

Economic growth 1

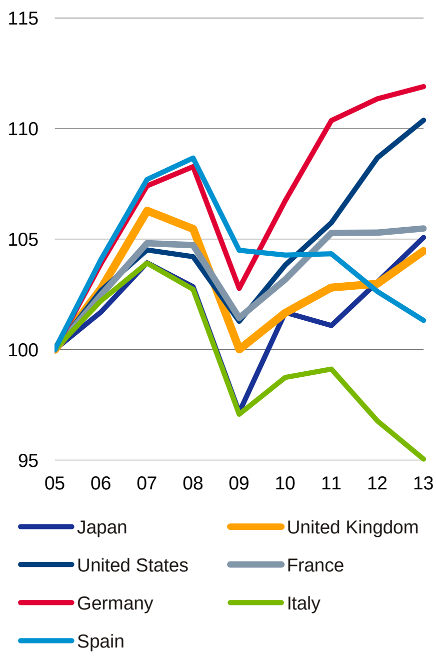
GDP; constant prices, index: 2005 = 100



Source: IMF

Economic growth 2

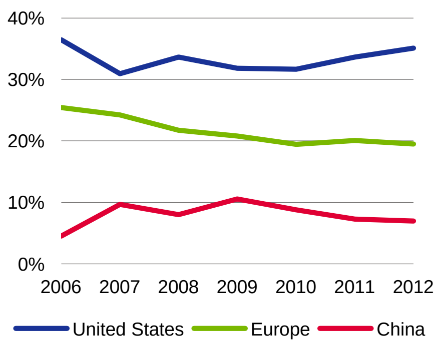
GDP; constant prices, index: 2005 = 100



Source: IMF

Stock market capitalisation 3

% of global total



Source: World Bank

The transatlantic financial markets act as the linchpin of the global financial system. Since 2007, however, the fairly steady process of transatlantic integration has suffered a severe setback in the wake of the financial crisis in the United States and Europe. In this survey, I examine the question of whether a return to these integrative trends is plausible or whether the prospect of fragmentation looms. The short answer is that the EU and the US run the risk of creating friction in key areas because although they are pursuing similar objectives by adopting similar approaches in the political arena, they are not applying consistent rules. Despite the considerable economic damage it has inflicted, the policy of prioritising national regulation over international coordination has not been scaled back much to date. Slightly divergent national policy preferences, the institutional framework and the relevant partners' differing ideas on reform have been the main factors driving this unfortunate trend.

Financial globalisation under pressure

The international integration of financial markets has gone through two major phases: from the middle of the 19th century to the First World War, and from the early 1970s to roughly 2008[1] – more or less mirroring the development of world trade.[2] During these periods the financial market segments grew more quickly than the real economy. Portfolio investment became increasingly cross-border in nature, and international finance followed a similar trajectory. According to a widely used measure, however, it was not until 1985 that the worldwide stock of foreign assets as a percentage of global gross domestic product (GDP) regained the high level that it had reached in 1914.[3] This gradually gave rise to the relatively free movement of capital and a multi-currency standard – as had existed during the Victorian era prior to 1914.

Whereas banks had still been the main drivers of this process during the 1970s and 1980s, financial institutions of all kinds soon entered the international markets. It also became second nature for the world's major corporations to borrow and invest globally. The number and type of market participants, the diversity of the forms of finance and investment available, and the international distribution of risk all increased. Technological advances, growth accompanied by very moderate inflation in the developed economies, and the liberalisation of financial markets were the driving forces here. Nonetheless, the globalisation of financial markets did not take place without any glitches. The period up to 2007 saw emerging economies in particular being repeatedly hit by financial crises, while industrialised nations had to contend with occasional currency crises.[4] Despite these setbacks, the transatlantic core held firm and was ultimately only acutely threatened by the Herstatt crisis of 1974, the Latin American crisis of 1982 and the collapse of LTCM in 1998; however, each of these crises was contained before it could spread.

At the same time, the rise of emerging markets such as China and India as key players in the global economy continued to build momentum (see charts 1 and 2). The BRIC countries (Brazil, Russia, India and China) grew by an average of

1 See Bordo (2002, 2000). Bordo, Taylor and Williamson (2003), Flandreau (2003), Eichengreen (2011, 2008²), Eichengreen and Park (2012), Cline (2010) and Posen (2013).

2 See Findlay and O'Rourke (2007). However, commodity markets and migratory movements did not return to globalisation to the same extent after the First World War.

3 Obstfeld and Taylor (2003).

4 For the years from 1973 to 2006 Obstfeld (2013) has counted 43 currency crises and five banking crises in industrialised nations as opposed to 84 currency crises, 57 banking crises and 74 solvency crises in developing countries; since then he reckons there have been six solvency crises, nine currency crises and 21 banking crises outside the eurozone.

around 6.5% per year between 1980 and 2010 (in real GDP terms), while the eurozone economies expanded by just under 2% and the US by 2.8%.

The growth rate achieved by the BRICs during the current decade is likely to be at least twice that of the US and the euro area.[5]

Transatlantic credit crunch was accompanied by external trade imbalances

The great transatlantic credit crunch[6] that hit the United States and parts of Europe from 2007 onwards soon wreaked havoc in the banking and capital markets, swiftly followed by the global economy and world trade, and subsequently had a seriously detrimental impact on countries' public finances. Given the stellar growth achieved by certain market segments during the boom years, regulatory authorities and market participants had fallen short of their risk surveillance and management responsibilities and, consequently, failed to keep tabs on the distribution of risk within the system and so lost control of the situation. This trend was reinforced by the rapid growth of gross external assets and liabilities – especially in the US and the United Kingdom, which host the world's largest financial centres – since the early 1990s, which in turn was accompanied by a rapid increase in the financial openness of the OECD countries. Credit transactions far outweighed activity in equities. At the same time, foreign trade imbalances grew massively. The credit boom coupled with these external trade imbalances presented significant risks and proved to be extremely dangerous.[7]

Europe's financial markets are still tainted by the crash

The interconnections and feedback loops between public and private-sector debt problems in Europe are especially pernicious and have serious consequences for financial markets. Once ailing financial institutions and the economy had been stabilised in the immediate aftermath of the crash, the focus shifted to stricter and more comprehensive financial market regulation, loose monetary policy, fiscal consolidation and structural reforms aimed at boosting growth. From today's perspective it is difficult to say what the medium-term consequences of this policy mix – which has prevailed since 2010 – will be for financial markets. The International Monetary Fund (IMF) finds that the banking sectors in the crisis-stricken countries of the euro area remain hampered despite the limited re-opening of funding markets and a certain easing of the situation in the euro money markets. The general message is that financial market integration in the EU has suffered severe setbacks from which it is only gradually recovering.[8]

Integration was initially driven by the euro

Given the fragile state of the global economy, it is hardly surprising that the crash adversely affected the trend towards growing integration of the international financial system that had been ongoing since the early 1980s. This integration process was facilitated by the stronger integration of the national capital markets in the EU during the introduction of the euro and the EU Financial Services Action Plan and was driven by the growth in transatlantic banking as well as securities and derivatives trading.

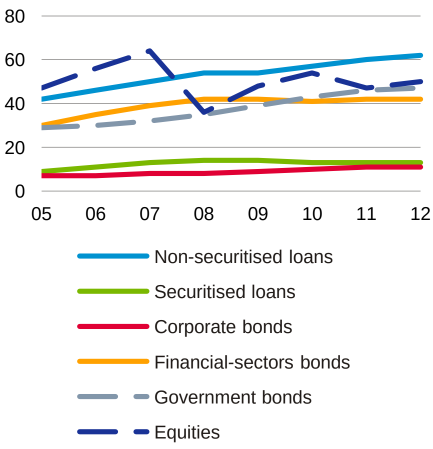
Asia's rise has contributed to financial globalisation

The growing integration of major Asian economies with the United States also helped advance the global integration of financial markets at times. As external trade imbalances have been reduced since 2010, however, this phenomenon has abated somewhat. Moreover, Asia is currently on a fast track towards deeper regional integration of its real economies, and this process is being accompanied by the beginnings of deeper financial and monetary policy integration anchored around Greater China (China, Hong Kong and Taiwan). At the transatlantic heart of the international financial system almost six years after

[5] See O'Neill (2013, 2011).
[6] Schularick and Taylor (2012), Rhee and Posen (2013), Reinhart and Rogoff (2009) and Gorton (2012) place this credit crunch within the context of the history of financial crises.
[7] Obstfeld (2013, 2012), Borio and Disyatat (2011), Acharya and Schnabl (2009).
[8] See IMF (2014) for a comprehensive survey, which includes Laeven and Tressel (2014a and b), as well as the European Central Bank's various reports on financial market integration, most recently ECB (2014).

