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Barely Contained *Outrage*

BY KLAUS C. ENGELEN

What the Europeans really think about America's regulatory blunders.

Today there is outrage and anger in Europe at those responsible in the United States for setting the world financial system on fire. The issue most upsetting to Europeans is "American rating power" and the misleading high ratings that the "rating duopoly" of Moody's and Standard & Poor's gave to what eventually turned out to be "toxic waste" in bank balance sheets and investor portfolios. Since all major rating agencies—including Fitch—are licensed by the U.S. Securities and Exchange Commission, Europeans have sounded a battle cry for stricter regulation of the rating business and for the establishment of a European rating agency.

There is also anger at those bankers and officials in Europe who helped bring the financial meltdown to their side of the Atlantic by looking for higher yields through off-balance-sheet special purpose vehicles such as SIVs and conduits investing in complex securitized instruments. The contamination of Europe's financial markets with highly toxic materials exported from the United States has left a path of destruction in bank balance sheets and in equity portfolios. Since banks ceased trusting each other, they stopped lending on the interbank and commercial paper markets and put their overnight money in central bank accounts at minimal rates. To be on the

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safe side is still the call of the day. So far, the €1 billion guarantee umbrella rolled out by the governments for the money markets seems not to be working on the continent. The liquidity crisis is ongoing. As equity markets tumble, investors not only in the United States but also Europe and the rest of the world are counting their losses.

One reason the U.S. subprime crisis has turned into a time bomb for the international financial system is that a crucial legal difference in U.S. mortgage finance was often overlooked by investors in securitized mortgage debt instruments. The United States has a non-recourse mortgage system under which only the real estate property—the homes bought and financed by a mortgage contract—serve as collateral. Someone who buys a house and takes on mortgage debt is not—as is the case in most other jurisdictions—personally liable to pay back and service the mortgage debt. Mortgage lenders have no recourse to other property or income.

Also overlooked by many outside investors was the debt explosion in the United States in the run-up to the subprime crisis. As analyst Kevin Phillips notes, in the critical period from 2001 to 2007, outstanding foreign debt increased from $872 billion to $1,783 billion, an increase of 104 percent. Outstanding home mortgage debt grew from $4,923 billion to $9,961 billion, an increase of more than 102 percent. Outstanding domestic financial debt expanded from $8,482 billion to $14,529 billion, an increase of 71 percent. And on a year-to-year basis between 2000 and 2006, the annual U.S. current account deficit increased from $420 billion to $857 billion, or 104 percent.

A Lafontaine Valentine

There are deep suspicions in Europe about the recent U.S. crisis management. Why did Treasury Secretary Henry Paulson let Lehman Brothers go bust? When the U.S. authorities on September 15, 2008, let Lehman Brothers file for Chapter 11 bankruptcy protection, after having saved Bear Stearns earlier in March and taken over the insurance giant AIG, the impact was seen by some in Europe as an act of economic warfare. Was Lehman Brothers chosen by the U.S. authorities, asks a German finance official, "fully aware of its staggering European exposure?"

Having amassed an estimated fortune of $700 million as chairman of Goldman Sachs, Paulson symbolizes the close collaboration of the U.S. government with Wall Street. On a popular talk show, Oskar Lafontaine, former German finance minister and SPD leader who now heads the left-wing "Die Linke" party, made this provocative comparison: "To put a former Goldman Sachs chairman in charge of the U.S. Treasury (and the U.S. rescue operation to combat the financial crisis) is like putting a drug baron in office to fight the war on drugs."

—K. Engelen

The U.S. Treasury's **Henry Paulson:** *Not winning any popularity contests on the continent.*

Both the official and private sectors are struggling with a credibility crisis of historic proportions.

What makes things worse now: In spite of the buzz of formal and informal interchange between the official side and the private sector, tension and distrust between supervisors and the chieftains of the finance industry are still building. This hampers addressing the financial turmoil and working on initiatives to make global financial markets and institutions more resilient.

Both the official and private sectors are struggling with a credibility crisis of historic proportions. Supervisors and regulators on both sides of the Atlantic are licking their wounds. What happened in the United States under the eye of the Federal Reserve, the Securities and

Exchange Commission, and other supervisory authorities has shattered the belief that a decade of reforming the international financial architecture and enhancing market and institutional stability has made global financial markets a safer place. And in view of the "supervision blackouts" in the United Kingdom, Germany, and Switzerland, Europe has also made its share of blunders. Repairing and rebuilding today's global financial model is all the more difficult. One of the few remaining icons on the global financial stage with credibility, former Federal Reserve Chairman Paul Volcker, sums it up rightly: "Simply stated, the bright new financial system—for all its talented participants, for all its rich rewards—has failed the test of the marketplace."

