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US financial market reform

The economics of the Dodd-Frank Act

US Dodd-Frank Act: Comprehensive reform. With the Dodd-Frank Act the US has set a yardstick for the regulatory response to the crisis. It provides a comprehensive reshaping of America's existing oversight framework, broadly in line with the priorities agreed in conjunction with its partners in the G20.

Regulatory objectives: Financial stability, consumer protection. The Act addresses a broad range of policy issues, including the institutional reform of financial regulation and oversight, prudential regulation of financial institutions, and the protection of investors and consumers.

Economic impact: Stability strengthened, costs up, market structures set to change. The Act's impact on the US economy – and possibly beyond – is likely to be substantial.

— Financial stability will be strengthened, through a reformed institutional framework, new macroprudential oversight, systemic risk regulation and more and higher-quality bank capital.

— Consumers will benefit from the reform, thanks to far-reaching improvements in the consumer protection framework. At the same time, the costs of banking are set to rise while the availability and choice of products may decline.

— Market structures will change. The number of banks in the US market will decline further, and on average their size will increase, while at the same time they will concentrate on reducing costs and work in a much narrower field of activities than before. New market structures will also be the outcome for the securities infrastructure business and non-bank financial services providers.

— Foreign companies are subject to additional uncertainty as their treatment is in large parts left to the implementation phase of the Act.

— Bottom line: The US financial market will remain a highly competitive place with strong financial centres, governed by an intricate system of supervision and a set of market rules of unprecedented complexity.

Implementation: Greater consistency with G20 and international standards needed. An assessment of the Act's impact necessarily remains incomplete due to the lagged impact of its provisions, and the current uncertainty over implementation – which is scheduled to span several years. Consistency with G20 and international standards remains imperative, including Basel and IFRS.

G20: More leadership needed. Two years after the first G20 Summit the spirit of cooperation has waned disquietingly. Disagreement over joint solutions and deviations from the original agenda prevail. The EU and the US take centre stage. They urgently need to get their acts together and lead the process.

EU: Important differences to US approach underline need for closer coordination. The EU is more systematic about institutional reform, more compliant with international standards, stricter on alternative investors, harsher on compensation. Key differences are in the offing on critical topics, incl. financial transactions taxation, bank levies, short selling. The EU should be careful to avoid deviations from the G20 consensus.

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Source: H.R. 4173

Introduction

The US government has finalised its regulatory response to the financial crisis. The so-called Dodd-Frank Wall Street Reform and Consumer Protection Act was passed by Congress on July 15, 2010 and subsequently signed into law by the President on July 21. The Act is considered to be the most comprehensive financial market reform in the US since the 1930s, and is relevant not just for the US as it will, no doubt, shape the thinking on financial market reform beyond the country's borders.

But the regulatory crisis response is far from over. The Act specifies 243 pieces of mandated rulemaking by means of which the law will need to be implemented by US regulatory and supervisory authorities in the coming months and years. At the same time, international discussions on regulatory reform continue, most importantly in terms of the broad strategic approach at the G20 level, but also on specific issues such as capital requirements in the Basel Committee, on reporting standards in the context of the International Accounting Standards Board (IASB), or on rules for securities markets at the International Organization of Securities Commissions (IOSCO). Finally, revisions of the Act are already being discussed in Washington.

Three major questions arise:

— What will be the impact of the Dodd-Frank Act on financial markets in the US and beyond?

— How does US legislation compare with the measures taken in the EU?

— How does the Act relate to ongoing policy debates at the international level?

Before addressing these questions, we briefly review the contents of the Act.

New rules for America's financial markets

Most important reform project since 1930s

The July 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act is the most important reform project in the recent history of the US financial market. It is a direct policy response to the financial crisis that commenced in the spring of 2007, and covers a broad range of policy issues identified as critical.

The Act's objectives include promoting financial stability, improving accountability and transparency in the financial system, ending "too big to fail" (TBTF), protecting taxpayers, and protecting consumers from abusive financial services practices.

In this spirit, the Act addresses four areas of financial market regulation.

— Reform of the institutional framework of regulation and oversight

— The prudential regulation of banks and other financial institutions

— Rules on the protection of investors

— Rules on the protections of consumers

Financial Stability Oversight Council (FSOC)

Objectives

— Identify risks to financial stability from financial distress, large interconnected banks or non-banks, or from outside the financial marketplace.

— Promote market discipline, by eliminating bailout expectations.

— Respond to emerging threats to the stability of the financial system.

Duties

— Data gathering, information sharing, monitoring, analysis of domestic and international regulatory developments.

— Recommendations to Congress and member agencies.

— Jurisdictional dispute resolution among member agencies (non-binding).

Composition

10 voting members from Treasury (Chairperson), Fed, OCC, BCFP, SEC, FDIC, CFTC, FHFA, NCUA, and an insurance expert, and 5 non-voting members from the OFR, FIO, and state insurance, banking, and securities commissioners.

Meetings

At call of the Chairperson, at least quarterly.

Source: H.R. 4173 Sec. 111

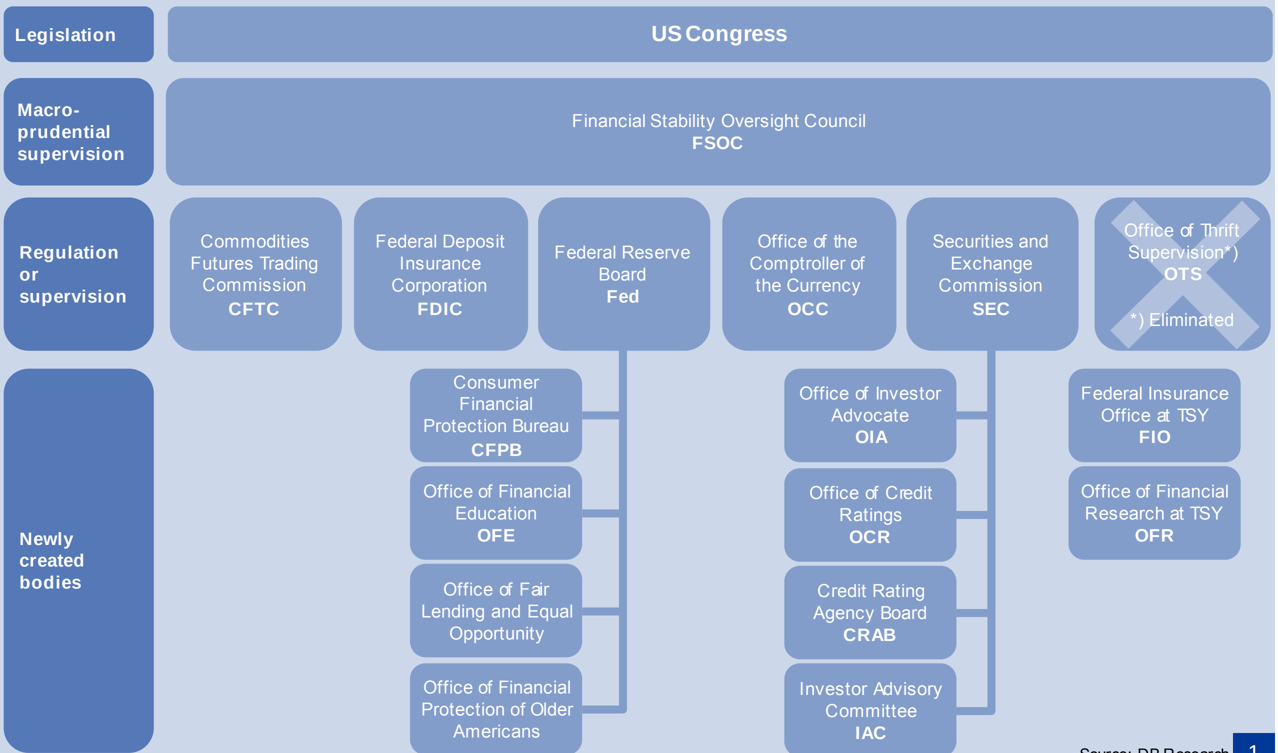
Overview of provisions

Regulation and oversight

Macro-prudential supervision: The lack of comprehensive macro-prudential oversight over the US financial system has been identified as a key shortcoming of the existing regulatory system. The Act therefore creates a Financial Stability Oversight Council (FSOC), mandated with identifying risks to the financial system, promoting market discipline, and responding to threats to financial stability. The FSOC will be headed by the Treasury Secretary and encompass representatives of a wide range of relevant agencies (see textbox). The FSOC can make recommendations within its remit, but has no immediate enforcement powers.

Ending TBTF: The question of how to optimally handle ailing financial institutions which were considered too big to fail severely complicated the rescue measures in the critical months of 2008. To provide for an orderly process, the Act establishes a new Orderly Liquidation Authority, designed to provide a framework for an orderly unwinding of systemically important financial companies which protects creditors and customers while discouraging bailouts and reducing any moral hazard that may exist among shareholders, unsecured creditors, and management. The provisions aim to ensure a due process in which the FDIC and the Fed agree whether a company is in financial distress, the Treasury appoints the FDIC as receiver, and shareholders and unsecured creditors bear the losses. Net costs of unwinding failing firms are to be borne by the financial industry through fees imposed after a firm's collapse on financial firms with assets higher than USD 50 bn or designated systemically important non-banks.[1]

The new US regulatory and superversion system



Source: DB Research 1

[1] H.R. 4173, Sec. 201-217.

