TAKING STOCK OF G20 FINANCIAL REFORMS

In 2009, the G20 launched a comprehensive programme of financial reforms to fix the fault lines that led to the global financial crisis in order to build a more resilient financial system. The reform programme has four core elements: making financial institutions more resilient; ending too-big-to-fail (TBTF); making derivatives markets safer; and enhancing the resilience of non-bank financial intermediation. A regulator emphasised that the source of prosperity in the future will emerge from the efficient allocation of capital in a global marketplace. Market fragmentation must be addressed through regulatory and supervisory cooperation, but currently there does not seem to be a clear way forward.

1. Addressing market fragmentation through regulatory and supervisory cooperation

International market fragmentation is a priority for regulators and supervisors across different jurisdictions. An increased use of equivalence regimes and better quality market data can drive this agenda forward.

1.1. Addressing market fragmentation is one of the priorities of the Japanese G20 Presidency

A regulator highlighted the importance of the G20 statement from the 2009 Pittsburgh summit. This statement committed the G20 nations to take action at the national and international levels to raise standards together, ensuring a level playing field and avoiding market fragmentation, protectionism and regulatory arbitrage. After 10 years of effort, reform measures have largely been implemented to enhance the resiliency of the global financial system, namely the Basel III, OTC derivative reforms and the resolution framework. However, some stakeholders have expressed concern that markets should have become fragmented along national lines, despite the fact that the G20 nations were committed to defer to each other in OTC derivative regulations and other areas. For its G20 presidency, Japan has proposed that market fragmentation should be a priority in G20 discussions.

However, it is difficult to define the scope of this discussion, because some market fragmentation is intended and reflects differences in domestic policy mandates or responsibilities. Due to the fact that these differences can have a positive effect on financial stability, it is necessary to consider carefully any trade off between the benefits of increased cross-border activity and the need to tailor domestic regulatory frameworks to local conditions. Subsequently, in discussions at the FSB and the G20 there is broad agreement that the industry should focus on regulatory and supervisory market fragmentation, which is often unintentional and can have a negative impact on financial stability and market efficiency. Market fragmentation can be driven by inconsistency in both the timing and substance of the implementation of international standards, extraterritorial applications of international rules or location policies that require transactions to be conducted within certain jurisdictions, or when incompatibility exists between home and host regulatory requirements.

The Japan FSA's approach to market fragmentation is to be practical and pragmatic due to its belief that small and practical approaches provide better solutions to complicated issues than big, principle based approaches. The Japan FSA is currently arguing for a practical approach to various stages of regulatory development. For example, international standard setters could consider the implications of implementation during the process of developing standards and cross-border supervisory cooperation could be enhanced.

1.2. The use of deference will prevent the fracturing of a global financial market

Another regulator emphasised that regulators could best promote the global market through the use of deference. The full promise of the G20 reforms cannot be realised by a single nation, but it can be actively defeated if each jurisdiction expects all others to adopt the breadth, depth and detail of their own rule set. In order for a global market to exist, each jurisdiction must recognise the sovereignty of other jurisdictions. The regulator expressed pride at the ongoing work of the CFTC under the leadership of Chairman J. Christopher Giancarlo, who has been advocating a deference based approach. In the coming months, the CFTC will be making concrete proposals on how the CFTC determines what a substantial risk to the United States is and how the CFTC's deference process will function. The CFTC has done comparability determinations with the EU and Singapore on swap trading platforms and with Japan and Australia on uncleared margins. These were done with an outcome based approach which considered how each regime identified and targeted specific risks.

One consequence of an approach that does not rely on deference might be more fractured marketplaces. This can happen when one jurisdiction imposes relatively punitive rules and fractures liquidity within its own markets or because the jurisdiction tries to impose these punitive requirements on other jurisdictions or on the provision of services to their market participants. As a result of the CFTC's own poorly constructed regulatory regimes, in the past US market participants were banned from foreign trading venues. It is important for the industry to ask itself whether it is approaching financial regulation from the perspective of deference and in terms of open markets, diversified risk and the efficient allocation of capital.

1.3. The reliability and the quality of market data still needs to be improved

1.3.1. There is a difference between the banking sector and the non-banking sector

An official noted that there is a significant amount of data on the banking sector and a regular reporting culture. Technological advancement such as the use of blockchain could facilitate real time reporting for industry players, however. These systems would enable supervisors to look directly at a financial institution's ledgers. Overall, the quality of data available is sufficient, given the level of safety and soundness being sought. Beyond banking, however, the situation is somewhat different. There are still significant swings in the FSB's annual non bank financial intermediation report from year to year, which are caused by improvements in data collection. Data collection in this area remains nascent, and the issue of cross-border data-sharing continues to be a challenge. Trade repository is another area where improvements have been achieved, but these are relatively recent. Once there is consistent data, a time series must be established before a credible analysis of the data can be made. The industry is quite far away from this point. It is possible to measure size, but interconnectedness is more important in relation to network effects and substitutability, which are very difficult to grasp in the current data sets.