Major reasons the "bright new financial system" failed the test of the marketplace include the blocking of even minimal regulation of over-the-counter derivatives trading by key U.S. policymakers such as former Federal Reserve Chairman Alan Greenspan, former U.S. Treasury Secretary Robert E. Rubin, and former SEC Chairman Arthur Levitt; the tearing down of regulatory barriers in mortgage finance in the United States which paved the way for large-scale securitization and global marketing of subprime mortgage debt; and the SEC waiver of its leverage rules in April 2004. Previously, broker/dealer net-capital rules limited firms to a maximum debt-to-net capital ratio of twelve to one. The 2004 exemption allowed them to exceed this leverage rule. Only five firms—Goldman Sachs, Merrill Lynch, Bear Stearns, Lehman Brothers, and Morgan Stanley—were granted this exemption. They promptly levered up to twenty, thirty, and even forty to one.

These were the Wall Street firms that provide the largest portion of campaign financing to Republicans and Democrats. And it was the millions of dollars flowing from the U.S. finance industry into the political system in Washington that helped tear down the remaining regulatory barriers and keep regulators at bay. Wall Street's "Masters of the Universe"—the five major investment banks and the globally operating commercial banking giants such as Citicorp, JP Morgan, and Bank of America—might have brought their downfall on themselves. But as it now looks as if they may have caused the worst global financial meltdown since the 1930s Great Depression. During the securitization boom they set themselves on the path to becoming multimillionaires. Now the political system they used to finance in order to keep markets free and unregulated has to socialize their staggering losses while helping to secure their private gains. The losers are the taxpayers, investors, and the unemployed.

Policymakers around the world who are struggling with today's economically and socially destructive global financial meltdown are learning the hard way that "regulatory capture made in the USA" can be more destructive and more costly than George W. Bush waging war in Iraq.

"Regulatory capture" is a term used to refer to situations in which

The Dangers of "Regulatory Capture"

When the prestigious Group of Thirty announced a new study on the eve of the Washington meeting, titled the "The Structure of Financial Supervision," by former Fed Chairman Paul Volcker and former Fed Vice Chairman Roger Ferguson, some European officials reacted sarcastically. For some of his former colleagues, Ferguson—called "Greenspan's Rambo-Deregulator"—epitomizes all that has gone wrong with U.S. deregulation and hands-off supervision of financial markets in recent years. After leaving the Federal Reserve Board in June 2006, Ferguson became chairman of Swiss Re America Holding Corporation and since 2008 has taken on the presidency of the retirement fund TIAA-CREF. So negative were some European reactions to the Group of Thirty announcement that on October 6 *Handelsblatt,* the German financial and economic daily, did a page-long piece about members of the Group of Thirty who, as former central bankers and supervisors, made a lot of money advising the major Wall Street firms that are at the roots of the crisis. In the view of a leading European financial market supervisor, the Group of Thirty should be selected as a case study of how "regulatory capture" at the highest power level worked in the lead-up to the present financial meltdown.

—K. Engelen

What key policymakers in European capitals are saying—speaking on or off the record—reveals a shattering of trust in the integrity of financial market regulation and banking supervision in a global financial system still dominated by the Anglo-Saxon banking centers.

a government regulatory body created to act in the public interest instead acts in favor of the commercial or special interest that dominates in the industry or sector it is charged with regulating. This theory, developed by Nobel laureate George Stigler and others, can be helpful in explaining at least partially how the worst global financial meltdown in our lifetime came about.

The levers of regulatory capture are not only influencing national regulatory and supervisory agencies but also international monetary and financial institutions. So one can ask: Did the International Monetary Fund or the Bank for International Settlements warn in time that the securitization boom with its frighteningly huge derivative volumes might end in a global financial meltdown? Was either caught by surprise?

Well, yes and no. Their staffs can argue that capital market experts at both institutions have published dire warnings for years. But they were not allowed to shed full light on the mountains of SIVs and conduits outside of bank balance sheets and what this may have meant in terms of systemic risk. In recent years neither the International Monetary Fund nor the Bank for International Settlements have provided aggregated overviews of the staggeringly large speculative investment flows through off-balance sheet special purpose vehicles that would have shocked market supervisors and policymakers. It didn't happen because it would have ruined the major segment of growth and profits—the securitization boom.

Here are some concrete examples from insiders of the International Monetary Fund and the Basel-based Financial Stability Forum on how regulatory capture works in such international bodies on issues that are sensitive to the interests of the world's biggest debtor.

"High on the priority list for the U.S. Treasury and the Federal Reserve Board was to keep the International Monetary Fund, the Financial Stability Forum, and other international bodies from assessing the U.S. financial system," says an IMF insider. "Since the International Monetary Fund started its Financial Sector Assessment Program in 1999, the world's biggest debtor country, the United States, is still playing the role of the 'Untouchables,' keeping the International Monetary Fund from having an in-depth look at the exploding debt that has been underpinning the U.S. housing and spending boom during recent years." The IMF website offers FSAP assessments for Uganda, Ukraine, United Arab Emirates, the United Kingdom, and Uruguay under the letter "U." The United States, whose financial sector absorbs a large part of the world's savings and capital surpluses, so far doesn't appear on the FSAP list. This may also explain, argues the IMF insider, "why in recent years U.S. policymakers made sure that not much aggregate global data on the so-called 'shadow banking' structures, flows, and leverage trends was gathered and published by the major financial institutions."

