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5

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Abstract

This paper attempts to explain the international policy consequences of the 2008 global financial crisis by comparing the regulatory response in Europe to that in the United States. Specifically, it accounts for the level of cooperation between the two jurisdictions in their efforts to improve oversight of the financial system. The paper is concerned primarily with the regulatory laws, agreements, and frameworks enacted since 2008, as efforts to improve financial regulation are ongoing and only starting to reach the implementation phases. Still, implementation plays a meaningful role in the analysis, as variation in implementation capacity among jurisdictions often shapes the breadth and depth of oversight. This paper also seeks to demonstrate that international cooperation in financial regulation is constrained by an incentive to defect, which arises from short-run negative effects of oversight on the profitability of financial institutions. Finally, the paper shows that the sheer complexity of the financial system, especially with respect to the derivatives market, is itself a hindrance to the creation of transatlantic regulatory standards.

Keywords

Financial crisis, financial regulation, transatlantic cooperation

Introduction

The 2008 global financial crisis has presented a monumental regulatory challenge across American and European financial markets. Based on the large-scale risk-taking from which the financial breakdown ensued, policymakers on both sides of the Atlantic have since endeavored to enhance macroprudential oversight of financial institutions. The goal of new regulatory measures is to reduce the degree of systemic risk present in financial markets, so that future disturbances in asset prices will be less likely to engender significant contagion and disrupt the proper functioning of the financial system. To date, these efforts have included several pieces of national legislation, such as the Dodd-Frank Wall-Street Reform and Consumer Protection Act in the United States (2010), as well as international agreements among G-20 members and international regulatory structures like the latest Basel Accords. All together, these measures set out to improve aspects of the financial system ranging from capital adequacy to derivatives trading, proprietary trading, securitization, and mortgage markets, among many others. Each area presents considerable regulatory challenges at both the domestic and international levels.

In this paper, I will focus on the level of transatlantic regulatory cooperation and the extent of transatlantic convergence with respect to capital adequacy requirements, derivatives trading (particularly over-the-counter derivatives), and systemically important financial institutions. These are a few of the most salient issue areas in regulation reform, based on Dodd-Frank rulemaking activity[1] and official G-20 communiqués ("G-20 Cannes Summit Communiqué," 2011; "Mexico City G-20 Communiqué," 2012). Additionally, these issue areas differ in the complexity of regulation, which allows for a comparison of the level of international cooperation across topics that vary in difficulty of oversight. This will eliminate the potential for bias that arises from selecting on issue areas for which regulatory cooperation is relatively simple or problematic.

In the first section, I will examine transatlantic cooperation in instituting new capital adequacy requirements. I begin by framing the issue, describing the need for new measures on capital adequacy and depicting what is at stake for the financial system. Then, I explain why capital adequacy reform has seen a relatively high degree of international cooperation, focusing on the standards stipulated by the third installment of the Basel Accords. Next, I perform a similar analysis for derivatives regulation, first delineating the problem and then evaluating policy convergence on the subject. With derivatives, cooperation takes the shape of harmonization of domestic oversight between jurisdictions, rather than explicit international agreements. In the third section, I assess the extent of international policy convergence that has taken place in relation to systemically important financial institutions (SIFIs). Finally, I will attempt to explain any disparities in the degree of cooperation observed across issue areas, and evaluate the overall level of transatlantic convergence achieved in financial regulation to date.

For this analysis, I concentrate on the United States (US) and the European Union (EU) as the world's largest financial markets (World Federation of Exchanges: Statistics). These are the areas that experienced the most financial distress resulting from the events of 2008. Moreover, these are the jurisdictions where the need for enhanced regulation is most apparent. Though the analysis will exclude other potentially important regions (Japan, China, Brazil, etc.), it is robust enough to draw meaningful conclusions regarding regulation of the

1 Based on Dodd-Frank and Related Reforms, Morrison & Foerster. Retrieved from http://www.mofo.com/resources/regulatory-reform/.

global financial system.

