Global cooperation in financial regulation

Hester Peirce

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Shared, shunned, shattered: fragmentation in the global derivatives market

The human desire to transact with other people all over the world is nothing new. Today's technology makes it easier than ever to engage in global interactions. Tomorrow's technology will further facilitate people's ability to collaborate across borders. Financial markets, including derivatives markets, play a central role in uniting the global marketplace.

Although we often think about our national financial markets as distinct and each certainly has its own characteristics, we share an integrated, international financial market. This market, when working properly, sends capital to its most efficient use and shifts risks to those most able to bear them, regardless of location. We must work together to be good stewards of our shared resource.

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>
> \- HESTER PEIRCE

There are a number of things regulatory caretakers of the global derivatives markets can do. First, we should recognize their appropriate jurisdictional limitations. We all make choices about how to protect investors and other market participants in transactions that occur within our borders. At the same time, we must also be sensitive to the potential distortions that we can introduce into the market when these transactions technically occur within our borders but involve two counterparties outside those borders. Second, regulators should make accommodations to allow foreign firms to compete in their markets. Third, we should eliminate immaterial but market-fragmenting differences in our rules. Fourth, mutual recognition is valuable. Our rules need not be identical to achieve nearly identical objectives.

In fact, a diversity of approaches can be healthy; if one regulator's approach engenders problems, the consequences will be less severe than they would have been if all regulators had adopted the same regulatory approach.

>>> Regulators around the world have implemented reforms in response to a shared post-crisis commitment to financial stability, but these reforms have sometimes produced results that are inconsistent with the equally important shared commitment to a unified, well-functioning financial system. Sometimes regulatory obligations are so onerous that firms take steps to avoid being subject to them. For example, in an appendix to a recent IOSCO report on market fragmentation, the Commodity Futures Trading Commission described how policy choices led to fragmentation "into separate trading and liquidity pools: those in which U.S. persons participate and those in which U.S. persons are shunned." Similarly, in a recent white paper, ISDA pointed to different data and reporting requirements as a source of fragmentation.

The SEC is finalizing its framework for security-based swaps, and we are inviting our counterparts to talk with us about substituted compliance. I know that we will learn much from each other in the process and expect that the end result will be a system in which we all work together—each within our own jurisdiction—to achieve the goal of a shared financial market that is robust and focused on serving, not undermining, the broader economy. Substituted compliance determinations will not be based on rule-by-rule assessments of foreign regulatory regimes, but on a broader look at whether the alternate regime achieves the same objectives as ours, even if it does so differently. Being able to defer to other regulators in the U.S. and abroad is a strength of our regulatory approach to security-based swaps. Shared concern for global derivatives markets serves not only to help those markets function well, but to deepen cross-border relationships.

These comments reflect my own views and not necessarily those of the U.S. Securities and Exchange Commission or my fellow Commissioners. ●

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Unfracturing the global swaps market

The global financial regulatory system today bears little resemblance to its state ten years ago, when G-20 members first discussed meaningful reforms in response to the financial crisis.

The world's largest swap markets have made substantial progress toward implementing the G-20 commitments, including trade reporting, clearing, margin for uncleared swaps, and capital requirements for uncleared derivatives. Given this significant progress, one of the new challenges that regulators face is regulatory-driven market fragmentation. Liquidity pools have fractured in response to regulatory disputes over the extraterritorial application of jurisdictions' rules, with counterparties from one jurisdiction unwilling to transact with counterparties from another jurisdiction if conflicting or overly punitive sets of regulations apply.

I am pleased that international standard-setting bodies, like the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB), have recently examined the fragmentation of derivatives markets along jurisdictional lines, including considering what actions regulators can take to foster global markets[1]. Both reports suggest that deference between regulators is crucial to mitigating or avoiding the adverse effects of fragmentation. I believe a cross-border regulatory approach grounded in deference offers the greatest potential to reduce market fragmentation. The full promise of the G-20 reforms cannot be realized by a single nation acting >>>

>>> alone, but progress can be actively defeated if each jurisdiction expects all others to adopt the breadth, depth, and detail of their rulesets.

For its part, the CFTC as it exists today – under the prior guidance of Chris Giancarlo and under the current leadership of Chairman Heath Tarbert – strives to work with its global counterparts to ensure that economic activity and risk management can occur across jurisdictions without concerns of market fragmentation caused by conflicting regulatory requirements. Most recently, the agency has approved comparability determinations for uncleared swap margin requirements for Japan and Australia and also exempted foreign trading venues in Singapore and Japan from registering with the CFTC due to comparable oversight by local regulators.

These actions adopted an outcomes-based approach toward evaluating the comparability of another jurisdiction's regulatory regime, rather than requiring line-by-line comparisons of rules or statutes. This holistic approach toward finding comparability appropriately respects the sovereignty of foreign jurisdictions to implement the G-20 reforms as they see fit, facilitates U.S. firms' ability to compete in foreign markets, and allows those foreign jurisdictions' counterparties to gain access to U.S. firms' services. In my opinion, the key to fostering a global, vibrant swaps market lies in each jurisdiction's recognition of, and deference to, the sovereignty of other jurisdictions, as well as other regulators' supervisory interests in regulating their own local markets. ●

1. Market Fragmentation and Cross-border Regulation, IOSCO (June 2019), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf; FSB Report on Market Fragmentation (June 4, 2019), https://www.fsb.org/wp-content/uploads/P040619-2.pdf.

