

# The New Financial Services Marketplace Towards a safer and sounder system





# Foreword



The last two decades have been a period of enormous transformation in the financial services industry. During that time, there has been a shift from domestic firms engaged in distinct banking, securities, and insurance businesses to the creation of universal banks which offer a variety of products and services globally. These fundamental changes in the nature of banking have exposed the shortcomings of financial regulatory models, some of which have not adapted to the changes in business structure. The financial turmoil of the last year has made these weaknesses more apparent as a number of country authorities have struggled to respond effectively to the financial crisis. These challenges call for a careful assessment of current regulatory approaches, which was addressed with great debate at a recent Deloitte symposium.

On April 23, representatives of both the public and private sectors met to discuss global financial reform. The symposium, entitled “Shaping Global Financial Reform,” and co-sponsored by the Bretton Woods Committee, the Morin Center for Banking and Financial Law, and the Deloitte Center for Banking Solutions, addressed the international, domestic, and structural reform necessary to improve and stabilize the financial systems. During the day-long program, over a dozen speakers led by keynoters Sheila Bair, U.S. Chairman of the Federal Deposit Insurance Corporation and Paul Volker, former Chairman of the Board of Governors of the Federal Reserve, as well as others with deep government and private sector banking experience, expressed a variety of views on the future of financial reform.

While the day brought no consensus on the issues, there were important key points on which the speakers agreed. These included the need to regulate systemic risk and with that, the requirement for an overarching regulator; require more stringent regulation of the securitization and capital markets; increase international cooperation and standardization in both regulation and crisis resolution of the financial system; create a mechanism to deal with market procyclicality; and develop a new regulatory structure to monitor the incentives of market players.

While the path forward will not be easy, the good news, as Paul Volker said, “...past illusions are shattered.” We are ready to move on and “address a coherent approach to markets, institutions, and official responsibilities in structuring reform.” In the pages that follow, we provide our perspective on the issue of systemic risk and the challenge before government to do more than insure economic recovery, but just as importantly, to create a safer and sounder financial system over the long term. To get there will require a process to streamline regulation, increase the quality and quantity of capital, increase transparency, and develop a safety net for the systemically important. We hope you find these insights worthwhile.

Sincerely,

A handwritten signature in black ink, appearing to read 'Don Ogilvie', written in a cursive style.

**Don Ogilvie**  
*Independent Chairman*  
Deloitte Center for Banking Solutions

July 2009



# Executive summary

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**There is no perfect solution for today's troubled markets. Maintaining safety and soundness will likely remain a constant work in progress.**

Over the last several months, there have been a number of proposals for financial regulatory reform, culminating most recently in the U.S. Administration's proposals.<sup>1</sup> These proposals all share a common objective — the creation of a stronger and safer financial system. If implemented effectively, a more robust regulatory system may emerge, which will have significant implications for the way financial institutions operate in the future. Despite these bold steps, financial markets remain turbulent. This suggests that although we may be moving in the right direction, more work may need to be done.

A broad consensus is emerging among major financial regulators around the world that regulatory reforms should have the following features:

- A more systemic approach across the whole financial system
- Increased standards for capital and liquidity
- More transparent markets
- Greater protection for consumers and investors

Yet, while financial challenges remain global in nature, government responses are primarily local. The global imbalances that contributed to the current crisis remain and are likely to get worse. Projections issued by the Congressional Budget Office show a growing U.S. budget deficit over the next several years. The process of financial recovery has substituted public for private debt, and credit markets remain stressed with the potential for more crises in the future.

Government proposals outline an ambitious agenda. Regulations still have to be developed and implemented. Markets have demonstrated their capacity to change much more quickly than regulations, leaving regulators constantly in the position of playing "catch-up." The current "catch-up" is an ambitious task, requiring new

regulations and additional expertise and resources to manage institutions and markets constantly in flux. Financial institutions are still in the process of recovery. Increased regulatory oversight, however necessary, may impact the cost of financial intermediation, which could have further implications for profitability at a time when many institutions are already struggling to rebuild balance sheets and revise business models.

Our challenge is to take the many regulatory reform proposals and give them substance, building a safer and sounder system at the same time as we continue to stem losses. To achieve this, regulatory reform should have the following characteristics.

