



Q&A

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**Key issues for global regulators post-Covid**

**Are there increasing signs of financial fragmentation at the global level? Which activities are most affected and what is the appropriate way forward for addressing this situation?**

In recent years, a key focus for international policymakers and standard setters was on harmful market fragmentation as an unintended consequence of regulatory changes following the global financial crisis, potentially undermining the effectiveness of the G20 reforms. IOSCO and the Financial Stability Board (FSB) promoted greater global consistency in the implementation of reforms, for example by establishing international standards for prudential requirements and setting out governance arrangements and technical guidance for over-the-counter derivatives clearing and trade reporting. However, local variations became all too apparent, and fragmentation also affected cross-border resolution regimes.

COVID-19 was an example of how a market crisis could be triggered by unanticipated events outside the financial sector, but where close communication and coordination at the international level helped to support synchronised policy responses. The initial outbreak put global markets under considerable strain, leading to a flight to safety followed by a severe liquidity crunch in core funding markets. The pandemic's spread and the containment measures to combat it created the conditions for increased fragmentation risk in the Eurozone and elsewhere.

However, central banks and other financial policymakers took very swift, coordinated and effective action to provide liquidity and other support across markets and to the real economy. Securities regulators were quick to acknowledge the risks and allowed a measure of regulatory flexibility to ensure that markets continued to function in an open and orderly manner. The overall level of cooperation was in fact of a high order, although there were inevitable differences; short-selling bans and dividend restrictions are cases in point.

Brexit has been another extraneous event which has important implications for the European Union's (EU) financial system as well as for global capital markets. For example, the UK's departure from the EU has led to fragmentation concerns in both trading and clearing activity. Changes to the rules for passporting rights for UK-based activities as well as delegation rules could also affect funds managed from Asia.

IOSCO has carried out a significant amount of work on cross-border regulation, including its 2015 Report on Cross-Border Regulation and 2019 Report on Market Fragmentation and Cross-Border Regulation. Last year, IOSCO published another report which identified good practices for establishing and operating deference, recognition or equivalence processes which are outcomes-based, risk-sensitive, transparent, sufficiently flexible and backed by strong cooperation. Fragmentation in the securities and derivatives markets remains one of IOSCO's top priorities, with its current two-year work plan focusing on ways to strengthen regulatory cooperation to support deference mechanisms and assist regulators in addressing areas where harmful market fragmentation may be taking place.

**In the increasing incorporation of ESG criteria in financial decisions calling for more standardization in this area at the global level? What are the priority areas concerning reporting in particular?**

Governments worldwide have committed to achieving net-zero emissions targets and recent surveys show that more investors are incorporating ESG issues into their investment and capital allocation decisions. Companies with strong ESG practices have outperformed during the pandemic, prompting a growing number of businesses to recognise the value of ESG and sustainability disclosures for investors as well as for a wider community of stakeholders.

A top priority for global regulators is to agree on a set of standardised sustainability reporting standards. The recommendations made by the FSB's Task Force on Climate-related Financial Disclosures (TCFD) are a good start, but it is crucial that they are adopted and further developed globally. This will help firms embed a broadly accepted framework for reporting on climate-related financial risks into their governance and risk management processes as well as their communications with stakeholders. The UK, Switzerland, New Zealand and Hong Kong have all pledged to align their disclosure requirements with the TCFD recommendations.

In Europe, major steps have already been taken to accelerate the implementation of non-financial reporting frameworks, such as requiring large firms to publish regular reports on the social and environmental impact of their activities. Whilst we are moving towards more consistent, comparable and reliable sustainability reporting, difficult issues such as differing standards and the availability of reliable data and agreed industry-specific metrics will remain, as will the risk of greenwashing and inconsistent ESG ratings. IOSCO working groups are very actively tackling all of these areas.

The important proposal by the International Financial Reporting Standards Foundation (IFRS) to establish a new global sustainability standard-setting board (ISSB)—similar to the International Accounting Standards Board (IASB)—is a very positive step. IOSCO strongly supports the IFRS proposal to create a comprehensive and harmonised reporting framework, starting with climate. IOSCO played a pivotal role in the establishment of the IASB around 20 years ago and will play a similar role in relation to sustainability reporting under a new ISSB. IOSCO will be closely involved in the design and ongoing supervision of a suitable governance framework and, ultimately, will create a mechanism to endorse ISSB sustainability standards for use globally, as it did with the IASB. This will require building more specific disclosure standards around the core TCFD elements, which are mainly to do with governance, risk management and strategic decision-making. An alliance of private sector standard setters has published a joint “prototype” standard for climate reporting which, together with the TCFD recommendations, should give the ISSB proposal a running start.

In the meantime, the EU and China are working on a Common Ground Taxonomy which can provide a common cross-border standard for identifying environmentally sustainable activities. Taxonomies are vital to the sustainable finance effort as they enable capital to be allocated to the right places to support the transition to a greener economy. In the long run, this could provide more transparency for investors and firms, reduce transaction costs and, ultimately, facilitate greater green capital flows across border.

## What are the main vulnerabilities exposed by the COVID crisis in the fund sector and more broadly in NBFIs (Non Bank Financial Intermediation) activities? What are the underlying issues and are further measures needed to mitigate such risks?

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The COVID-19 crisis demonstrated the deep and complex interconnectedness between the capital markets and the wider financial system as well as potential structural and regulatory vulnerabilities in the activities of non-bank financial institutions (NBFIs).

The unprecedented demand for liquidity in March and April 2020 amidst the “dash for cash” created considerable strains across core funding markets, and especially in short-term markets, which placed investment funds in the spotlight. There was a major deterioration in funds' liquidity profiles and increases in redemption pressures, particularly those open-ended funds invested in riskier and less liquid corporate credit. Mismatches between the liquidity of funds' underlying assets and redemption requests can expose funds to vulnerabilities. A particular area of stress was experienced in money market funds exposed to short-term commercial paper. In addition, leverage in some investment funds, especially hedge funds, may make them more sensitive to sharp swings in asset prices. Funds may be forced to sell assets to obtain liquidity and deleverage during periods of market stress.

The funds sector and the broader financial system nevertheless proved to be resilient. However, issues in NBFIs have now been brought to the fore amidst questions as to whether unprecedented central bank interventions were as much about vulnerabilities in underlying core funding markets as they were about structural vulnerabilities in NBFIs. One question is how the higher capital requirements introduced as part of the reforms following the global financial crisis may have led to structural changes in the financial system and contributed to the rapid growth of NBFIs and associated vulnerabilities amidst compressed risk premiums after years of low interest rates, quantitative easing and “reach for yield” behaviour.

Authorities should proceed with caution when considering policy options to address lessons learned from the stresses of last year. One key consideration is how to ensure that NBFIs activities are sufficiently resilient, but to do so in a way which does not stifle investment flows and hence their contributions to the real economy, especially during times of stress.

Financial stability risks arising from NBFIs is one of IOSCO's key priorities in its current work plan. We are working with the FSB on a number of policy areas, including the resilience of money market funds, liquidity risk management for open-ended funds, leverage in investment funds and the provision of liquidity in corporate bond markets.