Financial Regulation in the Context of Transatlantic Relations

Once a close-knit entente cordiale, particularly in the early part of the Cold War era, the vessel of transatlantic relations has in recent decades encountered a spot or two of uneven seas. Although the United States and Europe have always retained very robust political and economic ties, the strategic and economic interests of the two regions have grown somewhat misaligned. The rift, though small, has become especially pronounced in the last decade, following the US-led invasion of Iraq and the global shift of power towards Asia (Tocci & Alcaro, 2012). In the realm of foreign policy, the United States' "unilateral moment," in which it bypassed the United Nations in pursuit of war against Iraq, did much to anger the French and Germans (Hanhimaki, Schoenborn, & Zanchetta, 2012). The subsequent debacle that was the Iraq War did little to mollify European mistrust. In the economic sphere, the United States and Europe have collaborated closely in the post-World War II period to bolster their security community. This resulted in a highly successful economic partnership, characterized by deep cooperation through programs like the Marshall Plan as well as institutions like the Bretton Woods system and the General Agreement on Tariffs and Trade (Eichengreen, 1995). The recent rise of Asian economies, however, has weakened transatlantic commercial interdependence to some extent by shifting the focus of American and European economic policy. Asia has been increasingly capturing trade and financial flows that would have otherwise been part of transatlantic economic activity (Hamilton & Quinlan, 2012).

The 2008 crisis shook the very foundation of the global economy, bringing American and European financial markets to their knees. The subsequent need for a new international regulatory structure presented a major test for transatlantic relations. The ability of American and European policymakers to construct an effective regulatory system bears directly on the future of cooperation between the two regions. Their capacity to restore the proper functioning of financial markets will likely indicate the potential for a sustained economic partnership as well as shed light on the feasibility of prospective initiatives such as a US-EU free trade agreement.

Conceptual Approach

It is difficult to gauge the level of international cooperation in regulatory reform without first understanding its objectives. In other words, we must know what financial regulation seeks to achieve before we can evaluate its success thus far. Since there is no single objective that regulators unanimously agree upon (particularly with the more complex problems pertaining to derivatives and SIFIs), I will use a conceptual framework that rests on "international consensus" (between the United States and EU member states). I argue that in each of these three issue areas, an international consensus exists that, although broad, specifies a distinct set of policy goals. Based on this, I will assess the effectiveness of transatlantic cooperation in realizing regulatory reform.

Section 1: Capital Adequacy

The 2008 financial crisis illuminated crucial structural flaws in the American and European banking systems with respect to capital reserves. In the aftermath, it became apparent that the capital requirements for banks in the United States and EU were inadequate to ensure liquidity and prevent exorbitant risk-taking (Harle et al., 2010). This inadequacy encouraged excessive credit growth and procyclical lending practices, while heightening counterparty risk. As a result, regulators have seen the need to raise minimum capital requirements, as well as improve the quality, consistency, and transparency of the capital base.

Owing to the deep interconnectedness of the transatlantic banking system, capital adequacy regulation must be addressed at the international level. It is of little use to enhance regulation in one jurisdiction if regulation in others is lax enough to allow risky practices to continue. In such a situation, international transactions and contagion would undermine increased oversight. Moreover, tightening regulation domestically without reciprocal policy actions abroad creates a significant competitive disadvantage. Because stricter capital requirements generally lower bank profitability, domestic banks would become less competitive relative to foreign banks in such a scenario. Therefore, enhanced domestic regulation can be highly contentious and difficult to implement unless it is matched in other jurisdictions (Basel Committee on Banking Supervision, 2011). An international framework is essential if meaningful capital adequacy reform is to be achieved.

The central vehicle for the formation of international banking standards has historically been the Basel Accords, issued by the Basel Committee on Banking Supervision, a division of the Bank for International Settlements (Basel Committee on Banking Supervision, 2009). The 2008 financial crisis prompted the latest series of agreements, known as Basel III (2010-11), stipulating new requirements with respect to capital reserves and market liquidity. This framework has been endorsed by the G-20 leaders and functions as the centerpiece of international oversight coordinated by the Financial Stability Board (Hannoun, 2010). As such, it marks a good starting point for the evaluation of transatlantic cooperation in financial regulatory reform.

