

# International Regulatory Standards: Vital for Economic Growth

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Brad Carr, Director, Banking Prudential Policy, [bcarr@iif.com](mailto:bcarr@iif.com)

Matthew Ekberg, Senior Policy Advisor, [mekberg@iif.com](mailto:mekberg@iif.com)

The role of international regulatory processes and standard-setters<sup>1</sup> is currently in focus, with some advocating a greater (and often, almost exclusive) emphasis on national-level regulation. While these calls have originated in different parts of the world, the debate has gained greater prominence since the election of the new US administration, creating some uncertainty as to its commitment to multilateral bodies, and therefore to the relevance and role of those bodies.

This presents a genuine threat to the effectiveness of the global regulatory framework and the functioning of markets. International consistency could be undermined, or even unravel, which would come at a considerable cost to economies around the world. Global standard setters make positive and important contributions across all economies, from large developed markets to emerging market (EM) economies.

## **The benefits of international standards are yielded in four major areas:**

- 1. supporting the flow of capital to investment opportunities;**
- 2. promoting greater and more fair competition, and better pricing and services for borrowers and end-users;**
- 3. reducing compliance costs and increasing efficiencies;**
- 4. supporting financial stability.**

Criticisms of international regulatory bodies refer to their opacity, their governance and accountability, and how the

scope of international rules intersects with local circumstances.<sup>2</sup> Some of these criticisms are valid, although it should be noted that multilateral bodies have no authority other than moral suasion, and it remains the domain of national authorities to incorporate international standards into national laws and regulations under their own due processes.

Nevertheless, there is room for improvement in how these bodies operate. There should indeed be greater transparency, public consultations should be more open and thorough, and new or amended standards should be subject to rigorous cost-benefit analysis on both an ex-ante and ex-post basis. But international standard-setting bodies should not be abandoned or greatly diminished, given the risks posed by greater regulatory fragmentation.

Consequently, there is a need for greater analysis and discussion on the role of international standard-setters, specifically as to how to preserve their role while making the necessary reforms to improve their transparency, governance and accountability.

This note sets out the main benefits of the role of global standard setters and their contributions, as well as the key aspects in which improvements could be considered.

## **1. SUPPORTING THE FLOW OF CAPITAL**

Andrew Bailey, CEO of the UK's Financial Conduct Authority observed recently, "The lesson of history is that

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<sup>1</sup> Specific international standard-setters included within this scope are the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the Financial Action Task Force (FATF) the International Organization of Securities Associations

(IOSCO) and the International Association of Insurance Supervisors (IAIS).

<sup>2</sup> For examples of such criticisms, see the letter from US Congressman Patrick McHenry to FRB Chair Janet Yellen on January 31, 2017

global capital flows are growth enhancing.”<sup>3</sup> Indeed, economic growth is strengthened when capital can flow to where it can be best utilized, is most needed, and can generate sustainable returns.

This has been empirically demonstrated through two key relationships, observed consistently across developed economies and emerging markets:

- economies where the financial sector has greater international connectivity (more foreign assets and foreign liabilities) have greater depth in their financial sector;
- financial depth (a larger financial sector, with greater capacity for private sector financing) is directly correlated to GDP growth.<sup>4</sup>

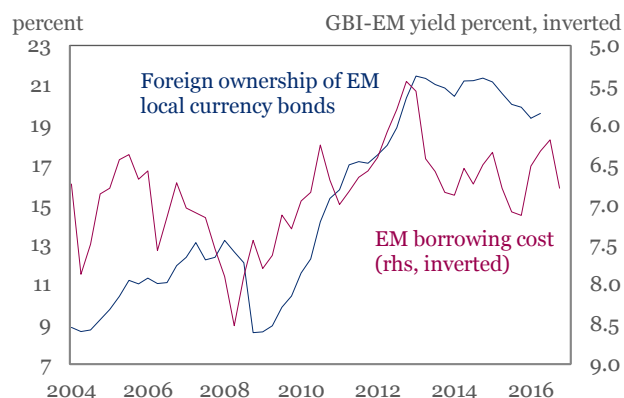
While some economies have substantial pools of available capital and others have a reliance on foreign investment, the international banking sector serves as an intermediary to facilitate the required flows, whether via (i) banks raising funding from investors in some economies and lending that out in others, or (ii) banks’ capital markets activities. Investment banks underwrite bond issuances by corporates and enable interest rate and foreign exchange risks to be mitigated via derivatives. They also act as market makers in the corporate’s traded debt, helping to reduce the illiquidity premium that would otherwise need to be priced in.