- **Comprehensive, streamlined regulations.** Regulatory reform should focus on a few key issues within the context of a stronger global regulatory framework. The most recent proposals from the U.S. Administration involve some streamlining and improved co-ordination across a number of regulatory agencies. Yet, different regulatory systems continue to exist in countries around the world, and these differences may persist for some time. To reduce the risks of regulatory arbitrage, regulators in different countries may consider focusing on a fewer number of essential regulatory requirements where there is a greater likelihood of international consistency, such as higher standards of capital and liquidity.
- **Government as "guarantors" of systemic risk.** The implications of recent regulatory proposals are that governments have accepted ultimate responsibility for managing systemic risk when institutions are unable to. This is reflected in the enhanced role of the Federal Reserve, which has become both lender and investor of last resort through its many programs. This represents a substantial de facto extension of government authority and responsibility from a financial system with assets

of \$13 trillion<sup>2</sup> (FDIC-insured banks) to one with assets approaching \$40 trillion.<sup>3</sup> While this may be within the scope of the United States to manage, smaller countries with a larger ratio of banking assets to GDP face considerable challenges in attempting to support an increasingly global financial system. Ultimately, the solution may lie in stronger supranational agencies, which would have important implications for national financial sovereignty that has already been eroded by global markets.

- **More transparent markets with continued innovation.** The recently announced U.S. proposals for financial regulatory reform would place robust reporting requirements on the issuers of asset-backed securities and require stronger oversight for over-the-counter (OTC) markets.<sup>4</sup> In addition, the SEC has announced its intentions to take a closer look at dark pools of liquidity, which enable large trades to be executed outside public exchanges at undisclosed prices. The financial system has grown beyond the scope of FDIC-insured institutions, sometimes at the expense of transparency. While this may have created additional risks, it has spurred essential innovation. The challenge is to preserve the ability to innovate without putting the whole financial system at risk.

- **Greater consumer protection in the context of more consumer and investor education.** The U.S. Administration in particular has signaled the importance of improved consumer protection. The European approach, led by the U.K.'s Financial Services Authority, has balanced the requirement for financial institutions to provide more information with programs that help consumers become more educated about financial products. Greater financial democratization may be a greater defense against another financial crisis than safer and sounder products alone. The FDIC is taking a similar approach.

The creation of a safer and sounder financial system requires striking a balance between the economy's need for a consistent and stable supply of credit and the market's need to reinvent itself as it constantly changes. We cannot "freeze" the financial system through regulation anymore than we can allow it to change without sufficient regulatory oversight. While we focus on a tighter regulation of the systemically important market, an ambitious task in itself, we must allow a less systemically important part of the market to thrive without threatening the stability of the system as a whole.



# The growing importance of systemic risk

The current crisis has highlighted the importance of systemic risk<sup>5</sup> — the interdependencies between financial institutions created by the growth of more integrated and global financial markets. A greater awareness of the role of systemic risk may have caused a shift in thinking about regulations away from focusing solely on individual institutions to also focus on the market as a whole. A number of reports and proposals have been published that recommend changes to current regulatory regimes. One recent report concluded “...most financial regulations seek to limit each institution’s risk seen in isolation; they are not sufficiently focused on systemic risk. As a result, while individual risks are properly dealt with in normal times, the system itself remains or is induced to be fragile and vulnerable to large economic shocks.”<sup>6</sup>

The U.S. Treasury Secretary has called for more extensive powers to address systemic risk within the U.S. financial system and for coordination with similar initiatives in other nations<sup>7</sup>. The U.K.’s Financial Services Authority (FSA) has called for a similar approach in their recently published Turner Review<sup>8</sup>. In the De Larosière Report<sup>9</sup>, the European Central Bank has called for a strengthening of both micro and macro prudential supervision—strengthening regulation and extending oversight across the whole financial system. As the Geneva Report<sup>10</sup> puts it, current “regulation implicitly assumes that we can make the system as a whole safe by simply trying to make sure that individual banks are safe...a fallacy of composition.”

