INSTITUTE FOR LAW AND FINANCE

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Regulatory Implications of the Global Financial Crisis

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Regulatory Implications of the Global Financial Crisis

by Brad Gans[1]

Introduction

Thank you Professor Cahn

I appreciate the opportunity to share my views; these are my views and not those of Citigroup.

It has become popular for journalists who are trying to sell newspapers, and politicians who are trying to solicit votes, to refer to this financial crisis as the worst since the Great Depression or WWII. I don't know whether it is the worst or not so will leave that question to the historians and economists of the future once the storm has past. But it is indeed a "storm" as described by Vince Cable, Member of Parliament in his UK bestselling book entitled "The Storm – The World Economic Crisis and What it Means". He describes this "storm" as a very destructive one displacing jobs, businesses, banks and whole economies from Iceland to the United Kingdom to the United States.

I propose to offer a short chronology and summary of the causes of the current economic crisis. Then I will review several of the regulatory responses to the crisis focusing on the Turner Report, the de Larosière Group and certain US Treasury statements. I will offer my critiques of these proposals and then make some predictions of what the financial services industry may look like in the future.

I. Chronology of the Financial Crisis

Rather than offer a detailed chronology that will be all too familiar to those of you who read the Economist or the FT, I will divide the financial crisis into three phases. While it is not necessarily correct to divide it this way I think it is a useful paradigm to see how the financial crisis has progressed.

[1] Chief Legal Officer for Citi's Europe, Middle East and Africa division in London

A. The Burst of the Sub-Prime Housing Bubble in the United States and Contagion to Other Asset Classes

In the first and second quarters of 2007, cracks begin to appear in the US sub-prime residential mortgage market. If very few people knew what sub-prime mortgages were in 2007, I believe everyone has an idea and an opinion of sub-prime mortgages today. HSBC warned its investors in the first quarter of 2007 that the frequency of defaults and the severity of the losses were beginning to rise in its US residential sub-prime mortgage portfolio.

These sub-prime mortgages were originated by local banks or mortgage brokers and then aggregated and distributed into the capital markets by large international banks through CDOs (Collaterized Debt Obligations). CDOs in this context are pools of sub-prime mortgages whereby the underlying cash flows are tranched from equity (first loss – typically 5%), junior and senior mezzanine (the next 25-35% of cash flow and are distributed to institutional investors and traded OTC) and finally to the Super Senior (top 60-70% and typically held by the bank that structured the CDO). The market value of these CDOs is tracked by the ABX index. In reaction to the increase in the frequency of the defaults, this index began to decline substantially in the second and third quarter of 2007 by 20 to 30 points. The marked to market (MTM) losses and the concomitant margin calls led to the unwinding of two Bear Stearns funds in June of 2007.

By September, contagion impacted other mortgage products and other complex structured credit. Again, MTM losses and margin calls led to fire sales and liquidity for certain vehicles began to seize up. KfW steps in to provide liquidity for IKB, eventually taking it over. There is a run on a mortgage bank in the UK, Northern Rock, that precipitates a minor government crisis. Structured Investment Vehicles (SIVs) around the globe start to have difficulty rolling their commercial paper (CP) which was used to fund their longer dated mortgage portfolio. SIVs are highly geared funds (30 plus to one) that buy long-dated mortgages and fund in the CP market with no, or minimal, backstop bank liquidity. SIV portfolios can have both prime and sub-prime exposures in their portfolios.

Also, in this timeframe the leveraged loan market trades off considerably and a number of big international banks get stuck with some very large loans. The leveraged loan market is a traditional bank market, but recently, non-bank institutions have begun to participate through CLOs (Collateralised Loan Obligations – the parent of CDOs). The leveraged loan market funded leverage buyouts by private equity firms and strategic acquisitions by industry. I leave it to economists and finance majors to determine the actual relationship between the sub-prime bubble and the leveraged loan market, but certainly by the third quarter of 2007 the financial and capital markets had two major asset classes (leveraged loans and mortgages/structured credit) being marked down considerably with liquidity seizing up. Consequently in October, Merrill, Citi, UBS, JPM and other major global banks begin to announce considerable (tens of billions of US$) losses attributable to marks on these two asset classes.

