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Abstract

This paper studies past and present financial crises from the perspective of financial reform and analyzes its effectiveness. The study shows that current and future financial regulations should be a globally involved process and not just a national concern. The banking infrastructures of the US and UK, in particular, are closely linked and the increasing nature of trans-border banking makes the reform process much more involved than in previous years.

This study shows a systematic route through historical regulations and their effects, current proposals and the recent consequences of reforms and will conclude with a possible solution to a need for global financial regulation reform.

Introduction

Financial regulation and reform has long been a complicated and highly debated subject. Ineffective regulation has been seen as the reason for past and current financially centered crises, and with each new attempt at controlling the system, loop holes are found and history continues to repeat itself. There has been unlimited amounts of research completed to try and find the answer that will once and for all regulate the financial markets in a way that will not put the citizens of a nation at risk while, at the same time, allowing the thriving financial sector to continue to contribute to the economy at the same level.

It is common knowledge that the US and UK governments are in the process of reforming the financial sector as a reactive strategy to the most recent financial crisis. This study attempts to draw similarities between the two nations and to offer a more global solution to the reforms rather than those being proposed at present.
Major Historical legislation

Financial regulation in the United States started with the creation of the Federal Reserve System in 1913, which was implemented under the Federal Reserve Act. The McFadden Act of 1927 was the next major step in banking legislation which prohibited banks from setting up across state lines, and gave national and state banks equal opportunities. One of the most well known acts, Glass-Steagall, came in 1933 which, among other things, created the FDIC (Federal Deposit Insurance Commission) and separated commercial banking from the securities industry. The Depository Institutions Deregulation and Monetary Control Act of 1980 gave thrift institutions more freedom with their activities, phased out interest-rate ceilings on deposits and created reserve requirements for depository institutions (Mishkin and Eakins, 2011).

More recently, the major legislation that has occurred includes, but is not limited to: The Federal Deposit Insurance Corporation Improvement Act of 1991 which recapitalized the FDIC, limited brokered deposits and the too-big-to-fail policy and increased examinations, capital requirements and reporting requirements. One of the most controversial acts came in 1999 in the form of the Gramm-Leach-Bliley Financial Services Modernization Act, which repealed Glass-Steagall, allowing banks to remove any separation between their commercial and investment banking activities. Sarbanes-Oxley came next in 2002 which created the Public Company Accounting Oversight Board (PCAOB), prohibited certain conflicts of interest and required CEO’s and CFO’s to gain qualifications in financial statement analysis. In 2005 the Federal Deposit Insurance Reform Act most importantly increased deposit insurance on individual retirement accounts to $250,000. The most recent, and most applicable to the remainder of this study is the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The general aspects of this act are as follows:
• “Created the Consumer Financial Protection Bureau to regulate mortgages and other financial products.
• Routine derivatives required to be cleared through central clearinghouses and exchanges.
• New government resolution authority to allow government takeovers of financial holding companies.
• Created Financial Stability Oversight Council to regulate systemically important financial institutions.
• Bans banks from proprietary trading and owning large percentage of hedge funds.” (Mishkin and Eakins, 2011).

Most of the financial regulation in the past has been in response to a financial crisis or banking panic. The creation of the Federal Reserve was supposed to prevent any such panics in the sector and it seemed to work for a number of years, with the economy having a relatively stable financial sector until 1929. At this time it was realized that not only was the Federal Reserve an entity that protects against volatility but also an entity that provided a last resort for banks and potential bailouts. This, in turn, provided banks with more confidence which made them less risk averse, making much riskier investment decisions with the understanding that the Federal Reserve would bailout any banks in problems (Shachmurove, 2011).

It is commonly mentioned that the latest financial crisis was, and still is, the worst crisis since the Great Depression.
The Great Depression started with a stock market bubble, moved on to a crash which all subsequently ended with a banking panic and a crisis. Glass-Steagall was the governments’ response to this crisis which, as stated earlier, prevented the scope and activities of a bank in regards to its commercial lending and securities elements. This, like the current financial reforms were reactive and not proactive to the problems. After World War II, free markets were the new idea in the sector which led to deregulation due to the belief that history would not repeat itself. This meant that most of Glass-Steagall was repealed, a decision still controversial to this day (Shachmurove, 2011).

The savings and loans crisis of the 1980’s was the other major crisis of the time period and resulted in more deregulation and the end of Glass-Steagall for good. The crisis came from the banks having high liquidity and a low risk portfolio after World War II which was coupled
with a very unprofitable savings and loans sector. Deregulation was seen as the answer and S&L institutions were given the same abilities to operate as commercial banks, but were not regulated with the same vigor as the commercial banks. Increased risk taking led to another bubble which, in turn, followed the same historical pattern of creating a banking crisis (Shachmurove, 2011). The cyclical nature of these banking crises’ is relatively obvious in the way that deregulation is followed by excessive risk taking, leading to a bubble and resulting in a financial crisis. The resultant regulation is always responsive to the current problems but not the global and long-term issues and infrastructure weaknesses.

**Current Issues**

After the most recent financial crisis, the G20 working group put together a paper which began by outlining the current weaknesses in the financial system:

a. “Weaknesses in underwriting standards

b. Lack of oversight of systemic risks

c. Lack of oversight of unregulated pools of capital

d. Weak performance by credit-rating agencies

e. Procyclical tendencies fed by regulatory and accounting frameworks

f. Shortcomings in risk management practices

g. Outpacing of risk management by financial innovation

h. Weaknesses in disclosure

i. Weaknesses in resolution procedures

j. Lack of transparency in various over-the-counter (OTC) markets” (Suarez, 2010).