**For capital markets to function internationally, it naturally follows that you need international banks to provide connectivity and facilitate intermediation across different pools of capital.**

As with the connectivity of international finance to GDP growth, the benefits of international banks connecting different pools of capital are shared across participating economies.

Where foreign investors participate in EM corporate bonds, there is a direct relationship in which the greater level of offshore investment helps to bring borrowers’ costs down, as shown in Figure 1. This reflects the important value of international investors bringing added depth to markets, not just to EMs but also other smaller capital markets. The European Commission’s Capital Markets Union initiative was directly motivated by a desire to remove barriers to cross-border investment, and to enable a deeper pool of capital that encourages more direct investment into smaller businesses.<sup>5</sup>

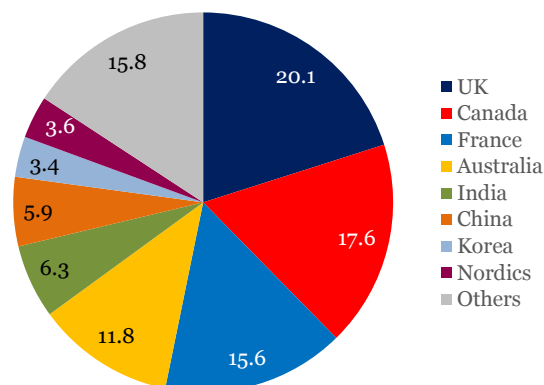
**Figure 1: Greater foreign investor participation and corporate bond pricing in Emerging Markets<sup>6</sup>**



Source: Bloomberg, IIF

In some countries that lack domestic corporate bond markets, local corporates rely on banks to lend and/or to arrange their issuance programs in major capital markets, such as the US Private Placement and 144A markets. As well as underwriting, the banks have a critical role in providing hedging via cross currency swap transactions to enable corporates to raise USD funding and invest it in their operations in their domestic currency.

**Figure 2: Foreign non-financial corporate issuers in the US 144A market – percentage of total outstanding bonds as of March 3, 2017**



Source: Thomson One, IIF

<sup>3</sup> Andrew Bailey, speech: *Free Trade in Financial Services and Global Regulatory Standards: Friends not Rivals*, January 26, 2017

<sup>4</sup> These relationships were each demonstrated in the McKinsey Global Institute report *Financial Globalization: retreat or rest?* In March 2013, across each of the World (in aggregate), the US,

Western Europe and emerging markets. McKinsey and Company will produce a refreshed version of this report in the near-term.

<sup>5</sup> European Commission, *Green Paper: Building a Capital Market Union*, February 2015

<sup>6</sup> Source: Bloomberg, IMF

Figure 2 shows the national breakdown of corporate issuers in the US 144A market, with again the shared benefits: to corporates from countries that lack domestic corporate bond markets, who can access diverse sources of finance; and to US investors, who can invest in a wider range of assets, achieve greater risk diversification and earn returns.