B. Liquidity Crisis

I do agree that it is artificial to divide the chronology into a credit crisis precipitated by the sub-prime housing bubble bursting and a separate liquidity crisis. It is a continuum and there is no logical break. Having said that, by September of 2008 and the bankruptcy of Lehman there is a fully-fledge loss of confidence in the entire banking and financial system and it is no longer a sub-prime crisis, or for that matter even a credit crunch. Sub-prime crisis, to credit crunch, to liquidity squeeze, to systemic failure all within the space of little over a year. Today sub-prime losses represent something in the order of 15% of the total MTM losses.

The credit crunch and liquidity problems continue to intensify through the end of 2007 and the beginning of 2008. This causes the CP market to dry up, SIVs to be wound up or supported by their bank sponsor, the municipal auction rate securities[2] market in the United States to trade off and requiring the US government to assist a rescue of Bear Stearns by JPM in March 2008. Without access to the Fed window through JPM, Bear Stearns had no liquidity in the market place.

In the first and second quarters of 2008, banks went out to their shareholders and new investors to replenish their capital, raising tens of billions in new capital and central banks pumped liquidity into the system. I remember one meeting between Sir Win Bischoff, then Citi's chairman, and Hector Sants, CEO of the FSA, where Sir Win was reviewing all the capital that Citi had raised in the Middle East. Sir Win said to Hector "We'll go out and get the capital and governments and central banks should provide the liquidity."

Further MTM losses and liquidity strains require the US government to effectively step in and support Fannie and Freddie (the two government sponsored mortgage giants) in the summer of 2008.

September 2008, more than a year after the crisis began, is the worst month. Deposit runs lead to the default/liquidation/nationalization of certain Icelandic banks, Bradford & Bingley in the UK, WAMU in the US and a number of banks in the EU. But the biggest bomb to explode was the week beginning on Monday 8 September when the US government effectively nationalized AIG (current tab of $185B), orchestrated the takeover of Merrill Lynch by Bank of

[2] Auction rate securities (ARS) are remarketed preferred stock that approximated commercial paper for US municipals. These securities are typically wrapped up by AAA rated monolines. These monolines ran into credit problems as a result of the financial crisis, which then impacted the trading value of the ARS.

America and, inexplicably, let Lehman fail. Those who have been crying "moral hazard" got what they had been calling for – global financial systemic gridlock!! Several days later Morgan Stanley and Goldman Sachs apply to become bank holding companies with access to the Fed window for liquidity. The entirety of the US broker/dealer giants disappeared, were swallowed up or converted into bank holding companies.

Now governments had to provide both the capital and liquidity. The range of government responses included providing direct equity or preferred stock capital, funding guarantees of interbank borrowings, direct asset purchases, insurance of certain bad assets and recapitalizations. This degree of government intervention around the world across the entire spectrum of the private finance/banking sector has not happened since the Great Depression.

C. Full Blown Recession

Popular wisdom of where we are today is that the financial crisis is now impairing the real economy. We are in the midst of the steepest deflation that we have seen in decades. Unemployment is increasing and has not peaked. The severity of the housing price collapse in a number of countries has not peaked. Consumer spending in the US, UK and Europe is in rapid decline. Credit card and consumer finance credit defaults are rising. There has been a flight to the $ and Euro, and devaluations of a number of emerging market currencies. The decline in the value of these currencies has not led to an export boom as the US and Europe is contracting. Sales of manufactured goods are way down and inventories have been rising. In short, we find ourselves in the middle of an old-fashioned recession. It remains to be seen how long it will run or how deep (severe) it will be. But I leave it to the historians and the economists to divine the links between the financial crisis and this recession. Having said that, our Citi economists estimate that the US consumer has lost $19 trillion, or 20%, of his/her net worth and it will take many years to recover this before US consumer spending and confidence are fully restored.

D. The Future - Government Deficits – Currency Devaluation - Inflation

I will offer a prediction of the next phase of this crisis – government deficits. The UK and the US, in particular, have embarked on huge stimulus spending programmes. This will create government deficits not seen since the Vietnam War, which could lead to inflation and currency instability. This pressure on the US dollar could force the world to assess the need for an alternative reserve currency to the US$. You have already seen the Chinese suggest that there should be an IMF controlled central bank currency as an alternative to the dollar. This could be the most serious threat to dollar supremacy in the post-World War II era. You see, I can be more hyperbolic than a journalist!

