IRSG

INTERNATIONAL
REGULATORY
STRATEGY GROUP

GLOBAL SOLUTIONS TO GLOBAL PROBLEMS

Promoting Regulatory Coherence in Financial Services for Pandemic Recovery

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TheCityUK

FOREWORD

A decade on from the 2008 financial crisis and as recovery efforts from COVID-19 take centre stage, support for global coherence remains critical, together with an enhanced commitment to solving issues (old or emerging) with international co-operation.

Global regulatory coherence and consistent implementation of global standards in a way that fosters cross-border activity, encourages fair and open competition, benefiting customers, firms and their regulators alike. This is good for economic growth and good for financial stability.

This paper argues the case for a renewed commitment to "global solutions to global problems", with practical examples on where market fragmentation may give rise to financial instability and other risks. This paper also makes recommendations as to how local and international bodies can ensure this principle remains central to their work in the coming months and years.[1]

> **"We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."**
>
> G20 Leaders' Statement, Pittsburgh, 2009

1 See also IRSG, "Global regulatory coherence within financial services", September 2018.

PRINCIPLES FOR REGULATORY COHERENCE

This paper recommends the following six key principles for global regulatory coherence:

1. CO-OPERATION

The regulation of individuals, firms and industries that operate across borders is best achieved through regulatory and supervisory co-operation and co-ordination.

2. COMMUNICATION

Policy-makers and supervisors can benefit from mutual exchanges of information and insight as financial services evolve and supervisory practices are refined.

3. TRANSPARENCY

Strong and close ongoing communication promotes trust and improves the effectiveness of regulatory and supervisory processes. International organisations and global standard setters should continue to work towards greater transparency and openness.

4. INNOVATION

Given technological developments, regulation and supervision are evolving disciplines requiring ongoing consideration of best practice, risk-based approaches and areas of improvement.

5. CONSULTATION

Consultation and impact evaluation are essential aspects of good policy formation and regulation.

6. RESOURCING

Resourcing of financial supervisors should consider the need for international cooperation and coordination.

PRINCIPLES FOR REGULATORY COHERENCE

As world leaders understood a decade ago, regulatory coherence is critical to a robust global framework for the conduct of financial services. The opposite, as the Financial Stability Board (FSB) has identified is "a divergence in regulatory frameworks, which could impede the development and diffusion of beneficial innovations in financial services, and limit the effectiveness of efforts to promote financial stability." [2]

The costs for society of fragmentation are many, and as the International Organization of Securities Commissions (IOSCO) has identified include:

i. *multiple liquidity pools in market sectors or for instruments of the same economic value which reduces depth and may reduce firms' abilities to diversify or hedge their risks and result in similar assets quoted at significantly different prices;*

ii. *a reduction in cross-border flows that would otherwise occur to meet demand;*

iii. *increased costs to firms in both risks and fees; and*

iv. *the potential scope for regulatory arbitrage or hindrance of effective market oversight.*

2 Financial Stability Implications from FinTech, FSB, June 2017

THE RISKS OF FRAGMENTATION

Despite the consensus among experts on the benefits of coherence, however, it is increasingly necessary to restate the case, especially in light of the risks of fragmentation:

- The global economic recovery efforts in the aftermath of the pandemic have raised global regulatory cooperation to the forefront once again, as new opportunities have emerged for regulators to share experience on their approaches internationally, given the global nature of this pandemic.
- Furthermore, the current environment is dominated by an increase in protectionist and nationalist rhetoric amongst global leaders, and tensions in international trade, as countries compete to remain competitive in these difficult circumstances. Financial service providers who are unprepared to innovate and compete, instead preferring captive markets welcome this trend, to the detriment of consumers in the jurisdictions concerned.
- In the EMEA region, Brexit has complicated matters, as perhaps the biggest single act of fragmentation. This risks being compounded by the EU's response should it result in the continental markets being cut off from global structures and liquidity pools.
- To complicate matters further, the conjuncture for asset prices and monetary policy is an outlier relative to norms and has been linked to greater economic and social inequality. For many of those who are discontented with the current environment, global regulatory coherence can be seen as something not to be promoted, but rather something to be curtailed. As may be expected, populist undercurrents have also led to a resurgence in protectionism. For instance, the impact of the US decision to pull out of the UN Paris Agreement has been raised in the context of global cooperation efforts.
- Another reason is that memories of the 2008 financial crisis are fading just as the world enters a new, deeper recession post-COVID-19 pandemic. The corollary is that the momentum behind regulatory coherence is faltering and market fragmentation seems on the rise.