The FSB (Financial Stability Board) indentified 5 areas in which regulation could be strengthened with reform after the 2008 financial crisis:
“(i) The regulation of banks’ interactions with shadow banking entities (indirect regulation), in particular, examining: consolidation rules for prudential purposes; limits on the size and nature of a bank’s exposures to shadow banking entities; risk-based capital requirements for banks’ exposures to shadow banking entities; and treatment of implicit support;

(ii) The regulatory reform of money market funds (MMFs) to mitigate their susceptibility to runs and other systemic risks;

(iii) The regulation of other shadow banking entities, including assessing the scale and risks of these entities and whether enhanced prudential measures (e.g., capital and liquidity regulation) are called for;

(iv) The regulation of securitisation, in particular with regard to retention requirements and transparency; and

(v) The regulation of securities lending and repos (repurchase agreements), including possible measures on margins and haircuts.” (Overview of Progress, 2011).

Global Actions

Attempts have been made recently to try and establish a more global and internationally minded banking system. A regulation authority called the Financial Stability Board (FSB) has been put in place to regulate national regulatory bodies and to try and implement common actions in member nations in regards to reform, laws and operating activities. The board is made up of various members of financial institutions, regulatory board members and central bank experts. On the surface, the FSB is attempting to create a global banking infrastructure, something that has been missing with the increasing level of global, multi-national banks and institutions. The worrying fact is that the FSB has many good ideas but has little in the way of implementation on a global level. Even with proposals such as Basel III, individual nations use
Analysis of US and UK Proposed Financial Reforms:  
A Case for a Global Regulatory Structure

their own methods and regulations to conform to the relatively loose requirements of the proposals. For example, the US has implemented the Dodd-Frank Act which, among other things, has set new rules for the requirements put on firms for recovery and resolution of any future banking strains. The UK on the other hand has piloted a project with six of its major banks and has now created two additional regulatory bodies to oversee the financial system. Both strong and relevant ideas, but neither has strong legislation that encompasses a larger and more global problem (Overview of progress, 2011).

The FSB has also found a way of determining which banks and institutions hold significant systemic risk, calling them Global Systemically Important Financial Institutions (G-SIFIs). Also called G-SIBs, they are determined by a methodology created by the FSB and works by assessing the likely impact of that individual bank failing on the entire global financial system. The banks that have been indicated to have such systemic risk were chosen using a range of criteria including: their size, their interconnectedness, the lack of substitutes for the services they offer, their global activity and their complexity. There are incentives for institutions to reduce their systemic risk with a lower loss absorbency requirement for those that do not pose such a risk. The absorbency requirement must be met with “Common Equity Tier 1” and will be required to hold between 1% and 2.5% in case of a banking crisis hitting again (Overview of Progress, 2011).

The standard to be used for resolving firms in a financial crisis has also been set by the FSB. Each nation must have in place a specific set of rules and procedures for dealing with banks that are failing or have failed. The Key Attributes, as it is called, has outlined a procedure for banks that are internationally operated and has given the home country the jurisdiction to create and operate their own procedures in a time of need. The rights of the home country are protected
and it is down to them to make decisions that affect the stability of the entire global financial market. This seems to be a step in the right direction for crisis prevention but it still gives individual nations the ability to make decisions without the need for input from other nations (Overview of Progress, 2011). Even with the oversight from the FSB a bank or institution would technically only have to follow the procedures from the home country, leaving any legislation or laws in other operating countries with little ability to impose. This is where recovery solutions, especially for G-SIBs should be a global decision, made by an external source and implemented in each of the operating countries.

**United Kingdom Reforms**

Post 2008 crisis, the UK has made their Financial Services Authority (FSA) redundant and has implemented new government initiatives. These initiatives include a new regulatory committee called the Financial Policy Committee (FPC) which is a single governing body in charge of monitoring the financial system and finding the risks associated with operations in the financial sector on a day-to-day basis. This new governing body is part of The Bank of England and has the power to intervene if the stability of the financial sector is at risk. Along with this committee the government has also introduced two new financial authorities: the Prudential Regulation Authority and the Financial Conduct Authority. The first being the external regulator on the day-to-day running of the financial sector and the later regulating how firms run their business and, consumer protection in relation to those businesses (Blueprint to Reform, 2011).
United States Reforms

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, is America’s answer to the financial crisis and to the new laws set forth by the FSB. The act covers five main areas of regulation: Consumer protection, resolution authority, systemic risk regulation, Volcker rule and derivatives. The Act basically covers the requirements that the FSB produced by the RRP’s with the addition of the Volcker Rule (Mishkin and Eakins, 2011).

The Volcker Rule deals with proprietary trading with banks and limits their ability to take risks and trade with their own money. The banks would also only be allowed to hold a small portion of hedge funds and private equity funds to try and prevent loss from excessive risk. This rule has only been proposed in the US, throwing up another concern that banks with operations in various different nations may find loop holes and will not be held accountable for the risks they are taking on their trading floors (Mishkin and Eakins, 2011).

UK Analysis

The Independent Commission on Banking was established in the UK in 2010 in response to the current financial crisis, to help develop strategies in changing the structure of the banking system in the UK, and the competitiveness of the system. The proposed reforms from the ICB are needed for three main reasons,

1. Make banks better able to absorb losses;
2. Make it easier and less costly to sort out banks that get into trouble;
3. Curb incentives for excessive risk taking

Basel III is the international set of guidelines that have been agreed upon to be the building blocks of financial structure reform across the globe. The UK wants to use those guidelines to
build their own reform package and feels that the international guidelines do not go far enough in protecting the consumer on a national level (Final Report, 2011).

In order to respond to the first issue above banks will be required to hold higher equity levels and liquid assets to be able to quickly absorb any short term losses that occur. The second point will be dealt with by some degree of separation between retail and investment banking, so the high risk is taken on by investors and not consumers on the ‘high street.’ The third point will be tackled by the level of equity being required increasing for more systemically risky banks. Those that work with the most risky products will be required to hold higher levels of equity against their risk-weighted assets (RWAs). These considerations are all very relevant, but implementation is the key, along with the extent of the regulations in comparison to other competitive financial markets. There are huge advantages in having universal banks because of their high money making potential, but with that come risks. The most important thing is to protect the consumers who do not wish to take part in the risk-reward nature of investment banking but at the same time allow those that do easy options and ways to be exposed to that risk.