Basel III

In order to assess the magnitude of change stipulated by Basel III, I examine reports of key industry commentators published in response to the new guidelines. I will make a conceptual leap and claim that the profusion of such reports, which detail the impact of Basel III on the banking industry, reflects a high degree of regulatory change (and therefore cooperation). Otherwise, there would be little need for such a comprehensive industry response. I then use the comments of policymakers in the United States and EU to the illuminate the role of preferences and implementation considerations in shaping these outcomes.

The Basel III agreements embody an "enhanced level of dynamism, complexity, and interdependency within the global regulatory landscape" (Greenlee et al., 2011). This has key effects on the way banks will conduct their future operations. Notably, common equity requirements have more than doubled under Basel III, with the Tier 1 capital (i.e. common shares and retained earnings) ratio rising from 2% to 4.5% (Basel Committee on Banking Supervision, 2011). At the same time, Tier 2 capital (i.e. higher-risk assets) requirements have been reduced and simplified, while Tier 3 capital (i.e. even higher-risk assets) has been eliminated (Auer et al., 2011). All together, these measures lower the amount of capital that can function as reserves. Meanwhile, Basel III raises the amount of risk-weighted assets[2] a bank must hold at any point in time (Harle et al., 2010). The overall outcome is that both the quantity and quality of capital reserves have increased under the stipulation of Basel III. On

2 The term, "risk-weighted assets," refers to the calculation of a bank's minimum capital requirements based on both the volume and risk of its holdings.

top of this, Basel III requires that banks reduce their leverage and adhere to higher liquidity standards.

The Basel III framework has profound effects on both individual banks and the greater financial system. Most directly, the new regulations place significant pressure on bank profitability and return on investment. With higher capital requirements, banks face higher costs, which in turn lower profitability and operating capacity. As a result, weaker banks are crowded out while those remaining are forced to revise their business models to ensure adequate profit margins. On a macro level, Basel III will likely lower the lending capacity of the banking system, while reducing investor proclivity for bank debt and equity (Basel Committee on Banking Supervision, 2011). This implies that Basel III carries deep and far-reaching consequences for bank operations worldwide.

The vast majority of industry analysts and commentators in the United States and EU agree that Basel III enacts significant and measurable reform. This is reflected in both the profusion and content of analyst reports. Since the Basel III guidelines were issued in late 2010, many major consulting firms and government agencies have released detailed insights on the implications for financial institutions. These reports consistently indicate that Basel III alters significantly the capital requirements for banks in a way that reduces systemic risk, but also hurts short-term bank profitability.

Considering that international consensus prior to Basel III called for capital adequacy regulation that does exactly this, we can infer that the Basel agreements reflect a high degree of transatlantic cooperation. Statement number 16 of the preamble to the G-20 Pittsburgh Summit Communiqué pledges, "to make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis. Where reckless behavior and a lack of responsibility led to crisis, we will not allow a return to banking as usual" ("Full G-20 Communiqué, Leaders' Statement: The Pittsburgh Summit," 2009). From recent analyst reports on the American and European banking industries, we know that policymakers have stayed true to their word. How did this fruitful cooperation arise? The answer lies in the details of the capital adequacy issue itself, as well as the similarity of regulatory preferences and capabilities among jurisdictions.

Any praise of cooperation in capital adequacy reform must be qualified by the relative simplicity of addressing the problem. The technical aspects of raising capital requirements are relatively uncomplicated, and markedly simpler than other aspects of financial regulation. While assessing capital adequacy involves intricate financial models, the technical nature of capital adequacy reform does not extend much further beyond these computations. Consequently, Basel III regulators found it comparatively easy to institute meaningful and effective regulatory measures. The straightforwardness of introducing a capital adequacy solution is a key factor in explaining the efficacy with which regulators have cooperated on the issue.