RENEWED CONSENSUS

As the Governor of the Bank of England and FSB Chair said in a speech in April 2017: *"The global financial system is at a fork in the road. On one path, we can build a more effective, resilient system on the new pillars of responsible financial globalisation. On the other, countries could turn inwards and reduce reliance on each other's financial systems".*

To avoid burdening the global economy for decades to come, now is the time to create a renewed consensus as to:

- **the benefits of regulatory coherence – in other words, finding global solutions for global problems for pandemic recovery, rather than each country or region going its own way;**
- **a common ground for balancing local vs global approaches to regulation;**
- **how regulatory coherence can best be achieved including addressing implementation issues[3]; and**
- **an agenda of key areas and issues to focus on in the next 3-5 years, to rebuild better post-crisis.**

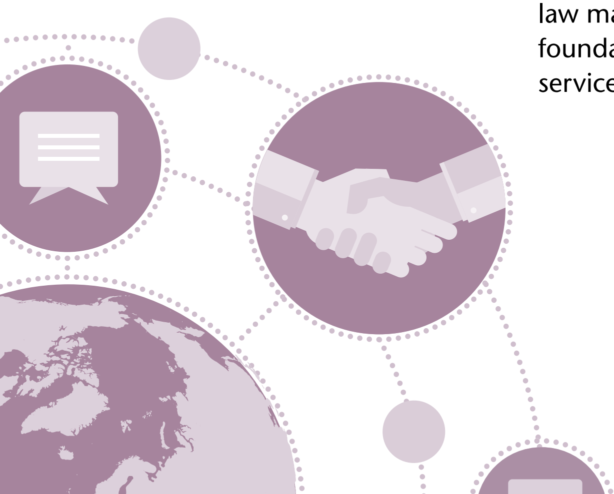
"We are at a fork in the road. One path builds on the foundations of a new responsible global financial system that are being put in place."

Mark Carney, Former Governor of the Bank of England and FSB Chair

3 From an operational perspective, how global standards are implemented via local laws can be just as important as the formulation of the standards themselves. As stated by the OECD: "Where financial regulation is developed internationally, coordination in implementation is important since compliance mechanisms and supervisory functions are largely organised at a national level. Any material inconsistencies in implementation could further aggravate the potential problems of regulatory duplication, burden, conflict and barriers, and create opportunities for regulatory arbitrage between countries." In the coming years, a specific focus on implementation issues and deviations that may inadvertently dilute the benefits of regulatory coherence would be well placed.

WHY SHOULD WE CARE ABOUT REGULATORY COHERENCE IN FINANCIAL SERVICES?

Where regulatory coherence is appropriate, it is good for customers, good for firms and their regulators, good for economic growth and good for financial stability.



BENEFITS FOR CUSTOMERS

- The need for firms to comply with different highly complex regulatory regimes in different countries creates inefficiency and cost, which is ultimately passed on to customers in the form of higher prices.

  This has been magnified in recent years with the pace of regulatory change and the volume of new requirements. For example, firms can be required to maintain separate pools of capital and liquidity to meet the requirements of separate national supervisors, develop different IT and risk management systems for different jurisdictions, and incur heavy compliance costs.

  Rationalising international standards could result in efficiencies which could be passed on to customers via lower prices, supporting the real economy and economic growth.

