POINT OF VIEW

IS THE ERA OF FINANCIAL REGULATORY COORDINATION COMING TO AN END?
Since the global financial crisis, there has been strong support among national and international regulators to develop consistent regulation and cross-border solutions on financial oversight. Many of the reforms put in place in Europe or the US have been mirrored in other jurisdictions to enhance financial stability and regulate conduct. International rule-making bodies, led by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), have achieved much in setting global standards to foster global financial stability and sustainable economic growth, while forums such as the G20 have encouraged cooperation and coordination on regulation, as well as incorporating macro tools in terms of monetary and fiscal policy.

However, there are signs that this concerted global effort to financial regulation is taking a pause for thought, as indicated by the Basel Committee’s 2017-18 strategic priorities, published last week. The Basel Committee will now place a greater focus on supervision and assess whether additional measures are warranted.

Indeed, when I attended the annual Institute of International Finance (IIF) G20 conference in Frankfurt in March, policymakers, regulators and business leaders voiced some common concerns about the current financial regulatory landscape – and clear arguments for a rethink. While the international capital requirements are widely regarded as adequate and sensible, there was a broad recognition that wider regulation should be reviewed. One example which attracted particular criticism from industry leaders is the notion that to comply with Know Your Customer (KYC) and Anti-Money Laundering (AML) requires banks to report on the customers of their clients. This burden is likely to have an unintended consequence in that it raises the cost of new customer acquisition, leading to a constraint on lending and driving financial exclusion. Ultimately, there is a growing consensus among regulators and policymakers over the economic cost of resilience, and that cost-benefit analysis must be conducted in a transparent manner for financial regulatory reforms.

The Basel Committee’s pause for thought is coinciding with national regulators’ pondering over their own agenda. Most notably, the US is currently reviewing its financial regulation in light of the new “core principles” the President set out in his executive order in February. And here in the City of London, some have started to wonder about the UK’s regulatory leeway post Brexit. Are we seeing the beginning of an end to the globalised approach to financial regulation?
Prospect of regulatory divergence in an era of localism

Geopolitical and macroeconomic sentiment have significant ramifications for the regulatory agenda. At the IIF annual conference, many of my conversations with finance ministers, central bankers and leading industry executives have been on the global economic and policy outlook, financial regulation and international trade - and the interplay between them. While some representatives expressed grounds for optimism, highlighting signs of recovery, particularly in the US – and the fact that previous deflationary worries are disappearing; many more focused on the challenges and the significant number of “headwinds”. These ranged from diverging and imbalanced economic growth, the persistence of low real productivity, high levels of debt and fiscal challenges – all act as impediments to a robust and synchronised global recovery.

Some of the most serious concerns expressed by the speakers and delegates were associated with the rise in populism – with the most obvious examples being Trump, Brexit and the fact that for the first time in six decades, neither the traditional socialist nor conservative party managed to reach the run-off round of the French Presidential election. Each of these developments carries their own risks and challenges to the regulatory landscape.

I have outlined potential consequences of Trump’s “America First” approach on the regulatory landscape here. The common theme is a worrying trend towards even greater levels of localism and protectionism on trade and regulation.

The prospect of a new era of regulatory divergence and fragmentation is real. This trend will undoubtedly create asymmetry in the global regulatory landscape and harm cross-border financial services, inhibiting flows in capital and liquidity between jurisdictions, which would adversely affect lending, stifle economic growth and lead to further financial instability.

Fissures in the global regulatory architecture

Several examples of this are already evident. The European Commission’s recent Intermediate Parent Undertakings (IPU) Proposals, which would require large non-EU banking firms with EU operations to establish an intermediate holding company (IHC) in the EU, is one such manifestation. This has caused concern among industry representatives in much the same way as the US Foreign Banking Organisation Rule (FBO), which placed the control of foreign banks more firmly in the hands of the Federal Reserve through the establishment of IHC to trap capital and liquidity.
Critics of this have noted that the prospect of requiring foreign banking groups to create IPUs will limit the structural and financial flexibility of these banking groups, with negative implications for the financing of the European economy and system stability. The EU had always adopted the principal of supervisory reciprocity (equivalence) without needing to establish a Holding Company Act. The IPU breaks this tradition and signals a lack of trust in third countries to resolve their branches or subsidiaries inside the EU. It should be noted that this could make Brexit even costlier for UK banking in the EU.

A further concern is that by imposing such measures, the EU is deviating from internationally agreed standards and from the international regulatory program of the G20, the FSB and the Basel Committee. The IPU could well complicate global total loss-absorbing capacity (TLAC) standards as the intent of FSB driven TLAC was to ensure global cooperation, whereas its proposed functioning of “internal TLAC” seems to be inconsistent with the FSBs global standard.

The proposal would make the European market a less attractive investment proposition for global banks. This also happened at a time when Brexit and Capital Markets Union combine to increase the need for well-funded market participation.

This is obviously not the only fragmentation taking place in the global system, as we articulated in our “America First” paper, President Trump has threatened to undercut the Consumer Financial Protection Bureau (CFPB) and further impose constraints on the Federal Reserve Prudential oversight especially with the resignation of Chief Supervisor Daniel Tarullo—a major proponent of stress testing.

Structural proposals in banking is another example of regulatory divergence globally. In achieving a common goal of protecting retail banking from investment banking, the EU follows Liikanen, whereas the UK adopts the Vickers reform which ring-fences investment banking activities. In the US, there are talks of a return of Glass-Steagall—a rule that imposes a strict firewall between retail and investment banking that was repealed in the 1990s. Inconsistencies across jurisdictions further impose significant complexity on universal banks’ operating model, potentially increasing operational risks and introducing board conflict of interest.
What next for the global regulatory landscape?

The regulatory response to the global financial crisis nearly a decade ago has been a global, concerted effort. But is this running out of momentum? Fissures in the global regulatory architecture are emerging across countries, regions and stakeholders.

There are three major stumbling blocks. The first is the sense of distrust between host regulators and home regulators. Structural reforms such as the FBO Supervision and the proposal for the IPU are symptoms of this distrust leading to “hard fragmentation” and complex operational business models. The second is that regulators on either side of the Atlantic follow different supervisory tools, as the US focuses on Comprehensive Capital Analysis and Review (CCAR) whereas Europe and the UK have their own assessments. Finally, even within the EU itself, recovery and resolution on an intra-European basis is itself fragmented, making it difficult to resolve banks.

These are likely to pose significant challenges for policymakers, regulators, the markets and the industry. Discontinuities in the regulatory landscape risk inhibiting flows in capital and liquidity between jurisdictions, which would not be in the interest of economic growth or financial stability. Such inconsistencies will no doubt be exacerbated by continuing geopolitical uncertainty, the impact of the new digital revolution and the prudential regulation of shadow banking. Ultimately, should regulatory fragmentation take hold, we will get yet more challenge to the business model and profitability of banks operating across multiple jurisdictions.
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