In the case of the US, repatriated investment income contributed to the 2016 trade surplus in financial services of \$70b.<sup>7</sup>

## 2. PROMOTING COMPETITION

**Consistent rules and regulations across borders encourages banks to invest and operate wherever there are sound investment opportunities, increasing competition for borrowers and depositors.**

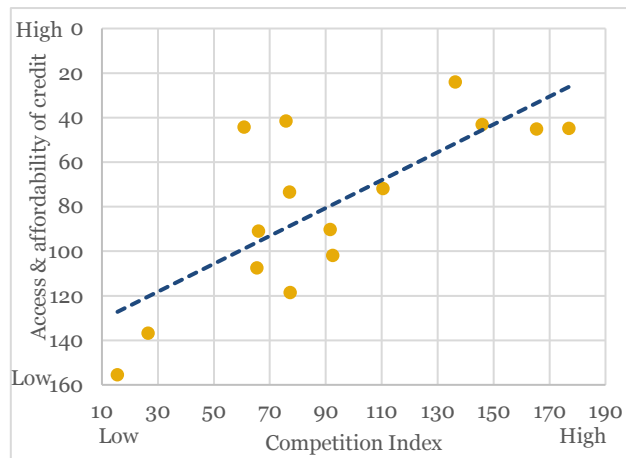
Greater competition within the banking sector has been shown to consistently generate more positive outcomes for customers, including:

- greater innovation in product offerings and delivery channels;
- better value for money, evidenced by reduced net-interest margins;
- improved access to credit;
- greater choice of products and providers.<sup>8</sup>

The enhanced value for the businesses and consumers that use banks' services is demonstrated in Figure 3. Across a range of national economies, credit is consistently more accessible and more efficiently priced when there are more participants bringing meaningful competition in the marketplace.

This is especially important when considering how international banks bolster competition when they operate beyond their home market. Through the crisis and its aftermath, while the number and composition of particular banks operating across borders changed markedly, the global market share for banks operating outside their own country has been steady at around 35%.<sup>9</sup>

**Figure 3: Ease of access to credit and Net Interest Margins in national economies compared with level of competition<sup>10</sup>**



Sources: World Bank, Federal Reserve Bank of St Louis, BIS, IIF

Having comparable capital standards enables a level playing field for lenders, and ensures that entrants (in particular, banks operating outside their own borders) can compete. Banks make decisions on whether to invest in particular business lines, where to deploy capital, and how to price credit according to the return that can be generated on shareholder equity (ROE).

The ROE equation for banks is significantly influenced by their home country's capital rules, e.g.:

- the level of minimum capital ratios required for capital adequacy;
- methodologies for calculating risk-weighted assets;
- eligibility for different instruments to count as 'capital'.

<sup>7</sup> US Census Bureau, US Bureau of Economic Analysis, *US International Trade in Goods and Services December 2016*

<sup>8</sup> Deloitte Access Economics, *Competition in Retail Banking*, Australian Bankers Association, March 2014, <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-retail-banking-competition-010314.pdf>

<sup>9</sup> Franklin Allen & Douglas Gale, "Cross-Border Banking Since the Crisis" in *Banking Perspective*, vol.3 issue 1, March 2015

<sup>10</sup> The access and affordability of credit index is the aggregation of (i) the World Bank *Doing Business 2015* ranking for ease of access to credit (1 for high access, 100 for low) and (ii) an indexed scale of each economy's Net Interest Margin; the competition index is an aggregation of (i) the percentage of market share not held by the three largest banks and (iii) the number of banks per 200,000 population. Economies within sample are Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland, UK, Canada, China, India, Japan, Singapore, Australia and South Africa.

Some scenarios which illustrate the impact of different national treatments for these dimensions are presented in Figure 4. These apply a required capital ratio of 10.5% (except in jurisdiction B), a 50% risk-weight for the potential borrower (except in jurisdiction C) and a target ROE of 10% that reflects a blended cost of capital (except in jurisdiction D, where capital is limited to only common equity, and is more expensive).<sup>11</sup>