II. Causes of the Crisis

A. Macro-Economic

This is largely taken from the Turner Report, not because the Turner report is necessarily right (though it may be), but because it is the most comprehensive and thoughtful piece to come out from the Chairman of a very influential regulator, the UK FSA, and we ought to try and understand what the regulator is trying to accomplish.

Over the last decade, OPEC, Japan, China and other exporters accumulated large account surpluses and US, UK and others in the EU running account deficits, which created large imbalances. These exporters invested in US government bonds and other AAA obligations (including CDOs) driving the cost of borrowing down. This build-up of liquidity and low interest rates over an extended period funded a housing bubble in the US and UK.

The "irrational exuberance" in the US and UK housing markets was further exacerbated by the "originate to distribute" model and product innovation (or product complexity). This combination allowed banks to take mortgages off their books and distribute them to the capital markets and a broader group of investors. Three or four years ago, it was the received wisdom that the "originate to distribute" approach to complex traded mortgage products better distributed mortgage risk throughout the financial system and banks were more diversified. Unfortunately today, what was heralded as the Holy Grail for diversification of bank risk turned out to be a poisoned chalice. Unfortunately, banks had to make markets in CDOs, create large "warehouses" of sub-prime mortgages for contribution to CDOs and hold the Super Senior, which turned out not to live up to its name.

Lord Turner goes on to make the point that the financial sector and debt grew at an unprecedented pace over the last decade. The growth in the financial sector outpaced growth in the corporate and retail sectors.

Increased leverage and complex structured products with limited historical data on their volatility were sold on a risk-weighted pricing assumption of liquidity and then liquidity disappeared.

B. Failure of Risk Processes

Lord Turner refers to this as misplaced reliance on sophisticated maths and models. I am sure I am not doing justice to Lord Turner's explanation but I will attempt to reduce his analysis to three points: 1) VAR didn't work because it didn't take account of product complexity; 2) bank risk models assumed liquidity (confidence) and ceased to work when liquidity (confidence) disappeared; and 3) the limited historical data around some of the new complex products did not allow banks to identify "fat tails." In other words, if your risk model should provide capital for a once in fifty year event and the product has only been around for a decade, then you most likely have not collected enough data points in order to identify all of the tail risk.

C. Failure of Supervision/Regulation

Basel II rested on two pillars which lie in ruins today: 1) reliance on internal bank models of risk and 2) credit ratings. I've mentioned why Lord Turner believes models failed. The credit rating agencies (CRAs) did give the Super Senior tranches and other structured credit product AAA ratings. In hindsight, CRAs (as well as the industry and regulators) did not recognize the correlated nature of the risks with CDOs. The modelling assumptions were unrealistic (i.e., assuming house price appreciation forever). None of the CRAs, the regulators or the banks ran stress scenarios that had house prices down 30-40% or double digit unemployment.

Everyone forgot the importance of liquidity to the banks. Hugo Banzinger, the chief risk officer at Deutsche Bank, said at a conference here in Frankfurt in the first half of 2007 (I paraphrase..): *I do not understand why regulators ask me to focus on capital. I have two metrics that I watch every day – cash flow and liquidity. If I do not have good cash flow and liquidity and I hit a market disruption event, by the time I get to capital I am bankrupt.* I have often thought how prescient Mr. Banzinger's comment was. Regulators and banks did not focus enough on liquidity. Lehman had significant of capital when it went under, but it simply had no liquidity

D. "Shadow Banking" of Financial Institutions Outside of Systemic Regime.

This has been a perennial weakness in the global bank regulatory regime, which allows systemically important institutions to stand outside of the bank capital, prudential supervision and systemic confidence regulatory oversight regime. This has been particularly problematic in the US with its archaic and Byzantine financial regulatory structure.