Another reason for the successful cooperation observed in the Basel III agreements is the relative homogeneity of preferences between jurisdictions. At a time coincident with the completion of Basel III, both the United States and the EU witnessed discourse with similar stipulations to those of the Basel Accords. In testimony before the Federal Reserve Board a few months prior to the finalization of Basel III, Chairman Ben Bernanke made the following statement, "Basel III should make the financial system more stable and reduce the likelihood of future financial crises by requiring these banks to hold more and better-quality capital and more-robust liquidity buffers" (Bernanke, 2011). In Europe, as early as 2009, President of the European Commission Jose Manuel Barroso described the need for new capital safeguards. In delineating a set of European Commission proposals, he noted, "these proposals aim to ensure that banks hold enough capital to reflect the true risks they are taking…supervisors will be given the powers to take measures, including increased capital requirements, to address any failures…" (European Commission, 2011). Such statements on the part of key policymakers in each jurisdiction point to a shared predisposition towards capital adequacy reform, and in particular, improvements in risk-weighted capital requirements.

While the creation of the Basel III framework has seen impressive cooperation among American and European regulators, this cooperation may yet prove incomplete. Indeed, despite being the best example of international regulatory cooperation, the agreements are likely to suffer from asymmetric implementation. A simple principal-agent approach can demonstrate that Basel III cooperation, though significant, may be stronger in principle than in practice. We can assume first that the domestic financial industry has some degree of lobbying power over policymakers. Moreover, any implementation of Basel requirements occurs solely through the domestic policy sphere. Based on this, it is possible to see why regulators might promote stringent requirements at the international level, before legislators defect at the stage of domestic implementation. This allows for, "regulatory arbitrage," a situation where divergent implementation creates excess profits for one region's financial industry at the expense of another's (Basel Committee on Banking Supervision, 2011). The financial institutions that benefit are the ones in the jurisdiction where implementation is relatively lax.

This emerged as a legitimate concern as regulators approach the first Basel III deadline (January 1st, 2013). The Basel Committee on Banking Supervision's early assessments of the EU and United States found "key areas where domestic implementation may be weaker than globally agreed standards" (Brundsen, 2012). A Basel III progress report from the Bank for International Settlements similarly found the EU and United States to be lagging in both timely implementation and consistency with regulatory requirements (Bank for International Settlements, 2012). In addition, accounts of inconsistent implementation of Basel III have recently propagated through news sources and analyst reports. It is difficult to argue that the EU and United States have a lower implementation capacity than jurisdictions that have been more compliant, such as Australia and Switzerland. Therefore, it is likely that the financial sector is exercising some sort of lobbying power over the policy process, in the interest of maintaining profit margins.

Evidently, the depth and scope of cooperation in capital adequacy reform can be understood in terms of the simplicity of the issue area, uniformity of preferences, and incentives to defect. The broad agreement between jurisdictions on the need for capital adequacy reform, coupled with the fact that solutions to the capital adequacy problem are relatively uncomplicated, have allowed for a robust international regulatory framework. Basel III engenders meaningful reform in the American and European banking sectors, creating important safeguards against systemic risk. Nonetheless, regulatory cooperation in this context is constrained somewhat by implementation asymmetries, which arise from the combination of strong financial industry lobbies and potential profits from defection. Still, the Basel III requirements represent the most substantive transatlantic reform to emerge from the global financial crisis.

Section 2: Derivatives

Perhaps the most obvious lesson from the 2008 financial crisis was the need to increase oversight in global derivatives markets. Prior to the crisis, derivatives trading in both the

United States and EU remained largely unregulated, allowing for vast speculation that produced enormous systemic risk. The most well-known example is the trading of mortgage-backed securities and credit default swaps, which amplified the real estate bubble and resulted in spectacular losses as well as the collapse of major financial institutions once housing prices declined ("A Long Road to Regulating Derivatives," 2012). While derivatives serve the important functions in financial markets of hedging risk and price discovery (Jicking & Miller, 2011), derivatives markets must be structured in a way that limits risk-taking and asset price uncertainty.