**Ring Fencing**

The ring fencing being proposed by the UK commission is, in essence, a protective ring around retail banking. This insulates retail banking from risks arising in the investment banking and trading sectors. Those banks within the ring fence would deal with such transactions as: household and business lending, payments services and retail deposits. The retail banking side of a universal bank would become a completely separate subsidiary meaning, among other things, equity and funds would not be transferable between them. There are many advantages and
disadvantages of ring fencing and the extent to which the ring fencing reaches is still in discussion (Final Report, 2011).

The retail ring fencing being proposed has two very important, clear cut issues which could be the key to the success or failure of the reforms in the long term. Where the fence should be and how high the fence should be are the two key areas. In regards to where, the statement pertains to exactly which activities should be allowed to happen within the ring fence. In regards to how high this is the degree in which the separation occurs between the retail and investment banks within the same corporate group (Final Report, 2011).

The regulations being proposed need to clearly state which banks will have the limitations imposed on them. At present, the commission wants the ring fence to pertain to: any standalone UK bank, any bank which is headquartered in the UK and any bank in the UK which is a subsidiary of an overseas headquartered bank. In regards to the same question, there is a possibility that the level of ring fencing incurred by a bank will be based on its size. The larger banks tend to have the most systemic risk, but complicated smaller banks can still pose a significant risk to the economy because of the current leverage opportunities. As the main aim of the reforms at this stage is to protect the consumer and prevent contagion from investment banks to the retail sector, small, complicated banks should be regulated as a high volume of those banks pose a comparable risk to the financial sector (Final Report, 2011). As a law, it would be detrimental to the economy to allow smaller banks to be exempt from the ring fencing. Most small banks do not conduct the activities that would be ring fenced anyway. Also, this would create another loop hole for banks to take advantage of and would also confuse consumers, which, is hypocritical to the aim of the reforms. Figure 3.1 shows the extent of multi-banking by turnover of company. This indicates the amount of companies that actually expand across
different banks, which poses a potential threat of contamination across the sector. This is a good visual representation of the need for ring fencing and to make the sector much simpler for recovery purposes.

The government in the UK does not want to completely constrain the banks activities as efficient banking is needed to push the sector forward. Banks rely heavily on diversified products to stay profitable and productive. It is highly important that the retail sector must make loans as well as take deposits. Both are necessary and paramount to the economy and the loans will of course provide risk. The government must make sure that both sides of a bank’s balance sheet are in compliance. Too much regulation would have negative effects on the economy in terms of personal lending, small business productivity and housing. Too little regulation would allow banks to revert back to former strategies, creating products which have underlying risks much greater than the risks anticipated by the consumer.

One globally recognized question is, should wholesale and investment banking activities be prohibited? The US has drawn a line in their legislation that banks are not allowed to engage in proprietary trading, along with, the inability to hold risky hedge funds and private equity funds (Final Report, 2011). In Turing’s working paper (Turing, 2011); he makes the clear cut statement that investment banking activities are dangerous in all forms. He believes that the general public should not be subjected to any of the risk that is posed by investment banking. There is inadequate understanding of derivatives markets and the exotic products that these firms are producing. Senior executives often do not understand their structure or purpose, which leads us to make the assumption that the general public has no idea of the risk that might be involved in complex, and apparently lucrative, investments.
The Volcker rule in the US does indeed make this complete separation between risky trading acts and the consumer banking sector. What it does not do, explicitly, is prevent banks from having a contagion effect on each other. The retail sector is not protected, under this rule, from the complicated derivatives and other products the bank can produce. The UK proposals do indeed protect the consumer, and most importantly prevent the flow of equity between investment and retail. The main reason for bank failures and the negative effect trickling down to the consumer is due to the high level of interconnectedness of the banks. The Volcker rule does not respond to this, whereas, the UK response is aligned with dealing with this problem (Final Report, 2011).

What must not be forgotten is the need which companies have for capital markets and financial products. These are a necessity for companies of all sizes to make profits and hedge against currency risk, among other things. Smaller banks, in the UK and US often offer these products to businesses as they are able to use their parent company or subsidiary to make the transactions. From legislation as it stands, the US would still be in a position to offer such services, whereas, the UK would not. This could lead to the UK becoming much less competitive in comparison to other EU or US locations, possibly leading to a transfer of new business and banking. This coupled with the possibility of the UK capital requirements and equity rules being higher than the EU would also make the UK a less attractive place to have a bank or business. Proprietary trading is a definite activity that does not need to be a part of ring fenced banks. The decision is, which other wholesale activities should be allowed by retail banks to stay competitive, but still keeps the risk to the general public as low as possible (Turing, 2011), (Final Report, 2011).
Banks have also lost their voice. For the majority of the time, banks are there to serve the client in the best way possible. Governments and the public have made the generalized assumption that the banks are solely responsible for the financial crisis and that all of their products and activities pose a significant risk. The banks should have much more of a say in the structure of the legislation as in some respects they will still be expected to be large contributors to GDP growth and economy stability in the long run. The financial sector in both the UK and US are huge contributors to the economy and too much regulation runs the risk of losing overall competitiveness to areas such as Asia. There is an argument that there are many successful banks in the economy today which do not engage in any wholesale or investment banking activities (Turning, 2011), (Final Report, 2011). The main concern of both nations at present should be continuing to be competitive and attractive for small and medium size businesses as these companies, for both nations, offer high growth potential and are paramount for the economy to grow.

**Economic Impact**

The financial sector in both the US and UK is a central focus for GDP and economic growth. Banking crises not only impact the financial sector but also the entire economy on a domestic and international level. The cross-border tendencies of banks and financial institutions have spread the risks between a greater number of nations and economies, making reform and financial law in each nation a necessity in each of its related nations.

According to the Basel Committee on Banking Supervision (BCBS), the average financial crisis costs a nation between 19%-163% of annual GDP, with the median figure being around 63%. If a financial crisis happens every 20-25 years, as predicted by the BCBS, it is the equivalent of an economy losing around 3% of GDP annually (Final Report, 2011). When
analyzing the financial crises in the past and, in particular, severe banking crises’ post World War II, the average magnitude of GDP declines is 9.3 percent. The average duration of the GDP decreases is only around 2 years, which is a much shorter period when compared to unemployment and house prices post banking crisis. (Rogoff, 2009).

