Feature Article

Global financial regulation – the decade ahead

Central to the response of the international community to the global financial crisis of the early 2000s was a move to strengthen international regulatory standards and to improve cooperation and coordination amongst regulators. A question for the decade ahead is how much of that global approach will survive?

Consensus building

At a meeting held in London, in early April 2009, the leaders of the G20 nations, responding to "the greatest challenge to the world economy in modern times", agreed to implement what they described as a "global solution" for a "global crisis".

The G20 leaders agreed that major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis. They resolved to take action to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector. A new Financial Stability Board (FSB) with a strengthened mandate was established and the scope of regulation was widened; there were real efforts to improve cooperation and coordination.

Even as sovereign parliaments insisted that they would reach their own views on matters of policy, there was a general coalescing around what could fairly be described as global principles proclaimed by the G20 and elaborated upon by the FSB, the Basel Committee on Banking Supervision, International Organisation of Securities Commissions (IOSCO) and others. Banks tended to recognise the need for change but complained loudly about the burden and impact of that change.

From its inception, the FSB played a role in coordinating the development of regulatory, supervisory and other financial sector policies. As it describes itself, the FSB has all the main players who set financial stability policies across different sectors of the financial system at one table. "So when policies are agreed, they also have the authority to carry it out." In truth, it has sometimes seemed that the FSB´s regular report cards on the status of implementation of those agreed standards in particular jurisdictions have carried little weight.

Countries were ready with explanations and excuses and little cost or even opprobrium attached to a fail grade. Even where any two jurisdictions could be said to have implemented an international standard, there were often differences that arose in the local legislative process and which led the banks to complain of inconsistent implementation. Those differences could not always be smoothed over.

But for all those challenges, there is little doubt that there has been a real strengthening of regulation in areas such as capital and risk management and there have been real improvements in international regulatory cooperation, including information sharing, and cooperation around recovery and resolution.

United States

Has momentum stalled?

In the early days of his administration, President Trump issued a set of Core Principles for Regulating the United States Financial System (Principles) and declared it to be the policy of his administration to regulate in a manner consistent with those Principles.

Many of the Principles could be expected to receive bi-partisan support: for example, principles to empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; to prevent taxpayer-funded bailouts; to foster economic growth and vibrant financial markets to enable American companies to be competitive with foreign firms in domestic and foreign markets.

Other Principles, however, especially when considered alongside contemporaneous correspondence that issued from influential members of Congress and criticism of aspects of the Dodd-Frank legislation might suggest that the US intends pulling back from efforts to reach an international consensus on the content of regulation.

Would "America First" be inconsistent with the approach to regulation pursued with vigour since that 2009 G20 meeting in London?

There is nothing necessarily troubling about Principles to advance American interests in international financial regulatory negotiations and meetings, nor in the wish to restore public accountability within Federal financial regulatory agencies and there have long been calls to rationalise the Federal financial regulatory framework, but there are questions nonetheless about US commitment.

And it matters. A breakdown in regulatory consensus makes cross-border business more complex and expensive and increases operational risk. As a practical matter, in most areas of the financial markets if there is no US agreement, there is no meaningful regulatory consensus.

The real test of US intentions and a guide to the future would follow from the second part of President Trump's decree. The Secretary of the Treasury was directed to consult with the heads of the member agencies of the Financial Stability Oversight Council (including the Federal Reserve, SEC and CFTC) and to report to the President within 120 days on the extent to which existing laws, treaties, regulations, guidance, reporting and record-keeping requirements, and other Government policies promote the Principles and what actions have been taken, and are being taken, to promote and support the Principles.

In June 2017, the Treasury duly reported and identified what it described as significant areas for reform in order to conform to the Core Principles. The review identified a wide range of changes that it said could meaningfully simplify and reduce regulatory costs and burdens, while maintaining high standards of safety and soundness and ensuring the accountability of the financial system to the American public.

