Addressing growing global financial fragmentation

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A sustainable system of supervisory cooperation

It is almost tautological to say that our derivatives markets are global, something we witnessed before the 2008 financial crisis and in its aftermath. As a result, exposed deficiencies in those markets required us to find a solution that went beyond national borders. In that regard, it cannot be said enough that the post-crisis G20 reforms have produced a more stable international financial system. The benefits have been manifold, as evidenced by the resilience of the derivatives markets during the recent period of extreme volatility wrought by the coronavirus pandemic. Unlike in 2008, the derivatives markets are now serving as shock absorbers of systemic risk.

In many ways, the G20 reforms promote ever more globally-integrated derivatives markets. Agreed internationally and implemented locally, the reforms enable local regulators to address the nuances of their markets while adhering to common principles around the world. When regulators operate on the basis of comity among jurisdictions applying comparable regimes, it both strengthens the effectiveness of the G20 reforms and enables the derivatives marketplace to serve its important role of mitigating risks within international financial system.

Now more than a decade after the G20 reforms, we are increasingly witnessing a transition from a collection of disparate and sometimes conflicting national regulatory regimes to a shared regulatory paradigm underpinning the world's largest derivatives markets. This has made the possibility of regulatory deference more than simply aspirational for national regulators. For our derivatives regulatory landscape now holds the promise of fostering a sustainable system of cross-border supervisory cooperation.

Pre-crisis, the U.S. regulated derivatives market was primarily a cleared futures market traded on exchanges. It was a mature market with deep liquidity that permitted foreign participants to access its liquidity without adhering to U.S. laws. The U.S. futures regime entailed, and still provides, a great deal of deference abroad. Post-crisis, the G20 reforms set out a new regulatory approach for the swaps market. In the U.S., an early adopter of the G20 swap market reforms, the swaps market was open for business but the price of admission was strict adherence to American rules.

In 2012, CPMI-IOSCO's PFMIs catalyzed a new path in financial market regulation. With internationally-agreed baseline standards for market infrastructures—generally CCPs, trade repositories, and payment systems—supervisors now had a means to harmonize different local adoptions of the G20 commitments. Equivalence, comparability, and substituted compliance became modes of trust between authorities in the oversight of globally active FMIs.

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From recognizing the comparability of our respective regimes, we set our sights on a cooperative supervisory approach, grounded in comity and mutual respect, where host country regulators may rely upon a home country regulator when each has adopted comparable international standards, such as the PFMIs and other G20 reforms. When effectuated as a two-way street, this approach streamlines burdens and limits the risk of inconsistency in host jurisdictions while recognizing the accountability of the home jurisdiction's authority.

The CFTC has taken many steps to pursue regulatory comity with like-minded jurisdictions. In July 2019, the CFTC and Japan Financial Services Agency agreed to assess comparability ▶

for regulating certain derivatives trading venues in the U.S. and Japan, respectively, using an outcomes-based approach. In December 2019, we issued proposed rules governing the cross-border swaps market that recognize the importance of a substituted compliance process for foreign-based swap dealers. These rules also establish a framework for seeking comparability determinations for applicable foreign regulatory regimes. In February 2020, we proposed swap data reporting rules to harmonize our reporting system with relevant CPMI-IOSCO standards and those utilized by other regulators, including ESMA. And we continue to pursue supervisory cooperation arrangements built on mutual respect and comity.

Supervisors in Europe, Asia, and the Americas can cooperate in mutually beneficial ways to maintain vibrant and resilient global derivatives markets. The alternative could be a state of overlapping and conflicting rules that introduces complexity and risk to the international financial system.

We must strike a balance that respects the supervision of primary authorities while preserving the ability of host country regulators to oversee their markets as appropriate. A supervisory approach based on comity and mutual respect among regulators, grounded in international standards, will help ensure that our markets continue to thrive in the decades to come.

Elke König

Chair, Single Resolution Board (SRB)

Closer international cooperation as the basis for mutual trust

Resolution strategies for banking groups with subsidiaries in several countries can follow either a single point of entry (SPE) or a multiple point of entry (MPE) approach. For groups with centralized structures, resolution authorities (RAs) will likely opt for an SPE approach and apply resolution tools at the parent level, while groups with a sufficiently decentralized structure may be subject to an MPE strategy.

SPE relies on the concept that the parent, being the resolution entity, will be the subject of any resolution action. This allows for the efficient allocation of resources within a group in going concern; in gone concern, the upstreaming of losses and down streaming of resources from subsidiaries and maintaining critical functions must be secured.

By contrast, an MPE strategy would be considered if a bank's structure is based on reasonably independent - in particular "self-funded" - entities or sub-groups. This would result in multiple, operationally independent resolution entities within a group that may be resolved without affecting the other entities or sub-groups. The prevention of contagion entails a challenging trade-off between banks not being fully decentralized in going concern for operational or supervisory reasons, but entirely separable in a resolution event, as outlined in a recent article by Antonio Carrascosa[1].