- Consistent regulatory standards can build trust between law makers, regulators and supervisors and provide the foundation for market access, giving consumers innovative services, more choice and value for money.

BENEFITS FOR FIRMS AND THEIR REGULATORS

- Differing requirements across jurisdictions create operational risk and complexity as firms try to comply with inconsistent rule books across borders. Operational and IT platforms must be fragmented, as well as compliance monitoring and reporting. This increases the possibility of mistakes and makes it harder for firms and their regulators to manage risk.

  A greater emphasis on regulatory coherence helps firms to develop a harmonised international operating platform, reducing operational complexity and making it easier for firms and their regulators to identify business risks and ensure they are properly managed.

- Consistent regulatory requirements create a fair, level playing field between local businesses and firms coming into the jurisdiction on a cross border basis and avoiding regulatory arbitrage. They enable local regulators to avoid local political or industry pressure in terms of a “race to the bottom”.

WHY SHOULD WE CARE ABOUT REGULATORY COHERENCE IN FINANCIAL SERVICES?

ECONOMIC GROWTH

- When financial services firms have clarity on what the future regulation affecting them is going to look like – both over time and across geographies – they can have the certainty they need to invest and grow. This can allow them to expand the amount of business they do, provide a wider range of products and services and/or push into new markets. In turn, this supports the real economy and helps to boost global growth and job creation.

FINANCIAL STABILITY

- Certain types of market fragmentation may reduce the resilience of both global and domestic financial systems, as observed by the FSB.

  The interconnected nature of the international financial system gives rise to contagion risk. This and the presence of excessive imbalances in some regions require a coordinated and adequately resourced global financial safety net and a strong framework for the prevention and (where relevant) resolution of a debt crisis.[4] Coherence is a way of managing the risks of contagion while retaining the benefits of integration, without suffering the consequences of fragmenting markets.

KEY FACT:

The International Federation of Accountants (IFAC) and Business at OECD found that regulatory fragmentation in the financial sector consumes 5-10% of annual turnover globally.[5]

“Where fragmentation limits opportunities for cross-border diversification and risk management, impairs market liquidity or prevents capital and liquidity from being channelled to where it is needed in periods of stress. Such market fragmentation may reduce the efficiency of cross-border investment and risk management, and thereby increase costs faced by end investors through inefficient resource allocation.”

FSB Report on Market Fragmentation,
Financial Stability Board, 2019

4 IMF, 2017 Global Prospects and Policy Challenges: G-20 Finance Ministers and Central Bank Governors’ Meetings, 17-18 March 2017, Baden-Baden, Germany.

5 International Federation of Accountants & OECD BIAC, Regulatory Divergence: Costs, Risks and Impacts, February 2018.

WHERE IS THE PROOF THAT REGULATORY COHERENCE WORKS?

The 2008 financial crisis prompted an unprecedented period of global co-operation and international standard setting in financial services, to mitigate the risk of future disaster and promote financial stability and resilience. A period of enhanced regulatory co-ordination followed, to deliver a reform package that included strengthening recovery and resolution planning; addressing too-big-to-fail and global systemically important financial institutions (GSIFIs); improving bank capital requirements through Basel III; and supporting reforms on over-the-counter (OTC) derivatives and shadow banking. This has resulted in a much more stable financial system. Indeed, the proof is the stability of the system in the wake of the current crisis, with no evidence of the levels of disruption following 2008 crisis. Examples of past successes assuring present stability are as follows:

- The Basel Committee, set up in the late 1980s to ensure that internationally active banks met minimum capital standards, reassuring a country that foreign banks operating in their jurisdiction were commercially viable and operating on a level playing field with domestic firms in terms of regulatory requirements. Banks have continued to be able to move funds and risks around the world using international private balance sheets to support economic development.

- Within the banking sector, significant progress has been made on identifying globally and domestically systemically important banks and putting in place a common approach to their resolution, either through a single or a multiple point of entry model. These resolution plans have been supported by international agreement on the distribution of loss-absorbing capital within banking groups.

