Taking stock of G20 financial reforms

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A holistic review of a global effort

The global financial regulatory system today bears little resemblance to its state ten years ago, in large part due to the commitment of G-20 members to enact meaningful reforms that address the prior crisis and support future financial stability and prosperity. To date, all 27 Basel Committee on Banking Supervision (BCBS) jurisdictions have finalized risk-based capital rules. Similarly, the BCBS jurisdictions with the most active derivatives markets have all implemented margin requirements for uncleared derivatives. This is an impressive accomplishment.

However, now that the post-crisis reforms have largely been adopted, regulators must evaluate the collective impact of these actions to determine if they are achieving their intended outcomes as efficiently and effectively as possible; if not, they should revisit and adjust the reforms to ensure the continued resiliency and efficiency of the financial system.

This past year, the Financial Stability Board (FSB) conducted an evaluation of the holistic impact of post-crisis reforms when it examined "Incentives to Centrally Clear Over-the-Counter Derivatives." Likewise, the BCBS issued a document proposing options for adjusting, or maintaining, the leverage ratio treatment of client cleared derivatives. I think it is critical that the standard-setting bodies that first developed these global standards continue to evaluate their impacts, seek public input as to their efficacy, and propose solutions to rectify counterproductive results. I want and expect similar reports to be undertaken in the future. But reports are only as meaningful as the efforts taken to address their findings. With respect to the FSB's conclusions on the leverage ratio's negative impact on access to clearing, coordinated action needs to be taken to ensure that the leverage ratio is rationalized and not continue disincentivizing the provision of clearing services to clients.

With that example in mind, it is critical to remember that harmonization is only as good as the standard to which we all harmonize. The financial system is not strengthened by unanimous adoption of a rule that misprices risk, inhibits innovation, or inadvertently incentivizes risky activity. I have strong concerns about the current swaps regulatory regime's reliance upon notional value to establish thresholds designed to achieve large policy goals and impose large regulatory costs. In my view, notional value is an extremely poor measure of activity and a completely meaningless measure of risk. Yet it is pervasive in our rules: swap dealer registration thresholds, leverage ratio estimates of off-balance sheet exposures, and the scope of firms required to post initial margin on uncleared transactions are all based off of notional value.

The Office of the Chief Economist at the CFTC has recently published papers outlining a new approach to measuring derivatives exposure – entity-netted notionals (ENNs) >>>

>>> – that I believe is more representative of the actual size and risk of derivatives transactions. As policy makers continue to improve upon their rules, there is an opportunity to move away from notional amounts to a more rationalized metric, such as ENNs or another construct.

On the topic of market fragmentation, I remain concerned that liquidity pools will be fractured due to regulatory disputes over the extraterritorial application of jurisdictions' rules. The full promise of the G-20 reforms cannot be realized by a single nation acting alone, but it can be actively defeated if each jurisdiction expects all others to adopt the breadth, depth, and detail of their rulesets. I support CFTC Chairman Giancarlo's embrace of a cross-border regime built on deference to home country regulators, rather than line-by-line comparisons of rules or statutes. In order for a global, vibrant swaps market to exist, each jurisdiction must recognize the sovereignty of other jurisdictions, as well as other regulators' supervisory interests in regulating their own local markets. Where regulatory regimes address G-20 goals and achieve comparable outcomes, I think it is appropriate for the CFTC to issue substituted compliance determinations that facilitate U.S. firms accessing and competing in that foreign market. A global deference approach best prevents the fracturing of a global financial market. ●

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Addressing market fragmentation through regulatory and supervisory cooperation

In 2009, the G20 launched a comprehensive program of reforms, coordinated through the FSB, to enhance the resilience of the global financial system while preserving its open and integrated structure.

With almost 10 years of endeavors by the G20, the FSB and other standard-setting bodies (SSBs), in terms of resilience of the global financial system, we have put a series of regulatory reforms, such as Basel III, OTC derivatives reforms and resolution frameworks, largely in place. On the other hand, in terms of promotion of an open and integrated global financial system, our progress has never been remarkable in spite of the efforts taken by each G20 member authority.

In the course of implementation of the agreed standards in each jurisdiction, inconsistent, overlapping or incompatible regulations or supervisory practices seem to have put unnecessary or excessive burden on cross-border activities of financial institutions in certain instances, potentially leading to global market fragmentation and regulatory arbitrage. These are apparently unintended consequences which could have negative implications not only for the efficiency but also for the stability of the global financial system.

Against this background, in December 2018, G20 Leaders declared in Buenos Aires that they will address fragmentation through regulatory and supervisory cooperation. And addressing market fragmentation is one of the priorities of the Japanese G20 presidency this year. The FSB together with the IOSCO has launched an initiative to explore ways to address the risk of market fragmentation. So, what should we aim for by discussing market fragmentation? In trying to address fragmentation, one tends to focus on convergence in regulations. Amending already promulgated regulations is, however, not the only way to address fragmentation. Sometimes it is easier to make a difference >>>

>>> through discussions earlier in the process by focusing on prevention of future proliferation of inconsistencies.