Assets worldwide 4

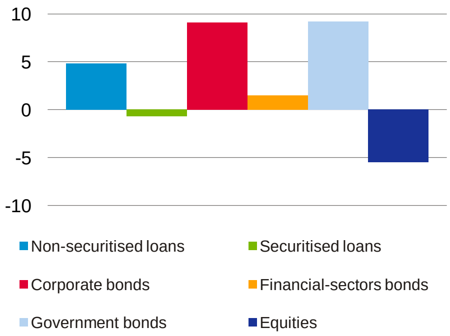
USD tn



Source: McKinsey Global Instiute

Average growth rate 2007 - 2012 5

%



Source: McKinsey Global Institute

the financial crisis broke, meanwhile, although the process of integration in some segments has been given a new lease of life, the integration of capital markets and other segments has declined sharply.

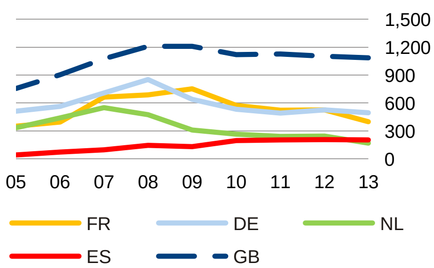
This process is, of course, not taking place in a vacuum and is influenced by macroeconomic trends, monetary and economic policy measures, new types of behaviour on the part of financial market actors, and changes in the regulatory framework. The jury is still out as to whether we will see the transatlantic financial markets return to their path of integration or whether they will simply tend to fragment. Writing with a Korean colleague on this subject, the leading economic historian Barry Eichengreen is of the view that the currently inadequate international coordination of regulatory reform poses a risk of conflict and the fragmentation of global financial markets. He also says that it is difficult to gauge what effect financial market regulation will have on economic growth.[9]

The financial crisis has generally altered the trend lines of some major capital market aggregates (see charts 4 and 5). Whereas corporate and government bonds have experienced a boom over this period, bonds issued in the financial sector have stagnated. Neither of these trends should come as a surprise to observers. Non-securitised loans have grown only moderately, securitised loans have decreased slightly as part of a correction of past excesses, and equities have actually fallen moderately.

One of the most striking trends in international banking and capital markets business is that the unresolved crisis in many eurozone member states – and in other EU countries as well – has caused leading EU banks to withdraw from business in the US, whereas US banks have been increasing their exposure in the EU (see charts 6 and 7). There are no discernible indications that other major groups of banks are withdrawing from business abroad. The levels of portfolio investment between the EU and the United States reveal that equity investments in both directions fell by roughly half after the financial crisis. Although EU investments in US equities recovered swiftly, the EU's equity markets are still not an attractive proposition for US investors. The same applies to bonds (see charts 8 and 9). The transatlantic derivatives market performed relatively normally (chart 10). The EU and US markets account for between 85% and 89% of worldwide volumes. The sharp fall in foreign direct investment during the years of the financial crisis was finally halted in 2011.[10] The dollar remains the most commonly traded currency in the foreign-exchange markets, while transactions in euros come second. These two economic areas also remain the leading regions in terms of their share of the relevant global indicators despite having steadily contracted in recent years.

Bank loans to the US from major EU-member states 6

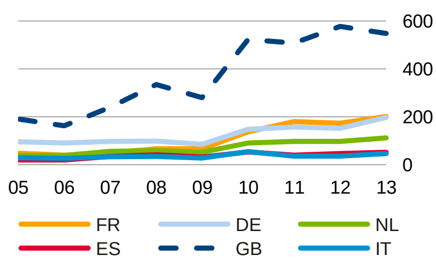
USD bn



Source: BIS

US bank loans to major EU member states 7

USD bn

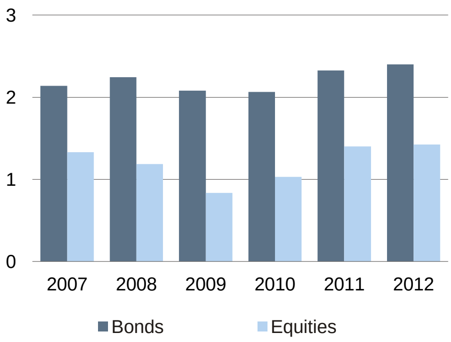


Source: BIS

9 Eichengreen and Park (2012); see also Véron (2012).
10 See Deutsch (2013).

EU portfolio investment in securities from the US 8

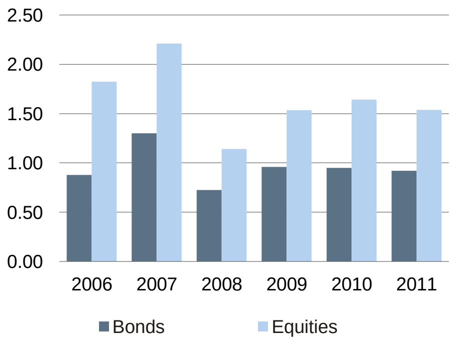
USD tr



Quelle: US Treasury

US portfolio investment in securities from EU countries 9

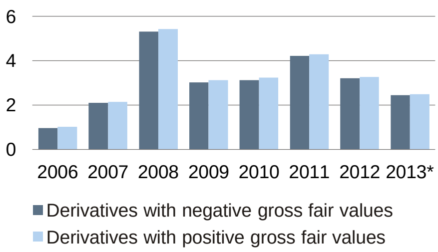
USD tr



Source: US Treasury

US residents' derivatives outstanding with EU residents 10

Notional amounts (USD tr)

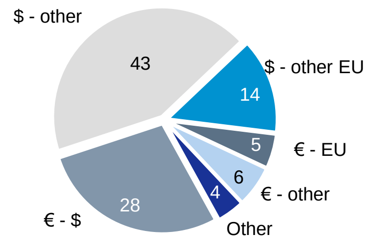


* Data from September 2013

Source: US Treasury Resource Center

Dollar and euro shares of global forex market turnover (2010) 11

%* (daily average)



* Global turnover of USD 40 bn

Source: BIS

Although these regions have 11% of the world's population, they still produce 45% of global GDP and generate a quarter of the world's exports and one fifth of imports. The EU and US are also the leaders in terms of their share of banking assets, with the EU accounting for 41% of the global total (in 2011) and the US just under 12%.

Bilateral trade in financial services remained fairly stable during financial crisis

Bilateral trade in financial services between the EU and US mainly consists of international operations conducted by subsidiaries and branches in the respective partner market. This system offers a measure of stability even during times of crisis. In 2011, US financial institutions had direct investments totalling roughly USD 430 billion in the EU, while EU financial institutions had invested around USD 330 billion in the United States.[11] Financial services account for almost exactly one fifth of total bilateral foreign direct investment in both directions. In terms of the value of financial services sold to non-residents by subsidiaries, both economic areas were neck-and-neck with just over USD 100 billion each in 2011. It is also consistent with this situation that US companies achieved a substantial export surplus in cross-border banking services trade with the EU (2011: revenue of USD 27 billion versus expenditure of USD 7.6 billion), whereas the opposite was the case in insurance (revenue of USD 3.5 billion versus expenditure of USD 12.9 billion). Conventional trade barriers and restrictions on freedom of establishment are now virtually non-existent in banking.

The insurance market in the EU is characterised by moderate barriers that vary significantly according to member state and business segment. The US market

[11] See Deutsch (2013) for these and subsequent figures.

still reveals moderate obstacles to cross-border business but imposes only minor restrictions on freedom of establishment. However, the supervisory regulation carried out by the individual states often creates complications for foreign institutions.

Transatlantic banking and investment business is dominated by large corporate customers. Retail financial products for consumers on the other side of the Atlantic are only sold directly in a few segments, such as investment funds, credit cards, insurance and other minor areas.[12] However, some EU institutions operate through subsidiaries in the US consumer banking market; there is less activity in the opposite direction in this segment.