The world now understands that the US broker dealer industry operated outside of a robust capital regime and did not have access to the lender of last resort in the US - the Fed. In the space of a little over a year, every major US broker was either bankrupt, taken over by a commercial bank or converted into a bank holding company under the umbrella of Fed supervision with access to the Fed window. AIG, Freddie and Fannie are other failed institutions outside of the central bank's reach. A credible argument could be made that the fact that these broker dealers (Lehman, Merrill Lynch and Bear Stearns) had no effective regulatory supervision and oversight of capital and liquidity and, more importantly, no access to the Fed widow, created the liquidity crisis. Certainly Lehman's bankruptcy is the most critical event, triggering systemic loss of confidence.

Another old villain here is the hedge fund industry. While hedge funds did not play a central role in creating the crisis, the fact that they, by definition, are leverage animals meant that the credit crunch caused them to rapidly de-leverage thus driving down prices and aggravating the MTM with the banks.

E. Credit Rating Agencies

In addition to the model and stress problems outlined above, the "issuer pays" model in the structured credit arena has come in for some criticism because of conflicts of interest. Indeed, the entire methodology for rating structured credit has come under critique.

III. Regulatory Response

A. Turner Report

I will not cover every aspect of Lord Turner's recommendations, only the more important ones related to the causes outlined above and which are likely to have the greatest impact on the future shape of the banking industry.

1. Capital. (Surprise, surprise … the industry will be required to hold more capital)

   - increase amount of bank capital (quantity and quality)

   - 3-5 x increase in trading book capital

   - pro and counter-cyclical capital buffers – build reserves in the good times

   - gross leverage ratio/no risk weighting

2. Liquidity. Local or entity level liquidity management. FSA has a consultation paper on liquidity management. Intense dedicated supervision of liquidity. Establish a core funding ratio.

3. Accounting. Published accounts should include "Economic Cycle Reserve" as an IBNR disclosed on Financial Statements but not run through the balance sheet.

4. Institutional and geographic coverage of regulation – "shadow banking". Regulators should have the power to extend prudential regulation of capital and liquidity to an institution if it has bank-like features, or can otherwise threaten financial stability, or otherwise becomes systemically significant

5. Credit Rating Agencies –should be subject to registration, and greater supervision to oversee disclosure, conflicts, transparency, ratings, models and, most importantly, the ratings of structured credit.

6. Remuneration. Regulation to ensure compensation policies that discourage excessive risk taking.

7. Enhanced bank supervision through 1) a local supervisory entrance programme (up close and personal); 2) increased prominence of risk management in governance process; 3) colleges of regulators; and 4) pre-emptive crisis co-ordination.

8. Utility banking versus investment banking. One of the more controversial goals of the Turner recommendations is that, through the combination of higher capital charges on the trading book and higher liquidity requirements, universal banks should shed proprietary trading businesses and become utility commercial banks. Commercial banks will have the benefit of depositor protection and provide a simple array of financial products and services to consumers. These "utility banks" would be the banks of the future that governments should bail out and the much smaller investment/merchant banks would be left to their fate and moral hazard. Lord Turner says this is not Glass Steagall revisited, in my mind it is Glass Steagall by capital and liquidity regulation.

9. Lord Turner does recommend the evolution of the Lamfalussy process and the creation of a super European institution with independent authority for rule making and input to macro prudential analysis. Who would have imagined the Chairman of the UK FSA would ever recommend creating such an EU leviathan? While supervision will continue at the national level, he recommends another level of oversight and coordination at the EU level.

10. Another controversial recommendation, and one I believe is at odds with the uber-Euro regulator, is that Lord Turner suggests increasing national powers to require subsidiarisation of EU banks' branches that take retail deposits cross border. In other words, to stop EU passporting cross border without greater local supervision of the local subsidiary. This is a reaction to the failure of the Icelandic banks and the inability of British citizens to access the Icelandic depositor protection.

B. The de Larosière Group

On 25 February 2009 a high-level group headed by former IMF Managing Director and ex-Bank of France Governor, Jacques de Larosière, recommended reform of cross-border financial supervision in the EU to remedy flaws in the bloc's patchwork of national based supervision. Faced with member state fears of losing local regulatory sovereignty, the report suggests changes should be phased -in over four years and stops short of introducing an all-powerful, pan-EU regulator. The report offers a two-level approach to reform - new oversight of broad, system-wide risks and a beefing-up of coordination among national supervisors. The Report's main recommendations are:

MARKET-WIDE SUPERVISION OF RISK

- Setting up a "European Systemic Risk Council" (ESRC) to be chaired by the European Central Bank president. It would be composed of members of the general council of the ECB, a member of the European Commission and chairs of the three existing pan-EU committees of banking, insurance and securities supervisors.