The key issue in transatlantic derivatives regulation is the mitigation of systemic risk through the promotion of transparency and protection against market abuse. The initial focus of these efforts was credit default swaps, as these contributed to the downfall of AIG, but quickly transitioned to over-the-counter (OTC) derivatives, which face far less regulation and were central to the demise of Lehman Brothers (Green & Jennings-Mares, 2011). Since, an international consensus has arisen from the G-20 Financial Stability Board regarding measures to be taken in regulating derivatives markets. These include standardizing derivatives contracts, establishing central clearing counterparties, moving OTC derivatives trading onto exchanges or electronic platforms, and requiring participants to report activities to trade repositories (G-20 Financial Stability Board, 2010).

Despite this consensus, derivatives markets present massive challenges to regulatory coordination. First, the sheer complexity of derivatives trading is itself a hindrance to coordinated oversight. Moreover, variation among jurisdictions in such factors as the size and nature of the derivatives market, the key participants, local market practice, and political considerations, as well as many others, has rendered an international derivatives framework akin to Basel III all but impossible to achieve. Therefore, transatlantic oversight of derivatives markets is best understood in terms of the convergence of American and European regulatory efforts.

In the United States and EU, derivatives regulation takes the form of two overarching pieces of legislation. On the American side, Title VII of the Dodd-Frank Act specifies a derivatives overhaul, with a host of new measures for standardizing trade in these financial instruments. Such modifications include central clearing and reporting, regulation of market participants, margin requirements, and position limits (Huntington, 2010). On the European side, the Commission has enacted the European Market Infrastructure Regulation (EMIR), which, combined with the revised Markets in Financial Instruments Directive (MiFID II), aims to standardize trade in OTC derivatives through similar mechanisms (European Commission, 2010). These parallel frameworks embody a convergent regulatory response to the derivatives issue between jurisdictions. The fact that both carry the objective of increasing the transparency and efficiency of derivatives markets is an important positive outcome in transatlantic financial regulation. Still, in order to determine the scope of these measures and the extent of policy convergence, we must examine the derivatives issue area in more detail.

In September 2009, G-20 leaders proclaimed in Pittsburgh, "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements" ("G-20 Pittsburgh Summit Communiqué," 2009). Articulated here, the goal is to make the positions of traders, the volume and aggregate risk of derivatives trading, and the price of derivative assets transparent. Another regulatory tool that has found its way into the policy discourse is the use of position limits, which cap the number of derivatives contracts an investor can hold in connection with one underlying security. All together, these measures aim to curb speculation and reduce the level of systemic risk that originates from derivatives markets.

Both American and European legislation target this goal through similar means, suggesting that a degree of policy convergence certainly exists. This arises from a desire on each side, as echoed by G-20 leaders, to prevent the recurrence of speculative bubbles and opaque OTC positions leading to financial crises. In a statement regarding new European derivatives oversight, EU Commissioner Michel Barnier described it as "a key step in our effort to establish a safer and sounder regulatory framework for European financial markets" (European Commission, 2010). In a 2010 statement on the Dodd-Frank Act, Chris Dodd, United States Senator and co-author of the legislation, noted, "the American people have called on us to set clear rules of the road for the financial industry to prevent a repeat of the financial collapse that cost so many so dearly. This bill meets that challenge…we have closed loopholes in regulations and required greater transparency and accountability for over-the-counter derivatives…" (United States Senate, 2010). Such parallel proclamations from policymakers on either side explain why the two jurisdictions have developed similar stipulations with respect to derivatives oversight.

Nonetheless, whereas the statutory components of derivatives reform in the United States and EU are fairly congruent, implementation and rulemaking activity have diverged significantly since the new frameworks were enacted. In terms of the issue area itself, the vast complexity of derivatives markets and oversight has led regulators on each side to encounter considerable problems and uncertainty. As a result, rulemaking activity has lagged behind deadlines, and in some cases has been inconsistent with statutory provisions. This explains a significant portion of the divergence in implementation. At a structural level, we observe that differences in the regulatory process between the jurisdictions have contributed to further divergence. Additionally, as with capital adequacy reform, derivatives oversight comes with an incentive to defect as financial actors stand to gain from regulatory arbitrage. This has also contributed to divergent rulemaking.