The G20 regulatory agenda

Pittsburgh summit set out path of reform in 2009

Since 2009 there has been broad consensus that the regulation of international capital markets needs to be fundamentally strengthened and improved in response to the huge crisis in many of the developed economies. This was one of the reasons for setting up the Group of 20 countries (G20) which, at the Pittsburgh summit held at the end of September 2009, laid down the guiding principles for the reformed regulation of capital markets.[13] The Financial Stability Forum was upgraded to a Financial Stability Board and has since been available to provide heads of government with advice and guidance. There was general consensus that the necessary strengthening of financial systems should be achieved by increasing capital and liquidity in the banking sector, making it possible to resolve failed financial institutions in an orderly fashion, implementing special precautions for the resolution of large networked institutions deemed 'too big to fail', enhancing the transparency of derivatives by creating central counterparties and trading platforms through which business in standardised contracts is to be settled, and introducing disclosure requirements, special safety precautions for such infrastructure institutions, and a number of supplementary measures. The regulatory process, which initially covered a total of 49 proposals, gained momentum and eventually included further projects such as the regulation of shadow banks[14], remuneration rules for the financial services industry (only in the EU), and policies on banking structures. The G20 finance ministers and central bank governors recently stated at their meeting in Sydney on February 22 and 23, 2014 that by the time the Brisbane summit is held on November 15/16, 2014, they hope to have finalised the key legislative acts needed to strengthen financial institutions, resolve the too-big-to-fail problem, mitigate risks in shadow banking and enhance the security of derivatives transactions.[15] However, they have already fallen slightly behind the Pittsburgh timetable.

Although international consistency is on the agenda, fragmentation is the norm

Nonetheless, they recognised that this process should not cause the integration of international financial markets to fragment, unnecessary costs should not be imposed on business, the mutual recognition of regulation that is equal in terms of outcomes should be practised in principle, and the parties involved should rely on the oversight and monitoring carried out by the respective home-country systems. This could hardly sound more harmless because it is fully consistent with the G20's objective – as agreed at the Pittsburgh summit – of setting a uniform regulatory framework for the global capital markets in respect of the key legal provisions in order to avert weaknesses in the overall system, prevent

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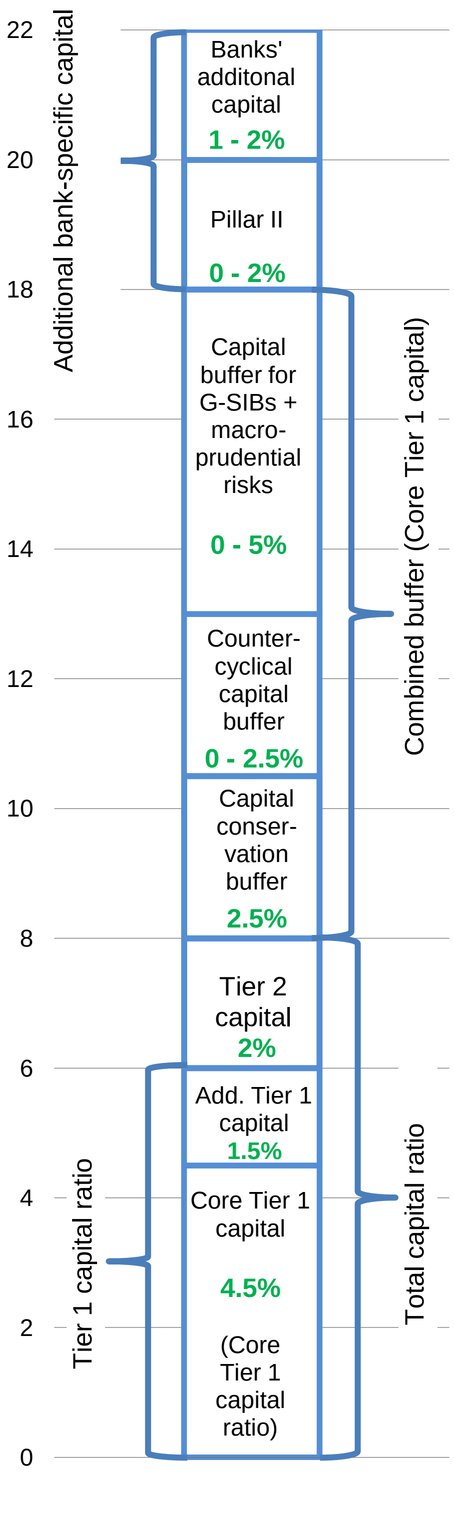
[12] Lannoo (2013).
[13] Communiqué. Leaders' Statement. The Pittsburgh Summit. September 24-25, 2009. See Hajnal (2014) on the G20 in general.
[14] For an overview of these and related regulatory activities see the Association of German Banks (2014).
[15] Communiqué issued at the meeting of finance ministers and central bank governors in Sydney, February 22, 2014.

A number of capital buffers and surcharges can be imposed

Capital requirements 12

in %



Source: European Commission

regulatory arbitrage and promote efficient financial regulation. Nonetheless, even the Financial Stability Board cautioned that the level of international consistency remained inadequate and that those responsible were working hard to rectify this.[16] Critical public voices describe the current situation as something more akin to balkanisation[17] or fragmentation. The regulatory agenda is, of course, already fairly restrictive in its remit, so we need to remain vigilant to any potential consequences for sustainable economic growth and to the stability of the international financial system. The question as to whether an internationally consistent approach will be achieved is not merely of secondary importance – it is a crucial economic policy issue.

However, the seemingly harmless language of the communiqué issued by the G20 finance ministers in Sydney cannot conceal the fact that the process of implementing the G20 proposals has in key areas revealed substantial trans-atlantic divergences and implementation gaps outside the transatlantic region which, in effect, are likely to seriously fragment the global capital markets over the course of this decade as a result of regulation. Although the EU and the United States in particular are already well advanced in adopting the most recent rules at each of the key regulatory stages, in doing so they have sacrificed international consistency temporarily at least.[18] This is true of the rules on both capital and liquidity as well as the regulatory framework for derivatives. Although the rules on the resolution of financial institutions have yet to be fully implemented, they are, nonetheless, similar to each other; the especially complex cross-border collaboration mechanisms required for this purpose are only gradually being finalised.

EU-US divergence in rule-setting

Capital standards

There was consensus within the G20 that the regulation of banks' capital adequacy and their liquidity positions needed to be improved worldwide. The Basel Committee on Banking Supervision therefore swiftly drew up a new regulatory framework for capital adequacy (Basel 2.5 and Basel III). These rules specify tougher requirements for banks' trading books and securitisations (Basel 2.5). The EU adopted the new Basel III capital and liquidity standards into law in July 2013, and this legislation will be fully implemented by 2019. The United States adopted the Basel III capital requirements in July 2013 in the form of regulation by the Federal Reserve and by the Office of the Comptroller of the Currency, which is located within the Treasury Department.[19] Other major G20 countries have also implemented these rules.[20] However, the regulatory framework for liquidity requirements has yet to be completed. Further Basel Committee projects covering a whole range of key issues – such as the risk weighting of assets – are still a work in progress.

Basel III has considerably raised the capital requirements applicable in both the US and the EU. The legal provisions governing capital have been significantly tightened. General capital requirements have been increased: the loss-absorbing Tier 1 capital ratio must be raised from 4% to 6% and, below that,

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16 Financial Stability Board (2014).
17 Economist (2014a, 2013).
18 Initial documentation can be found in EU-US Coalition on Financial Regulation (2012). A full review of EU financial regulation is available in European Commission (2014c).
19 Federal Register (2013).
20 See the Basel Committee reports (2013), Atlantic Council (2013), Johnson and Schott (2013), Lannoo (2014), Ingves (2013) and – for information on economic trends in both banking markets – Schildbach (2013).

Core Tier 1 capital has to be increased from 2% to 4.5%. As under Basel 2, the total capital ratio must still be at least 8% of risk-weighted assets (6% Core Tier 1 capital plus 2% additional Tier 2 capital). All banks will also be required to hold a capital conservation buffer of common equity amounting to 2.5 percentage points as a countercyclical capital cushion. In addition, the authorities can specify a buffer of up to 2.5 percentage points for cyclical purposes. On top of that, a capital surcharge of between 1 and 3.5 percentage points is being introduced for global systemically important banks (G-SIBs). EU member states can use a phased approval process to impose an optional surcharge of up to 5 percentage points either on the financial system as a whole or on individual institutions for systemic or macro-prudential risks; in addition, the capital backing required for various asset classes may be increased. More generally, the authorities can impose further capital requirements on individual institutions as part of the regulatory review process. It will be possible to offset systemic buffers against each other.