The Treasury report runs to nearly 150 pages and again, many of the proposals will surely enjoy bi-partisan support but what stands out is how inward looking that report is. There is remarkably little regard paid to international fora nor to the importance of international consensus. Where reference is made to international standards, it is often to recommend a pause in implementation to better assess the appropriateness of that standard for the US domestic market. Even allowing for the historic distinction made by US regulators leading to the non-application of Basel standards to some US domestic banks, there seems to be a real change in attitude to the international order. For example, Treasury recommends delaying the domestic implementation of the Basel Net Stable Funding Ratio and Fundamental Review of the Trading Book rules until they can be appropriately calibrated and assessed. It is said that "both of these standards represent additional regulatory burden and would introduce potentially unnecessary capital and liquidity requirements on top of existing capital and liquidity requirements. US regulators, it is said, should also rationalise and improve the risk-based capital regime over time through, for example, reducing redundant calculation approaches and improving risk sensitivity in the measurement of derivative and securities lending exposures". Of course, the US authorities were leading participants in the Basel discussions that led to agreement on all those international standards. Going forward, one may ask, will the US continue to participate in the international fora in the same way as an opinion leader in efforts to shape international consensus? Or will they operate on the basis that convincing others to accept their view may be desirable but no longer regarded as important? Anecdotally, regulators from other jurisdictions have noticed a change in approach by US regulators to the discussions in those key international fora.

The US Treasury report recommends increased transparency and accountability in international financial regulatory standard-setting bodies and improved US inter-agency coordination before concluding that international regulatory standards should only be implemented in the US through consideration of their alignment with domestic objectives and should be carefully and appropriately tailored to meet the needs of the US financial services industry and the American people. At one level, one might say that is a very sensible, indeed responsible approach but it does seem to foreshadow a significant change in attitude.

For example, Treasury recommends additional study of the recalibration of standards for capital and liquidity that have been imposed on US globally systemically important banks. These regulations are said to add significant complexity to capital and liquidity requirements and there is concern they may have adverse economic consequences that can be addressed without impacting safety and soundness. In other words, the US is walking away from the consensus, built up over several years and commencing with that G20 meeting in April 2009 on how to ensure the effective and consistent prudential oversight of the world's largest internationally active banks.

The US Treasury does "generally" support efforts to finalise remaining elements of the international reforms at the Basel Committee, including establishing a global risk-based capital floor, because it believes banks in other jurisdictions receive more favourable treatment than US banks and "in order to promote a more level playing field for US firms and to strengthen the capital adequacy of global banks, especially non-US institutions that, in

some cases, have significantly lower capital requirements". Regulators in other jurisdictions will, of course, dispute the premise of Treasury's "general" support: support for international standards because you believe that they are bringing others up to the standards required domestically is qualified support, at best.

There is, however, some good news for those who believe in the importance of international regulatory consensus. In its report, Treasury considers foreign investment in the US banking system to be an aid to diversifying the risk of the financial system and propelling economic growth. It is recommended, therefore that regulatory standards on living wills and liquidity, should be recalibrated and greater emphasis should be given to the degree to which home country regulations are comparable to the regulations applied to US bank holding companies. That is a change for the better when compared against the previous policies of the US FDIC and shows that a willingness to recognise and rely upon regulation in other jurisdictions remains part of the US approach, at least where there is a discernible US interest.

Other regulators do not necessarily follow where the US leads but, one may ask, in the absence of strong US support for international standard setting, should we expect the drive for global consistency to fall away?

