

# International Regulatory Standards: renewing and refocusing for future growth

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In March 2017, the IIF published a staff paper on international standard setting bodies and their role in supporting economic growth and financial stability.<sup>1</sup> We emphasized the contribution of international consistency and co-operation in the efficient flow of capital, enabling competition, creating efficiencies and reducing costs. These benefits are in addition to the enhancements made in global financial stability, and the positive work of bodies such as the Financial Stability Board (FSB), the Basel Committee, the International Association of Insurance Supervisors (IAIS) and IOSCO to make the system safer and more robust.

That paper was produced in light of some calls to re-evaluate international commitments, and suggestions for greater emphasis on national-level regulation. We acknowledged a series of criticisms levelled at international bodies in respect of opacity and accountability, and urged international standard-setters to undertake proactive reforms, to ensure that their positive contributions can endure.

This updated paper evaluates the current state of global dialogue on regulatory cooperation and offers a refreshed assessment on the mandate and mission of international standard setters to foster cooperation, build on their legacy of achievements, ensure the durability of lasting global stability and support dynamic, inclusive growth.

## 1. RECENT DEVELOPMENTS

The last six months have seen some positive developments in support of international consistency and co-operation, but the risk of retrenchment and fragmentation remains a genuine threat. The undermining or unraveling of international consistency would come at a considerable cost to the effectiveness of the regulatory framework and the functioning of markets. Global standard setters make

positive and important contributions across all economies, from large developed economies to emerging markets.

In April 2017, FSB Chairman Mark Carney outlined the important collective efforts of policy makers, regulators and the private sector to make the financial system safer and more resilient, offering a blueprint for further progress, by:

1. resisting fragmentation;
2. working together to take advantage of improvements made in the financial system; and
3. undertaking dynamic implementation of the post-crisis reform agenda and delivering efficient resilience.<sup>2</sup>

The G20 reform objectives need to be considered in a dynamic environment, where economic and societal priorities have continued to evolve since the immediate post-crisis period. Governor Carney's comments were also accompanied by the concurrent release of the FSB's proposed framework for evaluating the effects of regulation, which we discuss further in Section 3.2.

At a national policy-making level, the concepts of efficient resilience and dynamic implementation were well supported by the US Treasury's first detailed report in June (on banks and credit unions), which reviewed the US financial regulatory system and called for specific refinements.<sup>3</sup> Significantly, that report reaffirmed the commitment of the US to international standard setting bodies, emphasizing that global US engagement is important to promote financial stability and competitiveness.<sup>4</sup>

The US Treasury's second report (on capital markets) also highlighted the importance of cross-border activity and level playing fields, both for US firms operating abroad and for international investors and institutions being attracted to US markets.<sup>5</sup>

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<sup>1</sup> IIF, *International Regulatory Standards: Vital for Economic Growth*, March 15, 2017; [iif.com/publication/regulatory-report/international-regulatory-standards-vital-economic-growth](http://iif.com/publication/regulatory-report/international-regulatory-standards-vital-economic-growth)

<sup>2</sup> Mark Carney, "What a Difference a Decade Makes," speech at the IIF Washington Policy Summit, Washington, April 20, 2017; [fsb.org/wp-content/uploads/What-a-Difference-a-Decade-Makes.pdf](http://fsb.org/wp-content/uploads/What-a-Difference-a-Decade-Makes.pdf)

<sup>3</sup> US Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions*, June 2017

<sup>4</sup> *Ibid.*, p. 55

<sup>5</sup> US Department of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets*, October 2017, pp.190-191

The US Treasury also advocated reform of international standard setters, echoing themes from our earlier paper, in the structure and mandate of these bodies, as well as the processes for establishing international standards.<sup>6</sup>

However, despite these welcome and encouraging signs, the future of international regulatory frameworks remains uncertain. The ring-fencing and trapping of capital and liquidity across jurisdictions is a growing concern, while the pending finalization of Basel III will bring implementation conjecture (see Section 2).

