GLOBAL FINANCIAL AND REGULATORY FRAGMENTATION

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The Berne Financial Services Agreement – A new way to enhance Swiss-UK cooperation

In the final month of last year, we attended the signing of the Berne Financial Services Agreement (BFSA) by Chancellor Jeremy Hunt and the Federal Councillor Karin Keller-Sutter. This concluded our negotiations of a transformative mutual recognition agreement designed to create more efficient and globally competitive conditions for cross-border financial services trade.

The journey toward this landmark treaty has been a meticulous exercise between our two countries, but one coloured by openness and willingness to explore new ideas. We have balanced shared goals of ambition and effective risk management to deliver an agreement which provides the basis for the recognition of regulatory and supervisory frameworks and greater cooperation in financial services, covering the vast majority of wholesale financial services (i.e., services to professional or sophisticated counterparties), and supported by a comprehensive governance framework.

Whilst not all concepts used in the BFSA are inherently new, the way they have been drawn together and applied in an international treaty is unprecedented and demonstrates the ability of both our economies to innovate. When it comes to cross-border trade in an area as highly regulated as financial services, this has been a historically difficult feat.

Based on a thorough assessment of each other's regulatory and supervisory frameworks, the agreement provides for mutual recognition where they achieve comparable outcomes. In some cases, where the wholesale UK and Swiss markets are already open, the agreement affirms existing access. In others, we are not only confirming existing access, but are also delivering genuinely new opportunities for cross border business. We have done this using the principle of 'deference'. This means firms in sectors such as insurance and investment services will largely be able to supply cross-border services whilst relying on the familiar rules and supervision of their home jurisdiction.

We have taken the strengths of established processes for international recognition of equivalence by supplementing these with stability-enhancing commitments in our governance framework and appropriate safeguard mechanism, meaning the new access businesses will enjoy under this agreement will be placed on a more stable footing, allowing them to plan for the long term.

One of the most challenging aspects of this agreement was delivering this ambitious cross-border package while preserving our respective sovereign ability to manage domestic financial stability and market integrity risks with no compromise. Under the BFSA we have developed a layered approach to risk management that overcomes this challenge. At the heart of this is a process for enhanced supervisory cooperation that makes sure there is suitable access to information on both sides to effectively manage risks to our markets.

Signing the BFSA marks the beginning of an exciting new chapter in Swiss-UK relations. This agreement not only expresses our shared commitment to fostering open and resilient financial markets but also demonstrates our readiness to lead and innovate in the global arena. As we look to the future, we are confident that the BFSA can serve as an illustration for cooperation between like-minded nations committed to open markets.

We extend our gratitude to the teams of negotiators, industry experts, and stakeholders who have contributed their knowledge and expertise throughout this journey. Their efforts have established a new standard for conducting cross-border financial business. The agreement includes mechanisms to enable its coverage to expand over time and we look forward working through its framework to deepen our relationship in the years to come.

In Berne, signature of the agreement on mutual recognition in financial services, the Berne Financial Services Agreement. Federal Councillor Karin Keller-Sutter (left-side) and the UK Chancellor of the Exchequer, Jeremy Hunt (right-side).

MARKUS RONNER

Group Chief Compliance and Governance Officer - UBS Group AG

March 2023 highlighted that international collaboration and consistency are key

The events of March 2023 again highlighted how the interconnected and global nature of financial markets requires supervisory cooperation, coordinated policymaking and consistent standard setting by international bodies including the G20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS). While the regulatory framework worked and proved its soundness, we must not be complacent.

In many respects, the response to the crisis showed the value of global regulatory frameworks and the progress made since the Global Financial Crisis. The wider financial system demonstrated resilience in March 2023, with the crisis contained to a small number of firms. Strong international supervisory coordination established over many years meant action could be taken quickly based on established standards, approaches and structures such as crisis management colleges.

As recently emphasised by the BCBS and FSB, the March 2023 events suggest that targeted, internationally coordinated adjustments to the existing prudential and resolution framework should be considered. These include addressing legal uncertainties over executing a cross-border bail in of eligible securities. The case of Credit Suisse, for example, showed the need for effective public liquidity backstops across jurisdictions. And while a single point of entry resolution strategy must continue to be the base case, creating optionality is key.

The execution of a rescue transaction, where feasible, can be a superior option, as in the Credit Suisse case, while sale of business or asset transfer might also be considered, complemented by appropriate preparation for the operationalization of such tools (eg. establishment of data rooms, valuation of certain portfolios). Developments in the US and Switzerland in spring 2023 show the importance of effective supervision and international cooperation, which is equally important as a strongly-aligned policy framework.