When looking at unemployment increases in a post crisis environment, the average rise is around 7 percent with duration of around 4.8 years until natural unemployment levels are again reached. In terms of real equity prices after a severe banking crisis, the average decline is around 55.9 percent, lasting around 3.4 years. When compared to the US and UK after the last crisis, the decline in equity prices is 45 percent and 40 percent respectively, as seen in 2008 at the lowest levels. Real house prices also get hit hard post banking crisis. The historical average for the decline in real estate value is 35.5 percent, tending to last around 6 years before rebounding. As of 2008, the US and UK had very similar, but not as severe declines of around 10 percent (Rogoff, 2009).

This data show two key factors relating to cross-border reform and regulation. Firstly, the data show the intense relationship between the US and UK economy and that on a macroeconomic scale they are very similar in the way they have reacted and been affected by crises in the past. Secondly, that macro-prudential reform is needed to not only stabilize the financial sector but also the entire economy of each nation because of the sector’s interrelatedness with others. The data presented shows a correlation between the two economies of the US and UK, indicating that when it comes to preventative measures to guard against something like this happening again they should be international endeavors, not only national priorities. What the data also shows is that governments and institutions have not learnt from what has happened previously. The trends are there to be seen, the reasons for these crises do not
differ greatly from each other and the repercussions continue to get greater as economies continue to grow and risk taking increases. This mentality is something which needs to be regulated. Governments and institutions cannot seem to consistently work towards reformation without forgetting what has happened previously. Two examples of excessive risk taking and a lack of ability to manage risk with consideration of previous events are as follows:

1. The level of banks’ leverage has steadily increased over time. In 1960 the median level of leverage was around 22 percent, falling to around 10 percent in the 1970’s. Compare this to median levels in 2008 of around 45 percent and maximum levels reaching over 60% (Final Report, 2011).

2. The total value of mortgages in the U.S at the start of 2008 was equal to 90 percent of GDP (Rogoff, 2009).

In both instances there should have been regulation in place which could have prevented the increasing risk and leverage. The first point is data taken from the UK, the second point comes from the US indicating that both nations had, and still do, have a problem with unregulated leverage and risk taking abilities. Not only does this need to be regulated, but it needs to be regulated in an international manner, preventing loop holes and the ability to move capital from regulated to unregulated entities.

This need for cross-border regulation also comes with a need for an international regulatory body. At present, the IMF does a good job at helping nations deal with crises which occur but does not do a good job at helping prevent these events form happening. At present, governments are free to produce regulation they feel suits their nation and their own needs. When it comes to the finance sector however, the need for international regulation should be
prioritized as a significant amount of institutions have the ability to move capital to subsidiaries in which they benefit from light regulation and higher returns. Financial reform needs to have coordination and even with Basel II and III which sets out guidelines for reform each nation is free to do what they like. Initiatives such as Basel have great intentions, but it relies on a group of nations to verbally agree what is needed to strengthen the economy from its current state. What it does not do is create an international regulatory reform package which includes a governing body that can proactively work to keep competition high but regulation tight on a global basis (Rogoff, 2009).

On an international level there needs to be an independent, authoritative organization which has the ability to set regulations and actually enforce them. If the regulation came from a governing body that worked on behalf of the global market place, one of the biggest advantages to individual nations would be political insulation. There would be less pressure on governments to decrease regulation or follow what the most influential institutions want. With standard rules and regulation on a global basis, the competition of individual nations would not be affected as there would be no ability to move to different markets to take advantage of deregulation. This would need an entirely new institution and would entail very complex staffing solutions because of the nature of that institution. Due to the global nature of the finance sector now, the only solution to keep the globe stable would be to create a regulatory body such as this, but this institution must have the ability to enforce and protect, not just offer advice. (Rogoff, 2009).

The financial crisis… and the next one

The most recent financial crisis has had many reasons associated with it but, at the end of the day, all of those reasons stem from poor regulation and a lack of insight into the new internal factors that financial institutions are now a part of. The process of poor regulation began, in the
US, with the Gramm-Leach-Bliley Act which allowed commercial banking and investment banking to be part of the same business within an institution. The Basel II framework is now being put in place in member nations, which, in theory, should prevent the conflict of interest. As mentioned earlier, the next stages of this implementation in the UK especially are yet to be set in stone (Wagner, 2010).

Not only are the financial sectors of different countries interconnected, but the banks in each nation are highly connected with each other, which is yet another reason why the most recent crisis occurred. Each bank was rated (arguably unsuccessfully) for their risk, on an individual basis. What was not considered was the systemic risk of each of those banks because of their interconnectedness with other banking institutions. The complexity of financial products often left regulators and other financial institutions unaware of the underlying risks associated with trading these products. With insufficient knowledge at the regulatory level, banks were able to leverage far more than before, showing, on the surface, limited risk and liability. Due to the level of the trading using these products, each institution was inadvertently connected and reliant on the other institutions, even if they had no direct deal or relationship with them. As the world saw with Lehman Brothers, once one institution hit trouble the waterfall effect on others became apparent. Credit was suddenly soaked up, loans were not available and debt became due. Mostly due to speculation and precautionary movements, banks and institutions that were in no way associated with the struggling banks were plunged into problems, proving the interconnectedness of the banking system. This, in turn, affects numerous nations because of the next level of involvement due to cross-border banking and finance (Wagner, 2010).

Another problem related to regulation is that of capital and what is referred to as the balance sheet effect. Something that Basel II and III is stipulating is capital requirements
dependent of the systemic risk the institution provides. There is a predetermined cyclical nature of risk taking by institutions in relation to the phase of the economic cycle we are in. Many more risks are taken in the upper phases of the economic cycle, meaning that leverage against assets is more. The problem in this financial crisis is that banks were regulated on the level of assets they held, but were not regulated on the level of liabilities they held in relation to that. The guidelines in Basel II and III set out specific levels for capital requirements against their most risky liabilities. This is a very important step forward to prevent the most systemically dangerous banks in over leveraging in the good times and then being the reason for complete financial sector meltdown when the problems occur (Wagner, 2010).