Burkhard Balz

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Financial fragmentation: regulatory reforms in central clearing

Over recent decades, economic globalisation and the liberalisation of national financial markets have led to ever more integrated economies and markets around the world. As a result, economic prosperity has grown. However, the safety of the international financial system was grossly neglected. The global financial crisis brutally exposed the system's flaws. In response, the G20 adopted a reform agenda that strengthened the global financial system and committed to implementing global standards so as to avoid regulatory-driven market fragmentation.

In particular, the G20 promoted the use of central clearing to limit systemic risk in the financial system. As things stand today, all major jurisdictions have implemented regulatory reforms that mandate the use of central clearing and govern the requirements for central counterparties (CCPs) – and thereby safeguard the financial stability of their respective jurisdiction. However, these regulatory reforms did not lead to major cross-border market fragmentation in central clearing, for two reasons. First, national reforms followed international principles and standards. Second, national regulation allowed for deference as long as financial stability was ensured. This means that Europe-based financial institutions are allowed to use CCPs in a recognised foreign jurisdiction and vice versa.

Three years ago, the United Kingdom voted to leave the European Union (EU) and with it its highly integrated financial markets. As a consequence, Brexit makes it likely that we >>>

>>> will see greater fragmentation of financial markets in the future. This scenario is in particular important for central clearing and the derivatives markets. While the derivatives markets are global markets where financial and non-financial institutions hedge their risks, the competence for the regulatory framework for central clearing still rests with the respective jurisdictions. Against this background, the EU identified substantial risks for its own financial stability when significant parts of EU-trades are cleared through a third-country CCP and is adjusting its regulatory framework accordingly.

The soon-to-be adopted revision of the European Market Infrastructure Regulation (EMIR) contains new requirements for third-country CCPs that are systemically important for the financial stability of the EU. Third-country CCPs deemed systemically important by the European Securities and Markets Authority (ESMA) must fulfil the requirements not only in their own jurisdiction but under EU regulation as well. Only then will they be allowed to offer their services to EU market participants. Furthermore, EMIR will include the possibility of not recognising third-country CCPs if they pose a continuous threat to the financial stability of the EU. Such CCPs would need to either relocate to the EU or stop offering services to EU customers, probably increasing financial market fragmentation.

To be clear, the new EU regulatory framework is intended neither to increase market fragmentation in central clearing nor to raise hurdles for EU market participants to use third-country CCPs, but to strengthen the stability of the EU's financial system and to insulate it from systemic risk. Thus, any possible degree of market fragmentation clearly is an inevitable by-product of the reform. It should also be noted that such fragmentation might have consequences in terms of reduced market liquidity. However, I am confident that the net benefit to financial stability will be positive.

Moreover, our common goal should be to avoid – or at least to minimise – the potential for market fragmentation in central clearing. Much has already been done in the past, such as the establishment of deference frameworks and close supervisory cooperation between jurisdictions. Therefore, it is commendable that the USA has opted for further regulatory deference. The EU is also committed to continuing its equivalence framework for a wide range of non-systemically important third-country CCPs. However, for systemically important third-country CCPs, both the USA and the EU reserve the right to impose stricter regulatory standards, which might lead to fragmented markets. Here, the key will be close supervisory cooperation across jurisdictions. Only then will we be able to mitigate the potential adverse effects on the financial markets and uphold high financial stability standards. ●

Shannon Lilly

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Fragmentation: re-joining the pieces

Let me start with the punchline: a financial system that is both global and stable is a universal public good and needs genuine cross-border regulatory cooperation and trust in order to thrive. Leading up to the crisis, the system was very global, but unstable. Now, after 10 years of reform, the system is very stable, but less global. This journey has been marked by changing attitudes and behaviours towards cooperation in global finance.

Early on, policy-makers recognised that the global crisis required a global solution. This leads to an extraordinary level of cooperation between central banks and regulators, which ultimately helped stabilise the global financial system. However, as the scars of the crisis began to heal, the political commitment to cooperation >>>

>>> started to fade. The outcome was a move towards protectionism and the ring-fencing of national banking systems. Global banks were seen as transmitters of crises resulting in some regulations, for example the GSIB surcharge, being designed to penalise the largest global banks for, well, being global.

Despite this, the global business model remains critical for economic growth and stability. Global banks create global economic benefits in two key ways. First, we serve multinational clients and facilitate cross-border trade, reducing costs for our clients, which in turn benefits consumers and the economy. Second, we are an important channel for directing excess savings from one country to another with investment needs. In doing so, we broaden the funding choices available to these markets, thereby reducing costs of borrowing and promoting growth.