Beyond these immediate points of focus, there is still work to be done to avoid fragmentation in the wider framework, in line with the longstanding G20 commitment.

While the regulatory framework worked and proved its soundness, we must not be complacent.

One example is implementation of final elements of Basel III. While the failure of some US regional banks last year reaffirms the need for comprehensive and consistent implementation of the Basel rules, we continue to observe inconsistencies in implementation, such as approaches to risk weighting unrated corporates. Overall, this results in an unlevel playing field and decreased comparability of capital ratios across banks, to the detriment of investors, while increasing operational cost and complexity for international banks. Ultimately, fragmentation can negatively impact the banking system's overall resilience, whether because certain risks are unaddressed, as with the US regional banks, or due to harmful regulatory arbitrage, including where jurisdictions decide to go over and above international standards.

Sustainability regulation in general and reporting requirements in particular is another important area where the regulatory approach is highly fragmented, chiefly because a number of key jurisdictions implemented their own, divergent frameworks in advance of agreement on an international standard. This has reduced the positive impact of ESG frameworks, as financial markets are less efficient at pricing climate related risks and opportunities, while firms operating globally face significant complexities and costs. It is thus important that the reporting standards now approved by the International Sustainability Standards Board are applied consistently in order to reduce fragmentation in ESG reporting and drive comparability in climate-related data to enable investors to support the net zero transition as effectively as possible.

Global regulatory standards have also been agreed for digital and crypto assets, but also after regulatory frameworks had already been defined in some jurisdictions. As a result, this is another area where we see regional divergence. To avoid the risk of increased regulatory arbitrage, we need alignment on the definitions and scope set out in the FSB and IOSCO crypto and digital assets standards.

Cross-border regulatory co-operation is equally important in the non-bank financial intermediation (NBFI) sector. This market is global and regulatory approaches must also be global to ensure effective risk management. We strongly welcome FSB-led work to conduct a mapping exercise on the interconnectedness of the sector, identify risks and develop appropriate policy recommendations.

As the NBFI work evolves, we are seeing efforts to promote convergence of policy and supervisory approaches, for example in addressing liquidity mismatch in open-ended fund structures. This is encouraging both in terms of addressing identified vulnerabilities as well as the signal it sends about the ability of international standard-setting bodies to deliver solutions to complex issues. However, we would welcome a greater sense of urgency to avoid the need for another crisis before regulation is introduced.

Promoting greater regulatory coherence at the global level should deliver more efficient financial markets, allow better risk management and, ultimately, lower risks to financial stability.

SADIA RICKE
Group Chief Risk Officer - Standard Chartered Bank

Regulatory divergence: competition, coordination and challenge

Regulatory divergence is the result of many factors: different contexts for national financial system, distinct policy choices made by governments, and diverse supervisory approaches taken by competent authorities in their local jurisdictions. Some regulatory divergence is inevitable and, arguably, even desirable given specific local conditions. No two countries or markets are the same.

While the risks (and benefits) around regulatory-driven fragmentation across jurisdictions are well known. The fundamental question is: where is fragmentation inevitable and where does it need to be minimised?

As a global bank operating in more than fifty markets, at Standard Chartered, we work with a certain degree of regulatory divergence. Across our markets, we continue to experience diverging local regimes as well as varied supervisory practices.

Unwarranted cross-border regulatory divergence remains a key concern. In fact, such policy differences can create financial and operational inefficiencies through duplicative or even conflicting requirements and expectations. This in turn can lead to the inhibition of cross-border capital flows, unnecessary additional costs for consumers, and even potential financial stability concerns as diverging rules might impact the ability of international firms to move resources during times of stress. These negative implications ultimately weigh on the ability of multi-jurisdiction financial firms to provide efficient financial services to the real economy.

International standard setters and the industry have focused on addressing fragmentation for a number of years. Yet, despite initiatives at various levels – including the extensive work that the FSB puts into building consensus on common minimum standards and facilitating regulatory alignment – the fragmentation trend has continued.

In the current complex geopolitical environment, there is an additional concern that this trend could accelerate due to competition between financial centres, resulting in conflicting standards.

This is evident in the areas of sustainability and new technologies where policymakers are regulating apace without the coordination seen in previous policy discussions, such as cross-border payments and banking resilience. In fact, despite some initiatives by global standard setters, the policy areas lack common structuring frameworks.