There has been contention on the implementation of the Fundamental Review of the Trading Book (FRTB) and the Net Stable Funding Ratio (NSFR). The US Treasury's suggested delays "until they can be appropriately calibrated and assessed" have drawn similar moves from some other jurisdictions.<sup>7</sup> While pertinent reviews and delays are often appropriate, they can exacerbate discrepancies and unlevel playing fields, and expose the perils for jurisdictions that front-run implementation. Where unintended consequences are identified, these should be evaluated on a coordinated, global scale, and it is encouraging that the FRTB and NSFR are currently the subject of review in Basel.

Inconsistency in the global approach to a systemically important bank failure will also have significant impacts on financial stability. Absent a well-developed understanding among national authorities on how resolution would work under their respective domestic structures, the ability of regulators to count on well-coordinated resolution planning with other countries would be compromised. Though the *FSB Key Attributes of Effective Resolution Regimes for Financial Institutions*<sup>8</sup> have largely been adopted across the G20, recent discussions in key jurisdictions on elements of their implementation may call into question the long-term commitment to cooperation in this area.

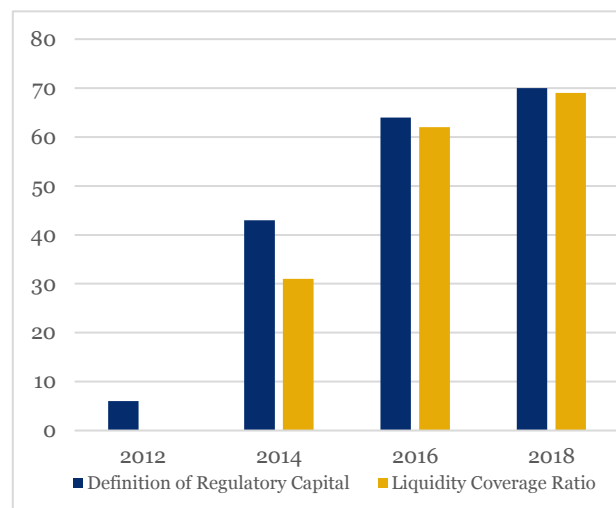
## 2. CONVERGENCE VS FRAGMENTATION

Though issues and challenges remain, the achievements to drive international regulatory convergence over the last decade are significant – achievements that are to the credit of the FSB, the Basel Committee, the IAIS and IOSCO.

For example, the Basel Committee's Regulatory Consistency Assessment Program (RCAP) has shown substantial consistency across its member jurisdictions in implementation of agreed capital and liquidity requirements.<sup>9</sup> This impact has extended beyond the 28 jurisdictions represented in the Basel Committee, with a

steady trend of other jurisdictions choosing consistency with Basel, as shown in Figure 1.<sup>10</sup>

**Figure 1: Number of non-Basel member jurisdictions that have implemented Basel III standards**



Source: Basel Committee on Banking Supervision

Besides providing an assessment, the RCAP itself has become an instrument in promoting implementation consistency. Where Basel peer reviews originally identified more than 1,200 "findings," the majority of these were quickly rectified before completion of those reviews.<sup>11</sup> While it is not perfect, and some cases of unlevel playing fields persist as a result, the progress made is a great achievement.

However, these gains could potentially be reversed from the emerging threat of fragmentation.

At the Basel Committee, a long-awaited agreement to finalize Basel III may be imminent, but the future role of the Committee will be called into question if this fails.<sup>12</sup> Beyond reaching an agreement without having to resort to national discretions, it will be critical to achieve a consistent implementation, or the convergence achievements shown in Figure 1 will be quickly undermined.

More broadly, nationalist and protectionist sentiments could have a more significant influence on policy positions, in a way that is not unique to any one country or region – if

<sup>6</sup> US Department of the Treasury, June 2017, p.55; US Department of the Treasury, October 2017, p.191

<sup>7</sup> US Department of the Treasury, June 2017, p.13

<sup>8</sup> FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

<sup>9</sup> The RCAP evaluates compliance, non-compliance and material variation in implementation, providing financial markets, bank customers, counterparties and investors with assessments on the extent to which a given jurisdiction complies with the Basel standards.