The Volcker Rule

The Volcker Rule was inserted in the draft legislation upon the initiative by former Federal Reserve Chairman Paul Volcker who had been appointed chairman of the Economic Recovery Advisory Board by US President Barack Obama in February 2009. The proposal was publicly endorsed by the President in January 2010.

Applicability: Any banking entity, including banks, thrifts, their controlling parent companies, bank holding companies, and any affiliates or subsidiaries.

Prohibitions and restrictions:

Proprietary trading: Any form of proprietary trading is prohibited. Important exceptions: Investments in US government, agency, state or municipal debt, in small business development companies, market making, hedging, business on behalf of clients, banking entities solely outside the US, activities by regulated insurance companies.

HF and PE sponsorship: Banking entities are prohibited from acquiring or retaining equity, partnership or ownership interests in or from sponsoring hedge funds or private equity funds. Important exceptions: Certain specified investments in HFs or PEs that do not exceed 3% of the total ownership of the fund within one year of the investment, and 3% of the banking entity's Tier 1 Capital, plus other conditions.

Securitisation: Securitisers of asset-backed securities are required to retain 5% of the credit risk. Banking entities cannot underwrite asset-backed securities that result in a conflict of interest. Exemptions: Hedging, liquidity provision, market making.

Concentration: Bank entities are prohibited from mergers or acquisitions that would result in a company with liabilities greater than 10% of the total liabilities of all US financial companies.

Implementation: The Volcker Rule does not become effective immediately. First, the necessary rules implementing the Volcker Rule need to be enacted by the competent authorities over a two-year period. In addition, agencies have been mandated to conduct studies into the performance of the banking system and the implementation of the Volcker Rule. This may take up to two years. Second, there will be a two-year transition period after the effective date during which banks are expected to conform their activities to the Rule. Third, extensions can be granted up to three years, in some cases up to five years.

Source: H.R. 4173 Sec. 619-623

Reform of the Fed: Lack of clarity regarding competencies, responsibilities, and overlaps among the regulatory and supervisory institutions has been a much-criticised issue in the US financial system. The Act aims at addressing this issue by granting the Federal Reserve a central position in the US regulatory and supervisory system, with additional supervisory tasks but also subject to stronger transparency requirements. Most importantly, the Fed will work with the FSOC on setting tighter disclosure, capital and liquidity standards for banks and non-banks. In addition, the position of a Vice Chairman for Supervision has been created who will serve on the Board of Governors and will develop policy recommendations and report to Congress semi-annually. At the same time, Fed will need to provide greater transparency, including on counterparties, and emergency and discount window lending. Emergency lending will in future need to be approved by the Treasury, and collateral will need to be sufficient to protect taxpayers from losses. The US Government Accountability Office is mandated to provide a report to identify measures to improve the governance of the Fed, beyond the abolition of member bank participation in selecting the presidents of the Fed's regional banks provided in the Act.

Reform of banking supervision: The Act further aims at streamlining the regulatory and supervisory system in the US by abolishing the Office of Thrift Supervision (OTS), eliminating overlaps of agency tasks, and by defining their responsibilities more clearly. At the same time, however, a multitude of new bodies is being created, including the already mentioned FSOC, BCFP or FIO, and a number of others, mainly located at existing agencies.

Banking and financial market regulation

Prudential regulation – Volcker Rule, bank capital, leverage: Overtly strong lending practices – partly reflected in high leverage ratios at numerous banks – have been identified as key risks in the financial system, adding to its size and complexity. To decelerate the growth of bank assets, the Act establishes a number of new prudential rules for the banking sector. Most prominently, these include the so-called Volcker Rule which aims at limiting the activities of banks in business that are considered particularly risky, including proprietary trading, and hedge fund and private equity management. Accordingly, the Act prohibits – with exemptions – any form of proprietary trading by banks, limits their investments in and sponsorship of hedge funds and private equity funds, restricts securitisation underwriting and imposes a concentration limit on mergers and acquisitions in the banking sector (see textbox).

In addition to the Volcker Rule, the Act provides enhanced capital requirements, leverage and risk-based standards for systemically important companies. According to the so-called Collins Amendment, the risk-based and leverage capital standards currently applicable to US insured depository institutions will be imposed over time on US bank holding companies, including holdings of foreign banks, thrift holdings, and systemically important non-banks. Thus, a bank will need to have 4% Tier 1 capital, 8% total capital and a minimum 4% leverage ratio to be considered adequately capitalised. To be regarded well capitalised, the thresholds are at 6%, 10% and 5%, respectively. As in the case of the Volcker Rule, a complex set of implementation phases and grandfathering clauses for existing assets have been defined. Exemptions include foreign parent

Corporate governance and executive compensation in the Dodd-Frank Act

Weak governance structures are understood to have contributed to the problems in the financial sector preceding the crisis. The Act addresses these weaknesses by requiring greater disclosure on the compensation of executives in the financial sector, and by enhancing the influence of shareholders on their companies. The broad, principles-based measures include criteria for the staffing of compensation committees, disclosure of the relationship between a company's executive compensation and its financial performance, and disclosure of internal compensation structures. Payment arrangements that encourage inappropriate risk-taking are prohibited. Further, the Act lays the foundations for clawback policies enabling the recovery of incentive-based compensation from current or former executives following a restatement of financial accounts. In addition, shareholders are granted the right to cast non-binding votes on executive compensation and golden parachutes.

Source: DB Research

companies, federal home loan banks, small banks with assets below USD 500m and others.

Derivatives markets: Derivative instruments, especially credit derivatives, can create substantial risk exposures among market participants. Moreover, deficiencies in derivatives market infrastructure were revealed by the crisis. The Act therefore provides for comprehensive regulation of the derivatives markets, especially of swaps, including credit default swaps (CDS), foreign exchange, securities-based, and mixed swaps. Most importantly, it requires mandatory clearing of derivatives transactions through regulated central clearing organisations, and mandatory trading through either regulated exchanges or swap execution facilities (SEF). Exceptions apply to non-financial companies and captive finance subsidiaries in case their business predominantly serves an industrial parent.

In addition, the Act establishes new conduct-of-business rules for swap dealers and major swap participants (MSP), i.e. non-dealers with substantial net positions in swaps or whose positions may create substantial counterparty risk exposure or which are highly leveraged. To that end, the CFTC and SEC are mandated to prescribe business standards relating to capital requirements, initial and variation margins, use of collateral, post-trade reporting, fraud, diligent supervision, position limits, eligibility standards, disclosure of material risks, and to their businesses with special entities, incl. pension funds, endowments or government agencies. Higher capital requirements and margin requirements will be imposed for OTC positions.

Swap operations into separate affiliates

Finally, banks will have to move certain swap trading operations into separate, individually capitalised non-bank affiliates, according to the so-called Swaps Pushout Rule, unless their trading activities are limited to hedging own risk, or interest rate, foreign exchange or commodities-based swaps.

Consumer protection regulation

Institutional reform: Finally, the Act also addresses consumer protection issues, which had been raised in the context of sub-prime disclosures and losses on securities portfolios during the crisis. Most importantly, the new legislation creates a Bureau of Consumer Financial Protection (BCFP) which will consolidate responsibilities previously held by other regulatory bodies. As an independent executive agency within the Fed with a director appointed by the US President, the BCFP is expected to become an influential agency in the US regulatory system. The Bureau will have broad rulemaking, supervisory and enforcement powers over any market participant offering or providing consumer financial products or services. Exceptions apply to SEC and CFTC-registered entities.

Consumer protection rules: Further new consumer protection rules primarily apply to the mortgage sector where lenders in future need to assess more diligently whether borrowers can repay their loans. Incentives to steer borrowers into more costly loans are prohibited, pre-payment penalties are outlawed, protections for high-cost mortgages are extended, penalties for irresponsible lending are extended, and additional information requirements on banks in dealing with borrowers are defined. In addition to these mortgage-related rules, the rights of depositors have been strengthened during the crisis by extending the FDIC's insurance limit to USD 250,000 for retail clients and by granting unlimited coverage for small business non-interest bearing transaction accounts.

Insurance – an industry (almost) without national regulation

The US insurance market remains essentially untouched by the regulatory reform package. Although a new Federal Insurance Office will be established within the Treasury, which among other things will report to Congress on improving US insurance regulation, the provisions fall far short of the idea of a federal insurance charter. The new office will have no enforcement powers and predominantly serve as a coordinating and information gathering body. Insurance companies, as a general rule, remain exempt from the Volker Rule and the Swaps Pushout Rule.

Source: DB Research

Investor protection in the Dodd-Frank Act

Securitisation: Securitisation is understood to have played a critical role in the run-up to the financial crisis, diffusing credit risks across the industry, potentially blurring incentives among market participants. To improve incentive structures, securitisers of asset-backed securities are required to retain 5% of the credit risk in the form of a vertical slice of the securitisation structure. In addition, the SEC can tailor risk-retention rules specific to individual products. Various exemptions have been specified.