1.3.2. There is a stark difference in data between the cleared and uncleared markets

A regulator suggested that the difference between the cleared market and the uncleared market is 'night and day', adding that this is a frustration he had had for some time. The cleared space is doing very well on data, however. It is one of the unsung benefits of central clearing that only a few entities report a substantial amount of information to supervisors in a standardised format. The CFTC has a number of years' worth of this data and now has real time visibility into client level positions across Futures Commission Merchants (FCMs), and institutions that also deal with cleared swaps in clearing houses. This data is a benefit of the reforms that have led to central clearing.

However, things are very different in the uncleared space. This area has been a source of frustration for 10 years. Previously, the CFTC knew what entities should report and instructed entities to do this, but it did not instruct entities in how they should report data in this space. This meant that the CFTC could not synthesise data. Data arrived in a variety of different formats and fields were left empty across multiple market participants. After a number of years of frustration, the CFTC returned to the international level to seek agreement on a uniform format for what is reported and the syntax in which it is reported in order to achieve visibility into the uncleared space. CPMI IOSCO has agreed to the LEI, the legal entity identifier, the UPI and the UTI, along with approximately 100 other critical data elements. Through Chairman Giancarlo's swap data road map, the CFTC will be one of the first regulators to propose rules concerning the adoption of those data fields. The regulator expressed hope that the CFTC would be able to finalise on this proposal relatively quickly after this point in order to intake data in such a way that it can then be synthesised and processed.

1.3.3. A way forward?

Another regulator felt that most regulators and supervisors are asking for highly similar data sets, but their templates or the details of their precise requirements could differ. These small differences place a huge cost on regulated entities. Therefore, while it is difficult to achieve true coordination with regard to data requirements, it may be possible to seek common elements before implementing data requirements in a different jurisdiction.

2. Resolving the fragmentation between the global and EU levels is not within sight

There remain several outstanding challenges with regard to fragmentation. The implementation of the Basel reforms has slowed, and regulators must prevent further fragmentation between jurisdictions. Resolution remains a key EU policy challenge.

2.1. The global banking framework: mission accomplished?

2.1.1. A slowdown in the implementation of the Basel prudential framework causes concern

An official expressed pleasure at the fact the focus is no longer on Basel III or the Basel Committee itself but on the implementation of Basel rules. This is exactly as it should be, and it is how things are today. Three of the BCBS's key priorities are: promoting full, timely and consistent implementation of the Basel Committee's post-crisis reforms; evaluating the effectiveness and impact of these reforms as they are implemented; and monitoring emerging risks. The industry has made good progress on implementation, but lately there has been a lamentable slowdown. Part of the reason for the slowdown is bandwidth. There is a substantial amount of work taking place. The industry is still addressing the lessons of the crisis 10 years on. There is work taking place on supervision, implementing the Capital Markets Union, and on recovery and resolution. There has been a slowdown in relation to areas such as the net stable funding ratio and the counterparty credit standard. The slowdown has happened either because there is a case of 'selective amnesia' regarding what happened 10 years ago or because people were simply not around then.

2.1.2. The banking industry has not been over-regulated

An official described how market participants often queried the need for various rules. Again, this appears to be some kind of amnesia. They ask whether rules such as the NSFR or the 72.5% output floor are necessary, which leads to a discussion about whether regulation has gone too far. The official reiterated their emphatic and unequivocal view that the industry had not gone too far on regulation. The industry has not been over regulated. If anything, it has under implemented. In the two biggest jurisdictions in the world, the EU and the US, there has been a slowdown in implementing some of the rules as and when agreed. The official considers it 'preposterous' to query whether regulation has hindered bank profitability and bank soundness. If anything, regulation has strengthened banks and banking systems. All around the world there are strong and well capitalised banking systems. It is very dangerous to suggest that regulation is impeding progress or the recovery of the system.

In Europe and in other jurisdictions there is still a lack of confidence in the banking system. Price to book value ratios are considerably lower in Europe compared to the rest of the world. There are a number of headwinds such as interest rates, challenges from non bank players and highly competitive markets in some countries in Europe. Ensuring the proper implementation of the Basel rules would be an important step forward to restore confidence.

2.2. Regulators should curb the tide of fragmentation so that banks continue to serve global customers and markets

2.2.1. Cost is directly impacted by regulatory fragmentation

An industry representative noted that the discussion had focused on the topics that their institution also considers to be extremely important. The representative's institution is one of the few very large global banks. It plays in around 40 countries, meaning that the topic of fragmentation is particularly germane to it and impacts its business on a day to day basis.