According to insiders, this policy of the "invisible hand" to limit IMF surveillance of exploding U.S. debt went farthest under the reign of Anne O. Krueger as first deputy managing director (September 2001–August 2006). To make sure that discussions of the vulnerabilities of the U.S. financial sector would not be showing up in IMF Article IV consultations with the U.S. authorities, she did not allow IMF financial sector experts to take part in the consultations with U.S. representatives. This way she could make sure that only macroeconomic issues would be covered.

During that critical period of relentless debt buildup and Wall Street excesses, U.S. representatives pursued a similar policy of "selective discussions" and "selective disclosures" in other important fora. When Roger Ferguson, deputy chairman of the Federal Reserve Board, headed the Financial Stability Forum (May 2003–April 2006), he let representatives of the other member countries know that the Financial Stability Forum should push deregulation but leave perceived vulnerabilities of the U.S. financial markets to the

Sarkozy, Steinbrück, and Brown: The Three Musketeers Take on the Global Crisis

Although French President Nicolas Sarkozy manages to project the illusion of European-U.S. unity when talking to the press on the lawn of the White House with outgoing U.S. President George W. Bush by his side, when addressing the work on a new financial architecture he didn't mince his words. "Financial turmoil around the world shows that markets and the laissez-faire attitude have failed," he said in Toulon. "The idea of self-regulation to solve problems is over. Laissez-faire is over. The all-powerful market is over."

Sarkozy called for heavy regulation of financial markets to dampen speculation and for practical steps to rid the corporate world of its excesses. He urged executives to self-regulate remuneration, or the government would intervene before the end of the year. Banks should go back to their basic job of providing money to businesses. "We've let banks speculate on markets instead of doing their job of collecting savings and financing production," he said. High on Sarkozy's agenda is a global effort "to regulate the financial sector and rebalance the foreign exchange markets." In his view, "we need to reset the whole world financial and monetary system, as happened at Bretton Woods after World War II." This will "allow us to create the worldwide regulation tools that globalization requires." And he warns: "We must oppose financial capitalism with a capitalism of entrepreneurs." The present system "has created inequality, demoralized the middle class, and boosted speculation."

Sarkozy: "Laissez-faire is over. The all-powerful market is over."

While British Prime Minister Gordon Brown and French President Sarkozy took center stage as "crisis managers," German Chancellor Angela Merkel left much of the nuts-and-bolts work to her finance minister, Peer Steinbrück, whose speech before the Bundestag on September 25 this year, and an interview with *Der Spiegel,* contained some of the harshest U.S. bashing heard on record in a long time. "Wall Street and the world will never again be the way they were before the crisis," said Steinbrück. "There will be shifts in terms of the importance and status of New York and London as the two main financial centers … State-owned banks and funds, as well as commercial banks from Europe, China, Russia, and the Arab world will close the gaps, creating new centers of power in the financial world. … The source and focus of the problems are clearly in the United States." The cause of the crisis "was the irresponsible exaggeration of the principle of a free, unrestrained market," he told the Bundestag.

Steinbrück: "The source and focus of the problems are clearly in the United States."

"This system, which in many ways is inadequately regulated, is now collapsing," he continued, although he stated that Germany's banking system remained "relatively robust," with German regulators confident they can absorb losses. "New traffic rules" were needed, he said. "The United States lacked laws, a regulatory framework that would have prevented," what Steinbrück called "uncontrolled speculation" in an interview. The world financial system will consequently become more "multipolar," he predicted.

He also doesn't hesitate to mock U.K. Prime Minister Gordon Brown's recent conversion to the cause of financial-market regulation that "comes two years too late," adding that "had Brown acted sooner he might have helped avert the current crisis." Lauding Brown's "six-point paper" pushing for tighter regulation and global bank supervision, including a strengthening of the International Monetary Fund, he reminded Brown: "I would have rejoiced if he had published that paper two years earlier." The fact is that similar measures that Chancellor Angela Merkel's government proposed during Germany's presidency of the Group of Eight were rejected by the United States and by Brown, who was then Chancellor of the Exchequer under Prime Minister Tony Blair.

—K. Engelen

Nicolas Sarkozy

Peer Steinbrück

Gordon Brown

The Best Regulators Money Could Buy

Only five firms—**Goldman Sachs, Merrill Lynch, Bear Stearns, Lehman Brothers,** and **Morgan Stanley**—were granted this exemption, a waiver of maximum debt-to-net capital ratio of twelve to one. They promptly levered up to twenty, thirty, and even forty to one.