Securities markets: In order to enhance the protection of investors in securities markets, the Act provides a number of rules raising the standards for broker-dealers giving investment advice, increasing the transparency of securities lending, establishing whistleblower rewards for the reporting of securities law violations, and enhancing the capacities of the SEC.

Credit rating agencies (CRAs): CRAs will be subject to tighter internal controls and stronger transparency requirements. These include the obligation to reserve half of the board seats to independent members, conduct-of-business rules for compliance managers, and the requirement for an annual compliance report. The Act also includes enhanced liability, penalty and antifraud rules, and a private right of action for investors. Also, internal controls, incl. firewalls, lock-back requirements, procedures and methodologies, rating symbols, and the required qualifications of rating analysts have been strengthened.

Hedge funds (HFs) and private equity funds (PEs): Even if HFs and PEs are generally not considered to have played a central role in causing the financial crisis, their growing importance as investors and counterparties in the financial markets have prompted policy-makers to extend prudential regulation and supervision to these entities. The new rules require HFs and PEs with assets greater than USD 150 m to register with the SEC and be subject to periodic inspections by SEC examiners. Further, the funds will need to report financial data to the SEC and implement compliance policies. Once a fund is found by the SEC to have grown too large or too risky, it is placed under Fed supervision. Venture capital funds remain exempted. Beyond these requirements, no prudential or conduct-of-business rules have been specified.

Source: DB Research

Implementing the Dodd-Frank Act

Just over one year after the US Treasury's report on reforming financial supervision and regulation[2] which set in motion the legislative process, the Dodd-Frank Act marks an important achievement as the centrepiece of crisis response in the US. At the same time, the Act cannot be regarded as the end of this process, but should rather be seen as a key milestone in a complex regulatory programme characterised by transition periods and implementing measures to be taken by the regulatory authorities:

— Transition periods and grandfathering clauses: For a wide range of rules in the Act transition periods have been specified which are intended to enable market participants to prepare for the new rules and adjust their operations[3]. Thus, the rules regarding the CFPB are subject to a so-called transfer date of up to 18 months, the interchange fee provisions take effect 1 year after enactment, and in the case of the Volcker Rule a combination of transition periods could postpone the effective date by as many as 12 years[4]. Transfer periods of between half a year and two years also apply to leverage, liquidity and capital requirements, securities lending, the new CRA regime, corporate governance securitisation and derivatives. It is worth noting that the legislators did not choose a single transfer date for the entire Act, but that a multitude of transition arrangements have been specified for different parts and even individual provisions in the Act.

— Implementing measures and implementation studies: Far from providing a final set of rules for the relevant market activities, the Act essentially represents a framework law which in the coming months and years will need to be filled with the regulatory details without which wide parts of the text would remain inapplicable or inoperable in practice. Estimates regarding the extent of additional work to be done as a result of mandates contained in the Act vary considerably, but FSOC, FDIC and Fed will have to draft several dozens of implementing rules each, while the SEC may need to work on as many as 100 implementing rules. The total number of pieces of implementation will amount to more than 350 items, and may even be higher than 500[5], plus between 60 and more than 170 studies and reports[6].

— Technical corrections: In the context of the final negations of the Act, US policymakers have already voiced the perceived need that a "technical corrections bill" may be required to settle issues that had not been possible to cover in the latest deliberations. Such a corrections bill may substantially change the contents of the Act and would come on top of the provisions discussed here.

These implementation modalities carry two important implications. Most importantly, the wide scope for the way in which the Act's rules can in many cases be transposed into practical rules suggests that – until the final rules have been adopted by the competent authorities – uncertainty remains as to the precise form, strictness, scope and density of future rules. The amount of additional regulatory work to

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2 Treasury (2009).

3 For a detailed analysis of the timelines for implementation of the Act see Davis Polk (2010).

4 Davis Polk (2010), p. 8.

5 Estimates by the US Chamber of Commerce suggest a total of 520 rulemakings, 81 studies and 93 reports that are mandated by the Act (Quaadman (2010).

6 Quaadman (2010).

Implementing rules and studies

Agency	Rulemaking	Studies
BCFP	24	4
CFTC	61	6
FSOC	56	8
FDIC	31	3
Fed	54	3
FTC	2	0
GAO	0	23
OCC	17	2
OFR	4	1
SEC	95	17
TSY	9	1
Total	**353**	**68**

Sources: Joyce, Kelly (2010), DB Research 2

Timelines for implementation

Maximum duration of implementation, cumulated, in months

Sources: Davis Polk (2010), DB Research 3

be done by the authorities as well as by market participants is substantial, and considering that the mandated reports and studies may in their conclusions stimulate further action, the scope and volume of further regulatory activity cannot be finally assessed for the time being.

Secondly, it will take years until the Dodd-Frank Act is finally implemented and becomes effective in its entirety. Again, the precise duration is beyond reasonable assessment at the moment, but the average maximum transition period specified in the major sections of the law amounts to more than 40 months which roughly indicates the time span market participants should reckon with[7].

The economics of the new regulatory environment

The financial industry is undergoing profound change, not just in the US but also in Europe and elsewhere. The crisis has left its marks on the markets, and new regulatory framework conditions like the Dodd-Frank Act are set to change the way in which markets function, products can be designed, and clients can be served.

The need for regulatory reform is widely recognised, and the legislative initiatives at the international and national levels have broadly met with support by banks. At the same time and in light of the multitude of regulatory initiatives that have been taken since the beginning of the crisis, market participants and policymakers are concerned about what the final impact on the financial sector and the economy will eventually be – of individual measures as much as of the regulatory reform agenda as a whole.

As the first major piece of regulatory reform in an international comparison, the Act offers a preliminary view of the economic changes the policy response to the crisis may bring.

A number of trends can be identified:

1. Limited assessability: Heterogeneous approaches, lagged impact, uncertain implementation

Most importantly, a precise assessment of the final impact of the Dodd-Frank Act will need to be left to ex-post analysis in a number of years from today, mainly for three reasons.

— First, the Act does not follow a coherent grand design tailored to a consistent concept of what the US financial market should look like after the final enactment of the law. Rather, the Act resembles a heterogeneous patchwork of rules designed to serve differing economic and political objectives and using diverse regulatory tools across and within individual market segments. Thus, new banking regulation targets the improvement of capital and liquidity provisions and the prevention of large financial agglomerations, while the insurance sector remains essentially unregulated despite the critical systemic role it can play. And even within the banking industry, the range of differential rules that will apply to different market participants is extremely broad. How the diverse measures will add up, amplify one another or cancel each other out can hardly be assessed in advance.

[7] Davis Polk (2010) and DB Research calculations.

Staggered approach sensible, but also has drawbacks

— Second, the implementation of the Act will not happen at a predetermined time, but will follow an intricate timetable of transition periods. This makes sense in the interest of a cautious phasing in of the large number of measures at a time of continued market uncertainty. At the same time, the staggered approach makes it impossible – *ex ante* or *ex post* – to quantify the economic impact of the package in a reasonably precise manner.

Extensive additional regulatory work planned

— Finally, the overall impact of the regulatory programme critically depends on the way it will be implemented. Most of the provision contained in the Act are general in nature and require extensive additional legislative and regulatory measures before they can become effective. This, again, complicates any prediction about the impact of the Act as adopted.

2. Regulatory and supervisory system: Moderate restructuring, while weaknesses remain

Institutional reform as key objective

Institutional reform of the regulatory and supervisory system is an important objective of the Dodd-Frank Act. To that end, the Act provides a broad range of measures, the most important of which include:

— Macroprudential supervision: The Act fills a key regulatory gap by establishing a regime of macroprudential supervision – extending the work of financial supervisors beyond the financial condition of individual institutions.

— Broad coverage: Banks as well as any non-bank financial institution can be brought under the supervision of the Fed if the FSOC finds that it poses a systemic risk.

— Enhanced toolbox: Large banks and systemically important institutions can be subjected to “enhanced prudential requirements”.

Issues left unresolved

Despite these important advances, the Act leaves important issues unresolved which had been debated in the wake of the crisis and before.

— Rising number of supervisory institutions: The institutional setup of regulation and supervision remains virtually unchanged. While the Office of Thrift Supervision has been abolished and integrated into the Fed, other executive bodies in this policy field continue to exist. Contrary to the widely held belief that the US system of financial market oversight needed streamlining, a number of additional Councils, Offices, and Bureaus have been added, raising the total number of bodies with competences in this area.

Systematic institutional overhaul politically not feasible

— Division of competences: The division of competences between the various bodies involved remains a complex matter. Even though the largest part of banking supervision has now been brought under the auspices of the Fed, especially securities market oversight remains spread out over the SEC and the CFTC. The fact that the leading oversight bodies are now expected to intensify their dialogue on financial market issues under the umbrella of the FSOC – at least with regard to systemic risks – can help mitigate this shortcoming. But it cannot belie the fact that a systematic overhaul of the institutions involved and the establishment of a more coherent and efficient oversight framework was not feasible at a political level.