Fragmentation can be approached through the customer shareholder lens, which all industry participants must consider, and the financial stability lens. From the customer shareholder perspective, banks take on less risk now than ever before. The representative's institution pursues a strategy called 'responsible growth'. It is fundamental to this strategy to remain at the top of the credit spectrum. The institution seeks to be a 'lighthouse in the storm'. It is expecting to be a shock absorber in the next downturn through the resources at its disposal in terms of both capital and liquidity. However, this means that its revenue does not grow particularly quickly; maximum growth is estimated to be approximately the rate of GDP growth. This means the institution is focused on cost, and cost is directly impacted by regulatory fragmentation. The industry representative described how his team perform 17 different risk weighted asset calculations from 40 countries. Having these 17 calculations on one platform would be an advantage but using one risk weighted asset calculation formula would be far better. Each one of the industry representative's teams has to engage with its regulator in a different way, on a different schedule and using a different template. There are very real costs here and the money that is spent on this removes the ability for the institution to innovate for its customers.

In respect of financial stability, the industry representative felt that the most disturbing trend relates to liquidity and capital. The representative's institution has $540 billion of liquidity and $160 billion of CET1. Very little of this capital sits in the centre, because it is pulled down into operating subsidiaries. As capital rules are 'armour plated' in many countries, there is increasingly less capital and liquidity available at the centre to travel to where a crisis occurs. The industry is blindly walking into an environment with less financial stability instead of more.

2.2.2. As risks move into unregulated areas of the financial system, regulators should ensure that their mandates, powers and resources are still fit for purpose

Responding from a query from the Chair, the industry representative agreed that there is no level playing field between traditional banking and non bank financing. There is more inspection, more sets of standards and in general more regulation at present. Regulators and governments should empower themselves with the powers to go beyond the banking system and regulate non-banking and shadow finance organisations. Additionally, many regulators and Central Banks are doing exactly this in respect of cyber security: extending their powers into the technology space. So much of bank infrastructure is moving into the cloud, and therefore the technology companies who have so far avoided inspection and regulation should become subject to it.

2.3. Achieving an effective resolution framework remains challenging

2.3.1. Liability versus control

An official considered that resolution policy is vital, because a substantial amount of fragmentation is a question of liability versus control. For instance, if resolution and deposit insurance cannot be fixed at a European level, it is difficult for national Central Banks or supervisory authorities to know what to do. The world learned the hard way that institutions cease to be international when they fail; they die nationally. If this is still the case, institutions will continue to die nationally. This is the origin of ring-fencing. The resolution regime must be credible, and there must be a European deposit insurance scheme. This will enable Europe to erase some of this national fragmentation. As long as liabilities are national, control will remain national.

2.3.2. The absence of global accounting standards makes the task more difficult

The Chair felt it remarkable that the EU and the US do not have a common accounting standard to determine what an impaired asset is, noting that this could make things 'pretty tricky' in particular circumstances of stress. An official pointed out that there is some convergence, although the Chair is correct in terms of the terminology. This is not only true of the US and the EU; terminology from all over the world is not consistent. The Basel Committee published a paper several years ago on problem banks, in which it agreed on a common vernacular for these terms. There are still differences in the IFRS's international standards and FASB. Importantly, though, the Basel framework smoothes out these differences. There will be differences between the expected credit loss framework in IFRS 9, which came into effect in Europe and most of the world in January 2018, and the US Current Expected Credit Losses framework, which will come into effect next year. They are slightly different, but the philosophy is the same: they are forward looking instead of backward-looking.

2.3.3. Banking fragmentation is increasing due to the lack of a common, transparent and predictable resolution regime

An industry representative considered that the SSM is a virtuous idea from the perspective of a bank. There is a single rulebook and one conversation with a single regulator, which regulates in a consistent way, using a consistent framework and methodology. This could save vast quantities of money, because banks could manage capital and liquidity in one way, using one rule book, with one set of calculations and by reporting once in one framework. The question is whether it is possible to propose something similar for G-SIBs around the world. An official suggests that the completion of banking union will enable Europe to reach out to other major markets in the world and discuss cross-border resolvability. A substantial amount of market participants' frustrations have their root causes in resolution and resolvability. Additionally, liquidation is an important topic. In Europe there remains wide divergence in practices. Europe is relatively comfortable with capital and liquidity requirements as they stand, but it is not comfortable with ring-fencing. If this issue is addressed, there will be space for further cross-border activities, better utilisation of the benefits of diversification and more freedom for capital and liquidity to move around within global institutions.