- Establishing an effective risk warning system under the auspices of the ESRC and the existing Economic and Financial Committee, which is made up of national treasury officials. If the ESRC thinks a local supervisor is taking inadequate action to deal with risk, it could take further action.

- Making improvements in how a banking crisis is handled. For example, EU states should agree more detailed criteria for burden sharing and who bails out a failed cross-border bank.

DAY-TO-DAY SUPERVISION

- Creating a “European System of Financial Supervisors” (ESFS) and a decentralised network, with existing national supervisors continuing to carry out day to day supervision.

- Three new European authorities would be set up to replace the existing three pan-EU committees of banking, insurance and securities supervisors known as CEBS, CEIOPS and CESR. Colleges of supervisors would be set up for all major cross-border institutions.

- The ESFS would be independent of political authorities but be accountable to them. It should rely on a common set of core harmonised rules.

REGULATORY REFORM

- A fundamental review is needed for the globally-agreed Basel II rules on capital requirements for banks, such as stricter rules for off balance sheet items.

- Supervisors should oversee the suitability of compensation policies at financial institutions.

- A common EU definition of regulatory capital should be adopted.

- National supervisors should collectively be responsible for registering and supervising credit rating agencies.

- A wider reflection needed on mark-to-market accounting standards, blamed by some for exacerbating the impact of the credit crunch on banks. The oversight and governance of the International Accounting Standards Board, which sets accounting standards used in the EU, should be strengthened. Neither Lord Turner nor the US authorities blame MTM for exacerbating the crisis. US authorities are more concerned about a level playing field.

- Regulation should be extended to the so-called parallel banking system, and there should be registration and information requirements on all major hedge funds. There should be capital requirements on banks owning or operating a hedge fund or engaged in significant activity with a hedge fund.

C. US Approach

1. Systemically Important Firms

Interconnected firms and markets need to be subject to greater regulatory scrutiny and supervision to ensure that the risks these firms pose to the financial system are understood and managed. Systemically important firms will be identified by certain characteristics such as: (1) the financial system's interdependence with the firm; (2) the firm's size; (3) the firm's level of leverage; (4) the firm's reliance on short-term funding; and (5) the firm's importance as a source of credit and liquidity to other market participants.

2. A resolution and stability regulatory authority

A single entity would have responsibility for systemic stability of systemically important financial firms and markets. This regulatory authority would be responsible for consolidated supervision of these firms and supervision of systemically important payment and settlement systems and activities.

3. Capital and liquidity requirements

In order to prevent future crises, firms will be required to hold greater capital and to build up higher capital levels during good economic times in order to have the ability to survive downturns. This non-pro-cyclical requirement would avoid the high levels of deleveraging during economic downturns that have exacerbated the current crisis. The capital levels of those institutions which pose potential risks to the stability of the financial system will also be substantially increased to match the systemic risk they pose.

The single stability regulator, it is proposed, would impose tough liquidity management requirements for systemically important financial firms, including a requirement to be able to aggregate counterparty risk exposures hourly on an enterprise-wide basis.

4. Regulation of hedge funds and other private pools of capital

Advisers to large hedge funds and other private pools of capital should register with the SEC, and are subject to disclosure requirements and regulatory reporting to enable the authorities to assess the level of threat they pose. Secretary Geithner stated that this will apply to fund advisers with assets under management in excess of a certain threshold, but did not provide details on this threshold level.

5. Reducing runs on money market funds

In the United States, money market funds "broke a buck" because of runs by investors. While money market funds are subject to SEC regulation, the SEC should strengthen regulation to enhance liquidity, capital and asset quality.

IV. The Banking Model of the Future

- There are two long-term trends in the financial services sector – universal banks and globalization – that have combined to make the consequences of this financial crisis more severe and the regulatory solutions more complex.