<sup>10</sup> William Coen, speech at 9th Islamic Financial Services Board Public Lecture on Financial Policy and Stability, Kuala Lumpur, April 5, 2017.

<sup>11</sup> Ibid

<sup>12</sup> This package of reforms (including changes to credit risk under the Advanced and Standardized Approaches, operational risk and a new output floor) has at times been labelled "the finalization of Basel III" and "Basel IV", and most recently by FRB Governor Powell "the Basel III end-game". These labels themselves reflect the uncertainty and lack of transparency as to the magnitude of the package's ultimate form, but for the purpose of this paper, the term "Basel III" has been used to describe this package.

one acts in isolation, others can often retaliate, reinforcing the fragmentation process.

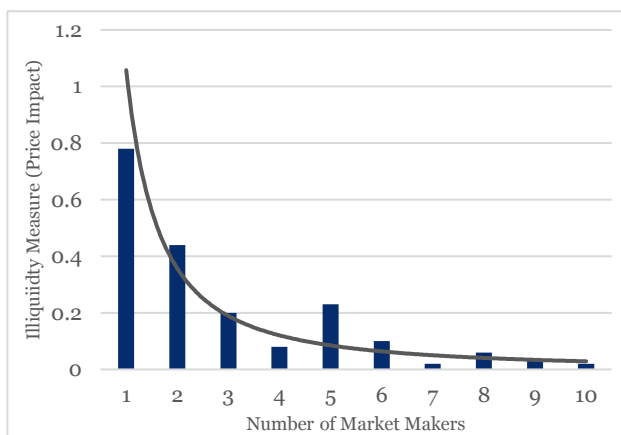
An example of this pattern is the Intermediate Parent Undertaking (IPU) requirement for local capitalization of large foreign banking firms operating in the EU. Introduced in November 2016, this proposal somewhat mirrors the Intermediate Holding Company (IHC) structures required by the US Federal Reserve, with each creating a ring-fenced scenario that traps capital. This can limit flexibility during periods of stress, for instance if a global organization needs resources elsewhere, and weaken cross-border resolution in a crisis. There are negative implications for counterparty credit risk for banking customers, the decrease in operational efficiency and the impairment of enterprise wide risk management.<sup>13</sup>

Such jurisdictional mandates impede cross-border capital flows and reduce economic efficiency, adding cost and complexity for banks that operate internationally, and disincentivizing participation in particular national markets and client segments. This can negatively impact growth-critical businesses, such as trade finance and SME financing.

Consistency across jurisdictions provides certainty for market participants in engaging in activity across borders. As noted in our March paper, a common set of rules for cross-border finance can contribute to efficiency in the system, removing barriers to entry and creating positive downstream incentives to finance the real economy.

As demonstrated in Figure 2, if banks pull back from a particular market, this can have direct consequences for the costs borne by end-users.

**Figure 2: Relationship between liquidity costs and market-making participants<sup>14</sup>**



Source: Trax, PwC analysis

While the particular data-points in Figure 2 are specifically on the illiquidity premia that borrowers are expected to pay when issuing corporate bonds against the number of banks making a market for debt, the same concavity principle applies in other products and markets. Where regulatory inconsistencies and costs drive one bank out of a particular market, this may have a marginal impact for end-users if it's a case of 10 market participants being reduced to 9, but it becomes a lot more pronounced in a case of 4 being reduced to 3. A reduction in participants can also test the capacity of syndicated finance, where the increased average exposure may exceed the appetite of individual banks.

New regulations and re-assessed risk profiles have already changed the viability of numerous products and markets. Where banks have reviewed strategies and exited some products that now fail to meet required returns, it is critical to ensure cross-border access and comparability, to preserve competition and avoid further retrenchment. Nations must resist the temptation to fragment – and this continues a critical role for the FSB and other global standard-setters to champion continued regulatory co-operation.

To ensure international standards continue to be adopted and faithfully implemented, international standard setters need to maintain their own continued credibility and relevance, and refocus on their core mandates – indeed, they need to dynamically evolve those mandates.