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Americans. But there are some at the Financial Stability Forum who reject this criticism of Ferguson, arguing that they have worked with him constructively over those years and found his contributions very valuable.

EUROPE: ALL TOGETHER NOW

"The mighty storm from America, channelled by the high degree of financial interdependence between the two sides of the Atlantic, has started to wreck Europe's banks," warned Nicolas Véron, research fellow at Bruegel, whose article, "All Together Now," appeared October 3 in the *Wall Street Journal.* That is exactly what happened.

After denial and delay, Europe is facing up to the turmoil and the shockwaves of a financial crisis that has threatened since investors started to withdraw from subprime mortgage debt instruments in the latter half of 2006. Never since outgoing U.S. President George W. Bush formed his "coalition of the willing" and started the war in Iraq have leading European politicians used such blunt words to refer to U.S. responsibility for the mammoth global crisis (see box).

There is also the realization among European bankers, supervisors, and regulators—as in the case of Germany—that they should have put the brakes on bank-sponsored off-balance-sheet special purpose vehicles in offshore centers such as Dublin. In the case of Germany, there is some hypocrisy at work as politicians and legislators lay blame on the banking supervisors. As owners of the Landesbanken, the politicians would have accused the bank supervisors of not allowing German banks the needed "level playing field" against their European and international competitors had regulators shut down the Landesbanken's Dublin offshore operations much earlier.

"In that respect Europe has its own severe moral hazard problems in bank regulation," admits Achim Dübel, who worked for the World Bank and is now a financial sector consultant. "Take Ireland as an example, which in the past fifteen years adopted aggressive beggar-thy-neighbor policies in finance. Germany had closed the option for mortgage banks to run open interest rate risk positions in 1999 through the so-called 'gentleman's agreement.' Less than two years later, one of the banks that was most dependent on generating profits in this way, public finance provider Depfa, relocated to Dublin where it benefited not only from looser regulation but also from a corporate tax rate of only 12.5 percent, far below German levels. By 2008, the interest rate risk exposures of Depfa—and its inability to get short-term refinancing due to the liquidity crisis—were the main trigger bringing down its new mother company, Munich-based Hypo Real Estate."

What key policymakers in European capitals are saying—speaking on or off the record—reveals a shattering of trust in the integrity of financial market regulation and banking supervision in a global financial system still dominated by the Anglo-Saxon banking centers. This crisis of confidence makes it difficult for governments, supervisors, and regulators to rebuild confidence in markets with lenders and investors.

As European policymakers are aware of their dismal failures of supervision in their own banking systems, they also are learning fast how the "Masters of the Universe" on Wall Street were able to get politicians in Washington to tear down regulatory barriers so they could make billions in additional profits in originating, packaging, and marketing structured finance products

In Berlin, politicians of both ruling parties are urging "new traffic rules" for global financial markets.

that turned out to be "toxic waste" contaminating the world financial system. In this process of reckless deregulation, the U.S. Federal Reserve and the major regulatory agencies played the role of willing helpers, as is becoming obvious as the U.S. Congress looks into the causes of the financial meltdown.

This explains why there are deep suspicions in Europe about the recent U.S. crisis management. Why did Treasury Secretary Henry Paulson let Lehman Brothers go bust? When the U.S. authorities on September 15, 2008, let Lehman Brothers file for Chapter 11 bankruptcy protection, after having saved Bear Stearns earlier in March and taken over the insurance giant AIG, the impact was seen by some in Europe as an act of economic warfare. Was Lehman Brothers chosen by the U.S. authorities, asks a German finance official, "fully aware of its staggering European exposure?"

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European policymakers and supervisory authorities, thinking that their largely deposit-based banking systems would be safe from the fallout of the demise of Lehman Brothers, were taught harsh lessons. Soon European governments were forced to come to the rescue of major banking groups. To save giant Fortis Group required a joint government operation with Belgium, the Netherlands, and Luxembourg. To bail out the Franco-Belgian Dexia banking group, France, Belgium and Luxembourg injected capital and guaranteed new borrowing. And to rescue the giant German mortgage lender Hypo Real Estate and its Dublin subsidiary Depfa called for €50 billion provided by the German government and leading German banks.

After British Prime Minister Gordon Brown, on October 12, presented a plan to deal with the financial crisis, Euroland had to come up with its own rescue proposals. The elements included unfreezing money markets through state guarantees on bank debt, adding liquidity to the system, recapitalizing financial institutions with injection of public money of appropriate value where necessary with the state taking preference shares or other instruments in return, and loosening mark-to-market accounting in order to mitigate some of

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the losses taken on assets that have been written down substantially.