Another regulatory dysfunction is that of the rating agencies. There is currently a discrepancy between the international guidelines being set forth by the Basel Committee and the US government’s new regulations in the Dodd-Frank Act. The Basel I Committee are still basing much of their requirements with the assumption that rating agencies will still provide global information on the safety and stability of individual companies, institutions and governments. The Dodd-Frank Act has a clause that the use of ratings agencies for valuation is now illegal because of the conflicts of interests that occurred between them and certain securitizers. To start, the rating agencies were not regulated, so institutions were able to pay off the agencies to enable them to have a lower risk threat. To make this worse, the regulators actually used the opinions of the rating agencies to make decisions on capital and other requirements that needed to be imposed on certain institutions (Wagner, 2010).

Simple solutions to complex problems are the key factors when producing new legislation and reform for the finance sector. Many problems occur when governing bodies or institutions do not fully understand the guidelines, leading to uninformed decisions and the desire
to find loopholes to exploit profit. An example of regulatory reform making things much simpler can be seen when looking at the formation of the European Union. Issues regarding the sovereign debt crisis in Europe and issues pertaining to the single currency in differing economic structures are still debates and challenges, but in regulatory terms there has been success. The economic and financial and economic integration has actually decreased the regulatory burden on the individual nations. Efficiency within the banking framework increased because of the formation of the European Central Bank (ECB) and the single currency, to start with, allowed for more effective monetary policy, in terms of regulation. The individual transaction costs, rules and regulations were all removed and the European standard was created, with a governing body at the top working on behalf of all the nations. An option, on a global scale, may be to introduce something similar to what the EU has, with an over reaching banking, governing and regulatory body which is unbiased and has authority on a global scale, instead of a national or regional scale (Moshirian, 2011).

As the world moves away from the last financial crisis, the question occurs as to how do prevent another one, or, how to deal with the next one when it is almost inevitable that it will occur. History has shown that after a financial or banking crisis, a number of new, regulatory organizations appear to try and fix the current problems and come up with ideas to prevent another catastrophe. Organizations such as the IMF, BIS and SEC were all formed because of instability in the financial structure. Where Europe differed, is how they set up their ECB and financial structure as a preventive measure and something that would already hold stronger than before. This has proved insufficient at present but may allow them to recover better in the long run as their regulatory structure and oversight is already in place, allowing them to focus on fiscal problems which have occurred. Those fiscal problems would have probably occurred
regardless of the banking and monetary structure so only time will tell as to whether or not the structure there is strong enough to deal with such problems.

The list of regulatory and advisor organizations goes on for what seems like forever. There are the BIS (Bank of International Settlements), IMF (International Monetary Fund), the World Bank, the ECB, the FSA (Financial Services Authority) and the SEC (Securities and Exchange Commission) to name just a few. After the most recent financial crisis there has been even more groups, organizations and regulatory bodies created to try and create a global standard. These include: the FSB (Financial Stability Board), the G20 group, the Basel Committee, the ICB (Independent Commission on Banking) and some others. There are two main points to be made with this observation. Firstly, there are far too many organizations working independently towards what should be the same goal on a global level. Secondly, the two organizations on the list above which have any authority are flawed. The FSA in the UK has been discontinued because of there incompetence and lack of insight into the banking structure (Final Report, 2011). The SEC has yet to find anyone guilty for actions leading up to the most recent financial crisis, which, on a very fundamental basis, shows another case of inability to enforce and regulate the financial sector (Bloomberg Markets, 2012). Most of the other organizations offer advice and guidelines as to what should be implemented in each economic region. The groups are built with representatives from each nation and guidelines are set. The problem then arises with implementation as there is no one in the position to take responsibility for the global process. Pressures are put on individual nations’ governments and other view points are taken into consideration when formulating a nations’ recovery process. The information is available and the guidelines are there with promising future prospects, but the world has been in similar situations before. Some important regulations are needed such as the
capital requirements and somewhat of a separation between commercial and investment activities. The main thing that is needed though is global cooperation and understanding because all the regulation in the world is not going to change a thing unless it is enforced in a non-biased manner on a global scale (Moshirian, 2011). There is, of course, still a need for a national regulatory body on a daily basis, but there needs to be an overreaching body that enforces international laws as well.

To prevent or deal with the next financial meltdown there must be a clear structure of information, regulation, policy and procedure. Reactive policy on a national level causes more problems than it solves and, with globalization at its current levels, reactive national policy is out of date and ineffective at dealing with problems created or including internationally systemically risky financial institutions. To create such a structure, banks operating in different countries should be held accountable at the same level in each of those countries. There needs to be a system in which banks do not have the ability to move certain business processes to different locations due to differing levels of regulation. For this to happen, and to be effective, the regulations cannot be too tight as it will most certainly threaten the financial sector and have the opposite effect on the economy. In regards to the US and UK, differing regulations will end up causing the exact same problems as we have seen in recent years. With a complete separation in the US and only a ring-fence with exception in the UK, the proprietary trading will end up being moved to the UK. This leaves the US less competitive for certain investors but also puts the UK in a position to continue to take risks. Many of these regulations are only going to apply to a bank which gives way to more risky and comparatively less regulated institutions to use the risky products for their gain. The point here is that tighter regulation will only move the risk to different locations and markets, whereas, reasonable and clear regulations with a monitoring
body on an international scale will provide a much safer and competitive environment. The risk has always been there, and will always be there to make the finance sector effective and profitable. The aim is to remove the risk from the public but allow the banks and investors to take those risks with their own money. If a central international monitoring body could collate and distribute information on a global level, indicating risk to all parties and acting upon excessive or dangerous risk, the market would remain competitive, free but safe for the people that do not want to be involved.

