GLOBAL COOPERATION ON FINANCIAL SERVICES

Following the 2008 crisis, global cooperation on financial regulation has become increasingly important over the last decade in order to achieve a resilient financial system. In 2009, the G20 launched a comprehensive programme of reforms, coordinated through the Financial Stability Board (FSB), intended to increase the resilience of the global financial system while preserving its open and integrated structure. Timely and consistent implementation of these reforms is essential to achieving sustainable growth. However, global regulatory cooperation is declining, and financial fragmentation is worsening in some areas at a time when emerging risks (e.g. cyber risk, crypto assets) require a continued adoption of globally consistent standards. In this context, ways forward are required for improving the consistent implementation of global standards.

1. Global financial fragmentation is emerging again

1.1. The global business model remains critical for economic growth and stability

An industry representative explained that fragmentation is a critical issue. There are three statements which the banking side can generally agree with.

First of all, global trade has been a fundamental driver of economic activity for the last several decades; global banks are essential to efficient global trade. Global banks create global economic benefits in two keyways. First, they serve multinational clients and facilitate cross-border trade, reducing costs for their clients, which in turn benefits consumers and the economy. Second, they are an important channel for directing excess savings from one country to another which has investment needs. In doing so, they broaden the funding choices available to these markets, and reduce the cost of borrowing and promoting growth.

Secondly, markets with a robust number of participants competing on a level playing field reduce cost to the end consumer, increase credit generation, improve market liquidity and financial stability.

Finally, shareholders expect a return on their capital. Incremental costs borne by the industry ultimately get passed on, in some respect, to customers and clients.

1.2. There are increasing signs of fragmentation at the global level

An industry representative noted examples showing that banking fragmentation is increasing at the global level. The first is the varied and inconsistent implementation of agreed upon international banking standards. His company has 15 to 20 risk weighted asset calculations. Across the space, in the order of 75 different capital ratios can quickly be reached that are looked at from time to time. This is actually not improving the robustness and stability of the overall system. Second, some alignment and collaboration need to occur with respect to resolution and stress testing. Some of the efforts being seen at the G20 and other meetings have been very positive in that respect, but there is more to be done there to avoid some of the prepositioning of capital and liquidity. As capital rules are "armour-plated" in many countries, there is increasingly less capital and liquidity available at the parent company level to travel to subsidiaries when a crisis occurs. Finally, there must be consistency of regulatory judgement to ensure the comparability of global banks. For example, the application of Pillar 2 should be more consistent across countries to allow such a comparability of risk profiles.

1.3. Not all fragmentation is bad

A regulator noted that whether national differences to mitigate important local risks means fragmentation was the first point discussed at the workshop between the regulators and industry and academics, hosted by the FSB in Basel. The conclusion was that not all fragmentation is bad. Full harmonisation of regulation across the world is not the aim; there is a need to reflect the difference in economic development and national policy priorities. However, not all fragmentation is the intended good fragmentation, and these unintended negative effects are the focus. There is a need for national discretion, though this is often abused to hide the weakness of domestic banking systems, or to avoid the painful things to be done.

1.4. Policymakers should look at the financial fragmentation driven by a gold-plating of the internationally agreed regulatory programme by national jurisdictions

An industry representative noted that policymakers should look again at the areas of inconsistency and fragmentation driven by the gold-plating of standards. That has been an area that policymakers at the global level have tried to stay away from, because the view has always been that the global standards are the minimum, and gold-plating is the prerogative of the national authority. Whether to second-guess a national authority's decision to gold-plate is a separate issue, but fragmentation is certainly driven by this.

1.5. The lack of international standards and a willingness to defer to another jurisdiction in case of implementation issues can also explain market fragmentation

An official noted that everything heard thus far is very consistent with the report IOSCO issued in June to the G20. There are two additional things that the report found. The first is that the lack of international standards in the first place is what in part causes market fragmentation. That is something where reflection is required in different areas. The other reason, with respect to fragmentation, is a lack of willingness or authority for one jurisdiction to defer to another when there are implementation issues following a particular standard.