A report by BNP Paribas dated October 23, 2008, shows that recent rescue pledges by governments—capital injections, new debt issuance guarantees, and other emergency measures—have been large for some countries, small for others.

Measured as share of GDP, Ireland with its large offshore banking center leads with 260 percent GDP, followed by Sweden (49 percent), Netherlands (39 percent), Austria (37 percent), Slovenia (24 percent), United Kingdom (21.4 percent), Germany (20 percent), France (19 percent), Norway (15.4 percent), Spain (14.3 percent), Finland (12.8 percent), Portugal and Greece (12.3 percent each), South Korea (10.3 percent), and Luxembourg (8 percent). In the case of the United States (5.1 percent), only the $700 billion, not the Fed's facilities such as the Money Market Investor Funding Facility, are counted. Since Italy's Banca d'Italia put the brakes on SIVs and conduits early on, its rescue pledge of 2.6 percent GDP remains very small, as is the case with Switzerland, where the capitalization of UBS amounted to 1 percent GDP.

THE GERMAN COMPLAINT

"After German and French officials, for years, have been prodding the United States and Britain for more transparency and more regulation and less self-regulation of financial markets," says a high-ranking member of the Financial Stability Forum, "one can imagine how furious the Europeans are now that they have to ask taxpayers to put up larger safety nets for their banks and depositors than Washington has been rolling out so far."

This is particularly the case for Germany, whose banks are highly exposed as leading international lenders to the world. Behind the high cross-border lending of

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Europe's Proposed New Rules of the Road

The Social Democratic Party of Germany proposes new rules for the international financial markets:

1. Increase liquidity and capital reserves for financial institutions! The liquidity cushions required under regulatory law must be augmented, greater attention must be paid to liquidity risks and liquidity buffers must be created. Stress tests must be optimized and the involvement of supervisors must be enhanced. Capital requirements must rise significantly as well: We want minimum capital ratios. This applies not least to loans to hedge funds. In future, banks should have to hold at least 40 percent capital for these loans.

2. Tighten accounting obligations for financial institutions! In the future, financial institutions must clearly state all risks on their balance sheets. They should not be allowed to transfer risks to special purpose vehicles—as was common to date. The EU Banking Directive is still not sufficiently precise in this regard. We believe there is an urgent need for a requirement to present risks using a standardized model. Current fair-value assessment must be made resilient to crises.

3. Establish a minimum 20 percent retention for securitizations! We need greater risk awareness across the entire financial system. The separation of lending decisions from responsibility for the associated risk must be reversed. As a consequence, financial institutions may no longer be allowed to securitize and pass on 100 percent of their lending risk. On the basis of international rules, they must, in our view, bear at least 20 percent of the risk themselves in the future.

4. Ban detrimental short selling! Detrimental short selling—in other words, speculation on falling share prices without holding the actual shares—has made the financial market crisis even worse. Detrimental short selling that exacerbates crises must be banned at international level.

5. Change incentive and remuneration schemes! Those who wish to benefit from profits must also bear losses. By amending financial sector reward and pay frameworks on the basis of an international code of conduct, we want to ensure that misconduct on the part of the individual is subject to sanctions for that person in the future.

We cannot accept the principle of "privatizing profits and nationalizing losses."

6. Make those responsible personally liable! We cannot accept the principle of "privatizing profits and nationalizing losses." We need international standards on greater personal liability for financial market participants. Their responsibility must also be reflected in the option for joint and several liability.

7. Strengthen European supervision! The European system of supervision must be improved further. Although initial steps have already been taken, they are by no means adequate. Above all, national and supranational cooperation between all regulatory authorities must finally be enshrined in the EU Banking Directive. The next step is to give the college of supervisors that are involved in regulating an international bank the powers to take binding decisions.

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German banks is the strong export performance and double-digit savings rate of the German economy. According to mid-2008 statistics from the Bank for International Settlements, German bank lending amounted to $4,600 billion (€3,700 billion), followed by French and British bank lending at about $4,000 billion, Japanese bank lending ($2,400 billion), and U.S. bank lending ($1,700 billion).

From a German perspective, there have been several encounters with the powerful levers of "regulatory capture" on the part of their Anglo-Saxon counterparts at the highest political level. German Chancellor Angela Merkel and her coalition partner, finance minister Peer Steinbrück, hit brick walls in Washington and London when asking for more transparency for hedge funds and structured products and getting some meaningful oversight of U.S.-licensed rating agencies. Merkel and Steinbrück, along with German financial market watchdogs BaFin President Jochen Sanio and Bundesbank President Axel Weber, are still feeling the bruises they received in these battles with the powerful interests of Wall Street and the City of London over financial market regulation. And Steinbrück's parliamentary experts on financial markets, SPD deputy chairman Ludwig Stiegler and Joachim Poss, used to come back from their regular scouting trips to Washington, New York, and London with the depressing message that only after a new financial crisis would the Americans and British give up their extreme deregulation policy.