The UK, US and Basel III

When analyzing the UK and US and present, there are positives and negatives to be drawn from each of their proposals, coupled with the proposals and guidelines set forth by the Basal Committee. Both the UK and US have set up further organizations within their nations to monitor risk and financial threats. The UK has established the Financial Policy Committee which has the authority to take action and remove any systemic risks it discovers. The US has established the Financial Stability Oversight Council (FSOC) which makes regulators on a federal and state level, including the Treasury, responsible for identifying any risks. On a related note, the EU has formed the European Systemic Risk Board (ESRB), which is in charge of overseeing the financial system on a macro scale. This is another organization which can identify, warn and advise but not enforce any of the actionable ideas. The only macroprudential organization which has any authority as of yet is the FPC in the UK. In this regard, the US should take steps towards giving power of enforcement to the organization that will be doing the monitoring and analysis (Overview of Progress, 2012).

Contained within Basel III are measures which will be taken to minimize the reliance on external credit rating agencies. It wants to address the problems that occur with financial
incentives towards the ratings agencies and try to come up with different methods of analysis when it comes to credit risk determination. The UK has yet to fully determine its stand on whether or not ratings agencies will be an integral part of the credit analysis process or not. This, however, is an area which must be globally agreed upon due to the global nature of any ratings an institution receives (Overview of Progress, 2012).

In the US, the Dodd-Frank Act and other regulation set forth by the Federal Reserve has been initiated to fall in line with international requirements. One regulation created by the Federal Reserve pertains to Debit Interchange Fees, which is, “a regulatory cap for many types of debit interchange transactions to equal no more than 21 cents plus five bps of the value of the transaction.” (Annual Report, Bank of America, 2011). In addition to the regulations surrounding proprietary trading, which has not been clearly defined as of yet, there is regulation encompassing derivatives trading as well. The financial reform act will require that a much greater scope of derivatives are going to be regulated. The regulations include imposing capital margin requirements, creating new reporting standards and new registration and business conduct requirements to contain the risk of the products. Certain OTC derivatives will also be highly regulated and some may not be allowed to be traded or held by certain institutions (Annual Report, Bank of America, 2011).

For any institutions which are insured by the FDIC, there are other proposed, and potentially costly, reforms to be implemented. There has been an increase in the required deposit insurance, which could be very costly for banks and negatively affect their operating margins. The FDIC is also requiring resolution plans for all insured banks with total assets of more than $50 billion. This is a very important issue for the banks as there are tough penalties for not having a clear and implementable resolution plan. If the FDIC or Federal Reserve do not feel the
plan is appropriate they have the ability to require higher capital or liquidity levels, lower leverage or may even restrict the operations and activities of that bank. There is a similar requirement being discussed in the UK, which will also have additional effects on banks with associates or subsidiaries in both the US and UK (Annual Report, Bank of America, 2011).

On a national level, the US seems to have set very tight regulations on banks but many of those regulations seem to be on a commercial level rather than in investment banking. The complete removal of some of the operational activities may harm the banks and the economy. Some of those most risky activities should be protected from the commercial side of banking, but should not be removed completely, especially if those activities are allowed in other economic areas.

The Importance of the Financial Sectors

The importance of the financial sectors can be shown by looking at some of the most lucrative and influential institutions in the UK and US. Here we will analyze some of financial data produced by the largest institutions in each of the nations. The data will show the level of GDP contribution of these institutions and whether or not they are in a position to follow the international guidelines which have been set by the FSB and IMF.

The institutions in mention are universal banks, which are those which have numerous banking entities and are the most appropriate for this discussion. The UK institutions being discussed are: HSBC, Barclays PLC, Lloyds Banking Group and Royal Bank of Scotland. The US institutions which will be analyzed are: JP Morgan Chase, Citigroup, Bank of America, Goldman Sachs Group and Morgan Stanley. All of these institutions have subsidiaries or operations in other countries and many in both the UK and US so the country of origin is based on where the headquarters of that institution is. Using their 2011 financial statements, analysis
of their financial strength and how they are responding to the proposed legislation will allow for a comparison between the institutions and lead to a conclusion as to whether or not reforms should be collaborative or not.

HSBC is a truly universal bank, with the full spectrum of services offered and those services are offered around the world. With a total operating income of over $83,000 million they are the largest bank in the UK based on market cap. Some of the most important factors based on the reasons for the last financial crisis include the loans, risk weighted assets, capital ratios and equity levels. At HSBC loans and advances to consumers were down in 2011 signaling either a fall in demand for credit or an increase in risk assessment at HSBC. Loans were up in 2009 and 2010 which was at the heart of the financial crisis, indicating that new legislation and a much higher emphasis on risk reduction is the most probable cause. When it comes to the issue of equity and risk-weighted assets, it is important for the individual institution to be aware of the proposed legislation contained in the ring-fencing proposal in the UK. The proposals which are being implemented to make banks better able to absorb losses state that large ring-fenced banks must have equity of at least 10 percent of risk-weighted assets. HSBC’s equity is at its highest level in the last couple of years; rising 7 percent this year to $166 billion but their risk weighted assets have increased 10 percent are up 10 percent this year to $1,210 billion. The increase in RWA’s was seen mostly in the commercial banking sector of the group, mainly attributable to associates in China. Also from the UK guidelines, banks are required to have Tier 1 Capital of at least 3 percent of total assets. Their equity to asset ratio currently stands at 5.6 percent, with core tier 1 capital accounting for 10.1 percent. All of these figures show HSBC’s diligent approach to the new reforms and a strong move in the right direction to recovery and stabilization (Annual Report, HSBC, 2011).
In the statement given by the chairman of HSBC, there is recognition of the UK reforms set by the ICB but also worries and concerns about the US regulation and the lack of cooperation between them. Cross-border resolution protocols are still a concern and a dark matter in the regulation proposals which HSBC has received. It is apparent that multi-national banks need more clarification and standard rules on the steps to prevent and resolve problems on a global scale, rather than in just each individual nation. Another concern is the total cost of the reforms for the banks, and the ongoing costs as the reforms are not being implemented in a structured way. This leads to the obvious need of a structured and implementable plan the banks can adhere to, which, at the same time, allow banks to be competitive on a global level and attract external investment, as this is one of the most important factors for the financial sectors long term stability and growth (Annual Report, HSBC, 2011).