### 3. THE FUTURE OF INTERNATIONAL STANDARD SETTERS

In urging international standard-setters to proactively pursue reforms to ensure their continued positive contributions to stability and sustainable economic growth, we highlight three themes:

- renewing and refreshing mandates, focusing on core issues and co-ordination;
- enhanced and expanded evaluation of impacts, and fine-tuning of regulations; and
- continued improvements in transparency and accountability.

In pursuing these in concert, we see great opportunity for standard-setters to sharpen the mandate focus to core issues, and to increase concentration on those same core issues, particularly the evaluation of regulatory impacts.

#### 3.1 Mandates

In order to maximize global consistency and avoid fragmentation, more needs to be done by the international standard setting bodies themselves to promote coordination, enhance their legitimacy and, in some ways, refocus on their core mandates. Such adjustments will assist in ensuring the

<sup>13</sup> IIF, *European Commission's Intermediate Parent Undertaking Proposals*, June 2, 2017; [iif.com/publication/regulatory-comment-letter/iif-comments-intermediate-parent-undertaking-proposals](http://iif.com/publication/regulatory-comment-letter/iif-comments-intermediate-parent-undertaking-proposals)

<sup>14</sup> PwC; chart is extracted from the data used in Appendix F of *Global Financial Markets Liquidity Study*, 2015.

accomplishments of the last decade do not unravel, or unnecessarily reduce economic growth.

Refocusing standard-setters' mandates is largely an FSB-specific issue. Bodies such as the Basel Committee, the IAIS, IOSCO and FATF have respective scopes that are specific, technical and more tangible. But in the FSB's case, an expanded agenda has drawn some critics, to some extent challenging the durability of its substantial achievements.

The FSB mandate emerged from the G20 Pittsburgh Summit in September 2009 as the impact of the Global Financial Crisis reverberated through the global economy and financial markets. The mandate at its core focused on supporting international financial stability and enhanced global regulatory policy. The Leaders' Statement from that Summit identified four critical areas for strengthening the international financial regulatory system:

- building high quality capital and mitigating pro-cyclicality;

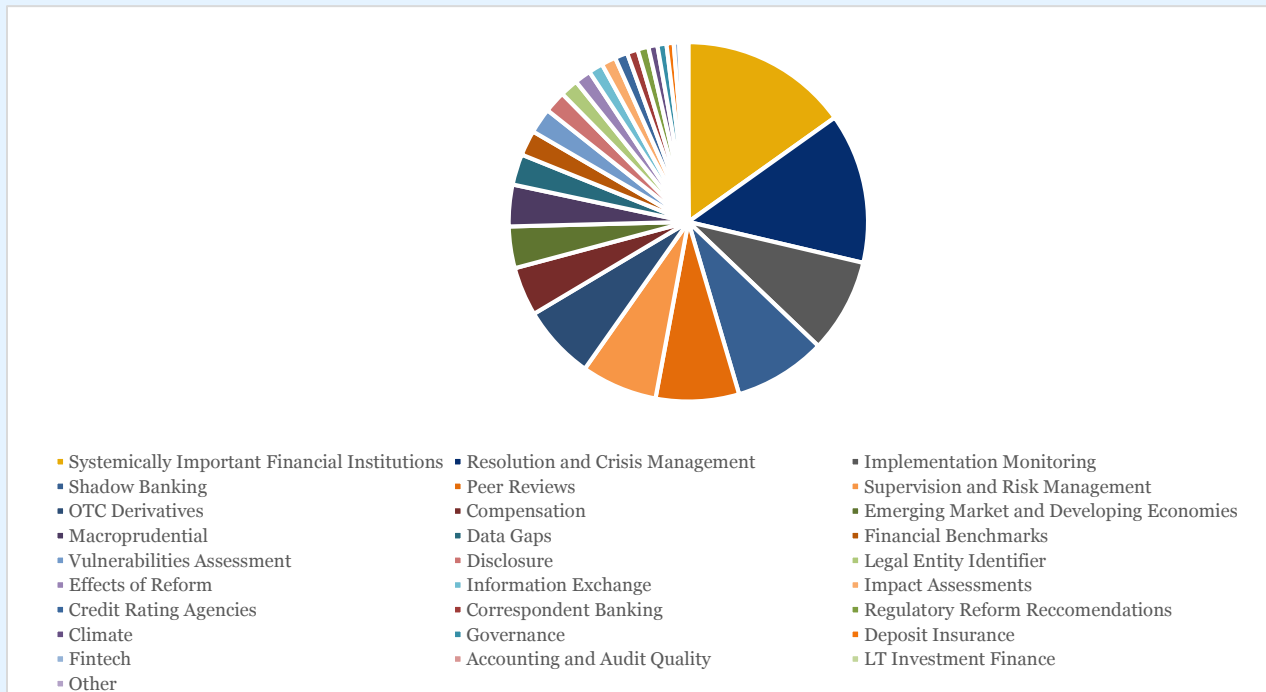
- reforming compensation practices;
- improving over-the-counter derivatives markets; and
- addressing cross border resolutions and systemically important financial institutions.<sup>15</sup>