Certain differences have emerged

All new instruments and requirements will be phased in by 2019. Differences between the EU and the US will remain in terms of the instruments that qualify as core capital (silent participations are still allowed in the EU, as is the consolidation of banking and insurance business into a single group and simply adding together the capital holdings) and with respect to specific legal provisions for groups of financial institutions. Furthermore, the Dodd-Frank Act bans the use of credit ratings from the relevant rating agencies under US regulatory law, which is why the Basel rules have not, after all, been implemented without being modified. It remains to be seen to what extent the many flexibility options available in the EU as well as the differences between the United States and the European Union severely distort competition in the respective markets and across the Atlantic. What is clear, however, is that the regulatory potential for such an outcome exists. A critical debate has already been triggered by proposals put forward by the Bank of England in February 2014 under which the supervisory rules governing foreign banks operating in the UK are to be tightened by the host country's regulatory authorities.[21]

Extent of fragmentation depends on practical application and regulation

The respective jurisdictions will ultimately have to strike the right balance between financial stability requirements and financial centres' competitiveness. There are signs that the both the larger and smaller Western global financial centres (US, UK and Switzerland) and some Asian locations are putting especially stringent requirements in place. Although the legal framework has been finalised, only the ways in which the available options are utilised and regulation is conducted on a day-to-day basis will reveal how this balance is struck and to what extent this will affect competition between financial centres. The best solution will probably be for the EU and the US to introduce similarly stringent requirements in order to prevent regulatory arbitrage.

Conflicting objectives of regulation versus financial centres' competitiveness need to be managed

US rules on foreign banking organisations

US has tightened regulation of foreign banks

In February 2014 the United States also took the highly controversial step of imposing additional requirements on foreign banks which, if conducting US-based non-branch banking operations with total assets of USD 50 billion or more, must by no later than July 2016 set up an Intermediate Holding Company that meets specific regulatory, capital and liquidity criteria. In imposing these requirements, the Federal Reserve followed a strict interpretation of the pertinent general regulations contained in the Dodd-Frank Act.[22] However, the relevant capital requirements will only have to be met under the Standardised Approach, liquidity will have to be made available for a 30-day stress test (and

[21] Bank of England (2014).
[22] See Kern (2010) for an overview of this legislation (Dodd-Frank Wall Street Reform and Consumer Protection Act. H.R. 4173), which came into effect on July 21, 2010.

Geographically based supervision policy contentious

separately for branches during the first 14 days of such periods) and the binding US leverage ratio will have to be complied with from 2018 onwards. Foreign banks will also have to meet requirements in the areas of stress testing, risk management and capital planning. This will force some foreign institutions to restructure their US operations. What's more, these criteria could in effect require much larger amounts of capital and liquidity to be held in the United States than would otherwise be necessary for financial or regulatory reasons at a global level.[23] The US has been criticised by the European Commission and other bodies for having abandoned the principle of the group-based setting of capital requirements in favour of a geographical policy and of having infringed the basic principle of the primacy of banking supervision by the home-country authorities. Nonetheless, the United States has stuck to its guns, citing the importance of financial stability in its domestic market.[24] The Fed has pointed out that at the end of September 2013 the number of foreign banks exceeding the USD 50 billion threshold – and thus qualifying for the stricter regulation of the Dodd-Frank Act – was exactly the same as the number of such domestic banks, namely 24 in each case. It has therefore stressed the urgent need for stricter regulation of foreign banks' US business.

Liquidity, *leverage* and other rules

Liquidity rules being finalised

In addition, the first few liquidity rules have been adopted. From 2015, for example, highly liquid assets will have to be able to cover net cash outflows over a 30-day period (liquidity coverage ratio [LCR]). Although the full details of the EU regulatory framework are still being finalised, these rules will be phased in from 2015 to 2018 by means of delegated legislative acts of the Commission. The proposed US rules on the LCR go beyond the Basel requirements and define liquidity stress scenarios as well as setting tougher limits. The Basel Committee has also stipulated that from 2018 onwards all long-term loans and securities with maturities of more than one year must be fully covered by long-term funding (net stable funding ratio [NSFR]). The full details of these rules are still being finalised.

US has introduced a leverage ratio

In addition, the leverage ratio (ratio of core Tier 1 capital to bank assets both on and off the balance sheet) was initially introduced as a flexible supervisory instrument under Basel III and set at three per cent. The regulatory instrument used by the US has traditionally been a leverage ratio based only on total assets. The US authorities will require the eight large globally systemic US bank holding companies to maintain a Basel leverage ratio of 5% from 2018 onwards; the banks that operate under these holding companies and whose deposits are protected will have to comply with a ratio of 6%; all other banks will have to maintain a minimum ratio of 3% from 2018; the Basel Committee had recommended 3%.

EU is still reviewing the situation

The EU has yet to decide on this matter.[25] The major eurozone banks' leverage ratio – defined as the ratio of equity to total assets under comparable accounting rules – was just over 3% at the end of 2012, while the corresponding ratio for the leading US banks came to slightly above 4%.[26] This largely reflects the long-term incentive structures prevailing in the past, which under Basel I encouraged banks in the United States to hold fairly risky investments and under Basel II encouraged EU banks to maintain high-volume, low-margin credit portfolios. The Basel Committee recently adopted a harmonised method of calculating various categories of securities and derivatives. This approach has eliminated some of

[23] See, for example, Economist (2014, 2013).
[24] For a defence of this position see the speech by Daniel K. Tarullo, the member responsible on the Board of Governors of the Federal Reserve System (Tarullo 2014).
[25] See Ingves (2014, 2013) on the work being done by the Basel Committee on this issue.
[26] European Central Bank (2013), chart A.17.

Other harmonisation plans in the pipeline

the discrepancies that resulted solely from the accounting standards applied.[27] This will enable transparency to be achieved consistently from 2015 onwards. Complex work on defining and calibrating a leverage ratio is due to be completed by 2017, and this ratio could then be introduced as a binding rule throughout the EU from 2018.

The Basel Committee is continuing to work on the methods used to determine risk-weighted assets in order to achieve a greater degree of harmonisation; the capital requirements calculated under the risk models used by banks in the EU differ by up to 3.5 percentage points – and those of banks in the US by up to 2.5 percentage points – from the respective average application of risk weightings to what are otherwise identical transactions.[28] Further work is being done on the definition of non-performing loans in the EU, for which no standardised approach has yet been agreed. Despite the basic recommendations made by the Basel Committee and the level of consensus on the broad policy outlines, however, it has recently become clear that a certain amount of national leeway under the EU's 'flexibility package' with respect to capital requirements and the right to deviate upwards from minimum standards are regarded as necessary in order to accommodate national interests.

Capital surcharges for global banks* 13

%

Surcharge	Banks
3.0%	
2.5%	HSBC JP Morgan Chase
2.0%	Barclays BNP Paribas Citigroup Deutsche Bank
1.5%	Bank of America Credit Suisse Goldman Sachs Group Crédit Agricole Mitsubishi UFJ FG Morgan Stanley Royal Bank of Scotland UBS
1.0%	Bank of China Bank of New York Mellon BBVA Groupe BPCE ICBC ING Bank Mizuho FG Nordea Santander Société Générale Standard Chartered State Street Sumitomo Mitsui FG Unicredit Group Wells Fargo

* G-SIBs (global systemically important banks)

Source: Financial Stability Board (as at November 2013)

Given the substantial differences within transatlantic banking and its regulation, it is generally the case that we cannot expect to see a fully harmonised approach any time soon.[29] Although the big banks and the banking sector as a whole on both sides of the Atlantic have very similar Tier 1 capital ratios, the riskiness of their balance sheets differs considerably. EU banks hold on their books large amounts of low-risk business which in the United States is traditionally transacted through the securities markets. Aggregate total assets as a percentage of GDP in the EU are roughly four times as high as the corresponding US figure (not adjusted for differences in accounting standards). The levels of earnings generated by European and US banks since 2010 have also diverged sharply owing to structural differences and disparities in economic performance.[30] Whereas major US institutions managed to raise their average return on equity from less than 2% in 2009 to above 9% in the second quarter of 2013, the banks in the euro area (DJ EURO STOXX banks) saw their RoE fall to virtually zero. Both groups of banks are still a long way off their pre-crisis levels of between 10% and 18%. US institutions' price-to-book ratio recently amounted to approximately 1, while the corresponding figure for eurozone banks was only around 0.6. Despite substantial consolidation in the number of institutions in the euro area (down by 9% on a consolidated basis between 2008 and 2012) and a reduction of almost 12% in assets as part of the deleveraging process, the eurozone banking system has not yet succeeded in convincingly rectifying the problem of its woefully low profitability, although there are substantial variations between crisis-stricken countries and stable member states. Although 2011 was the only year in which these banks incurred losses in aggregate, 2012 was only slightly better. Seven countries' banking systems were still making losses overall in 2012, while the provisions set aside for losses on loans in the eurozone have risen steadily since 2008. Only now that the economy has started to recover in 2014 are we likely to see banks' earnings gradually improving as well.