- Lord Turner, I believe, is quoted as saying "in life banks are global and in death they are national". This summarises the fundamental problem with the banking sector in this crisis in that universal global banks have had to be bailed out by national economies. Banks that became too big to fail have also become too big to save. You only have to look at Switzerland, the UK and Iceland to see that you have global banks that exceed the national capacity to bail them out. The proposals in the Turner report and the other regulatory changes that I have described, aim to correct this situation by a combination of increasing capital on global systemic banks, reducing the gross leverage within the financial sector and therefore the size of these banks, and then, through local liquidity and capital requirements, making global banks more decentralized and responsive to local supervision.

- Capital, Capital and more Capital. While given the bleak capital status of banks and the financial system and the massive government intervention to save many banks and the system itself, it is hard to argue against an increase in capital requirements. Having said that, it is important to ask yourself what the impact of greater capital requirements will be. Increased capital requirements will make banks less profitable. Bank profits are the quickest and surest way to increase bank capital. Increased capital requirements may drive the cost up of goods and services delivered to retail and institutional customers. It may also reduce availability of certain products. Driving up the costs of mortgages, for example, and reducing the overall mortgage lending capacity will put home ownership out of reach of a larger percentage of the population, require homeowners to allocate larger percentage of their income to repaying their mortgages and drive down the value of homes. All of this could exacerbate the recession. This is a policy choice between "guns and butter". You can have more capital in the banking system and presumably more systemic stability, but you will also get less mortgage capacity (for example) at a higher cost.

- Large increases in trading book capital which has as one of it objectives the dismemberment of universal banks into their parts. As I said earlier, Lord Turner is targeting the universal bank through exponential increases in trading book capital and liquidity management. This is likely to bring about the return of Glass Steagall only this time across the globe with utility banks delivering retail products and services and enjoying depositor protection. Investment banks, hedge funds and merchant banks will be outside of these utility banks. They too will have massive capital requirements as well as a gross leverage ratios limits. Between not being part of utility banks and having very onerous capital and leverage limits, these banks will be permitted to fail without systemic implications. What surprises me about this aversion to global universal banks and preference for smaller utility banks is that monoline brokers and mortgage banks faired worse than universal banks in the crisis. Indeed, HSBC and some of the Spanish global universal banks weathered the storm quite well. Global universal banks have a more diversified risk portfolio, which may not have worked perfectly in this current crisis but that is no reason to throw the baby out with the bath water – diversification in asset classes both from geographic and wholesale/retail perspectives should lead to more stable institutions than monoline single risk entities.

- Balkanization – Branch capital and liquidity, or trapped capital and liquidity within local entities, could result in centrally managed banks becoming decentralized federations of national banks. Instead of global banks with centralized product, liquidity management, capital and distribution, a small geographic entity model will develop. These local banks, or branches, will be smaller and more responsible to local regulators, but less efficient. If every country did what the UK FSA is currently proposing with regard to liquidity and capital, this Balkanization would lead to considerable inefficiency in the deployment of liquidity and capital by global universal banks, exacerbating the current liquidity and capital crisis.

- Large increases in trading book capital on securitization capital products will stifle the recovery of the capital markets. Capital markets investors have greatly expanded the funding capacity of the traditional bank markets. So, for example, increased capital charges on securitization capital products will drive the overall mortgage/securitization capacity down in the US and UK especially. In the US the capital markets and wholesale investors provided something in the order of 75-80% of the US mortgage capacity and banks provided the remainder. In the UK, that relationship was reversed. In either country, however, if you impose punitive capital charges on a secondary securitisation product such that it substantially reduces the size of these markets there will not be enough bank capacity to make up the shortfall. A very important objective in solving this crisis is to revive liquidity in the secondary market for securitization or mortgage products. Punitive capital charges on these types of asset classes undermine this objective.

- In many respects, Lord Turner's vision of utility banks and investment banks reminds me of Frank Capra's 1940s classic "It's a Wonderful Life"; Jimmy Stewart and the Bailey Brothers' Building and Loan Association taking deposits from the community and reinvesting in homes for the community's working and middle classes, with the evil Mr. Potter and his big global bank trying to thwart the Bailey Brothers at every turn. Unfortunately that is the past and we cannot return to it. Banks will continue to provide a wide array of financial products and services because that is what retail and wholesale customers want. The world economy is far more globally connected than that of Capra's Bedford Falls in 1945. Banks of the future will need to be global to match the globality of business and economies. It may be necessary to have larger capital charges for these universal systemic global banks because no one nation is able to provide sufficient support in a time of crisis, but it is not a solution to break universal banks up into utility and commercial banks, nor is it a solution to divide them into a confederation of stand-alone national banks. The economy is global. Banks will be global. Regulation and regulators need to be global.