Recognizing that even this may not be enough, the Group of Twenty (G20) has called for a new Financial Stability Board (FSB) as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission. The G20 has proposed that the FSB collaborates with the International Monetary Fund (IMF) to provide early warning of macroeconomic and financial risks and identify the actions needed to address them. This recommendation would reshape regulatory systems and extend regulation and oversight to all systemically important institutions, instruments, and markets. It proposes this should include hedge funds.<sup>11</sup>

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In summary, there is broad agreement on the approach to regulatory reform across many countries, but in designing a new regulatory system, we are still in the early stages of developing a blueprint. More details must be developed and many new regulations likely implemented before a new architecture emerges.



# Comprehensive, streamlined regulations

The financial regulatory systems in many countries have evolved largely in response to crises, have taken a variety of forms, and are in different stages of development. Some countries, and certainly the global financial system, lack an overall regulatory architecture. Reforms have often been incremental, with targeted changes made to existing oversight regimes. Others were wholesale adoption of very different regulatory approaches. This was recognized in a recent report by the Group of Thirty (G30) which identified at least four different regulatory approaches that have emerged around the world.<sup>12</sup>

- **Institutional approach.** This focuses on a firm's legal status (for example, a bank or broker-dealer), rather than its economic substance.
- **Functional approach.** Supervisory oversight is determined by the business transacted by the entity without regard to its legal status. Each type of business may have its own functional regulator.
- **Integrated approach.** A single regulator conducts both safety and soundness oversight and provides conduct of business regulations for all sectors of financial services.
- **Twin peaks approach.** This is a form of regulation by objective in which there is a separation of regulatory functions between two regulators: one that performs safety and soundness supervision and one that focuses on conduct-of-business

No "pure" example of any of these models actually exists, and blurring between approaches is prevalent. These different regulatory approaches have generally performed well in addressing disruptions during national level benign market conditions. They tend to focus more on the supervision of individual institutions than on the interdependence and interconnectedness among financial institutions and among markets that create systemic risk.<sup>13</sup> In addition, different approaches to regulation create opportunities for regulatory arbitrage, with financial institutions likely seeking regulatory regimes they consider more favorable.

## Towards a more global regulatory approach

It is unlikely that a global central bank will emerge in the near term to provide macro prudential oversight for the global financial system given the possible implication this has for national financial sovereignty, but a number of proposals have come forward recommending stronger powers for supranational agencies. To create an effective global regulatory structure, including both supranational and national regulatory authorities working together within a common framework, the following elements may be important:

- **A rule making (regulation) process.** To determine that systemically important markets and institutions are stable. This role could be assigned to Basel, the International National Association of Insurance Supervisors and other bodies.
- **A regulatory review process.** To determine that regulations passed by the rule making (regulation) process are consistent with broader principles of financial stability. Also regulations passed by national authorities could be reviewed to determine their consistency with broader international standards to prevent opportunities for regulatory arbitrage. This role could be performed by bodies such as the IMF and the FSB.
- **An enforcement process.** To ensure enforcement of global regulations at a national level. This role could be performed by national regulators.
- **A crisis management process.** This could be handled by national regulators, if necessary working together where cross-border issues were involved.

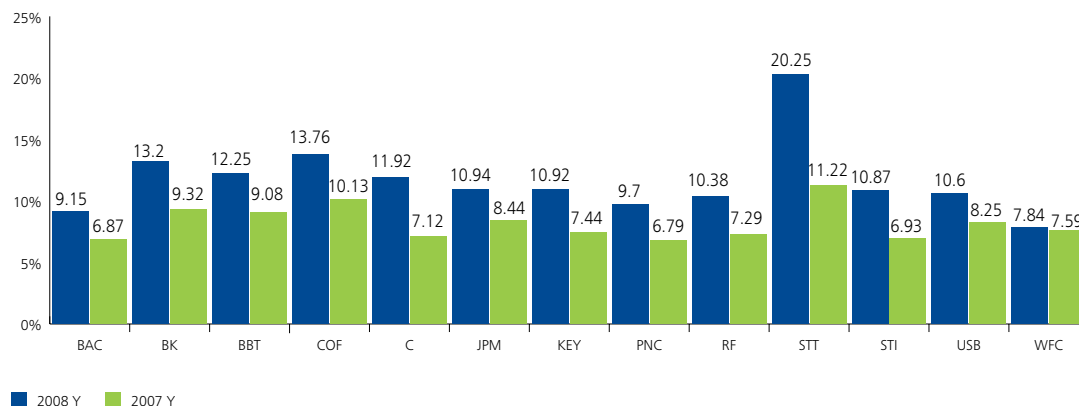
Such a framework has been suggested by Andrew Crockett, President of JP Morgan International and former Head of the Bank for International Settlement.<sup>14</sup> Support for a wider role for the IMF has the support of a number of bodies, such as the G30 and the European Central Bank. Whether such a structure will emerge or not, there appears to be a growing momentum in favor of a stronger global regulatory framework, with regulations issued by domestic authorities that consistently address global standards.