In regards to another UK banking group, Barclays PLC has produced slightly better results when it comes to managing risk and conforming to the new proposals in the UK. Their core tier 1 capital increased to 11.0 percent while at the same time reducing their RWA’s by 8 billion, to 391 billion (Pounds Sterling). The reduction in RWA’s came mainly from the capital side of the group, with sales of credit market exposures and lower levels of activity in their foreign exchange activities. This is a good example of the high risk these activities pose and the relative ease of risk reduction when there is enforcement. The slightly lower levels of profit for Barclays this year were not due to these risk reductions, showing a very simple example that profit and operations do not need to be affected greatly by risk reduction. Barclays also has a strong liquidity pool, which is only slightly lower year-on-year at 152 billion (Pounds Sterling), which are comprised of high quality central bank deposits and highly liquid government bonds. Barclays believes that with their current levels of RWA’s and tier 1 capital they will be able to
successfully absorb the impact of Basel III implementation. Also in regards to risk, Barclays actually funds 82 percent of its loans to consumers with consumer deposits, only relying on wholesale and investment activities for 18 percent of its consumer loans. This puts Barclays in a seemingly good position to deal with any possible ring fencing, as funding should not be a problem if the different sectors of the bank are separated form each other in terms of capital flow (Annual Report, Barclays, 2011).

One of the largest, and recently publicized, US headquartered banking groups is Citigroup. One of the most noticeable differences between Citigroup’s annual report and that of the UK banks analyzed already is that of the negative tone towards the proposed US regulations. HSBC and Barclays both have concerns with the costs of new regulations will pose, but Citigroup is much more forward in expressing concerns with structure, cost and competitiveness. The most obvious concern of Citigroup is international competitiveness because the new regulations in the UK will pose significant problems and higher costs for their non-US subsidiaries, which, in turn, will make their business as whole less competitive compared to non-US institutions which will not be held to the same standards. Especially in regards to the Volcker Rule, Citigroup are concerned that without similar regulations in the UK and EU, they will be significantly worse off in terms of competitiveness compared to those institutions based on other countries. Some of the rules in the Dodd-Frank Act would actually require Citigroup to collect more margins from its non-US based derivatives clients, directly affecting costs and competitiveness. These concerns stem from the same fundamental problem: there is not effective and clear reform being proposed that has international elements which can explain how multinational banks will be regulated if regulations differ from nation to nation. The high costs associated with the Dodd-Frank Act may be magnified because the European reforms will not
take effect until after those in the US, meaning banks like Citigroup cannot prepare for the combined effect of the regulations. At this point, those banks operating in more than one economic area will have serious negative effects in terms of additional costs and restrictions on business. This, in turn, will be detrimental to the economy as the competitiveness of the financial sector on a global level is important for growth and stability. These concerns follow the same logic as the rest of the analysis in this paper has shown. Reform, in the end, must allow banks to still operate in a competitive market. Without being able to compete the reforms will not help in an economic recovery, but instead provide tougher and longer-term problems which will take much more effort to fix once competitiveness has been lost. Compared to the UK banks, Citigroup is not certain how it will provide the new capital requirements, and it actually depends on their future earnings and whether or the wind-down of Citi Holdings is successful or not. This seems to indicate that, on a micro scale, the US institutions either took on far more risk and leverage than the UK banks, or have been hit much harder in the financial crisis than the UK banks did (Annual Report, Citigroup, 2011).

Bank of America (BofA) has been much more successful compared to Citigroup in its attempts to reduce risk and increase its ability to cover its obligations without tapping into external sources. They have successfully doubled their tier 1 capital compared to 2007 to 9.87 percent, which is still low compared to competitors, but also indicates the glaring problem with bank capital levels before the financial crisis. They have managed to decrease their RWA’s, while reducing their total assets by removing high risk exposures in their global banking and markets business. The magnitude of how important these banks are to the economy is evident by the sheer value of risk weighted assets held by BofA which is currently at $1.28 trillion. Compare this to the GDP of the US which is just over $14 trillion in nominal terms and the
potential systemic risk of these institutions becomes apparent. In terms of concerns about the proposed reforms, BofA is not as concerned with the international competitive element as its core businesses are based in the US. Its main concern is the Volcker Rule, which will increase costs and negatively affect their trading and holding operations. They believe that as it stands, the Volcker Rule will reduce trading profits in the company and will cause problems with its asset holding in hedge funds and private equity, leading to problems when off-loading those assets in the open market. Along with Citigroup, BofA is concerned that those assets which are no longer allowed to be held by the institution will be sold on the open market, along with all the other institutional holdings, creating an over supply and leading to those assets being sold at a heavy discount to their true valuations. The general view taken by BofA is that the reforms are confusing, very costly and are not structured in a way that allows them to successfully prepare for what is ahead. BofA, along with all other institutions are not able to predict when the final reforms and legislation will arise and because of the complicated and relatively vague proposals at present, they are unable to predict the impact these reforms will have on their business, their customers and the financial sector as a whole.

There does seem to be a common issue with all of the big banks with the current proposed reforms in general. Due to the most recent financial crisis, banks are now not trusted to make any decisions. The reforms have not been discussed with anyone within these banks, and the opinions of the banks on what needs to be done to keep a competitive or safe market place are not being considered. The problems which occurred were relatively acute, and the problems the wider financial sector faced were due to speculation and fear within the market, not necessarily due to excessive risk taking or poor operations. There has to be some give and take at the governmental and regulatory level, in the way that on the one hand the regulations must be
implemented to try and prevent this type of excessive and dangerous risk taking by banks while, at the same time, allowing the banks in each economy to remain competitive and innovative.

Innovation within the financial markets should not be looked upon as a bad or dangerous thing; instead, there should be proper regulations in place to protect those that need protecting and to prevent any contagion effects on other areas of the bank or on other institutions. The true experts in the financial sector are those in the banks, whether people like that fact or not, and so it is important that on a certain level those banks should be involved when it comes to providing a blueprint for the reform.