Derivatives regulation has an immense number of elements, with substantial difficulties arising in each. One area that has proven tricky and problematic is that of central clearing counterparties. Regulators have faced the challenge of determining which end-users and financial entities should be subject to clearing obligations. In the United States, the solution is that the clearing requirement applies to anyone trading an eligible contract, yet certain non-financial entities may be exempt when engaging in hedging activities. The EU maintains an exemption based on the magnitude of the non-financial entity's derivatives position (Lambert et al., 2011), rather than the nature of the position (whether or not it is employed for hedging purposes). This is a technical discrepancy that stems from the intricacy of derivatives markets and signifies variation in the level of reform. The European approach likely represents more effective oversight; a position limit accomplishes the goal of curtailing risk without the need to create distinct definitions for hedging and speculation. In practice, the line between the two types of derivatives positions is difficult to demarcate, as hedging can often easily disguise speculative bets (Kelleher, 2012).

Another area of complexity is the extraterritorial impact of derivatives reform. In connection with commodity-based derivatives, the Dodd-Frank Act targets all swaps that have a "direct and significant connection with activities in, or effect on, commerce in the United

States." Meanwhile, the EMIR and MiFID II apply to OTC derivatives contracts that have "a direct, substantial and foreseeable effect within the EU" (Dening et al., 2012). The global interconnectedness of derivatives trading has given rise to a situation where different rules apply to the operations of European financial entities in US markets and the operations of American financial entities in European markets. This marks a failure of regulatory harmonization, and is an issue that will have to be addressed in the near future through transatlantic coordination.

The divergence of implementation in the two jurisdictions is also due to structural and institutional differences in the way regulation works. One of the key differences between the American and European approaches is in the assignment of rulemaking powers. The Dodd-Frank Act grants regulatory agencies, such as the US Securities and Exchange Commission (SEC) and the US Commodity Futures Trading Commission (CFTC), wide-ranging authority to create the necessary rules and define requirements pursuant to the Act. For instance, it bestows the designated agencies with primary responsibility in developing the organizational and business conduct standards to be required of central counterparties and trade repositories. The EU framework, by contrast, provides less authority to regulatory agencies, and instead directs them simply to enforce predefined technical standards (Latysheva, 2012). The delegation of authority in the American framework allows regulators some freedom to implement policy in a manner inconsistent with the letter of the law. In the rule defining "swap dealers" and "major swap participants," the SEC and CFTC have included an exemption for swap dealer activity that hedges commercial risk. However, the Dodd-Frank Act stipulates a hedging exemption only for major swap participants, but not for swap dealers (Kelleher, 2012). In this manner, the structural mechanisms of regulation in the United States have the potential to undermine some aspects of derivatives oversight, while causing American reforms to diverge from their European counterparts.

Finally, as in the case of Basel III, derivatives regulation is affected by regulatory arbitrage. In both the United States and EU, derivatives reform has a significant impact on the profitability of financial institutions, according to analyst reports (Margolin & Henderson, 2010). Therefore, tougher derivatives rules in the United States are likely to push financial profits overseas and vice versa (Protess, 2011). In other words, policy convergence is inhibited by an incentive to defect. Implementation failures such as the one pertaining to swap dealer hedging in the United States, as well as the general slowness of implementation in the EU (Felsenthal, 2012), are likely due in part to financial industry resistance to the OTC derivative overhaul. Certainly, regulators are aware of the problem of regulatory arbitrage and have expressed concern over the implications of rulemaking asymmetries (Walter, 2012).

Derivatives regulation, then, has seen significant convergence in the frameworks for oversight, but subsequent divergence in implementation of reforms. The financial crisis exposed the free-for-all that has been the OTC derivatives market in both the United States and the EU, and both jurisdictions have recognized the need to address this. This has led to convergent outcomes in new derivatives legislation. At the G-20 level, policymakers have expressed the need for internationally harmonized derivatives reform, a need that has been emphasized by the interconnectedness of global derivatives markets and the phenomenon of regulatory arbitrage. Despite this, regulation has diverged between the United States and EU on account of the complexity of the derivatives issue, structural differences in oversight, and the interests of the financial industry. For this reason, derivatives regulation resulting from the 2008 financial crisis is less effective as a transatlantic regulatory response than the Basel

III agreements.