### Increasing the quality and quantity of capital and liquidity

Recent investor and regulator concern has focused on the quality as well as the quantity of capital.<sup>15</sup> Many banks have raised higher capital ratios than before, some boosted by government intervention in the form of preference

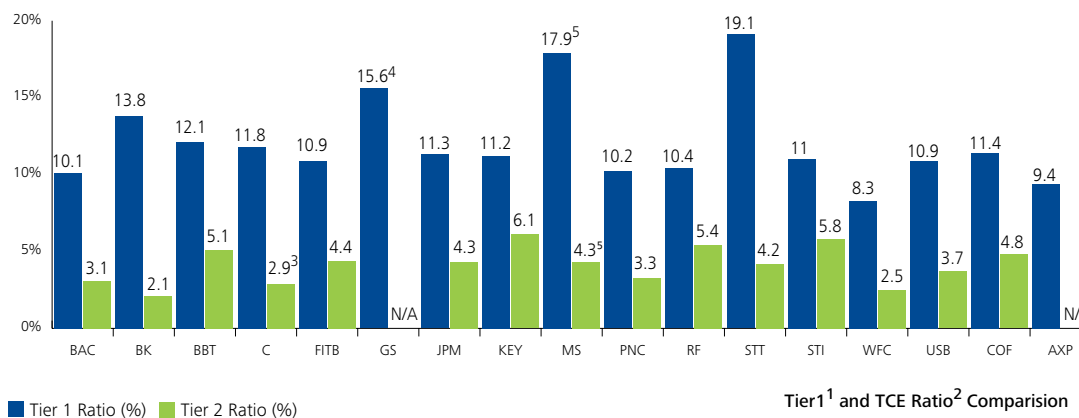
capital. (See Exhibit 1.) Regulators have long recognized the importance of common equity (core tier one capital) as the dominant form of capital. (See Exhibit 2.) Government preference capital is redeemable, and is therefore seen in a different light to other elements of core tier one capital.

**Exhibit 1: Tier one capital ratios – selected U.S. banks 2007-2008 (%)**



Source: SNL Financial

**Exhibit 2: Tangible common equity (TCE) and tier one capital ratios – Selected U.S. banks 2008 (%)**



Tier1<sup>1</sup> and TCE Ratio<sup>2</sup> Comparison

**Notes:**

- 1) Tier One Ratio as defined as Tier One Capital/Risk-Weighted Assets (RWA).
- 2) TCE Ratio as defined as Tangible Common Equity/Tangible Assets.
- 3) Figure is as of year-end FY08, December 31, 2008. Figure represents TCE/RWA.
- 4) Figure is as of year-end FY08, November 28, 2008.
- 5) Figures are as of year-end FY08, November 30, 2008.

Source: SNL Financial

### Measuring capital against risk

There are at least three reasons reinforcing the consideration of higher capital standards:

- **Capital may need to be adjusted for changes in RWA.** If an assessment of risk proves incorrect, then the adequacy of capital may need to be revised. Faced with continued uncertainties about future economic conditions, regulators are raising the standards of capital adequacy to improve market confidence in financial institutions.<sup>16</sup> Capital buffers could be adjusted to provide additional cushions for higher levels of risk, if the composition of risk weighted assets or their assessments changes significantly.
- **Current capital adequacy approaches may not sufficiently consider systemic risk.** Given the focus of regulators on individual institutions around capital adequacy, there is perhaps insufficient attention given to systemic risk. This suggests capital adequacy standards should not just address the risks within institutions, but should make some allowances for market risks as well.
- **Fixed capital ratios may be procyclical.** Capital ratios that remain fixed throughout economic cycles (like the Basel I and II capital requirements), may have a procyclical rather than a counter-cyclical impact. As losses mount during recessions, bank capital may be reduced and under a fixed capital ratio regime, lending may decline, which can further deepen the downturn. Similarly, as profits improve and capital increases through retained earnings during recovery, there is the potential for excessive risk taking.