The Banking Package strengthens the feasibility and credibility of implementing SPE, by requiring RAs to set internal MREL and TLAC requirements, which should facilitate loss absorption within a group. However, the new provisions also provide for a high level of pre-positioning of internal MREL, potentially leading to locked-in capital. It is too early to judge the consequences, but the SRB is concerned that this de facto ring-fencing within the EU might reduce substantially the needed financial flexibility at parent level.

Ring-fencing can increase risks and hamper resolvability, by trapping funds in different parts of the group, thereby not allowing for the optimal allocation of capital, resources and bail-inable liabilities within a group. In contrast, host countries fear that they might have to foot the bill if the subsidiary of a foreign banking group in their jurisdiction were to fail.

> *Trust among authorities is the main driver to overcome ring-fencing attempts.*

For this reason, we encourage policymakers to take forward concrete work on a legally enforceable group insolvency support mechanism for banking groups. These measures should apply to banking groups in Europe, but concrete solutions are also needed at FSB level. In the meantime, the SRB has made "bail-in playbooks" a priority of its work since 2018 and is focussing

on credible and executable plans to upstream losses and downstream capital within a group, if need be.

Moreover, the SRB strives to further enhancing mutual understanding among RAs in the Banking Union and beyond. We are dedicating considerable efforts to reaching joint decisions on MREL and involving not least NRAs outside the Banking Union with material subsidiaries in determining resolution strategies. Similarly, the SRB has enhanced cooperation with third countries through cooperation agreements, workshops and multilateral simulation exercises. We remain convinced that trust among authorities is the main driver to overcome ring-fencing attempts.

1. https://www.risk.net/comment/6787136/how-to-adapt-a-bank-for-mpe-resolution-strategy

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Market fragmentation: through a different lens?

In June 2019, the FSB and IOSCO each published reports on market fragmentation and frictions in global financial activities. In particular, they focused on whether regulatory reforms adopted in response to the 2008 global financial crisis may have given rise to fragmentation.

The reports make it clear that certain types of fragmentation may be intended, but unintended fragmentation could raise issues for financial stability and the effective oversight and supervision of financial markets.

The current COVID-19 pandemic is a public health crisis with spillover to the real economy. The crisis should demonstrate that strong banks can prudently support households and businesses through lending, intermediation, and other activities to ensure the smooth functioning of the global financial system.

Both global standard setters and individual jurisdictions have quickly begun to address aspects of the current regulatory framework that could constrain banks' full support for the economy, such as lack of clarity around the use of buffers. Various recent announcements from the BIS, FSB and IOSCO are positive indicators of coordination at the global level.

Decisions by Basel to delay the implementation of Basel III, and by BCBS and IOSCO to extend the deadline for completing the implementation phases of the margin requirements for non-centrally cleared derivatives, should assist in avoiding the type of fragmentation identified in the FSB Report that results from differences in timing of national implementation of international standards. However, it remains to be seen as this current crisis continues, whether issues arise that make the case for further cooperative mechanisms among jurisdictions.

A type of fragmentation that has been recognized as most difficult to address is described in the FSB report as "jurisdictional ring-fencing." Prior to this crisis, the discussion focused on whether these requirements, if excessive, could impact financial stability by impeding the ability of firms to allocate resources where needed in times of stress.

It remains to be seen whether issues arise that make the case for further cooperative mechanisms...

Now, tensions may arise if a firm's need to allocate resources to support lending and markets is not aligned with the views of regulators and supervisors as to the level of resources that should be maintained in a particular jurisdiction or legal entity. The COVID backdrop may highlight these tensions and how these types of requirements should or could operate in a stress situation.

The COVID-19 crisis may also shed light on other regulatory approaches that had not been a focus of the 2019

fragmentation reports, such as the development of standards and supervisory approaches around operational resiliency. This area may be informed by actual experiences from this crisis and further emphasize the need for a coordinated, rather than fragmented approach, across jurisdictions and regulators.

In the midst of this crisis, actions must be taken quickly to address the crisis; when the crisis subsides, there will be an opportunity for policymakers and financial institutions to look at the issues of fragmentation through a different lens.

Tetsuro Imaeda

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Sumitomo Mitsui Banking Corporation

Regulatory fragmentation – potential approaches

Economic cooperation and international trade contribute to stability and wealth. Inconsistent regulation may introduce friction, reduce efficiency and use resources that could be put to better use. Through bodies such as the Basel Committee, FSB and IOSCO global policy makers have developed internationally agreed regulatory standards for the financial markets.

However, the stresses in the global financial system since the 2008 financial crisis have acted as a major brake on globalisation, partly because countries have focused on national legislative solutions and partly because detailed country or regional implementation of the post-crisis reforms has been inconsistent. Global policy makers have a central role in mitigating the effects of market fragmentation arising from financial regulation.

So, what are the factors which have contributed to market fragmentation?

Despite efforts by regulators to work collaboratively, implementation at a jurisdictional level often differs, sometimes in seemingly insignificant ways. However, the impact may be material. An example is the jurisdiction-specific implementation of the G-20 standards on trading, clearing and margining of over-the-counter derivatives. These standards were intended to make trading safer but have introduced friction and inefficiency in cross-border trading.