**Potential Economic Effects of Weak Implementation**

The creation of the reforms are at the forefront of discussion at present, but, in theory, the actual reforms do not matter; what really matters is how the reforms are implemented and how they are enforced before the next crisis, instead of in hindsight of it. One of the most obvious and dangerous potential effects of weak implementation is the contagion affect if regulations on disclosure is not enforced correctly. One of the biggest problems in the most recent financial crisis is that once one institution fell into problems, either the products in mention affected other banks or other banks tightened up and stopped lending in fear that they were next. There needs to be regulations and plans in place to prevent the drying up of credit for those institutions that are not in problems due to risky investments but rely on the supply of credit for their operations. One of the simplest ways of doing that is following the proposed reforms of higher capital requirements and enforcing the regulations which require more liquidity.

William Isaac, Forbes columnist (Isaac, 2012), makes some very good points about the proposed US regulations and their weakness for long term reform. One of the most fundamental weaknesses is its complexity. The Obama administration presented a 1,300-page proposal; most
of it is incomprehensible and does not contain any real and implementable information. Any information it does contain is, for the majority, explaining symptoms of the financial crisis, not the reasons behind it and actions to prevent another one. Another issue that is mentioned is the complexity behind who regulates what and how. In other words, there are so many regulatory bodies in the US that large banks are actually able to play one off against the other, creating loop holes and problems which prevent any kind of effective regulation (Isaac, 2012).

The political nature of the banking industry is also still a problem and is not being addressed directly in the new proposed reforms in the US. The FDIC in particular is supposed to be the oversight authority of the banking industry, but consistently receives resistance from financial institutions and other regulators (Isaac, 2012). Until all the regulators are working towards the same over reaching goal, there will be loop holes and ineffective regulation no matter what the proposals or requirements are. There must be clear cut and effective enforcement agencies within the industry which does not have exceptions; this can only happen if the reforms are created with that in mind and have a structured implementation proposal as well.

Another issue that is not discussed too often is the fact that the Dodd-Frank Act isn’t actually Sen. Dodd’s original proposal and does not contain the effective measures it originally had. Sen. Dodd was very critical of the Bill that was proposed by the government and refused to vote on reforms in a rush. Then Dodd retired, and created something that was in no way effective but was able to pass the Bill without any votes. The Bill, as it stands, does a poor job at bringing to the table any reforms that will actually fix the regulatory system that has continued to fail, and does not address the problems with the SEC. The Federal Reserve, FDIC and SEC are still in charge of the same things. A potential remedy would be to actually reform those institutions rather than the regulations they should be enforcing (Isaac, 2012).
Some of the opinions from Isaac are a little biased but he makes a good point about the complexity and lack of direction the reforms have in the US. It is easy to create a reform package that indicates the current problems and looks at the main issues and deals with them. What is more difficult, and required, is a reform package that looks at the fundamentals from the very bottom and reforms an entire system, not just the banks and their operations.

**Conclusion**

From the data and analysis presented here, it is evident that weak enforcement of regulation was one of the main causes for the most recent financial crisis. There has been an acknowledgement of the need for financial reform on an international basis and there have been movements within nations to try and strengthen the structure of the financial sector. Even with these positive steps being taken, the confusion and lack of structure is already evident, and these first steps seem to be potential stepping stones for inadequate and weak reform in terms of implementation. There seems to be many recommendations for fixing the problems that have arisen from the financial crisis, which, in the short term, will benefit the economy. The global recommendations from the FSB and the Basel Committee do make an attempt at trying to address the underlying problems, but, without enforcing abilities, the actions being taken by the nations themselves are far more short term and reactive. This is due to political and social pressures on governments who are much more likely to take on short term, actionable and visible solutions, rather than looking for long term stability which may be undesirable in the short term. The recommendations I will propose should help to remove the dependency on politically affected organizations and will create a structured, understandable and loop-hole free financial sector. My recommendations will also lay foundations in regards to consumer protection, while
allowing for continued financial innovation and access to risky investment strategies when appropriate.

The recommendations start with one, unbiased, global regulatory organization which has the ability to enforce agreed upon global regulation and laws. This will form regulations which give clear, decisive and effective instructions and will keep all nations competitive within the marketplace. With differing regulations, there could be indirect negative competitive effects, leading to banks and institutions leaving certain nations to gain access to certain products and laws.

The next level of regulation would be a single, unbiased regulatory organization within each country, which represents itself in the global organization and also answers to the global regulatory body. Each nation requires a regulatory body for daily regulation and the ability to keep a constant eye on the structure and activities in the finance sector. With one, national, unbiased regulatory body which has the ability to enforce regulation, there should be limited loopholes and political pressure, ensuring a fair and safe financial sector. The job of financial regulation is obviously too big for just one organization, but rather than allowing several, independent organizations providing enforcement or decisions, those organizations will be regulated by the single national entity and any decisions on reform or regulation will be made by that single entity, with the backing of the single global entity.

In regards to the UK and US proposed regulations, certain aspects from both should be used, which actually proves that a global regulatory policy would work best, taking the best from each nation and implementing it. The UK ring fencing and loss absorbency plans seem to be heading in the right direction in terms of consumer protection. The ring fencing will provide protection for those that do not want to take excessive risk and will protect their money from
being used for that purpose. By ring fencing and not having complete separation, it allows individuals and businesses to take advantage of the products and expertise within the investment banking sector if they have such desires. One main factor should be the inability for equity and asset transfers between the commercial and investment banking departments of a universal bank. Any exceptions should allow for equity transfers from the investment banking sector to the commercial sector, but not vice-versa. In the US the regulation of proprietary trading and derivatives is a strong and appropriate law to try and prevent excessive risk taking. Proprietary trading and investment in hedge funds is not an imperative part of the baking system, especially the commercial sector. My recommendation would be a complete separation of proprietary trading, with separate regulatory bodies as the scope, risk taking and incentives are much different compared to the rest of the investment sector. Proprietary trading should be allowed, but those involved in such activities should be well aware of the risk and should not pass that risk onto third parties or other indirectly involved individuals.
References


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