The application of procyclical capital ratios has been proposed by the Turner Review as a means of counterbalancing the impact of financial cycles. This follows a practice used by banking regulators in Spain applying higher capital ratios to banks during economic upswings so that additional lending didn't accelerate the cycles and applying lower capital ratios during the downswings so that increased lending could dampen their severity.<sup>17</sup>

Additionally, the Office of the Comptroller of the Currency (OCC) has also recommended the implementation of loan loss provisioning that allows banks to increase provisions during strong economic periods to provide a greater cushion for potential losses during weaker economic times.<sup>18</sup>

This raises the following issues:

- Are current standards of capital adequacy sufficient and how should that be determined?
- Should different standards of capital adequacy be applied to different businesses within a financial institution, such as higher capital for the proprietary trading desk?
- Do uniform capital ratios deepen business cycles and should capital ratios be adapted to reflect different phases of the cycle?

The FSA's Turner Review attempts to address each of these issues with the following proposals:

- A doubling of the core tier one and tier one capital ratios recommended by Basel I and II (from two percent to four percent and from four percent to eight percent, respectively, of RWA).
- An increase in the capital required to support trading operations and a review of the Value-at-Risk (VaR) methodology commonly used to assess trading book risk, a recommendation also supported by the G30<sup>19</sup> and included in the U.S. Treasury's proposals for regulatory reform for systemically important institutions. The review of VaR might include some evaluation of CoVar, which is suggested in the Geneva Report.
- The creation of counter-cyclical capital buffers based on economic cycles and macro prudential concerns. Higher capital ratios would be required during strong phases of the business cycle, and regulators would be allowed to set higher capital standards for banks if in their judgment higher levels of systemic risk justified this.

Requiring higher capital ratios will likely increase the cost of financial intermediation. Some of these cost increases may be absorbed by lower bank profitability and some by higher risk spreads. Higher costs, however absorbed, may reflect an increased recognition of the systemic risks inherent in more globally integrated institutions and markets, and the need to avoid the potentially greater costs of further global market instability.

### Measuring liquidity against risk

Managing liquidity is likely to remain an area of regulatory focus.<sup>16</sup> Banks are providers of maturity transformation—converting short-term liabilities in the form of bank deposits into long-term assets, performing an important function for the economy as a whole. To do this, they must maintain the confidence of depositors and counterparties. The quantity and quality of capital play an important part in this process, but liquidity does as well. The response of individual banks to liquidity problems can place strains on other banks not directly affected. The simultaneous efforts of many banks to address liquidity issues likely create a systemic issue for the financial system as a whole. The current contraction in wholesale credit markets reflects these concerns, both in the banking sector and beyond. It is reinforced by the asymmetry in international banking between the high demand of non-U.S. banks for dollar positions in money market funds and the lower need for U.S. banks to hold similar positions in European currencies. This asymmetry adds to the liquidity pressures in financial markets and reinforces the global nature of liquidity risks.

Part of the solution to managing liquidity risk more effectively might be to reduce the gap between the maturity of long-term assets and short-term liabilities. However, any reduction in this gap may reduce the value of financial intermediation that banks provide the economy. Greater dependence on wholesale markets may add to liquidity risk since these markets are based

on advances with specific maturity dates, while retail balances are often protected by government guarantees in many countries. The existence of fixed maturity dates for wholesale deposits creates the risk that those advances might not be renewed on maturity (rollover risk).