The FSB has been very successful in achieving these objectives. The financial sector is more resilient and supported by higher and better quality capital and liquidity buffers; total loss-absorbing capacity (TLAC) and resolution regimes for GSIBs have become more sophisticated; and weaknesses in derivatives markets and shadow banking are now being evaluated and addressed. But these achievements have been accompanied by a proliferation of divergent policy areas, some of which have only a tenuous link to the core focus on financial stability. Subsequent G20 Summits have expanded the depth and breadth of the FSB's mandate, with the number of working groups expanding in a very significant way.<sup>16</sup> Figure 3 depicts the diversity of topics covered in FSB publications.

**Figure 3: FSB Publications by Policy Area**

*The chart below outlines the diversity of policy areas covered by the FSB, using the FSB's own identification tags for over 300 publications since September 2009. Beyond the most prominent items of systemically important financial institutions, resolution and implementation monitoring, there is a total of 28 topics listed, with approximately a third of FSB publications dispersed across 21 different topics.*

*Where international regulatory standards can be an effective supporter of economic growth, it is notable that the evaluation of these standards (defined by the FSB identification tags of 'effects of reform', 'impact assessments', and 'regulatory reform recommendations') collectively account for less than 4% of FSB publications.*



<sup>15</sup> G20, *Leaders' Statement: the Pittsburgh Summit*, September 24-25, 2009; [g20.org/Content/DE/StatischeSeiten/Breg/G7G20/Anlagen/G20-erklarung-pittsburgh-2009-en.pdf?\\_\\_blob=publicationFile&v=1](http://g20.org/Content/DE/StatischeSeiten/Breg/G7G20/Anlagen/G20-erklarung-pittsburgh-2009-en.pdf?__blob=publicationFile&v=1)

<sup>16</sup> The FSB's original three ad hoc working groups (in addition to the three Standing Committees) were set out at: [fsb.org/wp-content/uploads/r\\_090925d.pdf?page\\_moved=1](http://fsb.org/wp-content/uploads/r_090925d.pdf?page_moved=1); the IIF has heard claims from official sector representatives that there are as many as 30, 50 or 80 working groups, however, these are not publicly documented.

Of course, it is acknowledged that finance is incredibly complex, and that this proliferation has been very well-intended. It must also be recognized that the FSB's proliferation has often been outside of its own control. The FSB follows the direction from the G20's political leadership, and while this is highly appropriate in the sense of the G20's geographical diversity and reach across developed and emerging economies, it also means the FSB addresses the interests of a wide and diverse group of constituents. For the FSB to refocus on financial stability and efficient resilience, a more targeted agenda is needed.

In the face of the fragmentation threat, it is timely for the FSB to focus its mandate around its function of global policy development and co-ordination. Where jurisdictions such as the US and EU are examining the effects of regulation, and looking to potentially fine-tune and recalibrate, the FSB and other standard-setters have a critical role in helping to promote this process in a common way, and leading to common outcomes.

### 3.2 Evaluating Impacts

Evaluating the effectiveness of reforms is vital. Examining impacts and potential unintended consequences is crucial to enabling fine-tuning, and ensuring that regulatory reforms can contribute to societally optimal outcomes. The intent of current initiatives in this area is commendable, but needs greater ambition.