In the area of sustainability this becomes problematic as overlapping and contradictory requirements across jurisdictions risks hamper the rapid scaling of sustainable investment and the channelling of capital to where it is most needed. In addition, the increasing reliance in certain jurisdictions on extraterritorial clauses also creates potential conflict of rules, particularly when local standards are designed without considering the specificities of other regions.

Similarly, in the area of new technologies, there have been a proliferation of different regimes. These differ by taxonomy, by focus of regulation, and by timing – for example, the EU's one-time approach versus the UK's phased strategy. This does not make for a level-playing field and increases the potential for regulatory arbitrage. In parallel, there has been the emergence of uncoordinated national restrictions on the cross-border flow of data risk. This impacts the capacity of regulated firms to deliver consistent digital services across many areas of the ever-growing digital economy, thereby potentially inhibiting the creation of an open environment that can fuel innovation. Against this backdrop, we encourage regulators to strengthen international cooperation to develop common frameworks, particularly when addressing emerging areas of regulatory concern. In this context, we welcomed the FSB's 2023 global regulatory framework for crypto-asset activities, which was based on the principle of 'same activity, same risk, same regulation' and attempted to provide a regulatory base line.

We also encourage regulators to continuously take into consideration the broader impacts of their regimes, and to ensure that local requirements are consistent and interoperable with global initiatives, where these exist. In this context, we support current efforts to ensure the interoperability of local sustainability standards with the ISSB's global baseline.

A focus by policymakers on addressing regulatory fragmentation is now more important than ever.

From climate change to new technologies and financial stability, today's major regulatory challenges are global and interconnected. No single jurisdiction can address them alone. Against this background, it is evident that a focus by policymakers on addressing regulatory fragmentation is now more important than ever.

The good news is that regulators have all a shared interest in a sound and competitive financial system and are now used to work across borders more closely than before.

At Standard Chartered, we remain fully committed to engage with policymakers and standard setters as they grapple with how to address these fast-moving policy questions in an internationally consistent fashion.

HIDEO KAWAFUNE

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How does financial fragmentation impact global banks?

In its report on the 2023 banking turmoil, the Basel Committee determined that the shock felt by the global financial system highlighted the importance of prudent regulatory standards and noted that the Basel III reforms implemented to date had helped shield the banking system from a more severe crisis.[1]

These shocks have reminded all in the sector of the interconnectedness of the financial system, but also that significant improvements in financial stability have been achieved through regulatory cooperation since the Global Financial Crisis. However, after many years of increasing globalisation of the financial system, in recent years financial fragmentation has increased, in part driven by geopolitical events and the Global Pandemic. Fragmentation is being seen in many areas, including in prudential regulation, the approach to sustainable finance and the impact on the diversity of business models in the banking sector.

Prudential regulation

Progress towards alignment on financial regulation through the Basel Committee has helped to set a global standard. The implementation of the Basel III standards across different jurisdictions globally has however resulted in different implementation timelines between major jurisdictions and divergences in transitional arrangements; this is an unfortunate outcome for global banks such as SMBC, particularly as Japanese-headquartered institutions will be implementing the standards ahead of other banks in 2024.

As well as adding cost and complexity for international banks, the impact of fragmentation can be felt in the real economy, the clients of financial institutions. For example, diverging rules on risk weights for trade finance products has the potential to make some services unprofitable for large international banks, reducing the choice and lending capacity for corporates.

> **Financial fragmentation leads to increased costs, ultimately affecting the lending capacity of banks and the pricing for customers.**

Approach to sustainable finance

In 2023, record breaking high temperatures have alarmed the scientific community and have reminded us of the urgency that is required of all players in the financial sector to support the transition to a decarbonised society. Decarbonisation is a key sustainability strategic priority for SMBC Group. In 2021 we pledged to achieve Net Zero in our global financed emissions by 2050, and later that year, we joined the UN-convened Net Zero Banking Alliance. SMBC Group is a global leader in financing renewable energy projects, and in 2023 we increased our commitment to providing sustainable financing to JPY 50 trillion by financial year end 2029. Greenhouse gas emissions know no national borders and co-ordinated action is imperative if we are to meet the targets set in the Paris Agreement. Improving the availability, quality, and consistency of data measured and reported is the first step toward decarbonising the economy and cooperation between different jurisdictions is essential to achieve a consistent framework for reporting ESG metrics.

Encouraging progress has been made to achieve a global baseline in climate reporting standards through the development of the ISSB standards, which are being adopted by major financial centres, including Japan and the UK. In the EU, the development of the European Sustainability Reporting Standards (ESRS) has provided banks with a robust framework to report on their environmental exposures, which will improve the quality and consistency of data reported in the EU. For international banks headquartered outside of the EU, it is important to achieve interoperability between standards, both in the EU and globally, to avoid fragmentation, achieve greater consistency, and to focus resources on financing the transition.