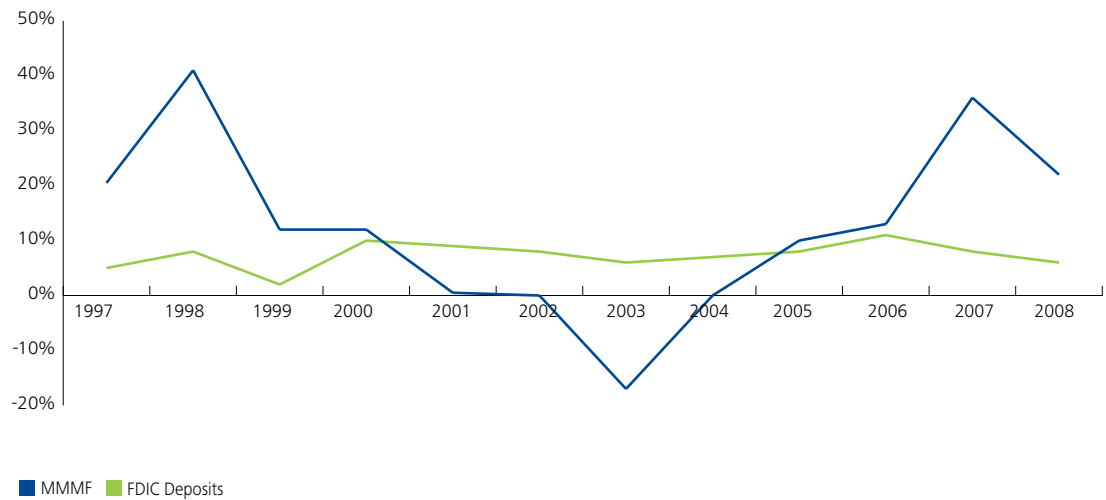
Attracting retail deposits may be part of the solution and could have a positive impact on bank profitability, partially offsetting the impact of higher capital ratios. Over the long term, however, financial institutions may need to operate under more conservative liquidity management provisions and in particular more generous liquidity cushions. These may include better contingency planning in anticipation of different scenarios and greater transparency of the liquidity management process.

### Leverage ratios as a backup

Leverage ratios may have had an important role to play in protecting the financial system from absorbing even greater levels of risk and have been an important part of the regulatory infrastructure for many years. However, they have been subject to regulatory arbitrage and have tended to be more valuable when adjusted for risk. They have also been unevenly applied across the financial system. For example, the requirements for FDIC-insured banks have differed from those for investment banks.

If effectively applied, however, a leverage ratio can provide important benefits in supporting a capital adequacy system, particularly if combined with limits on risk concentration. A sudden loss of liquidity around a specific asset class may significantly affect the level of risk associated with it. The consequences can potentially be limited by placing an overall limit on leverage—restricting the amount of assets that are absorbed by individual institutions and the system as a whole as well as on their concentration in one asset class or another.<sup>17</sup>

**Exhibit 3: Rates of growth of FDIC bank deposits and money market mutual funds (MMMMF)**



Source: FDIC, Investment Company Fact book, 2008

### Liquidity in wholesale markets

Money market mutual funds are very important for wholesale credit markets. They accounted for a quarter of the short-term money markets and supported approximately 40% of all commercial paper in the first half of 2008.<sup>18</sup> In September 2008, there was a sudden outflow of funds from money market mutual funds which had significant implications for credit markets. The government has responded by providing and renewing its guarantee for the market. The vulnerability of these funds to sudden outflows underlines the potential volatility of wholesale markets as a funding source. While the growth in money market mutual funds has been dramatic, their

rate of growth has been much more volatile compared to bank deposits. (See Exhibit 3.) The Securities and Exchange Commission has announced its intention to move quickly to strengthen regulation of these funds by considering ways to improve the credit quality, maturity, and liquidity standards applicable to them. In the meantime, the Investment Companies Institute has come up with its own plan for the funds which involves shortening the maturities in their portfolios (the average holding period would be cut from 90 days to 75 days).

# A safety net for systemically important institutions

Regulations sometimes, but not always, come with access to government support. That support comes in the form of financial help, such as deposit insurance, capital infusions, and financial guarantees, but also in the form of an orderly unwinding of financial institutions. Now that the organized unwinding is likely to extend to all systemically important institutions, should the government also provide financial support? Is the government now effectively the guarantor of the whole U.S. financial system and not just a part of it? Given the rapidly increasing level of public sector debt, are there limits that need to be placed on government guarantees?

In considering the extension of such a safety net, however, there are practical considerations to be addressed.