2. Global cooperation in insurance: progress, challenges and perspectives

2.1. Fragmentation issues in the insurance sector

An industry representative felt that fragmentation is a reality of their business, operating across more than 60 countries and having been designated systemic in 2013. Unlike the banking sector, in the insurance sector colleges of supervisors were set up in the wake of the financial crisis. A decade earlier, they would have been caught between different regulators on different issues and there was no structural forum for a continuing dialogue. There has been a great change in the quality of the dialogue and interaction with the regulators. There is an annual college in Paris and one in Asia. Harmonising standards is virtually impossible for political reasons but reaching a pragmatic implementation and interpretation of the rules can go a long way.

10 years previously there was a roundtable at the Securities and Exchange Commission (SEC) when they had started letting foreign issuers file International Financial Reporting Standards (IFRS) accounts without reconciling it with the US generally accepted accounting principles (GAAP). The whole debate tried to drive convergence between US GAAP and IFRS, which has gone in the other direction over the last few years. The impact of IFRS 17, at least in the insurance sector, will be much bigger than people might anticipate, and will have a real influence on comparability.

In the insurance sector there is a multiplicity of capital standards such as the risk based capital (RBC) in the US, or Solvency II in Europe. There is a project on international capital standards (ICS) to reach a coherent view of capital across the regions of the world. The ultimate objective is a level playing field, but that only works if there is a convergence with an existing framework, and if this global standard does not come on top of current requirements. That is often the risk, layering a new standard on top while the old one continues to exist.

The General Data Protection Regulation (GDPR), was a monumental directive that has been transposed everywhere in Europe. In Europe, there is focus on protecting data and citizens. In the US the tendency is to focus on commercialising data. In Asia, the focus is on controlling data. Looking underneath all the different regimes, when doing business across 60 countries, is something dealt with every day.

Finally, over the last two years national security considerations have entered the business world. Security reviews are now going well beyond security and defence companies. It is also seen in cloud services: legislation is popping up on national cloud acts and this is an element of balkanisation.

2.2. Making more effective the crisis management framework in the insurance area

An industry representative explained that in insurance there is no Basel Committee, which has been around for many decades. Over recent years it has become deeper and richer. There is always a risk that it might become a tick-the-box exercise. Their company attends the annual college meeting with all regulators. The best part is the Q&A. There is convergence between the regulators of the college of Supervisors because they have prepared the meeting: they meet for an entire day or two beforehand and the insurer goes prepared to address the questions. Then there is much open dialogue, which has become better and better every year.

2.3 Consistency of implementation is required once a regulation is reached

An industry representative stressed that there is something about putting everybody in the room. It does not happen if it is not structurally there. The colleges have regulators from 25, 30, 40 jurisdictions, many of whom have never met each other. The day and a half or two days they spend preparing and dialoguing before the insurer spends half a day with them becomes deeper and better each year. It sounds simple, but the sustained effect of that over a period of years is quite substantial. The objective is to take a step back and think about what makes sense. When regulators and supervisors do that, it is important to think about what are the broader macroeconomic objectives, particularly in an environment where people are accumulating money for retirement, which is a big issue in a low interest rate environment. Cyber-risk is a big subject for everyone. The question concerns who can cover these risks, and whether a backstop is needed.

3. Ways forward for addressing market fragmentation and key areas where global cooperation is necessary

If market fragmentation is accepted to be a negative factor, and one affecting markets globally, then it stands to reason that the response needs to be similarly global, encompassing national and supranational bodies, as well as industry actors.

3.1. Getting from fragmentation to cooperation: the efforts at the G20, IOSCO and FSB in prioritising fragmentation as a financial stability concern is a step in the right direction

An industry representative noted that the issue of whether market fragmentation is a problem to be addressed is well-established as a consensus view among policymakers and the industry, thanks to the good work of the Japanese Presidency of the G20. Policymakers essentially endorse the view that there is an issue with regard to fragmentation, that at this stage of the post-crisis reform agenda, needs to be looked at carefully and systematically. The fact that capital markets operating on a global basis are more resilient, efficient, effective and stable is widely agreed on. A number of issues came out post-crisis that policymakers have had a need to deal with, including some of the issues concerning resolution and frictions that come into the implementation of global standards, and whether there are inconsistencies in the specificity of implementation. Global coordination can be deepened, but actually can be made more resilient, by allowing for a feedback loop of global standard setting, implementation, reassessment, and then potentially recalibration based on the lessons learned.