**Figure 4: Example – Capital Requirements and Interest Spread for a \$1 million loan**

| Home jurisdiction      | A        | B        | C        | D        |
|------------------------|----------|----------|----------|----------|
| Required capital ratio | 10.5%    | 14.0%    | 10.5%    | 10.5%    |
| Borrower risk-weight   | 50%      | 50%      | 75%      | 50%      |
| Capital requirement    | \$52,500 | \$70,000 | \$78,750 | \$52,500 |
| ROE Target             | 10.0%    | 10.0%    | 10.0%    | 14.0%    |
| Interest Spread        | 150bp    | 200bp    | 225bp    | 210bp    |

Figure 4 shows that only one of these variables needs to be adjusted to create a material difference in banks' ability to compete, serving as a deterrent to competition and a barrier to entry in some markets. In this example, those banks headquartered in jurisdictions B, C or D would not get close to matching the spread that a bank domiciled in jurisdiction A can offer; and if they exit this particular market, the remaining lenders may then opt to charge more than the 150bp spread.

Level playing fields are also important when banks are competing for investors – in having comparable disclosures, and reporting on a set of metrics that are consistent in their meaning and calculation. This is especially critical for the ability of institutional investors to invest in debt instruments issued by banks in other jurisdictions. If there are disparate measures and reporting standards, an investor could not be reasonably expected to learn all national variations, and so would be encouraged to focus on the local jurisdictions that they know, thereby reinforcing a home bias.

It is stressed that there has been considerable recent progress in reducing and disclosing discrepancies, and in driving greater convergence to promote more level playing

fields. In addition to supervisory colleges, the BCBS's Regulatory Consistency Assessment Programme (RCAP), which was instigated in 2011 to assess jurisdictions' implementation of the Basel III framework<sup>12</sup>, has already started playing an essential role in highlighting deviations from international standards, and putting the onus on national authorities to explain such deviations.

As a further example, the Australian Prudential Regulation Authority published a comparison that a Common Equity Tier 1 Ratio of 10.0% in its jurisdiction is comparable to 13.5% under international standards.<sup>13</sup> It would help all market participants if this approach was more widespread.

### 3. CREATING EFFICIENCIES AND REDUCING COSTS FOR BUSINESSES AND CONSUMERS

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.

**Banks do not function solely within national boundaries, and indeed some of the most important growth opportunities for financial institutions rest in their ability to serve clients abroad as well as at home. It is significant that while the compliance costs for banks of all sizes have increased post-crisis, this effect is magnified when operating across multiple jurisdictions in cases where there are inconsistent standards.**

These costs often impact the users of financial products. In this context, international standard-setters play a significant role in helping to provide greater clarity as to how regulations are to be interpreted and applied. This is critical for enabling and incentivizing banks to provide cross-border financial services, and to enable the benefits of competition to be realized for end-users and the economy.

While national specificities play an important role in the development of any regulatory framework, variable rules layered upon one another can lead to unintended differences and create potential conflicts. The requirements of individual jurisdictional mandates can trap resources and capital that could be more effectively deployed, a situation that is particularly acute for low-margin but growth-critical business lines, such as trade finance and SME financing. Ambiguity in the application of rules across countries can lead to a reevaluation of transactions and a potential withdrawal from certain sectors, with ultimately deleterious consequences for downstream lending to businesses and consumers.

<sup>11</sup> These calculations also assume a 50% efficiency (cost:income) ratio and a 30% corporate tax rate. The scenario on risk-weights for jurisdiction C is equivalent to the move from a 30% Loss Given Default (LGD) to 45%.

<sup>12</sup> Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP), Assessment of Basel III regulations – United States of America*, December 2014

<sup>13</sup> Australian Prudential Regulation Authority, *Insight*, Issue 2, 2016

Regulatory coherence and level playing fields are critical for enabling banks to provide affordable financing to advance economic growth.

Banks and insurers can also achieve greater risk diversification (and therefore greater stability) if they can expand geographically and develop successful businesses in different countries and markets, taking less correlated risks than those that exist in a single country. Consistent international standards and reasonable home-host rules are essential prerequisites for institutions to achieve this diversification.