Diversity of business models

The great strength of the EU banking sector is its diversity. The EU's financial system has benefitted from having banks with differing and complementary business models and third-country banks have benefitted from the EU's openness to foreign direct investment. This has created a competitive environment in the EU which helps to improve choice and pricing for customers. The EU and Japan share a very positive and constructive relationship, and at SMBC we see the EU market as an important driver of growth; many of our largest customers are EU-based corporates and financial institutions.

However, financial fragmentation leads to increased costs, ultimately affecting the lending capacity of banks and the pricing for customers. International banks have absorbed large costs in recent years due to the impact of Brexit and more recently the Global Pandemic. The recent EU Banking Package and the third-country branch regulations will lead to further organisational changes for international banks and will require time and resources for both banks and regulators to implement.

Fragmentation is unavoidable in certain areas; international banks are complex organisations operating across different continents with differing laws and customs. However, the real economy relies on a well-functioning financial system, and therefore it is important that fragmentation is minimised.

1. *Report on the 2023 banking turmoil (bis.org)*

MICHAEL JEFFERSON
Head of UK Financial Services Public Policy - Amazon Web Services (AWS)

Delivering interoperability in regulations for third-party risk management

Regulation can help enable businesses, support customers and protect societies. However, ensuring regulations strike the right balance and meet the objectives of all stakeholders is crucial, especially in highly regulated industries like financial services. For third-party risk management and outsourcing in financial services there is the opportunity to deliver on these objectives and develop regimes that promote international interoperability and alignment.

Jurisdictions around the world are continuing to review and update their laws and regulations to address increased adoption of third-party technology and services, including cloud services, among financial services firms. The benefits driving this adoption include increased security, flexibility, operational resilience, rapid scalability and reliability.

The US Bank Service Company Act (BSCA), the EU Digital Operational Resilience Act (DORA), the UK's critical third parties (CTPs) to the financial sector, and Singapore's Notice and Guidelines on Outsourcing are examples of measures which have either already been adopted or will come into effect before the next EUROFI High Level Seminar in spring 2025. Despite origination in a number of jurisdictions, the goals of many of these regulations are consistent and this provides the opportunity for harmonisation that can help support the consistent adoption of third-party services that benefits the financial services ecosystem.

Many third-party services, such as cloud computing, are provided on an industry- and location-agnostic basis. Delivering interoperability in regulations will be crucial to ensure that the goals of policymakers, customers and the industry can be met while financial institutions continue to benefit from the advantages of third-party services and outsourcing.

The establishment of an internationally consistent, proportionate and risk-based approach for third-party risk management and outsourcing supports digital transformation of the sector. It means that jurisdictions can ensure regulations meet their needs, but are also interoperable with other jurisdictions to ensure firms can utilise services on a cross-border basis consistently. With the rapid level of technological innovation in financial services, flexibility to ensure any measures can handle increasingly dynamic complexities in the financial and technology spaces is also crucial. Therefore, it is important that the interoperability between jurisdictions and industries is front of mind as regulations are finalised.

Harmonisation can support consistent adoption that benefits the financial services ecosystem.

Supranational bodies will have an important role to play and it is good to see they are already prioritising the areas that can help deliver an interoperability that works. The Financial Stability Board (FSB) published its *Enhancing Third-Party Risk Management and Oversight: A toolkit for financial institutions and financial authorities* in June 2023, the Basel Committee for Banking Standards (BCBS) is reviewing its *Guidelines for Outsourcing in Financial Services* originally published in February 2005, and the International Association of Insurance Supervisors has its Operational Resilience Task Force (ORTF) are examples of key bodies looking at the issues.

AWS continues to engage with these bodies and to advocate for:

- enhanced coordination between financial authorities based on proven standards (for example ISO and NIST standards), and risk-based, outcome-driven regulation to limit fragmentation and redundancies;
- dialogue between financial authorities and their regulated entities, which enable practical guidance on interpreting regulations; and
- skill-development programs within financial authorities focused on new technologies.

As jurisdictions look at how they treat the issue of third-party risk management and outsourcing in financial services alignment, interoperability with principles agreed within international organisations provides a real opportunity to drive the financial services industry forward for future prosperity through digitalisation. This approach will help deliver effective forward-looking regulation and also adapt thinking so regulations are ready for the next wave of innovation.