The IIF welcomes the FSB's initiative in launching a new program for evaluating the impacts of regulatory reforms, but this should go further. With its framework finalized in July 2017, the FSB has set a modest ambition of just 1-2 confined projects per year, and supported by what we understand to be scarce resourcing. To provide comprehensive analysis, this initiative needs greater ambition, embracing cumulative impact analysis, and with the support of additional resourcing from other areas, so that the delivery of these projects can be expedited.

Moreover, the FSB's framework is limited to exclusively examining fully implemented regulations, which prevents it from anticipating detrimental future effects of regulations that are still in flight. While the FSB's announced focus on infrastructure finance is pertinent and commendable, the most significant impacts for that asset class are the proposed Basel III changes for specialized lending and NSFR impacts on maturity transformation, each of which are yet to be implemented. The anticipated procyclical effects of the Expected Credit Loss requirements under IFRS9 and CECL also warrant attention, noting that procyclicality was a headline item in the 2009 G20 Pittsburgh Communiqué.<sup>17</sup>

While processes such as the Basel Committee's Quantitative Impact Studies (QIS) play a useful and important role, they

have a different objective, and are insufficient to negate the need for comprehensive impact assessment on proposed reforms. For instance:

- the QIS intent is to examine impacts on banks' balance sheets; it doesn't examine impacts on end-users in the wider economy, or even on dividends and consequential wealth in the economy;
- data submission and cleansing practices are handled at national levels on highly inconsistent bases;
- a given regulatory proposal is assessed in isolation, rather than in concert with other items impacting banks' balance sheets;
- use of theoretical starting points based on assumed implementations of prior rules, rather than banks' actual (publicly reported) positions, meaning the QIS can materially understate impacts;
- an assumption that banks maintain a static portfolio, with no rebalancing in their business mix, which is where impacts on end-users might be most felt either in credit availability or cost;
- a focus on banks' "top of house" metrics, lacking any granularity in terms of the impacts on specific markets.

This last point is critical. Any impact evaluation must look beyond the "top of house", and examine product and business line impacts, if it is to consider downstream impacts on end-users and the wider economy. This necessitates looking at the multiple constraints that banks manage to, and which of these are binding (and therefore driving strategies and pricing) for particular firms. Downstream impacts and unintended consequences are shaped significantly by whether a given reform binds on a firm, and which products and customer segments are more susceptible to which constraint.

An insightful 2016 report by the International Association of Credit Portfolio Managers (IACPM) illustrated banks' top three binding constraints, shown in Figure 4.<sup>18</sup> This survey firstly highlighted the variance between banks – that different regulations bind on different banks, according to their own balance sheet composition and the sensitivities of their respective customer franchises and business models. Secondly, it is notable how some banks are bound by new standards that haven't yet been fully implemented, underlining the need for impact assessment to not be exclusively backward-looking.

The sheer range of elements identified by various banks in Figure 4 also highlights the conflux of different regulations that are impacting their businesses, underlining the criticality of cumulative evaluation across the full suite of reforms. It is also important to test (and be responsive to) how these many items in the framework actually operate through business cycles.

<sup>17</sup> Leaders Statement – the Pittsburgh Summit, September 24-25, 2009, [treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh\\_summit\\_leaders\\_statement\\_250909.pdf](https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf)

<sup>18</sup> International Association of Credit Portfolio Managers / Oliver Wyman, *Financial Resource Management Survey*, 2016.



It must be emphasized that undertaking such reviews (and finding items that need tweaking or adjusting) is not a criticism of the original regulations or their drafters. The reality is that market conditions, structures and participants all change over time; more insights emerge, and firms and regulators alike each learn and evolve through experiences. Even if crafting a perfect set of responses for one type of crisis, such responses might cause unwelcome effects in normal conditions or in a different type of crisis. Evaluating effects (and adjusting for them) is not a criticism of what went before – rather, it reflects those concepts of dynamic implementation and efficient resilience.