Most voluminous and complex banking and financial market rulebook

— Size and complexity of rulebook: Finally, the Act has added more than one thousand pages of new rules, which will be followed up by an even greater volume of implementing measures. The new provisions come on top of a historically grown inventory of market rules which may well constitute the most voluminous and complex banking and financial market rulebook in an international comparison. As a result, market participants incur substantial expenses on legal services and operational adjustments to make sure they are compliant with the full body of the law.

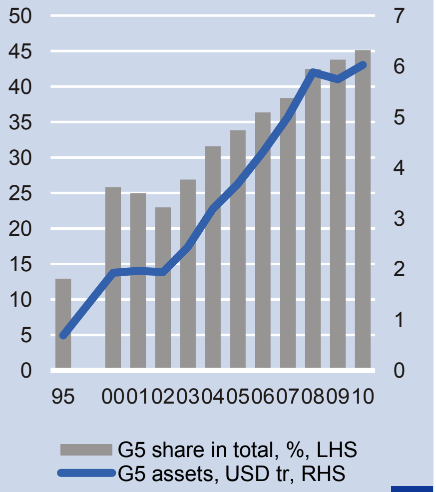
Substantial expenses for market participants

Shortcomings affect performance and stability of the system

Institutional fragmentation, wrangling over competences and the complexity of market rules can have an influence on the performance and stability of markets. Most importantly, they may facilitate regulatory arbitrage, i.e. the exploitation of differences in rules or supervisory practices by market participants. Arbitrage can be pursued with a view to differing rules for similar financial transactions or between the jurisdictions of different competent authorities. Where regulatory arbitrage prevails, the effectiveness of market rules and their enforcement can be undermined, putting the stability and the protection of clients in the market at risk. In this regard, the US oversight system remains vulnerable.

Concentration in US banking market

Total assets of largest 5 banks in USD tr, share of assets of largest 5 banks in total assets of US banking system in %



Sources: Fed, FDIC, DB Research 4

3. Financial stability: Strengthened markedly

Promoting the stability of the financial system is the key concern of the financial reform activities. There can be no doubt that US lawmakers – in adopting the Act – have made an important and big step in support of this objective. Key improvements include:

— Systemic issues: The establishment of the FSOC, as discussed above, which can help identify and resolve systemic issues as they emerge, and across the entire financial system, including the banking, fund, and insurance sectors.

— Volcker Rule: At the individual company level, the Volcker Rule will limit bank activities which are considered by policymakers to be high financial risks. In separating discretionary investment activities from core banking businesses, the Volcker Rule may reduce the contagion potential between the two activities. The Rule, however, does not contribute to reducing the riskiness of these business activities *per se* and the probability of failure of individual institutions.

— Resolution: The new resolution authority to address the TBTF issue by facilitating an orderly unwinding of failing financial entities without the market fallout a Chapter 7-style liquidation bankruptcy may cause.

Regulatory system substantially tighter

These and a number of further provisions make the regulatory framework for banking operations – which has traditionally been strict compared to other segments in financial markets, let alone other industries – substantially tighter than before. Especially a comprehensive approach to systemic risk as well as an efficient system of dealing with failing financial institutions will address important regulatory gaps that became critical during the crisis.

No silver bullets

At the same time, market participants and regulators are acutely aware that regulation and supervision – however intelligently designed – cannot address every conceivable case of market development. Key questions which will need to be answered in future include:

— Systemic issues: How to identify systemic risks, and how to counter them effectively is subject to continued debate.

Consumer protection – further measures in the Dodd-Frank Act

Abusive market practices: The BCFP has a mandate to prevent institutions under its jurisdiction from engaging in unfair, deceptive or abusive acts or practices.

Lending practices: In its mortgage reform and anti-predatory lending section, the Act restricts certain loan features or practices considered abusive, including the imposition of stringent "plain-vanilla" criteria for "qualified mortgages,", while "non-qualified mortgages" are strongly discouraged. Additional rules for advisory services, new reporting requirements, and limitations on unfair lending practices bring additional protection to consumers.

Deposit insurance: Investors are set to benefit from a permanent increase in the standard maximum federal deposit insurance coverage to USD 250,000 and additional protection from raising the minimum reserve ratio to 1.35% and other safeguarding measures for the deposit insurance scheme.

Securities transactions: The Act intends a number of improvements of investor protection pertaining to business practices of broker-dealers and investment advisers, and strengthening the enforcement of existing rules.

Payment cards: Consumers will in future benefit from new rules on transaction fees on debit and credit card transactions, and restrictions on certain business practices by card issuers.

Ancillary effects of provisions not directly related to consumer protection: Consumers will further benefit from provisions not primarily directed at their protection. Thus, greater financial stability will ultimately be an important improvement for consumers. Similarly, an orderly wind-down of ailing financial institutions will be in the vital interest of their clients and their shareholders.

Source: DB Research

— Volcker Rule: It remains controversial whether separating the prohibited activities from client-related business will, in fact, contribute to reducing risks, and how such a separation can in practice be achieved.

— Resolution: Whether the new resolution procedure will suffice to prevent TBTF issues from arising in future remains an important question, especially as the growth of financial institutions in absolute term has resumed. The concentration of the US banking industry continues to rise and has in fact accelerated through rescue-related mergers and the crisis-induced decline in the number of banks (see chart 4). In addition, the new resolution mechanism will need to prove its effectiveness regarding a number of conceptual issues, especially in cases where systemically important entities are at stake.

— Regulatory arbitrage: The patchwork of federal and state agencies involved in banking oversight with multiple and overlapping mandates remains one of the key structural points of discussion.

4. Consumer protection: Investors set to benefit from reform package

Protecting consumers has historically been a central concern of US financial market legislation, and the Dodd-Frank Act tightens the existing framework further, addressing a series of issues that became salient during the crisis (see also textbox).

— Centralised oversight at the federal level: With the creation of the BCFP, the Act creates a central office in charge of regulating, supervising, monitoring and enforcing consumer protection in a wide range of financial market activities, from which only a selected – albeit notable – number of market segments are exempted. Given its far-reaching rule-making powers and its position within the political system – it has a special status within the Fed and reports independently to Congress – the BCFP is expected to play a crucial role in continuing consumer protection reform and ensuring a strict enforcement of existing and new rules at the federal level. It should be noted, however, that the Act also strengthens the role of the states in financial oversight, including that of federally-chartered banks, and in enforcement. Further reducing the scope for federal pre-emption, the US system essentially remains a 50-states-plus-federal-law consumer protection regime.

5. Market efficiency: Higher costs for financial institutions – and final clients

Functioning of markets set to change

The measures of the Dodd-Frank Act are designed to change the way markets function. Market efficiency will be the most important area where the effects of the reform package will be felt. Key trends include:

Tighter rules on capital and risk

— Higher costs for market participants and consumers: Economically, and without calling into question the rationale of individual measures, raising standards necessarily raises the costs of doing business. This is most visible in the area of heightened capital requirements, where the costs of maintaining higher levels of capital and the higher standards on optimising a company's risk profile, e.g. from new securitisation rules, are expected to be substantial.

Costs from more demanding conduct-of-business rules

Similarly, ensuring compliance with more demanding conduct-of-business rules and the growing investor protection rulebook at the federal and state level represents an additional burden on services providers. This is not simply a matter of individual policy measures adding up, especially in the area of consumer protection. Rather, the Act suggests a paradigmatic change from the disclosure-based consumer protection approach typically pursued in the US in the past to a rules-based system. If pursued consistently, this systematic transition will increase the costs of compliance with the rulebook significantly. Such costs accumulate when other measures, e.g. the reform of deposit insurance, are taken into account. Additional costs to clients may arise from a greater number of enforcement actions, uncertainty over the interpretation of federal and state laws, and probably heightened litigation activity[8].

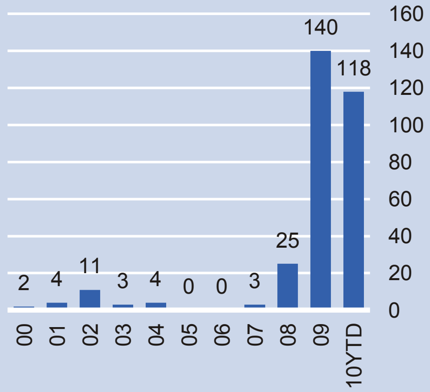
Paradigmatic change from disclosure-based to rules-based system

In the end, the key question for consumers is, to what extent these additional costs will get passed on by the financial system to final clients.

— Lower volumes of lending, less product choice: Undesirable side effects of heightened consumer protection standards may also include a decline in lending volumes or the disappearance of certain products and services. Such volume effects may be the result of falling supply, as several once-common practices, such as mandatory arbitration provisions, prepayment penalties and stated income loan applications are either prohibited or effectively banned by the Act[9], but also of falling demand due to rising product prices, even though the overall attractiveness of financial market transactions may rise due to greater consumer-protection induced market certainty. Typical examples of product areas with downward pressure on volumes include the markets for consumer credit and mortgage lending, complex derivative instrument and securitised assets, and also hedge fund activity as bank financing conditions have tightened. At the same time, it cannot be excluded that the new regulatory framework conditions will probably also give rise to the development of new products and services, designed to accommodate the new requirements on product features. This, however, would primarily reflect a substitution of products and volumes rather than a net expansion of the business, in as far as the latter will be limited by tighter rules on bank capital and liquidity. All in all, more limited access to financing and less consumer choice may be among the consequences of a full implementation of the Act.