Two key events made German officials increasingly suspicious about whether their American and British counterparts were presenting an adequate vulnerability assessment of their financial markets and institutions. After the German authorities saw that difficulties in the

8. Improve ratings! We should look into creating a European rating agency as a counterweight to the ones that have existed solely in the USA up to now. Rating agencies' advisory activities must be restricted. Rating agencies must undertake to apply the IOSCO Code of Conduct—which must be developed further. A European agency—potentially the Committee of European Security Regulators—should register and oversee rating agencies. The importance of ratings in assessing risks should be reduced.

9. Give the IMF a new core role! We need enhanced early warning capacities and better coordination between the International Monetary Fund and the Financial Stability Forum. To achieve this, the core competencies of both institutions must be bundled and enhanced. A joint IMF/FSF report could, in particular, raise the effectiveness of crisis prevention measures.

Ban detrimental short selling!

10. Strictly regulate hedge funds and private equity funds! Hedge funds and private equity funds must be monitored and regulated more effectively. The key issues for us are obligations to disclose asset and ownership structures, more stringent requirements to inform investors about risks, the limitation of excess debt financing and restrictions on investments.

11. Demand more transparency from sovereign-wealth funds! We welcome the latest progress facilitated by the IMF in obtaining a voluntary commitment from sovereign-wealth funds on greater transparency. We support further international, European and bilateral steps towards constructively integrating sovereign-wealth funds into the global financial system.

12. Strengthen participation rights for employees! Employees' role in the governance and management of a company is an important instrument for the business' long-term survival and must therefore be reinforced. There must be tougher sanctions for companies that breach their duties to provide information to works councils, as augmented through the German "Risk Limitation Act" (Risikobegrenzungsgesetz).

13. Plug the tax haven gap! Tax havens that exist internationally and the offshore financial centers that are largely free of regulation and legislation must be laid dry. Above all, we must fight tax evasion resolutely. We need new methods to do this. Regrettably, tax havens and places to park illegal funds still exist in Europe. Europe must therefore lead the way in combating both. We are calling for a revision of the EU Savings Directive with this aim.

14. Preserve Germany's three-pillar banking model—consolidate the Landesbanken sector horizontally! We are committed to Germany's tripartite, distinctively decentralized banking system of savings, cooperative and private banks. In the current crisis in particular, the federated group structures of the savings and cooperative banks have demonstrated a stabilizing effect. For this reason, we reject the idea of converting savings banks into joint stock corporations or other organizational forms under private law. The Landesbanken sector must undergo horizontal consolidation.

[Edit. note: Exclamation points have been reproduced verbatim from the original document.]

U.S. subprime mortgage market and in associated credit default swap products were causing turbulence in the markets for structured products, representatives at the Financial Stability Forum meeting in Frankfurt on March 29, 2007, were on high alert. To their surprise, U.S. authorities were still brushing aside the mounting risks in rising default rates on U.S. mortgage loans, weakening credit standards, and the growing problems of specialized mortgage lenders and structured finance packagers. German officials began using the code phrase "regulatory capture" to signal the cause for alarm.

Shortly afterward, against strong resistance from the United States and the United Kingdom, Merkel and Steinbrück took advantage of the Germany's host status at the G8 summit meeting at Heiligendamm on June 8 to put "recent developments in global financial markets, including hedge funds … along with the emergence of advanced financial techniques and products, such as derivatives" on the agenda.

They pointed out that "the assessment of potential systemic and operational risks associated with these activities has become more complex and challenging" and, "Given the strong growth of the hedge fund industry and the increasing complexity of the instruments they trade, we reaffirm the need to vigilant."

FINANCIAL INDUSTRY: SELF-REGULATION DISCREDITED

Few could have predicted some months ago that politicians, governments, and regulators would now be calling the shots. How the power equation between the official and private sector has rebalanced became apparent at the recent Washington meeting of the Financial Stability Forum.

This explains why the unprecedented effort of the finance industry—coming up with self-regulation proposals through the Institute of International Finance and the Counterparty Risk Management Policy Group (CRMPG)—was unceremoniously rejected by supervisors and regulators of the Financial Stability Forum. When FSF Chairman Mario Draghi, Italy's central bank governor, was asked how much of the finance industry proposals were accepted by the supervisors forum in its new "Implementation Report on Enhancing Market and Institutional Resilience," his frank answer was, "Not much." Out of the two-hundred-page report from the IIF Committee on Market Best Practices and its 118 recommendations, 39 principles, and 34 "considerations" that IIF Chairman and Deutsche Bank CEO Josef Ackermann presented in July as the work of one hundred senior executives from sixty leading banks working for about eight months: A single sentence in the FSF executive summary that reads: "We call on … private sector organizations that have recommended improvements to industry practices to establish frameworks for rigorously monitoring and reporting on their timely implementation."