All of the above has caused some to conclude that the US banks are not only better capitalised and have to contend with far lower impending losses but that they must also be meeting a stricter regulatory regime. By contrast, they are of the view that the situation in the EU cannot yet be properly assessed at least

[27] United States Generally Accepted Accounting Principles (US GAAP) allow net positions in repo and derivatives transactions with counterparties to be calculated, whereas International Financial Reporting Standards (IFRS) do not.
[28] See Byres (2013). The models and applications currently being used still allow so much leeway that Bank A and Bank B can value exactly the same transaction differently.
[29] See Schildbach (2013) on the underlying trends.
[30] See European Central Bank (2013).

until the various preparatory stages prior to commencement of supervision under the ECB's Single Supervisory Mechanism (i.e. balance sheet analysis, comprehensive risk assessment and stress testing by the European Banking Authority [EBA] and the ECB) have been completed.[31] The European Commission, however, stated that EU banks added equity between 2009 and 2012 in the order of almost EUR 500 bn (+27%). The median Tier I ratio increased from 8.7% (2009) to 12.7% (2012). Also, the leverage ratio of large banks increased to some three per cent whereas for all other banks it remained steady around 3.4% recently.[32] It is undoubtedly the case that these similar regulatory changes are impacting on banking systems on both sides of the Atlantic that currently find themselves in strongly divergent structural and cyclical situations. Given that it will take several years for the banking system – especially in the eurozone – to recover, this divergence will not be reversed any time soon and will probably continue for some years, even if the euro area stages a strong cyclical rally. The exact nature of this recovery will partly depend on the policies adopted towards the European banking sector.

Recovery and resolution of financial institutions

Financial institutions must be able to fail

If, nonetheless, all the new capital and liquidity requirements prove insufficient to prevent a major financial institution from becoming insolvent, comprehensive precautionary measures have been introduced to ensure the orderly recovery and resolution of financial institutions. Governments, parliaments, regulators, central banks and other market participants never again want to be faced with the situation of having to take decisions over the weekend to rescue a struggling financial institution at the taxpayer's expense without having a workable legal framework or any useful information or tools instead of simply being able to go down the route of an orderly resolution. This concern was particularly acute in the case of large systemically important financial institutions. In the EU, however, there was no such thing as a standardised legal framework, in the member states there was generally no specific bank insolvency legislation for the resolution of financial institutions, and in the United States the legal framework in place before the Dodd-Frank Act was passed applied only to deposit-taking institutions but not to investment banks or insurance companies.

Resolution of systemic institutions

Resolution rules for the EU and US are in the pipeline

Consequently, the G20 and the Financial Stability Board (FSB) agreed on uniform principles for the recovery and resolution of large financial institutions. These principles require the authorities to work closely together, set up crisis management groups, draft plans for the resolution of financial institutions that become insolvent, and stipulate specific regulatory cooperation rules for individual entities.

FSB laid down criteria and regulatory timetable

Whereas, when the financial crisis broke, the United States already had an appropriate national legal framework in place and – in the shape of the Federal Deposit Insurance Corporation (FDIC) – a public agency for this purpose in many individual cases,[33] the EU countries first had to develop the necessary institutional and legal framework for financial institutions in general and large financial institutions specifically.

[31] This opinion can be found in US political institutions and in the views of think tanks; see Atlantic Council (2013), Johnson and Schott (2013) and Lannoo (2014) for pertinent comments.
[32] European Commission (2014c), p. 65-67.
[33] However, this only applied to deposit-taking institutions. The financial crisis revealed that other financial institutions, such as investment banks, required the government and the central bank to provide special solutions because the FDIC was not responsible for them. The Dodd-Frank Act closed this gap. For further information on these events see Blinder (2013), Paulson (2010), Stein (2009) and Wessel (2009).

The issues needing to be addressed were the definition of 'systemic institutions', then the specific regulatory process and, finally, the entire dedicated legal framework for the recovery and resolution of financial institutions.[34] The FSB drafted this definition according to uniform criteria. This definition covers eight banks in the US and 14 in the EU (see chart). It only covers a few insurance companies (five in the EU and three in the US). The FSB tried to carefully coordinate its work on regulatory instruments and loss absorbency requirements so as not to distort competition in capital markets. The FSB recently cautioned that further work needed to be done in areas such as domestically important banks and outside the banking sector.[35] What's more, there are further discrepancies in the precise rules governing capital and liquidity at G-SIBs.

International consistency is necessary for global financial institutions

Pertinent institutions in the US (G-SIBs) have had to submit resolution plans to the authorities. Although cross-border crisis management groups have also been set up, concrete action plans and bilateral arrangements are only gradually being agreed between the regulators responsible for any given institution. Viewed in the round, it is still too early to say with any certainty whether consistent rules can actually be achieved in this area because the necessary international components in particular are still missing. Nonetheless, it is worth considering the fact that specifically geographical approaches to the regulation of foreign banks, such as the Federal Reserve's rules on foreign banking organisations (FBOs) – and potential retaliatory measures in other regions – could have the effect of making it more difficult to create a consistent resolution framework. Given the ongoing debate as to when and how a 'single point of entry' or 'multiple point of entry' approach to resolution should be applied, there is still hope that consistent rules can be achieved.

Resolution in general

Furthermore, the rules on resolution must be sensibly framed for all other financial institutions as well. Here, too, the main issues are the specific nature of insolvency legislation – which should follow common principles – and the exact division of responsibilities and legal remedies between the authorities in the country of establishment and those in the key host countries. One very tricky but necessary task will be to reach agreement in principle on the approach to be adopted when regulating cross-border matters, such as derivatives books that are governed by various jurisdictions in the event of resolution, because national authorities have no access to contracts concluded under foreign law. Internationally concerted action is therefore needed. This has not yet been agreed with legally binding effect in the EU-US relationship, especially as the Dodd-Frank Act contains no legal provisions concerning international aspects.

Political agreement has been reached in the EU

Although this process has not yet been completed either in the EU or in the US, in December 2013 a trilogue of the EU's three Brussels institutions agreed on the general legal framework (Directive on the Recovery and Resolution of Financial Institutions) and, additionally, on March 20, 2014 it reached political agreement on the basic regulatory framework for the recovery and resolution of banks in the euro area (Single Resolution Mechanism and Fund), while in the United States the Dodd-Frank Act enables systemically important financial institutions (not just deposit-taking institutions) to be resolved.

EU and euro area have approved resolution rules

The EU legislative acts have yet to be finalised and adopted. The various EU rules governing these matters contain very strict legal provisions on loss absorbency in the form of bail-ins of shareholders, creditors and, if necessary, depositors not protected by law (deposits in excess of EUR 100,000)[36] up to a

34 For a discussion of all these issues see Zhou et al. (2014).
35 Financial Stability Board (2013a).
36 Deposits held by individuals or by small and medium-sized enterprises as well as liabilities owed to the European Investment Bank are given priority over shareholders and creditors. The

Transatlantic divergence likely

maximum of 8% of the institution's total assets, which in the past would have covered all eventualities. The resolution authorities can sell the company, create a bridge institution, hive off assets and bail in creditors. Rules governing collaboration with authorities from non-EU countries have also been incorporated. In addition, all member states must set up national resolution funds with resources which after ten years must amount to 1% of insured deposits. This rule will apply from 2016. A similar fund eventually containing total resources of EUR 55 billion will be set up for the banks in the 18 eurozone countries subject to the ECB's Single Supervisory Mechanism. 60% of the fund's total resources will be paid in within the first two years; the fund is also authorised to borrow.