Europe

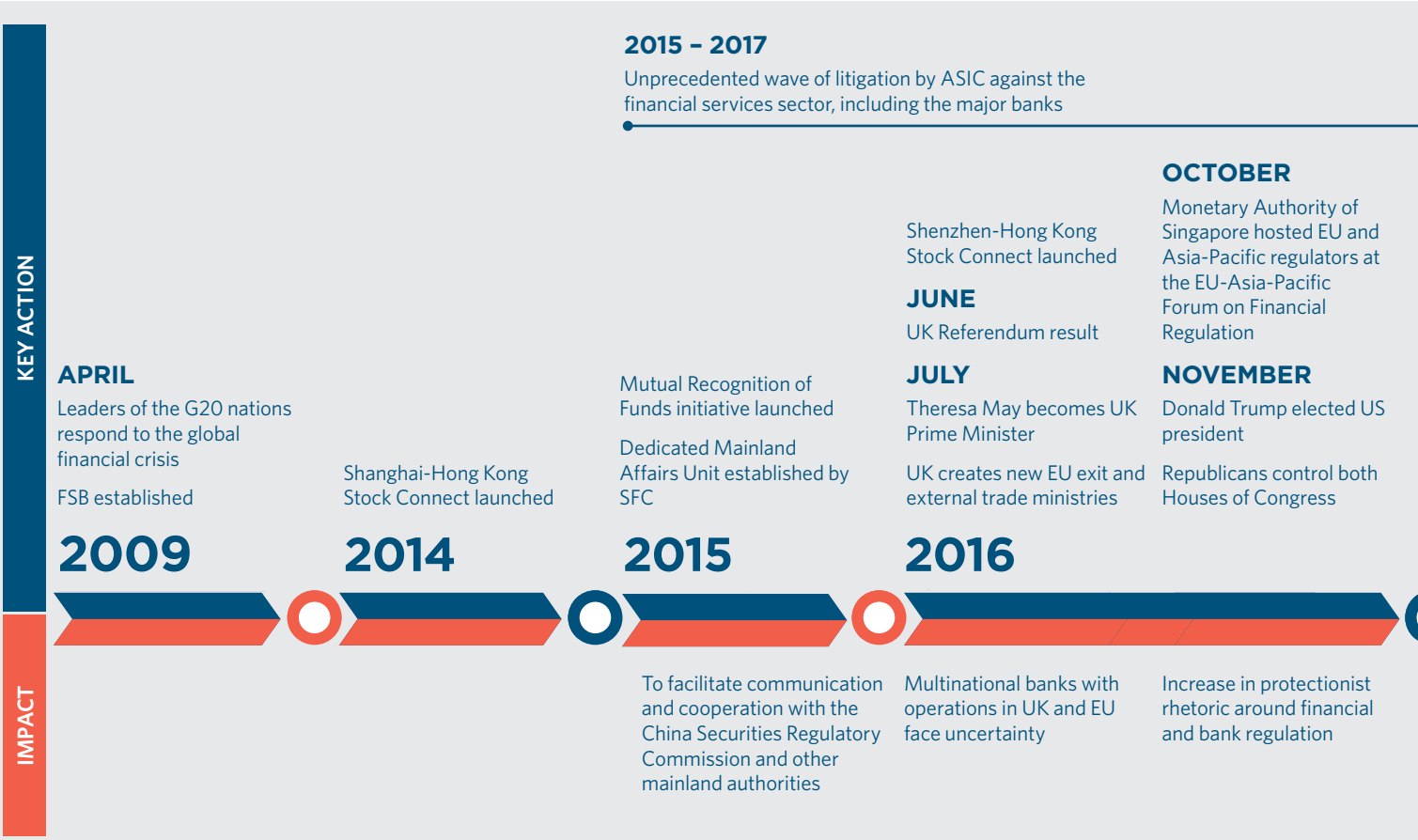
Europe at the crossroads

As already observed, there have been examples in recent years of the EU departing from or going beyond international consensus in agreeing post-crisis regulation. There have also been cases where the EU appeared to operate on the mistaken assumption that if it implemented an international standard in a particular way, the US and others would follow. More recently, there is an example of the EU appearing to follow the US (some would say in reprisal) in proposing that large foreign banks operating in the EU should establish a EU domiciled holding company to sit on top of those operations. Whatever regulatory arguments there may be in favour of such a measure, the proposal is likely to increase the cost of funding for affected banks and result in further regulatory fragmentation.

Within the EU there remains an apparent resolve to continue to strengthen the single market and there does not appear to be any wavering of commitment to institutional structures such as the Single Supervisory Mechanism allowing the European Central Bank (ECB) to oversee the supervision of the largest Eurozone banks.

What impact might Brexit have on international consensus?

For the UK, the immediate effect may be a strengthening of its position at the major standard setting bodies. Generally, the UK already has a seat of its own, for example at the FSB and in Basel at IOSCO but after it leaves the EU, it will no longer have any need to maintain a position consistent with that of the EU. Of course, that may lead to further fragmentation of regulation.



The UK, even as a member of the EU has gone its own way in several important areas including the introduction of ring-fencing legislation, a tougher approach to bank bonuses and the introduction of the senior manager regime to strengthen individual accountability.

In the second half of 2017, the outcome of Brexit negotiations for the withdrawal of the UK from the EU at a political level remains unclear, as just one element of the broader global geopolitical, macro-economic, and environmental uncertainty which prevails in early decades of the 21st century. What is certain, however, is that the EU's financial authorities are making preparations for what some commentators predict to be a mass exodus and what others predict to be just a repositioning of international financial firms from London to the continent.