Failing banks

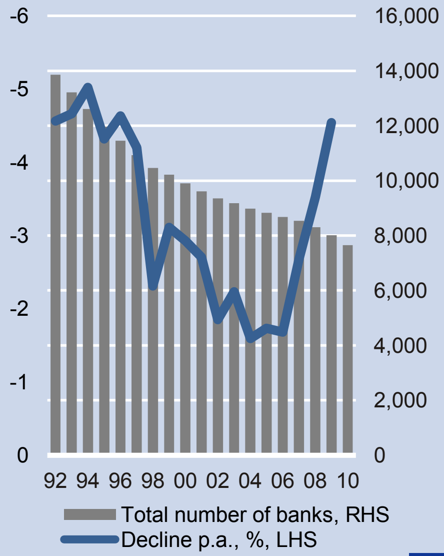
Number of failed banks as reported by FDIC



Sources: FDIC, DB Research 5

Banking: Continued shake-out

Number of banks in US and annual decline. 2010: expected values for year end



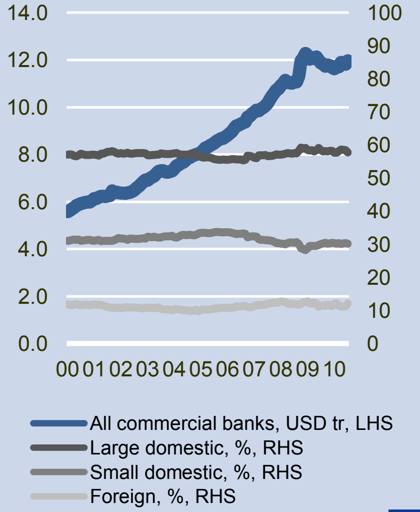
Sources: FDIC, DB Research 6

What seems certain is that the economic impact of banking reform as currently discussed and enacted can be substantial, even though first estimates of the costs vary considerably. Thus, the Basel Committee on Banking Supervision – a forum for regular cooperation on banking supervisory matters close to the Basel reform process on capital requirements – estimates that each one-percentage-point increase in a bank's actual ratio of tangible common equity to risk-weighted assets will lead to a decline in the level of GDP relative to its baseline path by about 0.15% after implementation is completed. The Committee also emphasises that, comparing the costs and the potential benefits of higher capital and liquidity requirements from a lower probability of the incidence of

[8] Skadden (2010), p. 97.
[9] Skadden (2010), p. 97.

Bank assets in the US

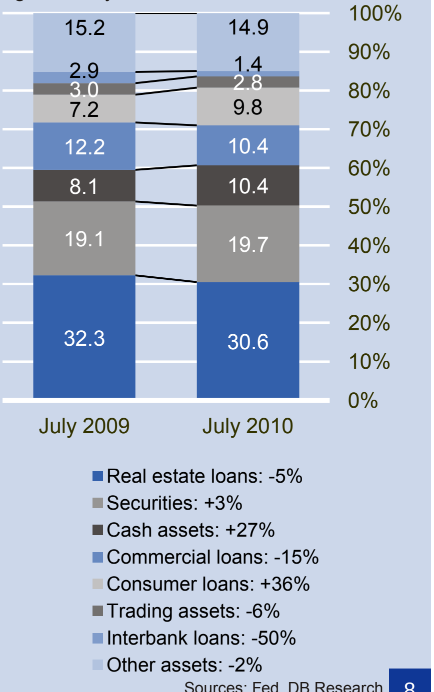
Total assets of commercial banks in the US in USD tr, and shares of large domestic, small domestic, and foreign banks in % of total assets.



Sources: Fed, DB Research 7

Asset structure of US banking sector

Selected assets in balance sheets of US banking sector, % of total, and % change against July 2009.



Sources: Fed, DB Research 8

banking crises, the net benefits of higher standards may over time in fact be positive[10].

Based on initial plans for capital reform, the Institute of International Finance, the global association of financial institutions calculated a cumulative real GDP growth differential to baseline of -0.3% in the US, leading to a negative GDP impact from banking regulation as initially planned of 2.7% by the end of the current decade[11].

While such quantitative assessments necessarily remain laden with uncertainties – the authoring institutions stress the potentially large inaccuracies of the results of their calculations – they are instructive of the potential outcomes of regulatory action. They illustrate that any piece of additional financial stability and consumer protection will necessarily need to be paid for by higher costs and lower output. To what extent this trade-off is pursued is a political decision.

6. Market structure: More concentrated, more segmented

Over time, the changes to the regulatory framework are likely to affect not only the efficiency of the US financial market but also its structure. As the industrial landscape evolves, some market participants will change their product ranges, others may disappear completely, while new competitors can emerge. Importantly, the breadth of the regulatory procedures implies that structural change will not be limited to the banking sector – even if it is going to be most pronounced there – but also in other segments of finance.

— Fewer banks, higher concentration: The consolidation and further concentration of the US banking sector – which has been going on for many years – is set to continue, temporarily accelerated by the crisis and the regulatory response. As a result of the more than 250 bank failures since 2008, many institutions have disappeared or merged with larger, surviving entities. As a consequence, the number of banks in the US system is declining comparatively rapidly, while the weight of the largest banks in the market overall continues to rise at an accelerated pace.

Regulatory reform adds to this process: Stricter capital requirements, tighter regulatory standards, and greater limitations on transferring risks through securitisation will raise the operating costs of banks which, other things equal, puts larger entities at an advantage over smaller ones, owing to economies of scale and scope.

In the first place, the logic of scale will be visible in terms of market concentration in the banking business as larger firms – through organic growth, or, subject to the 10% share limit on deposit-taking, mergers with smaller entities – will continue to increase their share in the market. This growth trend, however, will not completely translate into a rise in the size of banking market overall. The Volcker Rule, as discussed in the next section, will require banks to either terminate certain activities, such as proprietary trading and hedge fund and private equity participations, or spin them off to independent entities. Stripping off these and other activities, will, *ceteris paribus*, have a shortening, even if comparatively minor, effect on balance sheets – which started to decline after the December 2008 peak and

[10] Basel Committee on Banking Supervision (2010), calculations for global impact, not US specific.

[11] Institute of International Finance (2010).

have recently shown signs of recovery (see chart 8) – while the structure of bank assets will continue to change (see chart 9).

Higher concentration in related markets

Finally, growing market concentration may not be limited to the banking market. Oversight rules have been tightened for other financial market segments, as well. It is therefore reasonable to expect concentration tendencies among broker-dealers, investment advisers, hedge funds, private equity funds, rating agencies, or insurance companies.

Scope for diversification narrowed

— Narrower scope of banks' business: Starting in the 1980s, the US had experienced an unprecedented growth of its banking system, characterised by an escalation of the size of banks as well as of their complexity, with many institutions engaging in a wide variety of financial activities reaching far beyond traditional consumer and commercial banking. These included investment banking activities – made possible by the abolition of the Glass-Steagall rules through the 1999 Gramm-Leach-Bliley Act – as well as broker-dealer transactions, private equity transactions and management, hedge fund services and management, as well as investment and other advisory services.

Options for ending operations

Under the Dodd-Frank Act, such business diversification will no longer be possible to that extent. After full implementation, banks are no longer in a position to pursue most of the proprietary trading, hedge fund and private equity businesses. Key banks have started considering options for their existing operations in these areas, which include terminating proprietary trading and hedge fund and private equity participations, or wholly or partially spinning them off to independent entities. Even though the Volcker Rule in its final form identifies some exemptions and relaxations, it is clear that banks have already started to prepare for major restructuring, while staff working in proprietary trading have been reported to be searching for employment alternatives.

Other provisions also promote concentration

The Volcker Rule arguably marks the most visible element of the reform package encouraging banks to end politically undesired activities. Other provisions, however, may have similar effects. Thus, the so-called Swaps-Push-Out-Rule as introduced by the Lincoln Amendment to the Act prohibits banks to pursue certain swaps businesses in future. It requires banks whose derivatives activities constitute acting as a swap dealer to terminate swap activities other than those specifically permitted. Even if the list of exemptions is considerable, the provision clearly limits the banks' ability to contract. Similarly, new capital and regulatory requirements will cause banks to review a broad range of their operations with a view to future profitability and may decide to cease activities which under the new rules are unlikely to deliver the returns needed and which would then be closed down or sold off to other services providers.

New execution requirements and conduct-of-business rules

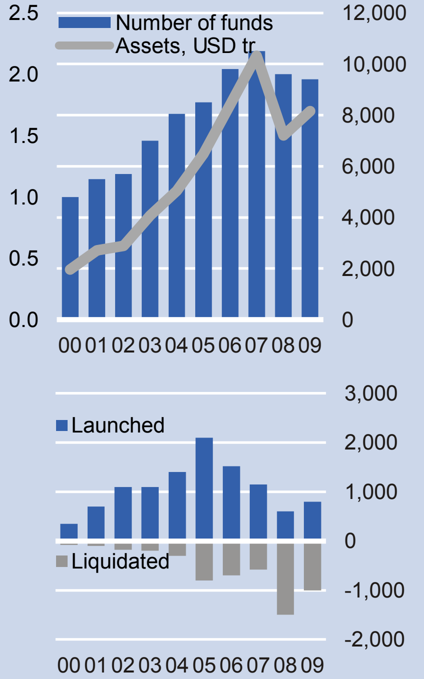
— Changing market infrastructure for derivatives: The market infrastructure for derivatives transactions will be subject to stricter rules regarding the way market participants execute their transactions as well as the way dealers handle them. The new execution requirements and envisaged conduct-of-business rules have been highlighted above.