#### 4. SUPPORTING FINANCIAL STABILITY

The global financial crisis clearly demonstrated the international interconnectedness of the financial sector and the economies they serve, and the need for an updated and enhanced international financial regulatory architecture. The post-crisis reforms have done much to ensure the safety and soundness of the global financial system by addressing previous gaps and fragilities. While it is timely to pause the reform agenda and take stock of what has been accomplished, it is vital to remember that international coordination and cooperation across multiple disciplines has substantially increased the stability of the global economy in a number of ways.

**Firstly, one of the most challenging post-crisis issues was the resolution framework for global systemically important banks (GSIBs).**

**“The crisis proved beyond doubt that we did not have the international machinery to handle this. The most important element in resolving an international bank is that it is global in death as well as in life.”<sup>14</sup>**

*- Sir Jon Cunliffe, Bank of England Deputy Governor for Financial Stability*

International standard-setters and domestic authorities have developed a co-operative regime on cross-border resolution through crisis coordination mechanisms of the authorities of home and host jurisdictions. Alongside the development of standards fair to all claimants that avoid inefficient and excessive ring-fencing, this has contributed to an environment which significantly improves the stability of international finance and the global economy.

**Secondly, the protection of the global financial system from misuse and corruption is of paramount importance.** As financial crime and cyber-security are issues of considerable international significance, the work undertaken to combat criminal and terrorist interests cannot be done in isolation by domestic authorities.

Vigorous and coordinated action on the part of the international public sector and the private sector is the only way to address such a truly cross-border issue, and reduce the possibility for systemic harm from money laundering and terrorist financing threats.

**Thirdly, cross-border banking businesses require cross-border regulatory coherence to ensure stability is maintained where systemic issues arise.** Disparities in capital and liquidity standards, inconsistencies in over-the-counter (OTC) derivatives regulation and divergent regimes for non-bank investment firms can all have repercussions beyond borders. Appropriately crafted minimum international standards which promote growth help to reduce spillover risk and maintain stability.

The pre-crisis regulatory framework, including efforts by the Financial Stability Forum, proved inadequate for our globally interconnected world. The examples noted above highlight that the enhanced mechanisms of the FSB, the BCBS, FATF, IOSCO and the IAIS were needed, and still are. This level of global standard setting requires continuing review and adjustment, but fundamentally the only way for a globalized world to maintain stability is through common, global standards and regulatory coherence.

#### THE FUTURE FOR INTERNATIONAL STANDARDS

While it is important that international standard-setters and processes continue to deliver the benefits described above, global regulatory bodies should nevertheless take the opportunity to proactively pursue reforms to improve their processes and accountabilities, and create greater assurances of their legitimacy. There have been some demonstrable incremental moves in this direction, which are commendable, and this trend should further continue.

Transparency and accountability could be improved by adopting the same standards that are required of many national authorities. These include the publication of meeting agendas, schedules and records, transparency as to the identity of meeting participants, and the members of the various working groups and streams that operate under the auspices of the FSB and BCBS. Recent published updates from the Bank for International Settlements (BIS) have started to include the dates of upcoming BCBS meetings, which is a welcome development, and more of this is to be encouraged.

Greater transparency should also extend to the consultation processes for proposed new standards. While the formal BCBS process invites industry and other interested parties to submit comments within a three-month window, it has appeared in the past on some topics that a *fait accompli* status had already been reached before officially launching

<sup>14</sup> Jon Cunliffe, “Ending Too-Big-to-Fail: How Best to Deal with Failed Large Banks” in *European Economy: Banks Regulation and the Real Sector*, December 5, 2016, <http://european->

[economy.eu/leading-articles/ending-too-big-to-fail-how-best-to-deal-with-failed-large-banks/](http://economy.eu/leading-articles/ending-too-big-to-fail-how-best-to-deal-with-failed-large-banks/)

the consultation (although such occurrences appear to have become less common in recent times).