Structural banking reform

The Volcker Rule has been enacted in the US

A further source of potential divergence arises from the wide-ranging measures and proposed policies on structural banking reform. The five federal banking and investment regulatory authorities in the US approved the final regulations on banking structures (known as the Volcker Rule) on December 10, 2013, more than three years after the Dodd-Frank Act was passed. This rule bans financial institutions with insured deposits from engaging in proprietary trading and restricts banks' business in hedge funds and private equity funds. However, it continues to allow hedging, market making in securities for clients' accounts, trading in US government bonds, foreign banks' trading in government bonds of the country in which the institution is established, and – similarly – trading in municipal bonds. These rules will come into force from the middle of 2015. Numerous detailed provisions regulate foreign banks' operations both inside and outside the US. Some rules give the US authorities the right to intervene in foreign banks' business. The exemptions granted for business that has clearly been transacted outside the United States are subject to a few conditions which in practice could still turn out to be restrictive. Moreover, the exemption on trading in government bonds could potentially have a substantial extra-territorial impact. In addition, the four regulatory authorities responsible for implementing these rules can exercise a considerable amount of discretion as to how they interpret them.

Many foreign banks are affected

Various laws on separation of commercial and investment banking in EU member states

Approaches to structural banking reform within the EU vary widely. Germany and France, for example, both passed legislation on the separation of commercial and investment banking in 2013. The German law (Act on Ringfencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups) will come into effect in July 2015. The United Kingdom is pursuing a policy of ring-fencing (Vickers report). The regulatory bodies in these countries have been given considerable leeway in terms of how they organise such a separation of commercial and investment banking. In January 2014 the European Commission submitted legislative proposals in line with the suggestions made by the Liikanen Group on the separation of these banking businesses. These proposals take the form of an EU regulation and would therefore override all national legislation with immediate effect and would require the Commission to grant an exemption for such national laws to remain in force.[37] Similar to the Volcker Rule, banks are to be banned from engaging in proprietary trading and investing in hedge funds. In addition, trading activities will have to be organisationally separated from deposit-taking and payments

Commission has already submitted proposals

following are exempted from bail-ins: insured depositors, secured creditors (including holders of covered bonds), liabilities owed to employees, and a number of other minor items. See European Commission (2013) and European Council (2013).

[37] European Commission (2014).

businesses as soon as certain risk thresholds are reached.[38] Considerable further consultation will be needed before agreement is reached at European level. Depending on how such legislation is framed, it could create further problems in the transatlantic relationship if the pertinent regulations do not dovetail properly, if EU rules give rise to new regulatory implications for EU banks' US business, or if US banks' business in the EU is directly impacted. Although the proposed legislation is intended to be applied to non-EU banks' branches, it gives the Commission the option of recognising a non-EU country's legal system as equivalent.

International coordination still in its infancy

It was not until the St. Petersburg Summit was held in 2013 that the various regulatory activities were subjected to a mild form of G20 coordination in the form of an inspection mandate[39] and, in other respects, they are not coordinated by any international body in terms of their underlying principles, strategic direction or key regulatory items. Nonetheless, all of these decisions and plans could potentially have a huge impact on the real economy, banking markets and non-EU countries. Joint regulation of at least cross-border legal provisions would be the absolute minimum level of cooperation needed in order to avoid conflicting regulation, but there are no signs of this happening any time soon. Quite apart from that – and in contrast to the other major regulatory proposals – there is no consensus in either academic or political circles as to whether these rules on the separation of commercial and investment banking could ever actually further the regulatory objectives jointly agreed by the G20. In this area there is therefore potentially the danger of a huge mismatch between the desired benefits of these rules and their actual cost, coupled with almost unavoidably complex, internationally inconsistent regulation. It would be much more expedient to work consistently on the resolvability of globally active financial institutions. If there is confidence in the legal resolution framework then there is very little need for structural banking reform. Resolvability requirements themselves might prompt some internal restructuring, though.

Derivatives market reform 14

	USA	EU
Legislation		
Central clearing	4	4
Exchange / platform trading	4	4
Reporting requirements	4	4
Capital	4	4
Margin requirement	4	4
Implementation		
Central clearing	5	1
Exchange / platform trading	5	0
Reporting requirements	5	6
Capital	3	6
Margin requirement	2	1

0 - no action taken
1 - consultation
2 - proposed
3 - partially adopted
4 - adopted
5 - partially effective
6 - effective

Source Financial Stability Board, 2014

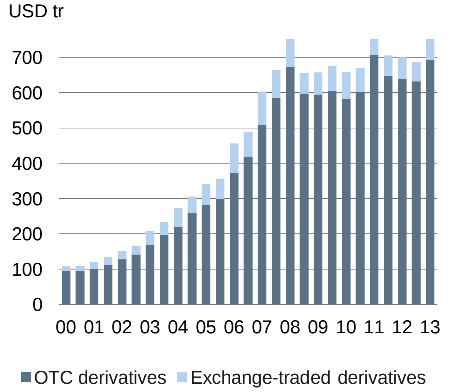
Derivatives

Another shared concern among the G20 countries was the need to re-regulate the global derivatives markets in order to remove systemic intransparency, eliminate any potential contagion channels and enhance market stability in general.[40] Standardised derivatives will in future be traded on central platforms and cleared through central counterparties. This will eliminate the counterparty default risk attaching to these transactions because it will be hedged by the central counterparties. This in turn will prevent any systemic contagion effects if a major financial institution becomes insolvent. In addition, derivatives transactions are to be backed by special collateral security and reported to trade repositories, thus enabling the regulatory authorities worldwide to enhance market transparency. The central platforms must themselves be regulated, and these institutions' access to central bank liquidity in times of crisis must be specified. Over-the-counter (OTC) derivatives are to be backed by collateral security and by banks' capital. These are the main planks of the reform.

[38] This rule is intended to apply to global systemically important banks and all banks which in three consecutive years have total assets of at least EUR 30 billion or engage in trading activities amounting to at least EUR 70 billion or 10% of their total assets.
[39] Point 68 of the G20 leaders' declaration issued at the St. Petersburg summit in 2013: "We recognize that structural banking reforms can facilitate resolvability and call on the FSB, in collaboration with the IMF and the OECD, to assess cross-border consistencies and global financial stability implications, taking into account country-specific circumstances, and report to our next Summit."
[40] For information on this topic in general see Kaya (2013), Atlantic Council (2013) and Financial Stability Board (2014b, 2013b).

Transatlantic consistency?

Notional amounts outstanding in the derivatives market 15



Source: BIS

In the United States these reforms have essentially been adopted as part of the Dodd-Frank legislation. The competent regulatory authorities – the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) – have already initiated the rule-setting process. The CFTC adopted substantive rules for swaps. On June 25, the SEC adopted first rules and guidance on cross-border securities-based swaps. The EU has laid the essential legal foundations with its European Market Infrastructure Regulation (EMIR), which covers OTC derivatives, central counterparties and trade repositories[41]; a further part of these rules is contained in the latest version of the Markets in Financial Instruments Directive (MiFID 2), which is currently in the legislative process. The implementation of further stages – such as the approval of central trading and clearing platforms – is under way.

The complexity of these rules has been greatly occupying market participants for months now. This is primarily because the EU and US regulatory frameworks are not consistent with each other in all respects, and the FSB and G20 are demanding the creation of internationally harmonised rules. This also applies to the regulation of central counterparties themselves, which can be cooperatively monitored, can themselves effectively be wound up and must meet strict liquidity rules. Different margin requirements and other rules hinder the mutual recognition of CCPs. At any rate, this issue is of great importance to the economy because the total notional amount of the global derivatives market has exceeded USD 600 trillion in recent years, over 80% of which has been attributable to the EU and the US.

Identical objectives and identical methods but different rules

The fundamental policy principles and components in the EU and the US are identical. There are differences in terms of the definition of the target groups (in the US: all market participants, in the EU: non-financial entities are only included above a certain threshold) and product categories covered by the rules, in terms of the exact structure and nature of the rules, in terms of the applicable disclosure requirements (in the EU: for all transactions, in the US: OTC derivatives only; in the EU: all counterparties, in the US: financial institutions only)[42] and in terms of the obligations incumbent on central trading platforms and counterparties. Because some of the rules are framed in a highly nuanced way according to the type of non-EU market participant, there are legal inconsistencies between EU and US requirements in some cases. Although it should, in principle, be possible for cross-border transactions to be cleared by foreign central clearing agents if equal legal provisions of institutions licensed under foreign law are available, individual rules effectively force certain market participants to process certain transactions.