Then, even when regulatory gaps remain among jurisdictions, we can have a better interface between different regimes by mutual recognition or deference. On top of that, we can avoid unnecessary regulatory/supervisory conflicts by enhancing supervisory cooperation among authorities.

As such, when considering market fragmentation issues, we can look at various phases in regulation: development of international standards, national rule making, recognition of foreign regulatory regimes, and daily supervisory activities. It may be useful to design processes and approaches fitted to each of these phases.

For example, on the phase of development of international standards, the FSB and SSBs should consider implementability or operational challenges more seriously before finalizing them in order to prevent inconsistencies in implementation among jurisdictions. They should also pay more attention to the burden on regulated firms unnecessarily multiplied by similar but different requirements.

We may also be able to prevent unintended regulatory conflicts by meaningful exchange of information on domestic rulemaking processes. Timely input from foreign stakeholders regarding potential impact of draft rules on cross-border activities could help prevent unnecessary regulatory conflicts beforehand.

With regard to recognition or deference, authorities need comparability assessment on foreign regulatory regimes. For such assessment, they tend to conduct line-by-line comparison of domestic rules, though there is a consensus for “outcome based” assessment. Also, the processes for comparability assessment tend to be duplicative and inefficient as they are conducted by each authority on a bilateral basis. Hence, we expect the IOSCO to discuss efficient ways to operationalize “outcome based” comparability assessment.

Sometimes, small and practical steps can make a difference. For instance, consistency in reporting requirements across jurisdictions may be a small step but could significantly reduce compliance costs for international firms. It would also enable relevant supervisors to conduct more comprehensive data analysis on a global basis. Each authority may need to be a bit more flexible and innovative in respective national frameworks. We look forward to discussing possible practical mechanisms for an open and integrated financial market with the colleagues around the globe. ●

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Post-crisis reforms: what next?

10 years ago, G20 leaders pledged to repair the financial system and strengthen regulation after the events of 2008. The simple pledge led to extraordinary fiscal and monetary support measures to stabilise banks, and significantly raised the bar for banks’ capital, liquidity and governance. And the outcome was successful. Overall, banks are now structurally healthier, less interconnected, and culturally more responsible. This means a higher probability banks get through the next crisis without constraining credit to the real economy and without recourse to the taxpayer.

A necessary consequence of the reforms was adjustment of bank business models to higher prudential requirements. They de-leveraged, de-risked and got smarter >>>

>>> on managing risk. Reducing leverage and risk means lower, but less volatile, earning profiles. So cost reduction became the priority to ensure sustainability of business models through the cycle. In Europe, with larger crisis overhangs, consolidation could play a key role in creating the capacity to reduce costs and clean up NPLs, for which a genuine Banking Union would be an important catalyst.

Now more stable and profitable, the banking sector can support global sustainability and growth. Regulators should reflect on and, if necessary, adjust the post-crisis rulebook to minimise impediments to future growth of socially impactful and economically productive lending (e.g. innovative small businesses, communities or green infrastructure). Policy-makers should encourage growth in areas that have historically been deprived of access to credit. Financial inclusion is a healthy goal for the financial system and for society overall.

It is also important to reassess the global regulatory construct and its impacts on banks' ability to serve their international customers and markets. Cross-border banking has re-trenched since the crisis, which is not good for growth. This is partly a consequence of regulatory fragmentation which increases the cost of sustaining a global footprint, through duplication of processes and trapping of scarce capital and liquidity. To ensure viability of global banking, better international regulatory cooperation and harmonization must be a priority for policy-makers. Increased consistency is required in three key areas:

- Implementation: level-playing-field in implementation of global standards, such as Basel 3 and capital buffers;
- Processes: alignment of processes, such as stress testing and recovery and resolution planning;
- Outcomes: consistency of regulatory outcomes, such as RWA densities and prepositioning of resources.

Separately, while there are new risks emerging from digitalisation in the banking sector (e.g. outsourcing and crypto-assets), the important question is where the risks that were squeezed out of banks have ended up. I think that they were pulled into the wider system in different ways:

- Huge growth in non-bank finance has reshaped the lending landscape. These lenders typically operate with less capital than banks and without central bank liquidity back-stops. This increases risk of funding shocks and reduced credit supply in a crisis;
- Market liquidity has deteriorated as banks play a lesser role as market makers, and may worsen as monetary policy tightens. This makes it harder to effectively monetise assets in a liquidity crunch due to higher volatility;
- Significant build-up of sovereign risk concentration across the financial system owing to liquidity buffer and collateral eligibility rules. This magnifies the "negative feedback loop" risk;
- With the shift to mandatory central clearing, CCPs have become highly concentrated systemic nodes within the financial system, with potential for significant market disruption should a major CCP fail.

In conclusion, policy-makers have been effective in fixing the banking sector, which helped economies recover from the crisis. It is now time to reflect on whether reforms have created any barriers to sustainable growth. In doing so, regulators should curb the current tide of fragmentation so that banks can continue to serve global customers and markets, increasing the overall sum of available credit. And with risks having moved out of banks into less well-lit areas of the financial system, regulators should ensure that their mandates, powers and resources, are still fit-for-purpose. ●