The concept of dynamic implementation put forward by the FSB is well developed in the US Treasury proposals as they seek to support stability in the financial system while at the same time fostering economic growth. Similarly, the EU embraced the concept of dynamic implementation in their 2015 call for evidence on the EU regulatory framework for financial services. The EU’s review examined where rules impact the ability of the economy to finance itself and grow, unnecessary regulatory burdens, inconsistencies and gaps, and unintended consequences.<sup>19</sup>

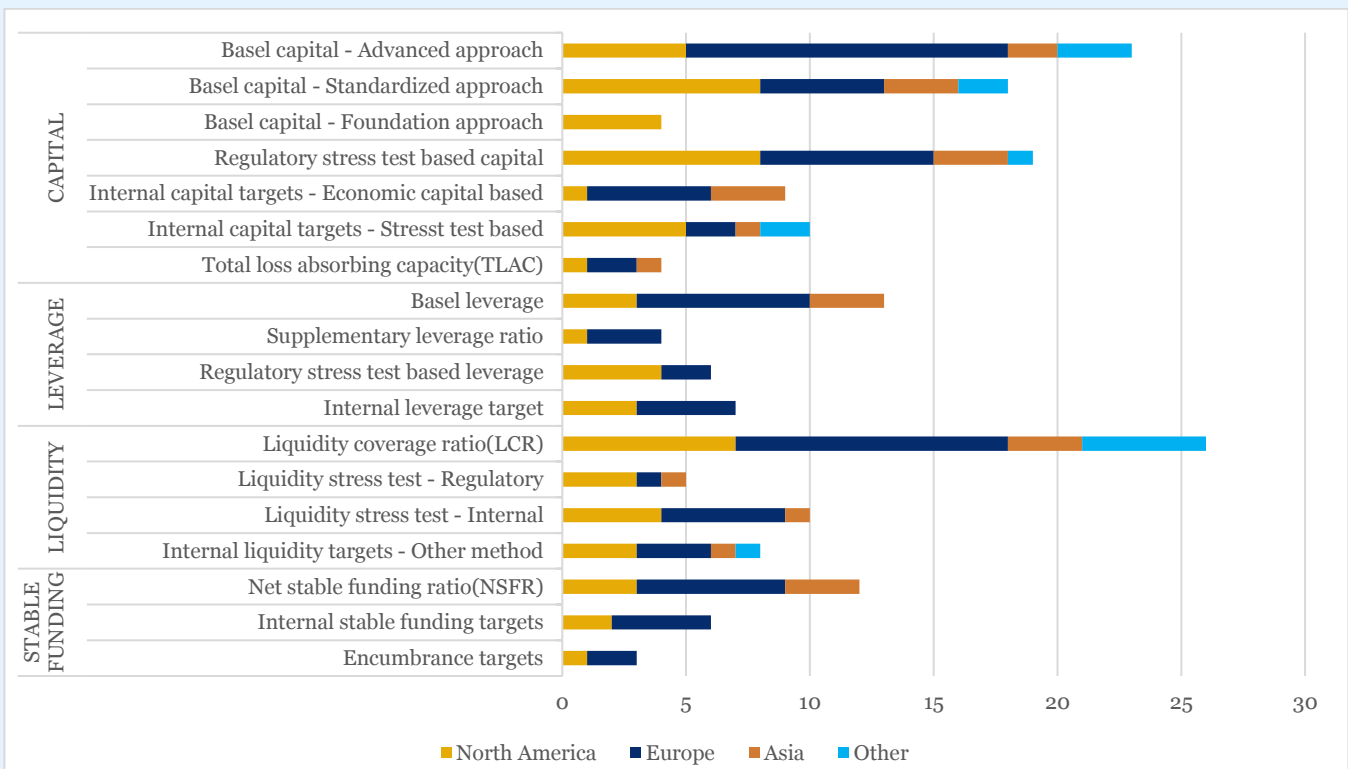
Against the backdrop of these US and EU initiatives, it is important that the FSB enhances and increases the concentration on its evaluation initiative. Dynamic implementation is only effective if regulatory refinements are also properly calibrated at a global level, resisting fragmentation and with cross-border coordination.