Ad-hoc measures are not enough

US law and regulatory frameworks vary the applicable rules according to the type of counterparty (foreign brokers with or without a licence, foreign branches of US brokers, domestic or foreign counterparties) and in terms of the requirements imposed on financial institutions and on transactions. EU rules require the Commission to make decisions on the equivalence of the legal systems of non-EU countries such as the United States; they also require the European Securities and Markets Authority (ESMA) to grant individual licences for clearing agents and trade repositories and to impose margin requirements on non-EU service providers; these rules also differentiate according to the type of market participant, product and transaction. Sometimes the US regulatory authorities use the legal instrument of unilaterally approving certain EU transactions – such

[41] Regulation No. 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC derivatives, central counterparties and trade repositories. Official Journal of the European Union. July 27, 2012.

[42] These disclosure requirements came into force in 2013 in the United States and on February 12, 2014 in the EU. They are of various kinds and have already caused the Bank for International Settlements (BIS) to make proposals for them to be aggregated in a global register; see Economist (2014b).

as derivatives that are not cleared centrally – but reserve the right to amend the pertinent rule at any time.

Mutual recognition of trading platforms not a guaranteed success

Another controversial matter is the mutual recognition of trading platforms that have already been approved by one jurisdiction but not yet by the other; this is because, once again, there are inconsistencies in the detail of the relevant rules. Nonetheless, the first steps towards the recognition of trading platforms were taken in February 2014 when the CFTC exempted EU trading platforms from all registration requirements and freed market participants from certain transaction requirements.

Unfortunately, these rules overlap in some cases. However, many requirements concerning institutions' performance of their functions offer scope for potential mutual recognition, while most transaction-related requirements are not covered by these rules. Specific US rules on business conducted with US persons both inside and outside the United States make this regulation even more complex. For some types of transactions it might not be possible to reconcile conflicting requirements. Derivatives transactions within large corporate groups, on the other hand, are governed by their own dedicated rules.

Joint way forward must be pursued

Given these practical problems, the European Commission and the CFTC are working to find a common approach to eliminating these inconsistencies. These proposals were announced on July 11, 2013,[43] and certain aspects have already been implemented. Nonetheless, there is still some way to go until the legal provisions governing institutions, infrastructures and transactions can be smoothly integrated. Inconsistent reporting requirements pose additional problems. The timelines are also not well aligned. As the objective here is not to decide to fully recognise the equivalence of other jurisdictions' regulatory frameworks, individual rules need to be examined and, where appropriate, recognised. In the EU these decisions are taken by the Commission, while ESMA makes recommendations. In the United States the competent authorities themselves decide. This process is likely to take a few years until all individual rules have been finalised and examined. By the time this survey went to press, no decisions on the equivalence of other jurisdictions' regulatory frameworks had been taken.

The BIS and other organisations recently found that the G20's main concern – putting in place a secure infrastructure for the global derivatives market – was gradually being met and that the proportion of centrally cleared derivatives was rising sharply. At the end of February 2014, roughly 59% of all interest-rate derivatives transactions that could potentially have been cleared centrally (46% of the outstanding notional amount) and around one fifth (19%) of credit products (e.g. credit default swaps) had actually already been cleared centrally. In addition, capital requirements for centrally cleared contracts already apply in the EU, whereas the relevant timetable in the US has yet to be finalised. The EU plans to introduce margin requirements for non-centrally cleared contracts in 2015, while the timetable in the US has yet to be decided.

The FSB also found that the vast majority of interest-rate contracts in the EU member states are traded across borders, with the corresponding proportion in the US exceeding 60% of all such turnover. Given the existing regulatory divergences, however, the concern is that, although a certain amount of progress has been made, the transatlantic derivatives market will not function totally smoothly over the next few years. The multilateral working group on derivatives market reform is due to submit a report to G20 leaders in time for the summit being held in Brisbane, Australia, on November 15 and 16, 2014.

[43] European Commission and CFTC (2013).

Solutions to the problem of divergence

Although the European Union and the United States have so far failed to agree on consistent rules concerning key regulatory aspects of the G20's jointly initiated project to reshape the international financial markets, they have vowed to improve the situation. In the short term, however, there are signs of further trouble ahead in all those areas where no finalised regulation has yet been adopted and the level of coordination has fallen short of the consistency required.

Divergence of national interests, regulatory institutions and ideas

This divergence in the implementation of regulation is not too difficult to explain. There is divergence in terms of national interests, financial market regulatory institutions, and ideas on the best regulatory approaches. Firstly, the financial situation of the banks and financial markets in the US contrasts sharply with that in the EU. Consequently, the vested interests of governments on this side of the Atlantic differ slightly from those on the other side in terms of how exactly they design their regulatory frameworks. The leverage ratio is probably the most obvious example of this. Secondly, the relevant regulatory institutions operate within totally different political systems. Although the Dodd-Frank Act provides a legal framework in the US, the task of framing these rules is the responsibility of several institutions that are independent of the government and Congress. International consistency criteria have to be upheld as part of a laborious process, but are often governed by national objectives. And thirdly, the EU and US differ in some respects in terms of their ideas as to what the ideal sort of regulation should look like. This is less true of capital – except for the FBO rules – and derivatives than it is of liquidity and banking structures. Because everything in finance is interconnected, the impact of these regulatory inconsistencies typically transcends all subject areas and national borders.

This causes problems in global capital markets

All of this might not be quite so critical if the brightly coloured patchwork of diverse regulations were intended for an art gallery. In the case of financial markets, however, this diversity often leads to arbitrage, severely reduced liquidity, new and unintended risk distributions caused purely by regulation, and subsequent additional regulation. A remedy is urgently needed.

Bilateral cooperation within a multilateral framework

Sensible to align regulatory activities with G20 leaders' political preferences

As far as virtually all the aforementioned issues are concerned, the G20 process has revealed a common concern that the international organisations involved in regulatory cooperation should be aligned with the political preferences of the relevant heads of state and heads of government. This approach is designed to ensure that major projects are actually implemented and receive political backing. As the leading market participants in global finance at the moment at least, the US and the EU will naturally have to do most of the heavy lifting in this collaborative relationship. Although the consistency of regulatory frameworks is highly important for the Asia Pacific region as well, the principal markets must lead the way here. What's more, the transatlantic divergence in these rules threatens to confront the Asian authorities with the dilemma of having to take sides one way or the other. Consequently, regulatory cooperation has traditionally primarily been handled by multilateral rule-setting bodies such as the Basel Committee and the International Organization of Securities Commissions (IOSCO) and has been spearheaded by the EU and the US.

Transatlantic cooperation in international regulatory bodies needed

Financial Markets Regulatory Dialogue an important starting point

Ever since the G20 launched its reforms, the European Commission and its downstream regulatory authorities as well as the US government and US regulatory authorities have attempted – with varying degrees of intensity – to directly coordinate their activities. In institutional terms this can either happen on a direct and theme-related basis or it can take the form of an occasional

Financial Markets Regulatory Dialogue (FMRD) or an insurance dialogue. It was not until early 2014 that both sides appeared to have realised the urgency of the work being done on regulatory consistency in the wake of highly critical media reports and the huge problems encountered in practice.[44] The only way to deal with the inconsistencies, especially in the derivatives market at times, was for the CFTC to issue temporary no-action relief. In addition, the European Commission and the CFTC started to conduct equivalence analyses. It is evident, however, that the current system of informal coordination under the FMRD and case-by-case collaboration between the European Commission and individual US authorities has not yielded satisfactory results and probably indicates a greater institutional deficit.

Friction in derivatives markets back on G20 agenda

The opportunities offered by the TTIP

Concrete trade rules desirable

There is, theoretically, a chance of creating a lasting, institutionally embedded and politically backed framework for the regulatory work to be performed jointly under the planned trade and investment partnership between the EU and US.[45] However, the US and EU have differing views on this issue. While both sides are looking to agree a reduction of traditional market access barriers as well as general rules on financial services as part of a concrete bilateral framework for the general arrangements resulting from the World Trade Organization (WTO) financial services agreement reached in 1997, the US does not want this regulatory cooperation to be legally or institutionally binding, whereas this is exactly what the EU is advocating.[46]

The final report published by the High Level Working Group on Jobs and Growth, which preceded negotiations, recommended that both sides should negotiate horizontal disciplines on regulatory coherence as well as transparency for goods and services, which should include rules on early consultations, impact assessments, regulatory cooperation and good regulatory practices. In addition, annexes containing targets for regulatory compatibility should be drafted. Industry associations on both sides almost unanimously support this focus on regulatory collaboration.