- Growth of "shadow banking". Between compensation regulation and greater capital requirements, the "brain drain" will cause entrepreneurial talent to find space outside of the bank regulatory regime. If governments create an arbitrage regarding capital and compensation, individuals and entities will spend considerable time and effort to find a jurisdiction, corporate organisation or tax regime that takes advantage of this arbitrage. So, rather than bringing more systemically relevant institutions into the bank regulatory environment you run the risk of many institutions and individuals fleeing further into the shadows, away from the bank regulatory environment.

- Gross leverage and the decline in the reliance of internal bank models will reduce innovation and reward mediocrity. While I agree with Lord Turner that models and sophisticated maths did not work as anticipated in this crisis, I would not recommend throwing the baby out with the bathwater. We still want to encourage improvements in risk management analytics. But if there is no reward for improvements in this area and all banks are treated equally, then innovation will stagnate.

- Let's turn to the regulatory front. The rise of international colleges with greater coordination and communication regarding large systemically relevant financial institutions has already begun, and will accelerate.

- A large systemic and prudential regulator will arise in the US. I believe this will be the Fed. I do not believe that the SEC and the CFTC will come within the orbit of the Fed.

- The next stage of Lamfalussy and the rise of two new EU institutions: an independent macro prudential surveillance authority; and some sort of pan-EU supervisory authority with rule making power. Both Lord Turner and the de Larosière groups support this. I believe this will impact London's competitiveness. The key for this entity is not only to impose liquidity, capital and prudential supervision standards for systemically important institutions but also to be able to partner with ECB to be a lender of last resort in Europe. In addition this futuristic Leviathan should also have sufficient resources and authority to ensure financial systemic stability across the entire EU.

- Through the combination of colleges and single systemic and prudential regulators in the US and EU, you will have enhanced communication and co-ordination in the future. Those two giant regulators will sit atop the two economies ($ and Eurozone) that have the capacity to fund large global universal banks and therefore will be better positioned to manage the size, capital, liquidity etc of the banking sector in the future.

- In other words, the problem with this crisis is that the regulatory solution was national when the banks and the banking crisis were global. This is not to say that banks are blameless, or that the total solution does not require changes with bank capital, risk management and liquidity enhancements, but the solution must also involve making regulators more global. The problem is not that banks got too big or too global. The problem is that regulation and the regulator did not keep pace with the globalization of the economy and banks and remained national. The solution is not to make banks and the banking system take a step backwards to the Bailey Building and Loan Association, but to make governments and regulators take a step forward and become more global and more co-ordinated rather than purely national.

* * * * * *

I picked up this weekend John Kenneth Galbraith's short essay – "A Short History of Financial Euphoria" written in the aftermath of the 1987 stock crash. From Tulip mania, to John Law and the Banque Royal, to the South Sea Bubble, to numerous American real estate bubbles of the 19th century and finally to the legendary 1929 stock market crash, a free enterprise economy continually gives itself over to "irrational exuberance" or episodes of speculation and greed. Galbraith concludes his short essay by saying: "The final question that remains is what, if anything should be done? Recurrent descent into insanity is not a wholly attractive feature of capitalism. The human cost is not negligible, nor is the economic and social effect…..Yet beyond a better perception of speculative tendency and process itself, there probably is not a great deal that can be done.

Regulation outlawing financial incredulity or mass euphoria is not a practical possibility." I am not so pessimistic as to say; therefore, let's do nothing since financial bubbles are inevitable. On the other hand, I am enough of a pragmatist to suggest that this financial crisis does not require wholesale revision of the bank regulatory regime. The lesson of history is that we cannot outlaw "irrational exuberance", we can only be more vigilant in our efforts to identify the next expanding bubble and then more prudential in how to deflate it without bursting it.

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2	Axel Nawrath	Rahmenbedingungen für den Finanzplatz Deutschland: Ziele und Aufgaben der Politik, insbesondere des Bundesministeriums der Finanzen
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