The new requirements have the potential of changing the infrastructure of derivatives trading substantially[12]. Despite

[12] For a detailed analysis of OTC derivatives markets and infrastructure see Chlistalla (2010).

Global hedge fund industry under stress

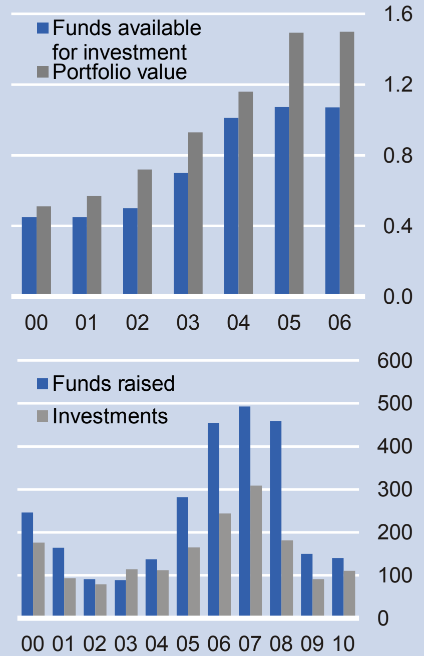
Global hedge fund industry, 68% of which is located in US. Assets under management in USD tr (LHS). Total number of funds (RHS). Number of launches and liquidation of funds.



Sources: IFSL, DB Research 9

Global PE industry stagnant

Global private equity industry, 66% of which originates from the US. Portfolio values and funds available for investment in USD tr. Funds raised and investments p.a. in USD bn.



Sources: IFSL, DB Research 10

numerous exemptions which may leave up to 80% of the trading activity largely unchanged, mandatory central clearing will lead to higher volumes of on-exchange derivatives transactions running through central counterparties, replacing bilateral contracts as previously used. The business opportunities for exchanges and central clearing houses are evident, and it is reasonable to expect heightened competition between existing and new services providers in this market. The requirements regarding capital, initial and variation margins, collateral, and post-trade reporting which CFTC and SEC have been mandated to prescribe will determine the extent to which demand for standardised derivative contracts will evolve in future and how the market structure will evolve. At any rate, conservative capital requirements for dealers and major swap participants and higher capital requirements for dealers for counterparty credit risk on OTC positions are expected to bring higher costs and higher capital demands for banks and dealers which may subsequently translate into reduced credit appetite, while end-users face higher expenses as rising capital costs may get passed through to clients.

— New opportunities for non-bank financial services providers: The reform package's focus on the banking industry has some important implications for the non-bank financial sector.

At a general level, the gap in the regulatory density between the banking and the non-bank sector has widened further. Even though the scope of part of the banking rulebook has been enhanced and conduct-of-business rules for other market segments have been strengthened as well, it is evident that no other part of the financial market will face a regulatory burden comparable to the banking industry. The structural competitive advantage of non-bank financial companies, including investment and pension funds, insurance companies or specialised finance providers has increased, and this will in the long run shape the business opportunities of the US banking industry.

Hedge funds and private equity firms are an obvious example of the broad trend. Not only have they been largely spared from comprehensive financial regulation. They will also benefit from the prohibition of proprietary trading, hedge fund and private equity activities by banks as the latter will be weakened as immediate competitors in the market. Possible spin-offs from commercial banks in response to the Volcker Rule will add to the market dynamics by stimulating competition, and by providing new opportunities regarding strategic co-operations, mergers and takeovers.

7. Foreign firms: Uncertainty prevails

Foreign companies make up more than 10% of the US banking market and are active players in a number of other financial market segments. Apart from business operations in the US itself, foreign companies are likely to feel an indirect impact from US financial market reform as market developments and trends are quickly transmitted through the global financial system so that the US reform package may have some significant spill-over effects on other markets around the world. Finally, the US practice of applying legal provisions in selected[13] cases to legal subjects in foreign jurisdictions raised again and again heightened attention abroad.

In all of these respects, the Act leaves a number of uncertainties which will probably occupy foreign players in the US for a while[14].

— Systemic importance: The Act does not specify whether only US assets would be considered when calculating the USD 50 bn asset threshold.

— Extraterritorial application: The Act does not provide details as to what extent enhanced prudential standards or other systemic risk provisions will apply only to US operations of foreign bank holding companies, and to what extent the reach of the provisions will be extended to the foreign parent.

— Regulatory discretion: In applying the new prudential and conduct-of-business rules to foreign market participants, regulators and supervisors enjoy considerable discretion on what might apply and how. In doing so, the FSOC and the Fed must give consideration to differences among systemically important companies, including their exposures in the US, to the principles of national treatment and equality of competitive opportunity, to the extent to which the foreign bank holding company is subject on a consolidated basis to home country standards that are comparable to those in the US, to the regulatory and supervisory rules and activities in relevant third countries, to regulatory developments at the international level, and to a study that the Government Accountability Office is mandated to prepare on capital requirements applicable to US intermediate holding companies of foreign banks.

— Termination of activities: The Fed and the SEC can terminate the activities of the US branch or subsidiary of a foreign institution that presents a systemic risk.

The implementation phase is generally expected to fill the gaps in the Act over time and thereby reduce the regulatory uncertainty that foreign companies are facing so far[15].

Thus, foreign financial institutions – more so than their domestic US competitors – are currently facing regulatory uncertainty that will need to be clarified as the implementation of the Act progresses. To ensure open access to the US financial market, consistent implementation of foreign capital and reporting standards and exemptions for companies from comparable jurisdictions have been identified as key concerns by the foreign banking community going forward.

Foreign banks – key policy issues

The international banking community's attention has so far rested on a number of key issues:

— Collins Amendment: The Collins Amendment – imposing the risk-based and leverage capital standards currently applicable to US insured depository institutions on US bank holding companies, including US intermediate holding companies of foreign banking organisations – applies primarily to US entities. Whether it will prescribe minimum capital standards, based on US definitions and ratios, for foreign banking organisations that are registered bank holding companies has remained open. US intermediate holding company subsidiaries of foreign banks are given five years from the date of enactment to come into compliance with the Amendment's requirements.

— Enhanced capital and other prudential standards: The Act requires the Fed, when applying the enhanced capital and other prudential standards to an international bank, to give due regard to the principles of national treatment and equality of competitive opportunity and take into account the extent to which the bank is subject to comparable home country standards.

— Volcker Rule: The Volcker Rule prohibitions on proprietary trading and on investing in and sponsoring private equity and hedge fund investments apply to US operations of international banks, with exceptions for certain activities conducted outside the US.

— Swaps pushout: The Act requires swap entities to divest their swap-related activities if they wish to maintain the option of Federal assistance, but insured depository institutions are provided a safe haven with respect to certain transactions. The Act, however, does not include uninsured US branches and agencies of international banks in the safe haven provisions. Key lawmakers have identified this as an unintended omission, and have suggested that this may be clarified in the course of the planned technical corrections legislation.

— Derivatives: Even though the Act includes language clarifying the territorial scope of the derivatives rules, it does not provide the CFTC and the SEC with clear authority to exempt comparably regulated institutions or otherwise take comparable regulation into account.

Source: DB Research

US reform and international policy coordination

The US reform package was not conceived and negotiated in isolation. Rather, it was designed while at the international level the US Administration, together with its G20 partners, promoted an

[13] The US Supreme Court has repeatedly upheld the principle that US legislation applies only within the territorial jurisdiction of the United States, unless the respective piece of legislation states otherwise. When a statute gives no clear indication of an extraterritorial application, it has none. For details see Davis Polk (2010), p. 16.

[14] For a detailed analysis of the treatment of foreign banks see Davis Polk (2010), pp. 16-19.

[15] For details see IIB (2010).

Broad G20 agenda

international coordination of the economic policy and regulatory responses to the crisis. The G20 Summit process, which was inaugurated by the US at the November 2008 summit, followed by meetings in London, Pittsburgh, and Toronto, brought strong commitments to close policy cooperation on the regulatory response to the turmoil. Subsequent summit communiqués reflected the resolve to find coordinated regulatory solutions on key issues such as macro-prudential supervision, complex financial institutions, systemic risks, prudential regulation, bank resolution, hedge funds, and credit rating agencies.