Some have been reacting with unease and disbelief that former highly respected—but now somewhat discredited—colleagues have been making the rounds as if nothing had happened.

Even before governments and central banks were forced to save the banking systems at taxpayer expense, official reaction to the new self-regulation move of the finance industry was at best "correct." The official line in most capitals regarding the IIF Best Practices initiative and "Corrigan Group" recommendations was that this time around they would not let the finance industry derail new regulation by accepting another round of feel-good self-regulation proposals.

WHY A LOT OF BIG NAMES ARE NOT ICONS ANYMORE

After what is coming to light now about why "the bright new financial system … failed its test in the market place"—to use former Fed Chair Paul Volcker's phrase—some European government officials, central bankers, and financial market supervisors have been reacting with unease and disbelief that former highly respected—but now somewhat discredited—colleagues have been making the rounds as if nothing had happened. "After having made millions advising leading finance giants that produced and sold toxic waste products to investors around the world with terrible consequences, these ex-officials have a serious credibility problem," says a central banker. He was listening to Jacob A. Frenkel, the luncheon speaker at the 2008 IIF membership meeting in Washington, as the Group of Thirty chairman and AIG vice chairman was poring scorn on the G7 finance ministers communiqué. "How could Frenkel as vice chairman of AIG not have been aware that something terrible was going on with the insurance giant that had to be rescued with taxpayers money?" he questioned.

When the prestigious Group of Thirty announced a new study on the eve of the Washington meeting, titled the "The Structure of Financial Supervision," by former Fed Chairman Paul Volcker and former Fed Vice Chairman Roger Ferguson, some European officials reacted sarcastically. For some of his former colleagues, Ferguson—called "Greenspan's Rambo-Deregulator"—epitomizes all that has gone wrong with U.S. deregulation and hands-off supervision of financial markets in recent years. After leaving the Federal Reserve Board in June 2006, Ferguson became chairman of Swiss Re America Holding Corporation and since 2008 has taken on the presidency of the retirement fund TIAA-CREF. So negative were some European reactions to the Group of Thirty announcement that on October 6 *Handelsblatt,* the German financial and economic daily, did a page-long piece about members of the Group of Thirty who, as former central bankers and supervisors, made a lot of money advising the major Wall Street firms that are at the roots of the crisis. In the view of a leading European financial market supervisor, the Group of Thirty should be selected as a case study of how "regulatory capture" at the highest power level worked in the lead-up to the present financial meltdown.

Of course, Europe too has its share of fallen icons. This became apparent when European Commission chief José Manuel Barroso set up a high-level group of experts

headed by the former Managing Director of the International Monetary Fund, Jacques de Larosière, to look at cross-border financial supervision. The idea is to follow possible developments at the international level, where a global system of supervision is under consideration in the context of a "new Bretton Woods." The nomination to the group of Rainer Masera, a former managing director of Lehman Brothers which collapsed recently causing terrible losses to European institutions and investors, met with sharp criticism, as did the choice of Callum McCarthy, former chairman of the British Financial Services Authority that failed dismally in the Northern Rock disaster.

With the nomination to the group of Otmar Issing, former chief economist of the European Central Bank, U.S. investment bank Goldman Sachs landed a strategic coup. Since Issing, a highly paid adviser of Goldman Sachs in Frankfurt, was asked to head a similar "Expert Group" to advise German Chancellor Merkel on combating the financial crisis, Wall Street's powerhouse now has its own man in the most important new European expert panels—a nightmare for main rival Deutsche Bank. Issing was invited by Merkel after her first choice, former Bundesbank President Hans Tietmeyer, couldn't accept the offer. He happened to be a member of the supervisory board of Hypo Real Estate, the huge mortgage bank that had to be rescued with €50 billion, largely from taxpayer money, and has already announced that it needs €15 billion more.

One urgent question both the EU High-Level Expert Group and the German "expert group" should look into is whether putting in force non-identical rescue programs in country after country opened the way to arbitrage incentives. Such arbitrage leakages are still hampering the functioning of interbank and commercial paper markets on the European continent.

This could have been avoided. Considering that the member countries of Financial Stability Forum got what amounted to a "worst case scenario planning paper" on April 1, 2008, the governments should be asked: With almost half a year of lead time, why was there not more international cooperation to make sure that possibly needed rescue operations would be timely and closely coordinated with the authorities of the major financial centers around world?

Had there been closer and timelier European and international coordination, the size and the costs to taxpayers of the government rescue pledges might have been substantially lower. In the case of the German rescue operation, some perverse forces are at work. So far the thrust of government aid—in terms of capital injections and guaranty pledges—is directed toward the public-sector Landesbanken. Thus, the new rescue operation is propping up the struggling Landesbanken at a much higher level, with two major advantages: no more controls by the EU Commission competition watchdog, and without the banking supervisors BaFin and the Bundesbank being able to say "No" or "How will the money be spent?"