- **How far should the safety net extend?** The current liabilities of the U.S. financial system fall just short of \$40 trillion.<sup>20</sup> It is not practical for the U.S. government to attempt to guarantee the whole system. The U.S. Treasury has recently proposed the focus should be on systemically important institutions, but a challenge is to define what is meant by “systemically important.” The Geneva Report<sup>21</sup> argues that the best measures are leverage, maturity mismatch, and asset growth, but these are characteristics that define risk at the institutional, rather than the system, level. The U.S. government’s Troubled Assets Relief Program already includes over 400 institutions. The definition of “systemically important” could be very broad indeed.
- **What to do with the existing government safety net?** Do we continue to maintain the existing FDIC infrastructure now extended to include money market funds? Alternatively, do we have just one systemic system that covers the whole market?

Having the government as regulator and backstop for the whole financial system seems to be desirable, because they are the only entity with the resources to adequately address systemic risk across the whole market. There may be a role for private insurance to ease the burden on government. A plan has been put forward, for example, for banks to take out private insurance that would recapitalize banks when economic conditions deteriorate.<sup>22</sup> But while insurance can undoubtedly play a wider role in mitigating risks, such solutions remain largely conceptual leaving government support currently as the ultimate backstop for addressing systemic risk.



### Creating more transparent markets

The drive to create greater transparency in financial markets has been summarized by the Leader's Statement in the April 2009 meeting of the G20: "The era of banking secrecy is over."<sup>23</sup> This impacts institutions, consumers, investors, infrastructure, and markets since more information is seen as a critical part of the recovery process. There are four areas in particular that stand out for consideration:

- **Greater level of disclosure from systemically important institutions.** The need for large, complex financial institutions to provide greater disclosure is most likely to be felt by institutions outside the FDIC-insured sector.
- **Increased disclosure in securitization and transparency on underwriting standards.** In its survey of investment management expectations for the future of securitization, Securities Industry and Financial Markets Association<sup>24</sup> pointed to three areas in particular for improvement:
  - Improved disclosure for the underlying assets of residential mortgage-backed securities
  - Enhanced transparency with regard to underwriting and origination practices
  - Improved confidence in valuations, methodologies and assumptions.

The *Wall Street Journal* echoed a similar theme in its call for increased disclosure to support "smart securitization." Such suggestions would appear to address some of the gaps in credit markets left by the collapse of securitization, some recovery in these markets will be important, but with increased transparency and accountability throughout the securitization chain.

- **Greater disclosure in price and volume data in over-the-counter markets for credit derivatives.** The market for credit derivatives has developed dramatically in recent years, but largely around customized contracts between bilateral counterparties. This may have been important for the early stages of the market's development, but the

lack of transparency around the positions of individual participants has added to the concerns about systemic risk. The transition of the market to a centralized clearing mechanism could go a long way to address these concerns.

- **Greater consumer protection and greater financial education.** The new financial marketplace may place greater focus on consumer protection. In some cases, this may be based on government guarantees for the system itself. Examples include FDIC insurance for bank deposits and MMMFs in the United States. Other countries have also provided guarantees of bank debt. Guarantees have become one of the biggest sources of government support around the world. The cost of this type of support can be significant. Nevertheless, government regulation in this area is expected to increase even more in the United States, with the Treasury expected to announce plans to regulate all financial products sold to consumers.

According to research conducted by the U.K. FSA, part of the reason for excessive levels of consumer debt lies in a lack of financial education. Although this alone does not explain the credit crisis, to some extent the crisis was fueled by a collapse in the savings ratio and a personal culture of debt. If consumers were more financially sophisticated, they might manage their money more effectively and make more informed financial decisions. This can be facilitated by a program of customer education. Such a program could help consumers become more financially aware and encourage institutions to provide more information on the products they sell.

The U.K. FSA has invested in a program of consumer education<sup>25</sup> to help increase the ability of consumers to make informed decisions, particularly about debt products. Improvement in consumer choices may place fewer burdens on institutions to guarantee their products.