Frame legal provisions on cooperation

In terms of content there are, indeed, good arguments for the provisions of the General Agreement on Trade in Services and the WTO rules on financial services to be framed more explicitly for transatlantic contexts. They would, for example, contain more precise rules on national treatment and non-discrimination. In addition, horizontal matters such as data protection and labour mobility within the sector could be included either in the general section on services or in the sectoral annex.

Investment and trade agreement provides opportunity to place regulatory cooperation on new footing

The third option would be to establish ground-breaking legal provisions on regulatory and supervisory collaboration by framing concrete provisions on regulatory and supervisory cooperation. A good approach here might be to agree legally binding rules concerning advance consultation on planned legislative acts or, alternatively, principles concerning extra-territorial matters, basic tenets of the mutual recognition of regulation[47] and of the procedures to be adopted to this end, and principles concerning the various forms of bilateral cooperation in international standard-setting bodies. In addition, the usual general trade agreement exemptions for national (or, in the EU, Community)

44 Joint Statement (2014).
45 See Deutsch (2013) in general for economic analysis here.
46 European Commission (2014).
47 The potential forms of cooperation defined by the debate on this subject are mutual recognition of entire regulatory frameworks, substituted compliance with certain rules, unilateral decisions to recognise the equivalence of partner jurisdictions' regulatory frameworks, and decisions not to apply rules owing to evident inconsistencies or target groups' inability to (fully) implement the rules.

supervisory law ('prudential carve-outs' under WTO agreements) could be much more precisely formulated so that, for example, priority is given to home-country regulators over host-country regulators, proportionality rules on regulatory acts that restrict market access are agreed and, where appropriate, procedures for arbitrating disputes between authorities are specified. It would be necessary to examine whether such a legally binding agreement of regulatory cooperation and supervisory activity would have to be formalised by amending the competent authorities' terms of reference. This form of collaboration appears to be quite feasible because, after all, this has worked really well in the past at organisations such as the Basel Committee and the IOSCO despite the legal independence of the institutions involved.

A fourth option would be to set the general cooperation framework – once a TTIP agreement had been concluded – for bilateral political monitoring of collaboration in this sector as well, possibly in the form of a requirement to report annually to the heads of government and heads of state at bilateral EU-US summits.

Dialogue with regulatory target groups expedient

And, fifth, it would no doubt be both sensible and useful to incorporate the input of regulatory target groups (financial services providers, companies operating in the real economy, and consumer organisations) on the forthcoming dossiers in a structured format once or twice a year so as to enable a transatlantic dialogue involving both rule-setting authorities to be held at a certain time and at a certain location. Given the complexity of the subject matter and the regulatory scope that affects all firms, such an unusual format would probably be justifiable in this case.[48]

Inter-institutional cooperation

New regulatory institutions should work closely together

The relevant transatlantic authorities will, as a matter of urgency, have to work closely with each other in the areas of banking, securities and infrastructure regulation. Generally speaking, the transfer of some banking regulation functions to the European Central Bank should make this task simpler because the number of parties involved is likely to decrease. As far as cooperation on resolution issues is concerned, it will also be important to find a harmonised approach that will be adopted by the US authorities, the newly created Single Resolution Board in the euro area and the resolution institutions of the non-eurozone EU member states. This should generally make it institutionally easier to regulate big banks from the euro area. This process will also require a number of rules and agreements on the proper procedures to follow when handling sensitive transatlantic regulatory data.

The CFTC and SEC on the US side and the Commission and ESMA on the European side are obliged to work especially closely with each other on securities regulation and the supervision of central counterparties. The underlying declarations of intent have already been signed.

[48] The United States already has a sophisticated system under which industry associations and institutions of civil society advise the government on trade policy. The EU set up its first such system in the form of a small group of advisers for the TTIP at the beginning of 2014. And, more generally, this measure might well also be appropriate for other topics and sectors at European level.

The G20

G20 remains obliged to coordinate all regulation

Five years after the Pittsburgh summit was held, substantive progress has been made on improving regulation of the international financial markets. The capital and liquidity rules governing the banking system have almost universally been massively strengthened over and above the minimum and in individual cases now comfortably exceed this minimum. Switzerland and many Asian countries have set much higher requirements in some areas; the United States and the EU have also gone beyond what is required in some areas. The reorganisation of derivatives business is already under way. Proposals for the harmonised regulation of globally active insurance companies have been submitted but are still some way from being adopted into law. The regulation of financial institutions that are neither banks nor insurers is in the pipeline and urgently needed.

Transatlantic cooperation on macro-prudential regulation a matter of urgency

Nonetheless, the G20's challenge of having to devise consistent regulations for the global financial markets has not diminished significantly.[49] For example, the work being done by the macro-prudential regulatory authorities in the US and EU – namely the Financial Stability Oversight Council (FSOC) and the European Systemic Risk Board (ESRB) – has made progress. During its first four years the FSOC has analysed various issues in the US and made recommendations, while the ESRB has already submitted initial detailed analysis and operational proposals on how to deal with such risks in the eurozone banking industry. It goes without saying that the EU and the US should both lead the way in designing a new regulatory framework because these two regions have the most complex financial systems and both of them have adopted appropriate rules and institutions.[50] ECB president Mario Draghi rightly stressed that global macro-prudential regulation was still in its infancy and that, although some progress had been made towards developing a set of policy instruments[51] for banks, there was still a good deal of work to do – both analytically and in practical terms – outside the banking sector.[52]

Numerous political differences need to be addressed

Furthermore, the G20 needs to give some serious thought to how it might resolve transatlantic political differences over the medium term. Given their divergent views on a number of issues, the EU and the US are unlikely to find common ground any time soon. Contrary to what President Obama originally intended, the United States will probably not set up a resolution fund financed from contributions levied on banks, while the eurozone countries will collect EUR 55 billion for this purpose. The EU has adopted strict legislation on remuneration in the banking sector, whereas no such laws exist in the US. Accounting standard-setting bodies' efforts over the past decade or so to bring about convergence between United States Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS) appear to have hit the buffers and urgently need a reboot.[53] No agreement has been reached on the regulation of credit rating agencies, with the US banning the use of such ratings while they are still permitted in the EU. In addition, eleven EU member states are planning to introduce a financial transaction tax, whereas the other EU countries do not intend to do so at present; the United States has no such plans.

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[49] See Tucker (2014).
[50] See, for example, FSOC (2013), ESRB (2014 a, b), Kern (2012), Speyer (2012) and Weistroffer (2012).
[51] In addition to the various capital buffers specified under the Basel III framework, the EU Capital Adequacy Directive and, in particular, the EU Regulation have introduced several instruments such as higher risk weightings and stricter lending criteria for mortgages, higher capital and liquidity requirements for large exposures and more stringent legal provisions for calculating losses in the event of insolvency. Further instruments available at national level include various lending ratios and debt ceilings. See ESRB (2014a).
[52] Draghi (2014). Draghi also chairs the ESRB.
[53] See Joint Statement (2014).

G20, IMF and FSB responsible for global systemic stability

Because it will take a few more years until the process of implementing the latest regulation of international financial markets has been completed, it remains important to align these regulatory activities with G20 leaders' political preferences. The international regulatory bodies themselves are engaged to varying degrees in drafting new rules, ensuring that they are implemented in individual jurisdictions, analysing differences and making recommendations. One thing that past financial crises have taught us, however, is that problems can arise in unexpected places whenever opaque markets or market practices, adverse macroeconomic trends and institutional weaknesses coincide either in economic policy or in banking and financial market regulation. The G20 has in effect delegated the task of overseeing the international financial markets to the Financial Stability Board and the IMF, and these two organisations no doubt possess the best expertise in the form of their respective institutions and the other international regulatory bodies supporting them.

EU and US are indispensable in this process

Nonetheless, such specialist organisations are always reliant on political backing in order to ensure that they can deal effectively with the really critical regulatory issues. Responsibility for reshaping the international financial markets therefore ultimately lies with the G20 leaders and especially, of course, with the economic heavyweights of the United States, the European Union, Japan and, increasingly, China. Although, in this quartet of the four largest economic areas, transatlantic cooperation is once again a necessary condition of effective action, it is no longer by any means a sufficient one.

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