A stable global business model needs effective global regulatory cooperation. Unfortunately, we're currently hearing "fragmentation" more than we're hearing "cooperation". Fragmentation undermines the global model as it increases the cost and risk of sustaining a global footprint through inefficiencies: from differences in prudential rules to duplicative processes to unnecessary trapping of capital and liquidity in subsidiaries.

The commercial reality is that banks will inevitably have to curtail their global footprint if costs consistently exceed the benefits. Financial stability suffers as a consequence: the system is less diversified; market liquidity contracts; capacity to monetise assets in a stressed environment is reduced; and banking activities are pushed outside of the regulated banking sector.

"A stable global business model needs effective global regulatory cooperation."

- SHANNON LILLY

So what does effective cross-border regulatory cooperation look like? Our shared strategic vision should be to minimise regulatory complexity and frictions for global banks by enhancing regulatory consistency across national regimes. In other words, regulators could improve the ease of doing business, whilst at the same time improve stability, through:

- Harmonized implementation of internationally-agreed standards to ensure a global level-playing-field. For example, the final Basel 3 package should be implemented in all jurisdictions without national deviations.
- Consistency of regulatory judgement, application and outcomes to ensure comparability of global banks. For example, application of Pillar 2 should be more consistent to allow comparability of risk profiles.
- Alignment of and collaboration on supervisory processes to avoid duplication and trapped resources. For example, processes such as stress testing and recovery and resolution planning should be more centralized.

Finally, how do we get from fragmentation to cooperation? As much as I'd like to take politics out of finance, national regulators work to accomplish objectives set by their governments - these objectives should be reviewed with a global lens. Perhaps in the longer term they might consider the operating model of the Banking Union in Europe as something to aspire to globally, at least for the oversight of GSIBs. In the meantime, the efforts at the G20 and FSB in prioritising fragmentation as a financial stability concern is a welcomed step in the right direction.

These efforts will be successful if they help lead to a cultural shift in the way national policy-makers and regulators think about global banks, particularly as they review the impact of post-crisis regulatory reforms (over-calibrated?). In doing so, it should be recognised that the sector is now structurally healthier, less inter-dependent, less complex, and culturally much more responsible. ●

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Global cooperation in insurance: progresses, challenges and perspectives

Global actors such as worldwide insurers are by essence used to complying with different regulatory approaches across jurisdictions and to adapting rapidly to evolving requirements. Global cooperation efforts are welcomed in that they facilitate global business through simplification and transparency and allow for comparability. Global cooperation improved since 2008, but divergences in regulatory approaches remained visible even in efforts to develop global supervision initiatives (e.g. global systemic frameworks), or regional requirements with extra-territorial scope (e.g. data protection regulation). This has created for global insurers a higher degree of complexity that risks affecting their capacity to rapidly adapt to changing customer needs, remain competitive or benefit from group synergies.

International cooperation efforts in prudential policies have intensified since the 2008 financial crisis. The entry into force of the International Systemic Risk Framework in 2016 brought positive perspectives in terms of better assessing and mitigating systemic risks in the insurance sector globally. But differences in approaches on the specifics of the framework led, among other reasons, the Financial Stability Board (FSB) to announce in November 2018 the suspension of the identification exercise of Global Systemically Important Insurers (G-SIIs), and refer to the progress made by the International Association of Insurance Supervisors (IAIS) on the Holistic Framework for Systemic Risk which should serve as an alternative.

The development, also by the IAIS, of an International Capital Standard for insurers (ICS) raises a number of questions. While applying a common rule-based capital standard is conceptually interesting, the feasibility of it will depend on whether the key jurisdictions involved can see how their key concerns on this topic are taken into account. A progressive evolution towards such a capital standard would be preferable rather than a rapid move that would fail to address these questions.

The implementation of General Data Protection Regulation's (GDPR) in Europe has initially been perceived mostly as a challenge by European companies. Because they had to invest heavily in personal data protection, they perceived it as possibly affecting their competitiveness compared to companies operating mostly in areas where data protection rules are less stringent. This has however brought significant improvements: on public awareness on data protection rights, on the increased attention and understanding of this topic by public and private actors, and on the level of ambition manifested by the extraterritorial scope of this regulation. To the point that similar initiatives are gaining ground in other jurisdictions outside Europe, possibly reflecting a global shift towards greater data privacy protection. The evolution of this trend will depend on whether diverging strategies on artificial intelligence, for instance, will impact it.

Looking forward, further cooperation and coordinated supervision will likely be essential in areas where the insurance industry is rapidly transforming. The industry is indeed becoming modular, the insurance value chain is getting increasingly fragmented compared to a few years ago with an increasing number of unregulated actors providing technological services in the insurance value chain's multiple areas. The Supervisory & Regulation model will need to be revised as the industry evolves. There is a clear interest in taking a rather global approach to these changes for they would enable groups to fully benefit from synergies. Overall, global cooperation in insurance will be successful if it can bring simplicity, transparency and consistency in the principles that will guide action globally. Should the lack of consensus on the specifics of their implementation persist, then global cooperation will be more efficient if it focuses on defining the overarching principles. ●