3.1.1. Even if the current level of fragmentation can be bearable, there is still a need to start working on trends of future direction toward less, rather than more, fragmentation

A regulator noted that the report the FSB published in June 2019 has various examples of market fragmentation developments, but the current level of market fragmentation is not unbearable. The more important issue is the direction and whether it is heading for more or less fragmentation. There is enough reason to worry about the future direction being more fragmentation. There is a growing anti-globalisation sentiment around the world. All of the banking regulation is reverse engineered from the resolution situation but, with regard to resolution, there is not enough trust amongst national authorities on the single point of entry resolution approach, thus leading to more ring fencing. It is a great achievement that the global regulatory community agreed on a single regulatory standard, but it is yet to be implemented. There are many standards which had to be implemented from 2017 to 2019 which have not been implemented or have been implemented in different ways or with diverse timeframes.

3.1.2. The global financial regulatory system today bears little resemblance to its state 10 years ago, but regulatory-driven market fragmentation is a new challenge

A regulator noted that the field is shifting, and there has been a lot of progress. There have been new challenges coming up, and it is easy to try and look at the current snapshot as to how different jurisdictions are addressing those challenges and try to find fault. These discussions are important and help lay the land for ultimately an environment where there is either more harmonisation or more deference, but one in which all jurisdictions have implemented their obligations under the G20 agreements. This is encouraging, and there is an important role for organisations like IOSCO. Developing either a baseline or a ceiling of international standards is very useful, which can be critical in a number of areas. However, the effectiveness of those standards is best when supported by a rigorous data analysis, with a public consultation process, a feedback loop and where issues that may not have been calibrated well can be recalibrated. There is a potential fragmentation in implementation. IOSCO has come out with some impressive standards. There are a number of tools held individually to manage the playing field from now to the 10-year mark to achieve harmonisation or non-fractured markets.

3.2. Key areas for further work to address financial fragmentation

A regulator noted that in 2018 the Japanese G20 presidency listed addressing market fragmentation as its priority. The FSB and IOSCO produced a report. The FSB had taken financial stability perspectives, and IOSCO had gone narrower but deeper, focusing on the wholesale derivatives market. In Osaka, the G20 leaders welcomed the reports and declared that they would address negative, unintended defects. The issue is back on the global agenda, but the two reports are not specific actions. The task to transform good declaration and two programmes into specific actions needs to be done. Without that, the world will not change.

The FSB report describes four key areas for future work. The first examines deference in the derivatives and securities market. The second area concerns the prepositioning and ring fencing of capital and liquidity. This is a difficult subject but might have the biggest implications for financial stability. The Financial Reporting Council (FRC) and the Resolution Group plan to host a workshop of industry and academics on ring fencing and prepositioning issues later in the month. The third area is the question of how to improve supervisory and regulatory communication and information exchange. The FSB report provides a section on mechanisms and approaches how to enhance coordination with specific ideas listed there. The fourth area is the fragmentation aspect, to be discussed in the effect assessment exercise the FSB is doing on regulatory reforms, and the too big to fail reform is the first topic to be analysed in that way. These areas of work will be coordinated by the FSB's standing committee on supervising and regulatory cooperation.

3.3. IOSCO proposals to mitigate the risk and potential adverse effects of fragmentation on global securities markets

An official explained that the foundation for enhancing international cooperation was laid in IOSCO's June report, which identifies three areas for continued focus. The first is fostering mutual understanding among regulators, with respect to their regulatory regimes. To a large extent, regulators around the world do not understand what other regulators are doing in specific areas. IOSCO's regional committee structure helps members understand what other regulators are doing. Secondly, it is really enhancing supervisory cooperation. This is done in a very appropriate way in some areas, particularly in the enforcement area, but when it comes to supervisory cooperation there is more work that could be done. Supervisory colleges are well-established with entities like credit rating agencies. It is developing in other areas, and needs to be picked up, in terms of making fragmentation less cumbersome. Finally, the work with respect to deference must be mentioned. Particularly around putting in some guideposts or some rules of the road in how these assessments take place, questions need to be answered concerning the time limits, the level of communication, the language used and the translations needed.