# Implications for financial institutions

While many reports and proposals have been forthcoming, the new regulatory approach is still evolving, and along with it the full implications for financial institutions. The proposals already issued suggest the following broad implications:

- Banking becomes a much more important part of the financial system. While wholesale markets recover, the burden of meeting the economy's credit needs falls more on banks. Under the terms of the U.S. Administration's latest proposals, all non-banks would become regulated bank holding companies under a National Bank Supervisor. Even with the recovery of securitization, the U.S. proposals envisage banks retaining an interest in the loans they originate and securitize. This represents a significant opportunity for banks to redefine their role as financial service providers after years of being disintermediated by wholesale markets.
- Financial institutions are likely to experience greater regulatory oversight. The impact is expected to be greater for large, systemically important institutions, particularly those outside the traditional bank depository sector.
- The credit crisis has accelerated consolidation in financial services, particularly in banking, but the consequences of being systemically important may favor the creation of smaller financial institutions.
- The cost of financial intermediation may rise, in part due to increased capital and liquidity requirements, with adverse short-term impacts on profitability, particularly for banks.
- Banks are likely to be more conservative risk takers for some time to come. With higher capital ratios and greater oversight, banks are likely to remain risk averse, which may pose issues for the recovery in credit markets.

## Conclusion

The challenge is not just to ensure recovery, but to create a safer and sounder financial system over the long term. To achieve this, focusing on enhancing basic safeguards and focusing on key priorities may be needed. Focus is an important theme to consider when exploring the extension of regulation to all parts of the financial system. Adding

to the complexity of the existing regulatory structure and expanding it in its current form will not necessarily lead to more effective regulations. While it may make sense to provide a wider safety net to cover the whole financial system, implementing such a program may be expensive and complex.

A financial system that has served us well for decades needs repairing, not just nationally but globally. Government support is important. Yet, the existence of government support may remove the imperative for change to happen. A way may need to be found for governments to provide support without permanently displacing private capital. Governments can act as a catalyst to help create a safer and sounder system, and have issued proposals to that effect, but the future effectiveness of regulatory reform lies in the details, and these still need to be developed.

A balance may need to be struck between the preservation of a tightly regulated core financial system that provides a stable supply of credit in the longer term and the preservation of less regulated markets where the freedom to fail is preserved as a necessary ingredient to innovation. Less transparency may be appropriate for the part of the market this is not considered systemically important since it may generate sufficient returns new solutions that might not otherwise see the light of day, but allow the financial system and the broader economy to continue to grow.

Beyond the possibility of a continued recession is a risk that a recovery will occur without significant reform of the financial system. Economic downswings provide good moments for making resolutions and upswings for casting them aside. None of these issues can be resolved through simple solutions, but neither can they be postponed indefinitely. Changes to the current system will likely be worthwhile if they help to navigate future market turbulence.

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## Endnotes

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<sup>1</sup> "Financial Regulatory Reform – A New Transition" U.S. Treasury, June 2009

<sup>2</sup> FDIC Statistics on Depository Institutions

<sup>3</sup> Federal Reserve Flow of Funds Report L1

<sup>4</sup> "Financial Regulatory Reform – A New Transition" U.S. Treasury, June 2009

<sup>5</sup> **Systemic risk** is the risk that the failure of one participant in a transfer system, or in financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of financial markets.

Source: *Bank for International Settlements, Committee on Payment and Settlement Systems: A glossary of terms used in payments and settlement, March 2003.*

<sup>6</sup> "Regulating Systemic Risk," V. Acharya, L. Pedersen, and M. Richardson, New York University Stern School of Business, 2009.

<sup>7</sup> "Treasury Outlines Framework for Regulatory Reform," U.S. Treasury, March 2009.

<sup>8</sup> "The Turner Review-A Regulatory Response to the Global Banking Crisis," Financial Services Authority, March, 2009.

<sup>9</sup> "The High-Level Group of Financial Supervision in the EU" Jacques de Larosiere, February 2009.

<sup>10</sup> "The Fundamental Principles of Financial Regulation" ICMB International Center for Monetary and Banking Studies. January 2009.

<sup>11</sup> "London Summit—Leaders' Statement," Group of Twenty, April 2009.

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<sup>13</sup> "Strengthening Macro prudential Supervision in Europe," Speech by Lucas Papademos, Vice President of the European Central Bank, Brussels, March 2009.

<sup>14</sup> "Shaping Global Financial Reform-A Public and Private Symposium," from a presentation by Andrew Crockett, JP Morgan Chase; event sponsored by The Deloitte Center for Banking Solutions, Bretton Woods and Boston University, April 2009.

<sup>15</sup> "The Supervisory Capital Assessment Program: Overview of Results," Board of Governors of the Federal Reserve System, May 2009.

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