It also appears that in the early development stages of a proposed new standard at the global level, some national authorities will informally consult with their domestic stakeholders, but that practice has not been universal. This is an important activity for national authorities to undertake to ensure that they fully understand the potential ramifications that a change in international standards could have for the market conditions of their own country. Trust and support for the international process would be enhanced if all participating national authorities were to engage in local consultation during the early stages on a more consistent basis, giving a greater opportunity for local circumstances to be reflected.

That is not to say that national authorities should complete a binding process domestically before engaging with their international peers – to do so would clearly tie their negotiating hands and undermine international discussion and debate. But transparent engagement in the early stages would help to make the consultation process more meaningful and informed.

There have also been occasions when global standard setters have issued a set of proposals for formal consultation, and then subsequently introduced new concepts during the course of their deliberations, that have been incorporated into the final standards.<sup>15</sup> Transparency would be enhanced if those new concepts were to be presented with an opportunity for comment in a second consultation. Rationale and explanations could also be provided for the decisions taken in final standards – something that several national authorities already do.

Impact assessment and cost-benefit analysis for new regulatory proposals should be adopted as common practice, and the results of Quantitative Impact Study (QIS) activities should be published at a detailed level. When the IIF & ISDA prepared our own *Cumulative Capital Impact Study* (an industry “shadow QIS”) on the BCBS proposals in 2016, several national regulators commented on the inherent shortcomings within the official Basel QIS process, and of substantial inconsistencies in the approaches taken by different national authorities in supplying and cleansing data submissions to the BCBS. Greater transparency, further engagement with contributing firms and the publication of results would help create a greater impetus to address this.

Impact assessments should also be undertaken periodically at a holistic level, examining the ways in which multiple sets of regulatory initiatives can sometimes compound or contradict others. We continue to commend the intent of the BCBS in 2015 of mobilizing a dedicated Coherence and Calibration Task Force, and we hope this Task Force will address the issues that the IIF highlighted to it in June 2015,<sup>16</sup> and publish its research and deliberations.

We also welcome the recent initiative of the FSB to examine the impacts of regulation in more detail. Invariably most reforms will have a cost and a benefit, and while ex-ante estimation of these is both necessary and difficult, this needs to be complemented with ex-post assessment on a periodic basis. The FSB’s initiative may ultimately provide a template for ongoing periodic ex-post review. The FSB is also well placed to assist with providing a basis for consultation and review across banking, insurance and securities bodies, and considering impact in terms of overall interaction across capital markets and bank financing.

Lastly, there is an opportunity to reflect greater proportionality in the application of international standards. As the FCA’s CEO Andrew Bailey noted recently, global standards should be applied and used as the basis for market access for internationally active firms and activities, but they need not be applied for smaller firms that choose to not trade across borders.<sup>17</sup>

**In conclusion, international standards and processes play an important role as an economic enabler in supporting capital flows; in enabling competition; in creating efficiencies; and in promoting stability.**

**International standard-setters are urged to engage their critics and to proactively review their processes, enhance transparency, and continue efforts to rigorously test costs and benefits. Such steps can be effective in ensuring that the value of international standards are preserved, for the benefit of borrowers and economies around the world.**

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<sup>15</sup> For example, under the Basel Net Stable Funding Ratio (“NSFR”), the concept of the 20% Required Stable Funding add-on that applies to gross derivatives liabilities before the netting of posted collateral or derivatives assets was not included in any BCBS NSFR consultative document prior to appearing in the final global standard. The industry did not have an opportunity to provide comment on this measure, which could have significant ramifications for banks’ business models.

<sup>16</sup> IIF, Letter to BCBS Coherence & Calibration Task Force, June 17, 2015, <https://www.iif.com/publication/regulatory-comment-letter/iif-letter-bcbs-taskforce-coherence-and-calibration>

<sup>17</sup> Andrew Bailey, speech: *Free Trade in Financial Services and Global Regulatory Standards: Friends not Rivals*, January 26, 2017