Section 3: Systemically Important Financial Institutions ("Too Big to Fail")

The most politically charged consequence of the 2008 financial crisis was the failure and subsequent bailout of major financial institutions such as Bear Stearns, AIG, and Citigroup. These institutions were believed to be "too big to fail," meaning that their financial holdings were so great that their collapse would spread to counterparties throughout the financial system and cause widespread panic. This view was probably correct, seeing as the fall of Lehman Brothers (which was not bailed out) had severe ramifications, while the bailout of certain institutions prevented large-scale financial disintegration. At the same time, these events illuminated the need to regulate SIFIs, such that governments (and taxpayers) are not handcuffed by an obligation to save "too big to fail" institutions if and when they go under.

The international consensus on TBTF regulation is centered around the need to address the systemic and moral hazard risks associated with SIFIs. It involves a new transatlantic standard for resolving the failure of SIFIs and new requirements for SIFIs to have additional loss absorption capacity, as well as more intensive and effective supervision of all SIFIs at the national and international level (G-20 Financial Stability Board, 2011). Such measures are intended to reduce the likelihood of SIFI failure, lower the impact of failure, and shift the burden of failure from taxpayers to the financial institutions themselves (Freeman et al., 2011). Considering that most SIFIs are multinational corporations whose financial activity is global in scope, international cooperation is an essential aspect of TBTF reform.

In the United States and EU, the key regulatory tool to safeguard against SIFI failure has been the requirement of "living wills" (known also as resolution and recovery plans, or RRPs). These are plans drafted by individual financial institutions in concordance with regulators that provide for "rapid and orderly resolution in the event of material financial distress or failure." (Smith et al., 2011). The goal is to minimize the financial disruption caused by such an event, while also protecting taxpayers from the obligation to finance SIFIs in situations of distress. From the range of possible responses to the TBTF problem, living wills have been pursued most strongly by American and European policymakers. In fact, the bulk of legislative proposals pertaining to SIFIs center on crisis management through recovery and resolution frameworks[3].

Progress on living wills (and the TBTF question in general) has been fairly uneven between the two jurisdictions, as construction of the EU framework has lagged significantly, owing mainly to the European sovereign debt crisis (Price & Khalique, 2012). For this reason, the analysis here will focus primarily on the debate regarding SIFI regulation, and determine why meaningful transatlantic agreements have yet to take form. An examination of the comments and proposals brought forth on the TBTF issue reveals that the major obstacles are structural and institutional heterogeneity. In addition, policymakers everywhere have struggled with TBTF as a vastly complex regulatory concern.

The largest structural obstacle to convergence in SIFI regulation is the need to maintain policy coordination and consistency among EU member states. Considering that the EU has not quite attained the status of fiscal federalism, it must take into account the legal separateness of the entities involved in SIFI resolution plans (Nieto, 2009). Several EU members have created their own resolution tools, while the European Commission has been slow

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3 Based on summaries of US and EU legislation from: Dodd Frank and Related Reforms, Morrison & Foerster LLP (See note 1); EU Response to the Economic and Financial Crisis, European Commission.

to develop an overarching framework. The United Kingdom's Financial Services Authority drafted its RRP proposals one year ahead of the European Commission ("Living Wills in the UK," 2012), and these proposals have already reached the preliminary stages of implementation (Huw, 2012). Spain has independently established the Fund for Orderly Restructuring of Banks, which acts as an insurance agent and provides financial restructuring to failing banks (G-20 Financial Stability Board, 2012). Other European countries have put in place different resolution measures, so while there has been progress in the EU with respect to living wills, it has been frayed and inconsistent across member states.