3.4. Cooperation and coordination should be differentiated according to the systemicity of market activities

A regulator stressed that that, broadly speaking, coordination approaches should be differentiated by a systemicity of activities and possible impacts. Cooperation and coordination need to be viewed through the lens of other foreign jurisdictions' interests, and how much of a company's business is in different jurisdictions. There are a number of different kinds of assessments that the regulatory community can make to create the right platform for cooperation and coordination, but it has to come with clarity and an understanding of where there is a history of strong oversight in the home country being acknowledged. The CFTC has done a number of exercises with international counterparts, demonstrating not only stress-testing capabilities but also technology capabilities, with real-time visibility into the client-level portfolios of clearing members at large clearing houses. Broadly speaking, there is a scale up to a certain point.

3.5. Key areas where global coordination is necessary

3.5.1. Climate and sustainability issues

An industry representative noted a range of areas where much good work is being done, including in climate and sustainability. There are significant regulatory and supervisory interests. Cooperation and collaboration amongst supervisors in terms of their expectations is helpful. Financial technology, products and innovations compose another area where more consistency in supervisors' expectations would be useful.

3.5.2. Effective international regulatory and supervisory cooperation is an important precondition for integrated financial markets

An industry representative noted that the big improvement that has occurred on the issue of fragmentation is that there has been, as a result of the G20's work, a clear statement of the issues regulators are trying to solve. Maintaining and enhancing global markets is one of the outcomes that should be considered in the work that regulators do. From that flow many other things, including making sure that the supervisory colleges work effectively and have the right participation in terms of the supervisors invited to attend. It is the same with crisis management groups in terms of putting some pressure on resolution authorities to make them work collaboratively. Some works together naturally, such as the Bank of England and the US authorities' track record of coordination. For other authorities without that history, a global mandate for cooperation would be a welcome outcome.

3.5.3. Improving the transparency of the global standard setting process

An industry representative stated that whether some of the inconsistencies in national rules are a necessary by-product of different macroprudential dynamics in particular markets is a fair enough point but would be eliminated naturally in the standard setting process if it is as transparent and as robust as it could be. There have been some steps forward in terms of allowing broader participation, input and visibility, which is helpful. To take the Net Stable Funding Ration (NSFR), the funding added on to derivatives for derivatives was never part of the consultation process; it was added late in the finalisation process. Europe diverged from that in implementation, for reasons which ultimately became understandable. Basel then clarified that national discretion is allowed in that area. The Basel Committee took the right decision in reassessing after the fact, but it could have been avoided with more transparency in the process.

3.5.4. Debating the appropriate amount of internal TLAC

An industry representative noted on Crisis Management Groups (CMGs) that it is for everyone to recognise how much progress has been made in that regard. Resolution planning is not something with the same history as capital standards or even liquidity standards, which are also very recent. Giving those bodies more power is one of the things that will improve the efficacy of how they operate. Many people have been talking about internal total loss absorbing capacity (TLAC), which is calibrated at the high end of the range. The original design would have been slightly more firm specific, and that is an area where it is possible to see a group of regulators getting together and debating what is the appropriate amount of internal TLAC to have at various levels. Nobody believes that 100% prepositioning improves financial stability. It actually makes it worse, but a common framework cannot be used to see how the problem can be considered to try and address the trappings of capital and liquidity that might be seen in a real stress crisis.

3.5.5. Crypto assets and financial innovation

An official noted that crypto assets constitute an area that a fair amount of time is spent on and that keeps morphing. It started out as initial coins, and now is morphing into stable coins and different things of this nature. The focus is on understanding these products, how they are really operating, and what is their economic function. It helps to then think about what the areas are where IOSCO really intersects with how these things function. Financial innovation is related to crypto-assets and the rise of this type of new product. It is the enabling ability of technology that is giving rise to the proliferation of many new things being seen in the marketplace. In part it is understanding what is actually happening and what innovation is really taking place. Related to that is artificial intelligence and machine learning, and understanding how these technologies are being used, not only by intermediaries, market participants and by regulators, and how these products, technologies and approaches can be used to do things better. These are a number of areas IOSCO are focusing on and will continue to focus on for the next year. There will be additional issues as well as the markets keep evolving.