At the end of May 2017, the European Securities and Markets Authority (ESMA) was the first of the three European Supervisory Authorities (ESAs) to issue principles to guide competent authorities in the remaining EU member states when facilitating relocations into their territories from the UK. In particular, the ESMA principles aim at strictly discouraging the establishment of so-called "letter-box" entities, that is, legal entities which give the firm access to the single market, while retaining substantive activity in London. In July, ESMA provided further more detailed guidance applicable for specific sectors of investment business. The European Insurance and Occupational Pensions Authority and the ECB, as supervisor for the Banking Union, have also issued relocation guidance and materials.

Such principles and guidance, as much as providing an insight into regulatory expectations for firms considering their response to Brexit, also speak to how EU level institutions might attempt to manage competition between Member States for the crown jewels of the financial world which London is expected to cede. Arguably, the principles must also apply to any non-EU, non-UK financial businesses seeking to access the single market. Politically, at least, the ESAs must avoid being seen to penalise the UK more than other non-EU countries.

It will be open to the UK to seek to negotiate a unique relationship with the EU governing financial services. For example, a treaty arrangement might be sought, which sits above the existing complexity of third-country relationships with the EU, governed as they are in a variety of ways by individual directives and regulations. The majority of commentators expect that in the early years post-Brexit the UK will remain close to the EU in the content of its regulation, partly because of the sheer volume of that regulation and the time it will take to review it and partly to enjoy such benefits as may arise from an EU assessment of "equivalence" in a particular area. But the existing equivalence landscape is fragmentary and not a sufficient basis for most banking models to operate out of the UK into the EU. Moreover, there is every reason to expect that on important matters of regulatory policy, the UK Parliament and UK regulators will eventually want to express their own views: divergence from the EU is inevitable over time. Perhaps, on a particular topic, the UK will move closer to the US than the EU, perhaps not. A "third way" seems distinctly possible.

Asia-Pacific

Asia-Pacific: champions of the international consensus?

What of Asia-Pacific? Generalisations about such a diverse region are inevitably open to exceptions but there are some discernible features of recent years that may be expected to continue into the future.

Although the European jurisdictions have a greater voice at many of the international standard setting bodies, the jurisdictions of Asia-Pacific have shown a willingness to implement those standards, and a willingness to enhance cooperation and information sharing within the region and beyond. The Asia-Pacific regulators have, for example, started to meet as regional regulatory colleagues to share information and coordinate the supervision of individual entities. Those same regulators and their legislatures have by-and-large shown a willingness to implement international standards in a manner that allows for both a positive equivalence assessment by the EU and a decision by US authorities to allow "substituted compliance": not always straightforward given EU/ US divergence! We should expect that to continue even as it becomes more difficult to meet diverging standards.

In October 2016, the Monetary Authority of Singapore hosted regulators from the EU and the Asia-Pacific region at the inaugural EU-Asia-Pacific Forum on Financial Regulation. The focus was on information sharing, the current and future regulatory framework governing financial services at an EU level and in the jurisdictions of the Asia-Pacific region, challenges in cross-border coordination and emerging policy priorities.

Similarly, market regulators, meeting as the Asia-Pacific Regional Committee of IOSCO are working toward the implementation of a regional road map. That work includes strengthening working relationships with other regional bodies such as the FSB Regional Consultative Group for Asia, the Association of Southeast Asian Nations and the Asian Development Bank. There are also existing regional initiatives, such as the Capital Market Takeovers Forum and the Regional Regulators Group on Market Surveillance. The IOSCO grouping has expressed a commitment to implementing consistent and effective regulation benchmarked against sufficiently granular international standards - although one might observe: if there are any.

Certainly the commitment to greater collaboration in the supervision of cross-border financial institutions, and strengthened financial regulatory cooperation in Asia Pacific appears strong amongst regional regulators. There is also work being done on developing mutual passporting and recognition arrangements in the region. IOSCO has also said it will look to map key areas of the regulatory framework to identify areas for capacity building, possible mutual recognition and cross-border opportunities.

In the view of some economists, by 2027 China will be close to overtaking the US to become the world's largest economy so let us end this discussion with some observations about how China may approach global regulation.