The G20 agenda

Next to improved macroeconomic cooperation, the strengthening of international financial institutions, and a number of other important policy objectives, the G20 process is dedicated to greater international cooperation in the following areas:

— Macro-prudential supervision: Establish framework to deal with macro-prudential risks and develop tools

— Complex financial institutions: Improve oversight framework

— Systemic risks: International guidelines for definition of systemic importance, and avoidance of regulatory arbitrage

— Prudential regulation: Strengthen prudential regulatory standards, improve quantity and quality of bank capital, discourage excessive leverage, strengthened liquidity requirements, adopt Basel capital framework

— Bank resolution: Address cross-border resolution

— Comprehensive data: Ensure gathering relevant information and international consistency

— Hedge funds: Registration and conduct-of-business requirements

— Derivatives: Improve OTC derivative markets, promote standardisation and resilience of credit derivative markets, and establish central clearing counterparties

— Credit rating agencies: Registration and oversight rules

Source: G20 Summits, various communiqués

The US reform package hits these G20 priorities square on the head. It provides a comprehensive regulatory package that addresses all the key issues identified at the international level and provides a series of regulatory responses to the long list of sensitive policy issues.

Not all of this was particularly coordinated at the international level, however.

— G20 design: The key problem with the lack of policy coordination rests with the G20 design. The G20 agenda has remained very broad, providing ample room for discretion in turning international policy objectives into national law, especially in cases where the G20 has not mandated the development of more detailed international standards for example by the FSB or the BCBS. Leaving this room for manoeuvre is a matter of political realism, reflecting the fact that diverging interests within the G20 probably would not have allowed for a more detailed and binding approach. Whether the minimalist G20 result will suffice to meet the policy challenges the crisis has posed, can be called into question.

Asymmetry in timing of policy responses

— Front running: Part of the lack of policy coordination within the G20 is rooted in the absence of detailed itineraries for arriving at legislative solutions in the participating nations. By effectively front running the policy process, the US has established the Dodd-Frank Act in many respects as an international yardstick for the individual policy issues it covers. While international bodies such as the Basel Committee on Banking Supervision or the Financial Stability Board are working on standards for cross-border policy coordination on key policy issues, and other G20 participants are engaged in drafting their own legislative response, the comparatively swift policy reaction in the US narrows the scope for more cooperative solutions. This, to be sure, is as much a problem created by those going at a slower pace as by the frontrunners. But the result remains the same: It will be difficult for other economies to arrive at substantively different policy solutions than those sketched in the Dodd-Frank Act without risking international market distortions and a diminished effectiveness of financial oversight due to increased regulatory arbitrage. In practice, this clearly limits the regulatory room for manoeuvre for the other G20 participants.

Volker Rule as precedent for deviations?

— Deviations from G20: Apart from procedural issues, the Act in individual respects deviates from the G20 consensus. The most prominent example is the Volcker Rule, a proposal not directly contained in the G20 agenda. To what extent other G20 participants will join the US by establishing comparable rules remains open to date.

Implementing the G20 agenda – US and EU in comparison[16]

G20 commitment	EU legislation: Measure	EU legislation: Adoption	US legislation
Macroprudential risks and financial oversight	– COM(2009) 499 – European Systemic Risk Board – COM(2009) 501 – European Banking Authority – COM(2009) 502 – European Insurance and Occupational Pensions Authority – COM(2009) 503 – European Securities and Markets Authority – COM(2009) 576 – Omnibus Directive	2010 2010 2010 2010 2010	Title I Title III
Basel capital framework	– *CRD II – Liquidity buffers* – *CRD III – Trading book and securitisation* – CRD IV – Bank capital, leverage ratio, liquidity buffers, counter-cyclicality	*2009* *2010* End-2010	Title VI
Accounting standards	– *IAS Regulation 1126/2008 – Adoption of International Accounting Standards* – Endorsement of IASB Standards	*2008* Ongoing	Title VI
Compensation	– *Recommendations on remuneration of Directors and financial services – sound principles* – CRD III – AIFM – Solvency II, Level 2 – Un-specified measures on non-banking financial services	*2009* *2009* End-2010 2011 2011	Title VI
Bank risk management and internal controls	– *CRD II – liquidity risk, large exposures* – *CRD III – securitisation, due diligence, retention* – CRD IV – counterparty risk	*2009* *2010* End-2010	Title VI
Insurance	– Level 2 – governance, internal control, risk management	2011	Title V
Corporate governance	– Green paper	2010	
OTC derivatives	– EMIR – mandatory clearing – CRD IV – capital requirements from non-CCP transactions – MiFID review – MAD review	2011 End-2010 2011 End-2010	Title VIII
Bank resolution	– Unspecified measure based on forthcoming FSB recommendations	2011	Title II
Deposit insurance	– *Immediate changes to Deposit Guarantee Directive 94/19/EC* – Overhaul of Deposit Guarantee Directive 94/19/EC – Overhaul of Investor Compensation Scheme Directive (97/9/EC) – White Paper on Insurance Guarantee Schemes	*2009* 2011-2012 2011-2012 2011-2012	Title VI Title VII Title IX Title XII Title XIV
HF, PE	– AIFM	2011	Title IV
Credit rating agencies	– *CRA Regulation 1060/2009* – Amendment of CRA Regulation	*2009* 2011	Title IX

Source: DB Research

Full implementation of Basel Accord at risk

More importantly, however, there is deep concern in the international community of policymakers as well as of market participants that the US may decide not to implement the international Basel Accord on bank capital which is currently being negotiated. The capital accord has formally remained on the G20 agenda and a high-level agreement on Basel III reform was reached in September 2010. Nevertheless successively softened formulations of that commitment, increasing hints at national deviations from the standard, and differing national implementation schedules are feared to be heralding a failure of the intention to make Basel a binding standard for bank capital in the major economies worldwide, including the US. This, to be sure, would be a serious setback in the attempts at promoting financial stability at the international level and would bring significant distortions in the competitive landscape of the global banking industry.

Not too late for coordinated policy response

Challenge for internationally aligned G20 approach

Eye-to-eye with the financial crisis, the G20 leaders had committed to an internationally coordinated policy response. It may not be too late to achieve this objective. But two years after the first G20 Summit the spirit of cooperation has waned disquietingly. The Dodd-Frank Act represents a remarkable achievement in terms of domestic policymaking, responding to the strong logic of timely political action while balancing important national and local political interests along the way. But it is also a challenge for the G20, possibly forestalling more internationally aligned policy measures. With a wide range of provisions left for implementation in the coming

[16] Various sources. Passages in italics denote EU measures already adopted.

Key elements of the EU reform agenda

— Financial oversight: The EU has decided to establish a European Systemic Risk Board in charge of systemic and macroprudential risks, and in this respect comparable to the FSOC in the US. In addition, the system of financial oversight will be reformed, establishing EU-level supervisory authorities for the banking, securities, insurance and pensions markets. The authorities will complement the existing oversight system in the member states by specifically addressing cross-border and system issues as well as inconsistencies in regulation and supervision among the member states.

— Bank capital: By means of the Capital Requirements Directives II, III, and IV, the EU is in the process of implementing the capital and liquidity reforms initiated by the FSB and the BCBS, and ensuing full compliance with the international standard on bank capital regulation.

— Derivatives, securities, market infrastructure: The reform of OTC derivatives markets, the requirement of central counterparty clearing, and adjustments to securities trading rules are to be included in a new European Market Infrastructure Regulation (EMIR) – addressing OTC derivatives, central counterparties and trade repositories – and in overhauls of existing directives on securities trading (MiFID) and market abuse (MAD).

— Hedge funds, private equity: Alternative investors will in future be supervised on the basis of a dedicated directive (AIFM), which covers registration and transparency requirements, conduct-of-business and governance rules, standards for the management of risks, liquidity and conflicts of interest, as well as rules for the market access of third country funds, for all alternative investment vehicles above a critical size.

Source: DB Research

years, US regulators and supervisors can only be encouraged to seek close alignment with the standards currently developed at international level, and to pursue a cooperative approach to financial oversight in daily practice.

US and EU regulatory reform in comparison

In contrast to the US where the key policy issues on the G20 financial market reform agenda have been addressed in summary in one framework act which will be implemented over the coming years, the EU has decided to issue separate legislative proposals on individual measures which are being negotiated concurrently.

Unlike in the US, where much of the legislative work has been achieved with the passage of the Dodd-Frank Act in mid-2010, the EU is planning to have the key legislative acts under discussion adopted by the end of 2010 or in the course of 2011.

Although guided by the same G20 agenda, the substance of the legislative proposals by European lawmakers differs markedly from the equivalent in America in important areas.

— Systematic institutional overhaul: In contrast to the US where institutional reforms focus on improving existing structures – by establishing the FSOC, giving more powers to the Fed, and by reducing overlaps in competences – the EU pursues a systematic overhaul of its institutional and procedural framework. With the ESRB and the sectoral supervisory authorities EBA, ESMA and EIOPA, the EU is creating an oversight structure at EU level complementing existing arrangement in the member states.

— Consistent implementation of international standards: Since the 1990s, the EU has consistently adhered to international standards on bank capital, financial reporting requirements, and securities markets. After the crisis, the EU has continued transposing the latest-generation principles as defined in the Basel accord, by the International Accounting Standards Board, and by IOSCO. This facilitates cross-border transactions and capital flows within the EU and with third countries, creates a level playing field for investors, and reduces the risks from regulatory arbitrage.