### 3.3 Transparency

We articulated in our March paper that global regulatory bodies should proactively pursue reforms to improve their processes and accountabilities, and provide greater assurances of their legitimacy, to ensure that they can continue to deliver their very positive contributions in the face of some criticism. This concern is still valid. It is also stressed that while the issues highlighted above on mandate and evaluating impacts are more specific to the FSB, the potential for enhancements in transparency and governance are themes that are more common across international bodies.

International standard-setters should publish meeting agendas, schedules and records, and provide transparency of

**Figure 4: Banks’ Top Three Binding Constraints**



Source: IACPM / Oliver Wyman Financial Resource Management Survey, 2016 (“For a select list of Capital, Leverage, Liquidity, and Stable Funding related constraints, indicate the top three most binding constraints”)

<sup>19</sup> European Commission, “Call for evidence: EU Regulatory Framework for financial services,” September 30, 2015;

[ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document\\_en.pdf](http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document_en.pdf)

meeting participants and membership of working groups. We reiterate the acknowledgement of the Basel Committee publishing its 2017 meeting dates, which is a welcome first step, and the IAIS publishes its members and meeting details. Similarly, the FSB has published the membership of its three senior Standing Committees, though the more intricate structure and membership of the many working groups and streams arranged under those is unclear.

Where there has been some hesitation on revealing working group members or meeting participants, it is stressed that many national authorities publish exactly these items. By not embracing the standards of national authorities, international standard setters may be providing ammunition to critics and those with perceptions of international bodies as not fully transparent and outside of democratic processes. Where differing reports have placed the number of FSB working groups at about 30, 50 or 80 (without explanation of how these might align or fit in a coherent overall structure), this demonstrable opacity has invariably fueled criticism. The FSB Plenary's recent agreement to a review of processes, procedural guidelines and transparency is a most welcome step.<sup>20</sup>

Increased transparency should also include processes for developing and refining new standards. Moving beyond the historic tendency where some topics had a *fait accompli* status prior to the official launch of a consultation process (which pleasingly is now less common), 2017 has seen the apparent ongoing refinement of the final Basel III package of reforms, all conducted behind closed doors.

While reports that the original Basel proposals have been moderated are generally welcomed by the industry, the lack of transparency on these revisions means this can only be imprecisely gauged. Mooted revisions such as moving selected asset classes from AIRB to FIRB, materially adjusting Standardized risk-weights for some external rating levels, or excluding loss history from operational risk calculations are of a magnitude that would have merited a new public consultation by the BCBS – or at least publication to enable a fully-informed and constructive dialogue with stakeholders. As it stands, results from the 2016 Basel III QIS have still not been published, more than a year after banks submitted data.

It is important that continued enhancements are made in transparency and governance, which will help to demonstrate the credibility and legitimacy of international standard setting processes.

**In conclusion, while 2017 has seen several welcome and encouraging signals of commitment to international regulatory processes, concerns of fragmentation do still persist.**

**We reiterate the very positive economic contributions that international standard setters make, by supporting capital flows, encouraging competition, enabling efficiencies, and in promoting stability. In continuing this, it is critical that they embrace the focus on dynamic implementation and efficient resilience, underpinned by comprehensive analysis of the impacts of regulations, and promote these on a global basis.**

**Concurrently, international standard setters are urged to focus on a renewed mandate, and continue proactive reforms to improve transparency. Such actions will help to ensure they can maintain and build on the legacy of their considerable achievements.**

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<sup>20</sup> Financial Stability Board, *FSB discusses 2018 workplan and next steps on evaluations of effects of reforms*, October 6, 2017, [fsb.org/2017/10/fsb-](http://fsb.org/2017/10/fsb-discusses-2018-workplan-and-next-steps-on-evaluations-of-effects-of-reforms/)

[discusses-2018-workplan-and-next-steps-on-evaluations-of-effects-of-reforms/](http://fsb.org/2017/10/fsb-discusses-2018-workplan-and-next-steps-on-evaluations-of-effects-of-reforms/)