China held its National Financial Work Conference in July 2017. According to Xinhuanet, President Xi Jinping announced at the conference that the mainland will set up a committee under the State Council to oversee financial stability and development.

The People's Bank of China will play a stronger role in macro prudential management and guard against systemic risks. China will, "at a steady pace", further open up its financial market to promote the internationalisation of the Chinese yuan and capital account convertibility.

The interconnectivity of the mainland and Hong Kong markets has increased rapidly in the last few years, resulting in the need for regulators in both markets to enhance regulatory cooperation. Contributors to such interconnectivity include the Shanghai-Hong Kong Stock Connect launched in 2014, the Mutual Recognition of Funds initiative in 2015, the Shenzhen-Hong Kong Stock Connect in 2016 and the Bond Connect earlier this year. In addition, mainland institutions are playing an increasing role in the Hong Kong market. According to the Hong Kong Securities and Futures Commission (SFC), about 13% of Hong Kong licensed corporations are controlled by mainland corporates. Mainland firms currently account for around 70% of sponsor business, 10% of securities dealing and 40% of margin loans in Hong Kong. In view of the increased connectivity with the mainland, the SFC established a dedicated Mainland Affairs Unit in 2015 to facilitate communication and cooperation with the China Securities Regulatory Commission and other mainland authorities.

China is a member of the FSB, the Basel Committee on Banking Supervision and the Board of IOSCO. Four Chinese banks are among the 30 banks identified by the FSB as the globally systemically important banks. The FSB assesses China to be ahead of the EU, and arguably ahead of the US, in its implementation of the Basel 3 capital reforms. If the US Treasury recommendations discussed earlier are implemented, the US may well fall further behind China in its FSB rating.

What does this changing regulatory environment mean for global banks?

We have then a situation in which the Asia-Pacific region, including the rising giant of China, is showing a strong commitment to international standards and consensus just as the US arguably moves away from its global leadership role. The EU remains apparently constant in its commitment but for how long if the US shows signs of withdrawal? The UK is poised to jump but in what direction, is unclear: perhaps, increasingly to take its own path.

All that suggests increased complexity and cost for internationally active banks. Those banks already struggle with the challenge of implementing new regulation. That challenge is likely to get more difficult in the years ahead.

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Australia

Australia: regulation by litigation

The past two years have seen an unprecedented wave of litigation by the Australian Securities and Investments Commission (ASIC) against the financial services sector, including the major banks. Banks are also being served with an avalanche of notices to produce documents and answer long lists of detailed questions. Even when an investigation does not warrant court proceedings, ASIC is increasingly insisting on "enforceable undertakings" with a substantial "community benefit" payment as the price of peace. Where a particular issue affects more than one bank, ASIC is adopting a divide and conquer strategy – obtaining a concession from one bank and then pressuring the others to do the same.

ASIC has received substantial funding to investigate and prosecute the banks. It may well be that ASIC, in turn, feels it should to deliver a return on that investment.

What is missing from the political debate and, it seems, from ASIC's strategy, is an accounting of the cost of the strategy of regulation by litigation. Hundreds of millions of dollars have been spent by ASIC (at the expense of taxpayers) and the banks (at the expense of customers and shareholders) dealing with enforcement. And the cost is not just financial. When ASIC and senior management of the banks spend significant amounts of time raking over the coals of the past, they are left with less time to focus on improving customer outcomes in the present and future.

To be clear, ASIC enforcement activity has an important role to play in regulating financial markets. If misconduct is not punished, it is encouraged. However, ASIC's track record of identifying institutional, as opposed to individual, misconduct in the financial services industry is patchy at best.

More significantly, much of the litigation commenced by ASIC does not truly concern misconduct but arises from genuinely held but differing interpretations of the relevant law. After one of its most significant court losses, against Citigroup in 2007, ASIC said that where it "feels that clarification of the law by a court is important, it will as a matter of policy, commence proceedings".

It is difficult to consider that litigation is the most efficient and effective way to clarify the law. If ASIC was prepared to reserve investigations and litigation for cases of suspected misconduct and to engage in dialogue with the banks as a whole about industry issues and legal uncertainty, customer outcomes for the future would be improved more quickly and cost-effectively.

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ASIC – Pending court proceedings (financial services)