— Tighter rules for alternative investors: Although the regulatory process is still at a starting point, it can be expected that EU rules for hedge funds and private equity firms will be stricter than those established in the Dodd-Frank Act. Judging by a first legislative proposal by the EU Commission, and despite critical objections by selected EU member states, it is reasonable to expect that the future AIFM Directive will be designed to cover a broad range of alternative investors, namely all non-UCITS funds, and will address a wide variety of regulatory issues, including macro-prudential and micro-prudential risks, investor protection, market efficiency, and corporate control and governance.

Broad principals aimed at risks and rewards

— Stricter on compensation: The Dodd-Frank Act addresses the compensation issue by means of establishing broad principles aimed at balancing risks and rewards and getting shareholders more involved in the decision on compensation schemes. The EU rules currently under negotiation are likely to be more

Abbreviations

AIFM	Alternative Investment Fund Managers Directive (EU)
BCBS	Basel Committee on Banking Supervision
BCFP	Bureau of Consumer Financial Protection
BHC	Bank Holding Company
CDS	Credit Default Swap
CFTC	Commodities Futures Trading Commission
CRA	Credit Rating Agency
CRAB	Credit Rating Agency Board
CRD	Capital Requirements Directive (EU)
EMIR	European Market Infrastructure Directive (EU)
FDIC	Federal Deposit Insurance Corporation
Fed	Federal Reserve System
FHFA	Federal Housing Finance Agency
FIO	Federal Insurance Office
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FTC	Federal Trade Commission
GAO	Government Accountability Office
HF	Hedge Fund
HUD	US Department of Housing and Urban Development
IAC	Investor Advisory Committee
IASB	International Accounting Standards Board
IOSCO	International Organization of Securities Commissions
MAD	Market Abuse Directive (EU)
MiFID	Markets in Financial Instruments Directive (EU)
MSP	Major Swap Participants
NCUA	National Credit Union Administration Board
OCC	Office of the Comptroller of the Currency
OCR	Office of Credit Ratings
OFE	Office of Financial Education
OFL	Office of Fair Lending and Equal Opportunity
OFP	Office of Financial Protection for Older Americans
OFR	Office of Financial Research
OHC	Office of Housing Counseling
OIA	Office of Investor Advocate
OMWI	Offices of Minority and Women Inclusion
OTS	Office of Thrift Supervision
PE	Private Equity Fund
SEC	Securities and Exchange Commission
SEF	Swap Execution Facility
SIFI	Systemically Important Financial Institution
TBTF	Too big to fail
TSY	United States Department of the Treasury

detailed, including rules on salary composition, variable components, and deferral conditions.

Depending on the political dynamics in the months ahead, the gap between the European and American approaches to the crisis response may widen further, as the EU, too, is pursuing gold-plating activities beyond the G20 agenda.

— Financial transactions tax: Some EU member states, prominently including France and Germany, favour the introduction of a tax on financial transactions. Although the proposal has not met with approval at the G20 Summit in Toronto in June 2010, the proponents are considering tabling a legislative proposal to that end in the EU. A solo run by the EU, however, may have dire consequences. A transactions tax would add nothing to the overriding objective of promoting financial stability. It would also bring additional costs for final consumers as the tax burden would eventually be passed on by broker-dealers or fund managers to their clients. Finally, it would distort capital movements between the EU and third countries as transactions would be diverted into non-EU jurisdictions by market participants whenever possible. This would hurt the competitiveness of the European financial services industry in an international competition. The US will refrain from such a tax.

— Bank levy: The EU is set to formally propose – in a legislative initiative on crisis management and resolution funds scheduled for early 2011 – the establishment of *ex ante* resolution funds, financed by a levy on banks to facilitate the resolution of failing banks, allowing the bank to be wound down in an orderly manner.[17] This commitment is laudable and has been applauded by many in the financial industry[18]. However, the institutional benefits of such a fund cannot belie the fact that a unilateral imposition of a bank levy would put EU banks at a competitive disadvantage against their competitors in the US and other countries where policymakers have rejected the imposition of an *ex ante* tax.[19]

— Short selling: The EU is understood to propose a draft Regulation on short selling. Under the new rules ESMA may be given emergency powers to ban short selling temporarily for three months in shares, sovereign bonds, derivatives relating to sovereign bonds and credit default swaps linked to government bonds. In addition, a requirement to disclose publicly all short positions of over 0.5% has been announced. The economic benefits of trading restrictions and disclosure requirements on short selling are debatable[20]. What is critical in the present context is that such restrictions would go beyond those in the US and other major financial centres and may cause reductions or diversions of trading activity in Europe and diminish – albeit marginally – the efficiency of securities markets.

These and other examples suggest that the G20 consensus on a coordinated crisis response is showing signs of weakness. The US and the EU take centre stage in this global debate. Not only are the

[17] EU Commission Communication "Bank Resolution Funds", May 25, 2010, COM (2010) 254.

[18] For a detailed analysis of the concept of *ex ante* bank resolution funds see Speyer (2010).

[19] The problem is particularly serious within the EU, where national initiatives have lead to inconsistent tax regimes and may result in double taxation on market participants.

[20] For a discussion see Kern (2010).

most important disagreements over G20 regulatory issues rooted on either of the two sides. With their higher than 70 percent share in financial services generated globally, they were also the starting point and main theatre of the financial crisis. At the same time, they are home to the most elaborate systems of financial market rules and the most experienced regulatory and supervisory authorities. Given their joint size, the high degree of economic interdependence, and the key political objectives that they share as a result, Americans and Europeans should have a strong interest in taking the G20 agenda to a good end.

Obviously, the US and the EU and its members need to provide joint leadership in the G20 activities going forward. In substance, this implies renewed joint US-EU efforts on the regulatory agenda: Both sides should work resolutely towards overcoming their disagreement over key parts of the G20 regulatory agenda. Most importantly, this includes the formulation and consistent implementation of global standards for capital requirements in the Basel framework as well as for accounting rules as developed by the IASB.

These are ambitious objectives. The current lack of cooperation often goes back to fundamental concerns regarding further market integration and internationalisation. These concerns are often rooted deeply in national politics and must be taken seriously.

It will, therefore, be essential for the US and Europe to intensify their economic and regulatory discourse. This may entail an intensified dialogue between the legislative bodies, and more formal cooperation among regulators and supervisors. The objectives are evident: The need to promote a transatlantic understanding at all levels of policymaking that adherence to globally coordinated standards, be they created in Basel, by the IASB or by IOSCO, is beneficial, if not vital, to ensure stability in the financial markets today and in future. To achieve that, closer coordination should entail:

— *ex ante* bilateral consultations on all new policy measures in the area of financial market regulation of national, bilateral or international dimension,

— close coordination of policy positions discussed in international fora, including the measures in the context of the G20,

— systematic work on resolving bilateral financial market regulatory barriers on the basis of the existing Statement of the European Commission and the US Securities and Exchange Commission on Mutual Recognition in Securities Markets of February 2008.

The net benefits of joint economic and regulatory solutions are substantial, and no other two economies know this better than the US and the EU, whose prosperity is founded on the openness of markets, the free flow of goods and investments, transparency, and a strong belief in the ability of markets to effectively allocate resources across and within societies. The US and the EU should therefore take the leadership role in the G20 process that they are legitimately expected to fulfil.

Conclusion

With the Dodd-Frank Act the US has set the pace and an important yardstick for the regulatory response to the crisis. It provides a comprehensive reform of America's existing oversight framework, broadly in line with the priorities agreed in conjunction with its partners in the G20.

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Important yardstick for international policymaking

Substantial economic impact...

... with strong structural implications

The economic impact of the Act will be substantial – even if an assessment of the effects is hampered by the heterogeneous approach taken by lawmakers, the lagged impact of its provisions, and the current uncertainty over the final shape of the regulatory landscape after implementation. Most importantly, financial stability will be strengthened markedly, through a reformed institutional framework, new macroprudential oversight, systemic risk regulation and more and better bank capital. Consumers can take pleasure in being important beneficiaries of the reform, owing to far-reaching improvements in the consumer protection framework. At the same time, the costs of banking are set to rise while the availability and choice of products may get reduced. Structurally, the number of banks in the US market will decline further, and on average their size will increase as they concentrate on reducing costs and work in a much narrower field of activities than before. New market structures will also be the outcome for the securities infrastructure business and non-bank financial services providers. To what extent foreign companies will be impacted by the change remains uncertain as their treatment is in large parts left to the implementation phase of the Act. What is certain is that the US financial market will remain a highly competitive place with strong financial centres, governed by a complex set of market rules and an intricate system of supervision.

Other economies may take different approaches...

... but should stick as closely as possible to G20 agenda

Being a yardstick, of course, does not necessarily mean that others won't do things differently – or maybe even better. National markets, legal and political realities may necessitate that the EU and its member states or the other participants in the G20 process take approaches that differ from the compromises found in the US. What is important is that they stay as close to the agenda established at the G20 level as possible. Deviations from this guiding line will cause competitive distortions, discourage cross-border capital flows, impede the day-to-day oversight of financial markets due to differing rules, and undermine the regulatory system if market participants escape the rules of the game by means of regulatory arbitrage. None of this is in the interest of financial stability or efficiency.

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