Given that cross-border banking accounts for a massive proportion of financial flows within the EU, regulatory disparities among member states inhibit Europe's ability to tackle the TBTF question. Dexia and Fortis, the largest European financial institutions to fail over the course of the crisis, had engaged in expansive cross-border activity. Moreover, foreign assets make up over half of the holdings of major institutions such as Deutche Bank, Santander, and UniCredit (Franklin et al., 2011). Therefore, in order to create meaningful reform, a comprehensive living wills solution must be orchestrated at the EU level. This means that only an EU-wide framework would be comparable to the RRPs instituted in the United States under the Dodd-Frank Act. Still, without a harmonized insolvency regime and a single supervisory authority for cross-border financial institutions, the best the European Commission can do is to construct a coordination framework based on common resolution tools and an obligation to consult and cooperate when problems arise (Green et al., 2011).

Beyond structural constraints, TBTF reform and the introduction of living wills have proven to be hugely complex policy issues. At the very core is the problem of defining size, interconnectedness, and systemic importance. In other words, it is extremely challenging for policymakers to determine what constitutes a financial institution whose failure would cause larges-scale economic disruption, and hence must put together an RRP. Then, there is also the question of what makes for an adequate living will for a given SIFI. Various methods and financial models can be used in attempts to resolve these uncertainties, but none provide obvious answers (Goldstein & Véron, 2011).

Though the TBTF issue has seen the least coordinated and significant international response, it has perhaps the greatest potential for successful implementation. In the case of living wills, preferences towards regulation are not tied to financial industry incentives. The introduction of living wills does not directly impact the operations and profitability of financial institutions (Freeman et al., 2011), and therefore does not generate an incentive to defect from regulatory commitments. As a result, there is little reason to fear the problem of asymmetric implementation with respect to any future cooperation or policy convergence in the realm of RRPs. Rather, if the policy challenges posed by the complexity of living wills and structural constraints are overcome, the changes that ensue are likely to be meaningful and long-lasting. This may enhance transatlantic financial stability by limiting the contagion effects from the failure of large financial players.

Conclusion

The regulatory challenges presented by the 2008 global financial crisis have been immense. The collapse unveiled deep structural flaws in the financial system, which have generated high levels of systemic risk and led to massive disruption of financial intermediation. Owing to the interconnectedness of financial markets, this problem has necessitated an international policy response. Specifically, transatlantic regulatory cooperation, or at least policy convergence among jurisdictions, has proven key to ensuring the future stability of the global financial system. If the EU, for instance, were to enhance macroprudential oversight while the United States did not, the EU would not achieve financial stability. A major shock to American banks could easily be transmitted to Europe, as was the case in 2008. Accordingly, a situation of policy asymmetry, or regulatory arbitrage, is to be avoided.

Transatlantic cooperation in financial regulation has been mixed in depth and scope, depending on the issue area. Reform in capital adequacy requirements has seen meaningful cooperation. Basel III is an overarching, far-reaching framework that requires banks to change their operations significantly in order to lower their overall risk. Nonetheless, it may yet prove ineffective since implementation lies in the hands of individual jurisdictions whose incentives may undermine new capital adequacy regulation. In derivatives, meanwhile, a fair amount of policy convergence has been observed, though the complexity of the derivatives issue and structural differences in rulemaking have generated considerable uncertainty. Furthermore, as with capital adequacy regulation, countervailing incentives may weaken derivatives reform. Finally, the "too big to fail" concern has mostly vexed international regulators, due to the remarkable complexity of the problem as well as structural differences between the United States and the EU. Despite this, living wills proposals appear to be a useful regulatory tool with potential for future success.

It is imperative that transatlantic efforts to institute financial regulation accomplish significant reform. In the United States and EU, the financial industry has exerted exorbitant political influence for too long, resulting in risky practices that have jeopardized the proper functioning of the economy. Though not all elements of regulatory reform are as straightforward as capital adequacy requirements, and preferences among jurisdictions are not everywhere consistent, regulators must make sure they get it right. Through deeper cooperation, the United States and EU should be able to prevent the recurrence of crippling financial collapse.

Author's Notes

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