WHY U.S. REGULATORS NEED HELP FROM EUROPE

Considering all the high-level talk about developing an early warning system with a refocused International Monetary Fund playing a key role, there are chances in the present crisis that should not be overlooked. One chance is to rebalance transatlantic financial and regulatory power.

We at *TIE* have had some experiences with major regulatory power plays back when European central bankers and banking regulators still had clout. Now that Europe's financial markets have become increasingly dominated by Wall Street's "Masters of the Universe" and their willing Washington helpers in deregulation, it might be useful to look how an earlier transatlantic row—a story not much noted in the financial press—was decided in Europe's favor on the basis of common sense.

As Edgar Meister, former member of the Deutsche Bundesbank's Managing Board in charge of banking oversight, admits looking back: "Ten years ago we in Europe and at the Bundesbank were influential enough to tell the Americans that their plan, to rely on the assessment of risks by the banks themselves, would not be accepted by the European authorities."

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Meister was referring to the push by major U.S. banks for the "pre-commitment approach" for capital adequacy

"for better use of equity capital." This concept amounted to a short-cut preferential self-regulation for the major banks that were technically equipped to use risk modelling to assess their "adequate capital" on a risk-adjusted basis. This concept was developed by Federal Reserve economists Paul H. Kupiec and James M. O'Brien and strongly supported by Greenspan and by William McDonough, then president of the New York Federal Reserve, and his predecessor Gerald Corrigan, who had become managing director of Goldman Sachs. To organize support for the pre-commitment approach, McDonough—who later became the architect of Basel II—sponsored a Fed conference on "Financial Services at the Crossroads: Capital Regulation in the 21st Century," in February 1998. The Bank of England and the Bank of Japan also supported the conference.

In view of the "supervision blackouts" in the United Kingdom, Germany, and Switzerland, Europe has also made its share of blunders.

Bank supervisors in Basel and on the European Continent rose up in protest. Edgar Meister and Jochen Sanio, then Deputy President of Germany's Federal Banking Supervisory Authority in Berlin, actively organized opposition among regulators and supervisors on the continent. "If put into practice, the concept of pre-commitment would boil down to a radical departure from the traditional understanding that capital requirements for credit institutions must be fixed, entirely or at least in its main features, by the regulatory authorities, which is also the basis of the Basel Committee's Capital Accord."

In a major piece in *TIE* ("Two Cheers for Basel?," March/April 1998), European supervisors and regulators attacked the Anglo-Saxon–led move by major U.S. banks for self-regulation in calculating their capital requirements, while the financial press on both sides of the Atlantic ignored the issue. These protests from Europe may have been helpful in blocking the joint move by major U.S. banks and their supervisors for deregulation.

This transatlantic row about easier bank capital adequacy rules ten years ago foreshadowed a similar push by the former five largest broker-dealers—Goldman Sachs, Merrill Lynch, Bear Stearns, Morgan Stanley, and Lehman Brothers—"to better use of equity capital" by the U.S. Securities and Exchange Commission on April 28, 2008. "If we supervisors on the European continent had not raised hell about the pre-commitment approach concept in time, we might have had the present global financial meltdown half a decade ago," says Meister, looking back on the row with the Americans and British about new risk adjusted capital rules. After the main deregulation promoter of the time, Federal Reserve Chairman Alan Greenspan, realized that European authorities would not accept the pre-commitment approach, he paved the way for new negotiations in the Basel Committee on Banking Supervision on the new Basel II Accord.

It remains to be seen whether Europe can regain some of its lost financial and regulatory power in the struggle over the new financial architecture and in future market developments on both sides of the Atlantic and globally. In Berlin, politicians of both ruling parties are urging "new traffic rules" for global financial markets. (See the "Europe's Proposed New Rules of the Road.") Some of their proposals will probably be met by strong resistance from the Americans and the British—if not during today's emergency phase, then in the medium term.

In any case, Achim Dübel, who predicted the U.S. subprime mortgage crisis and the threat of contamination of the markets for securitized products years before they caused the current global financial meltdown, adds a hopeful note. "I am optimistic that U.S.-European antagonism on regulation concepts will diminish after this crisis," Dübel argues. "Americans have understood that they need to overcome their S&L trauma, which led many to believe that bank regulation was useless and that capital markets and the shadow banks running them were the place to manage all financial risks. Europeans, more slowly, will start to understand that the reverse trend towards mega universal banks, moreover as national champions beefed up with lavish public deposit insurance, is perfectly undesirable as it may spell even greater trouble in the future through excessive risk concentration. The common discussion ground is therefore about which risks should be borne by the capital markets, how a reformed bank charter that makes productive use of the capital markets should look, and how for finance in general the lack of risk transparency, excessive product complexity, and transfer of risk to the wrong addresses can be penalized." ◆