- In international markets, foreign exchanges and trading venues have been recognised and allowed access on comparable terms. This allows the concentration of trading where markets are most liquid and transactions can be netted, to the material benefit of customers. Reporting requirements have been largely aligned, a common Legal Entity Identifier (LEI) system has been introduced and banks have voluntarily agreed to stays on their rights in the case of an major bank failing to provide time for the situation to be addressed in an orderly manner.

Much has been achieved in these areas. However, implementation variations in international requirements remain, particularly in technical areas. This creates unnecessary friction, cost and operational complexity. A case in point is the implementation of the Market Risk reforms arising from the Fundamental Review of the Trading Book (FRTB). Some jurisdictions will not be able to meet the initially agreed timeline, and it will be essential for future regulatory coherence that an internationally agreed adjustment to the timeline is delivered.

WHAT BENEFITS COULD WE GET FROM REGULATORY COHERENCE IN THE FUTURE?

The benefits that could be achieved by renewed efforts towards regulatory coherence should not be underestimated, three areas in particular stand out:

1. CLIMATE CHANGE

2. CYBER CRIME

3. FINANCIAL CRIME

Background: In the report 'Better Growth, Better Climate', the Global Commission on the Economy and Climate estimates $93tn to transform the world's infrastructure into a sustainable one by 2030, as opposed to $89tn if no carbon emission reduction goal was reached. Despite the capital needs, the G20 Green Finance Study Group set up during China's G20 Presidency in 2016 showed there is potential in green investments: Only 5-10% of bank loans are 'green' in the few countries where national definitions of green loans were available. Less than 1% of total bond issuance are green. Less than 1% of holdings by global institutional investors are green infrastructure assets.

Opportunity: As countries rebuild infrastructure post-pandemic, many are rebuilding "better" by leading with economic recovery plans with criteria attached that incentivise green transformation. The Canadian government has set up a Large Employer Emergency Financing Facility to provide bridge financing to the largest employers in order to avoid bankruptcies. Funding is contingent on publishing annual climate-related disclosure reports consistent with the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), including how their future operations will support environmental sustainability and national climate goals. More can be done to develop common approaches to issuer disclosure (such as leveraging TCFD and SASB standards), greenwashing, and ESG data and ratings. IOSCO's 2020 report on Sustainable Finance and the Role of Securities Regulators leads with relevant recommendations.

"There is potential in green investments."

WHAT BENEFITS COULD WE GET FROM REGULATORY COHERENCE IN THE FUTURE?

1. CLIMATE CHANGE

2.
CYBER CRIME

Background: Over the next 5 years, companies risk $5.2tn globally to cyber crime, according to Accenture's 9th Annual Cost of Cybercrime Study. Due to the interconnectedness of digital devices and networks, an attack on one institution can have significant cascading, systemic effects. A single-point attack on an intermediary responsible for payments, clearing or settlement could spread to the entire system, leading to widespread payments outages.

Firms strengthen their own defences, but there are additional, negative externalities not owned by any single firm or regulator, such as contagion and potential for systemic escalation, which are harder to take into account given the difficulties with assigning accountability or costs for 'public' good in competitive, market sectors. This necessitates market intervention.

Opportunity: The pandemic has reshaped our use of digital technologies, bringing the issue of cyber crime to the forefront regulatory and standard setter agendas globally. The UK National Fraud & Cyber Security Centre (NCSC) has reported that COVID-19 related fraud reports increased by 400% just in March 2020, linking this to the increase in home working. The NCSC have amended existing and issued new guidance to help organisations deal with this threat. Cyber security is an area requiring international co-operation and information sharing to develop new, global standards to address new, emerging risks.

3. FINANCIAL CRIME

"Cyber security requires international co-operation."

WHAT BENEFITS COULD WE GET FROM REGULATORY COHERENCE IN THE FUTURE?