When combating crises, local policy makers tend to focus on protecting taxpayers and ensuring financial stability at a country level. Examples include measures relating to bail-in, ring-fencing, resolution and capital buffers.

The purpose is to insulate the national or regional economy from loss by ensuring firms' capital and liquidity is available at a local level. This comes at a cost to regulatory harmonisation and broader economic stability.

Fragmentation may also be driven by rules restricting the ability of non-nationals to access financial markets. Although the final stages of the UK withdrawal from the EU are yet to be played out, it is clear that the withdrawal will result in reduced access to the EU market for UK financial service providers and similar restrictions for EU firms accessing the UK market, giving rise to a patchwork of market access solutions across the EU.

How should global policy makers approach these issues?

It is crucial to develop a greater understanding of fragmentation. Policy makers can ensure that a review of cross-border regulatory issues becomes a regular item in their regional meetings, with detail of where and why fragmentation is happening, and at a global level they could add to their agenda an annual evidence-based report on the unintended consequences of fragmentation.

There should be a targeted expansion of the use of bilateral arrangements such as Memoranda of Understanding to gather information relevant to fragmentation.

Existing cooperation can be improved by making regulatory fragmentation a consistent topic in the work of supervisory colleges, examining topics such as resolution and the pre-positioning of capital and liquidity by international banks.

Finally, policy makers should use the emergence of the digital economy as a catalyst for enhanced international cooperation through the creation of a consistent cross-border approach to the regulation of new products and participants.

Wilson Ervin

Vice Chairman, Credit Suisse

Into the ring: Basel III vs. COVID Crisis

The COVID-19 pandemic is first and foremost a human tragedy. It is also wreaking havoc on health systems, social freedoms and economies. Will it do the same to the new Basel III (B3) regulatory regime? B3 was a powerful impetus for banks to strengthen their resources. But how will B3 perform when it leaves the training stage and enters the ring, for a real fight against a sharp economic crisis?

Round I – the initial shock: The last decade has been well used to address the glaring gaps exposed in the GFC and build robust capital and liquidity. Coupled with swift steps by central banks, the financial system has withstood the initial punch of the COVID Crisis. Unlike 2008 or 2012, banks are generally seen as strong and part of the solution. B3 has won the first round.

Round II – procyclicality: B3 is risk-sensitive, which is good for "point in time" risk assessment. But this creates problems for policymakers looking to smooth an economic cycle. In the last few weeks, economic and financial risk measures have spiked. This will push up RWA for existing balance sheets, as VaR models, credit downgrades, commitment drawdowns, counterparty risk rules, IFRS9, etc. roll into the calculation machinery of B3.

Estimates for RWA inflation range from ca. 10% to 30%+. This will cut capital ratios by 100 to 300 bps, eating into buffers when they're needed most. This will reduce banks' ability to absorb credit shocks or expand lending. Regulators have already leaned against some of the drivers, like IFRS calculations. More footwork is needed to parry this issue in the short term, together with a fundamental review in the longer term. The crisis looks to win this round, on points.

Round III – buffers: The capital B3 stack is a complex layer cake of minima and buffers. While the official minimum CET1 is 4.5% of RWA, few think regulators (or markets) would all allow all buffers to be released and allow a major bank to dip so low.

We don't yet know how much credit damage will be caused by the economic shutdown from COVID. If the credit cycle is harsh, some banks could see capital drawdowns on top of the RWA pressures noted above. This will force a tough tradeoff between two goals: supporting the real economy and supervisory comfort with lower capital levels. Round III will be close – it's too early to call.

Round IV – fragmentation. A fragmented banking market means that local COVID hotspots hit local banks, intensifying the impact in both financial and operational terms. An incomplete Banking Union is not helpful.

Home-host dynamics in the new regime are also untested. How will drawdowns be shared between nations: Will hosts release buffers to help a struggling home, or vice versa? Without cross-border cooperation (resource sharing), our research shows that bank risk can rise by 4x or more. Without clear rules of the road, local legal entity issues could create bottlenecks at exactly the wrong time. The FSB has identified fragmentation as a possible 'glass jaw' of the current system. Strong cooperation between homes and hosts is important to avoid a KO punch.

Pro-cyclicality, buffer flexibility and fragmentation were theoretical issues just a few months ago – now they are critical regulatory challenges.

Europe could build on precedents like the successful 2009 Vienna Initiative (which addressed home-host tensions in the southeast region), perhaps via crisis-proof home host financial support agreements. Broader branching could provide another solution. Europe has often advanced in crises, and we hope it emerges stronger from this round.

Basel 3 – the new financial regime - won the first round but has several tough rounds to go. Procyclicality, buffer flexibility and fragmentation were theoretical issues just a few months ago – now they are critical regulatory challenges. A successful response to each is essential if banks are to both remain safe and support the critical needs of the real economy. ●