1. CLIMATE CHANGE

2. CYBER CRIME

3. FINANCIAL CRIME

Background: A whole industry has built up around compliance with AML and KYC regulations. The complexity of the rules has created a regtech industry which is applying technology-based solutions to the challenges of compliance which costs banks an estimated $100bn annually. Despite this, since 2008, financial institutions have been fined over $321bn by regulators.

Opportunity: The Financial Action Task Force (FATF) has set global standards against money laundering and terrorist financing for over 25 years. FATF recommendations increase transparency and enable countries to take action against illicit use of their financial system, and have been adopted globally, with robust monitoring processes in place to ensure co-operation from national stakeholders.

"Early on in the COVID-19 crisis, the FATF flagged the increasing risk of criminals exploiting the situation, for example by obtaining financial aid by fraud or by embezzling public money. The FATF's risk-based standards are crucial in a situation like this. They allow funds to be brought swiftly and efficiently to those in need – but also guard against funds wrongly falling into illegal channels." [6]

6 FATF President's remarks to G20 Finance Ministers and Central Bank Governors meeting, 14 October 2020

"FATF standards guard against illegal use of public financial aid funds"

RECOMMENDATIONS

The past year has seen an increasing number of voices expressing concern about the risks of market fragmentation, notably the FSB and IOSCO. Such work shines a light on the cost of the breakdown of an international consensus on regulatory requirements. The IRSG believes that a renewed focus on coherence is important to ensure that the regulations governing the global financial industry are fit for purpose and reflect the evolution of the opportunities and threats on the horizon in the post-COVID-19 world when global economic recovery takes centre stage. We would also suggest the following three specific recommendations:

1. FOSTER OPERATIONAL RESILIENCE

A call on global regulators and standard setters, in co-operation with national stakeholders, to play a leading role in global economic recovery by developing guidance and a set of standards to foster operational resilience of global supply chains within the financial services industry in the post-pandemic environment.

2. ENCOURAGE INNOVATION IN DIGITAL GOVERNANCE

Create, shape and influence the global digital regulatory framework by fostering regulatory and standard setting collaboration and information sharing in critical emerging areas, including cyber security, data privacy, cross-border data transfers, fintech and regtech, in order to avoid regulatory fragmentation, promote an open and level-playing field, and mitigate emerging digital security risks and vulnerabilities.

3. INCENTIVISE SUSTAINABLE FINANCE

Encourage the development of a better financial services framework for incentivising green finance, financial inclusion and sustainable finance objectives, including where appropriate common standards on disclosure, to prevent green washing, and enhance ESG data and ratings.

CONCLUSION

This paper has sought to argue the case for a continued commitment to "global solutions to global problems", inviting a renewed focus on regulatory coherence and suggesting ideas as to how this can best be done as countries around the world focus on global economic recovery efforts. The final words may, however, be left to the FSB, which are now more salient than ever…[7]

"The work of the FSB reflects the fact that, in a global financial system, we cannot see and address emerging problems alone. Working as allies and colleagues, we have bound up most of the wounds from the last financial crisis. To avoid reopening them – and returning to a fragmented international regime – we will have to recommit to collaboration, embrace insight where it emerges, and follow evidence where it leads. With broad engagement, rigorous vigilance, and committed analysis, the risks ahead of us can be less dangerous than the ones we left behind."

7 Randal K Quarles (FSB), Speech titled "Beyond the Fog of Battle", 2 April 2019, page 7 (https://www.fsb.org/wp-content/uploads/S020419.pdf).

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The International Regulatory Strategy Group (IRSG) is a practitioner-led group comprising senior leaders from across the UK-based financial and related professional services industry. It is one of the leading cross-sectoral groups in Europe for the industry to discuss and act upon regulatory developments.

With an overall goal of promoting sustainable economic growth, the IRSG seeks to identify opportunities for engagement with governments, regulators and European and international institutions to advocate an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing views.

TheCityUK and the City of London Corporation co-sponsor the IRSG.

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