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President and CEO

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Dr. Agustín Carstens
Chairman, International Monetary and Financial Committee

Dr. Marek Belka
Chairman, Development Committee

Dear Chairmen:

As investors worldwide assess the implications of U.S. monetary policy normalization, weakness in emerging economies and next steps after considerable achievement on the regulatory front, the IIF on behalf of the global financial services industry submits the following views.

Assessing progress on implementing financial reform; considering unintended consequences

The G20 regulatory reform agenda has comprehensively addressed the vulnerabilities that threatened the stability of the financial system in 2008, and has undoubtedly made the system safer and more resilient. These reforms, which the IIF supports, have delivered a substantial increase in banks' capital levels, stronger funding structures, more robust market infrastructure, and revamped cross-border bank resolution regimes, among many other accomplishments.

Further reforms are of course still in consultation; some, such as the calibration of Total Loss Absorbing Capital and the significant proposed changes to the Basel regulatory capital framework, can have profound effects. The IIF urges policymakers to focus on consistent implementation across jurisdictions (as highlighted in recent B20 proposals) and consider the impact these reforms are having on firms' capacity to fulfill their desired roles in servicing customers and markets—including SMEs—and in supporting the overall economy. Consideration should also be given to the potential tension between regulatory tightening and the current accommodative monetary policy settings, which may be hindering progress on the Brisbane growth targets, as well as the effect on market liquidity and the way markets operate—specifically by means of a cumulative impact study. As the FSB presents its first annual report on implementation and the effects of reforms at the Antalya G20 Summit, continued monitoring of regulatory impact should inform the final calibration of pending measures and adjustments to policy decisions, as well as the implementation time frame.

In addition, both policymakers and the industry should consider and define what kind of financial system is most desirable for the future. Regulation should not lead to a single common business model. A diverse financial ecosystem, with strong local and global players as well as retail and wholesale banks can best cater to the needs of different types of customers. A diversified financial system also reduces systemic risk. Hence in developing regulatory frameworks that are consistent across jurisdictions, careful consideration should be given to differences in financial structure, local financial markets, and bank business models.

Improving the regulatory capital framework and RWA comparability; preserving risk sensitivity

The recent focus of policymakers and the Basel Committee on improving the bank regulatory capital framework, particularly on comparability of risk-weighted assets across jurisdictions and balancing of additional policy goals such as simplicity and risk sensitivity, is welcomed. The industry (and the IIF in particular) has contributed to the BCBS work on strengthening the capital framework, refining internal risk modeling, and eliminating undesirable RWA variance. However, we are concerned that the value of risk sensitivity has been discounted in recent policy discussions, and that proposed revisions would reduce incentives to improve the accuracy of determining the economic risks carried by banks. Such de-linking could dramatically alter the relationship between risk and capital, penalizing low-risk assets while favoring high-risk exposures. If backstop measures (such as the leverage ratio or a capital floor) are calibrated to be the generally binding constraint, they would compromise the sensitivity to underlying risk in all banks' key strategic and performance drivers.

Similarly, significant pending changes to the Basel framework, such as new rules for the trading book, charges for interest rate risk, and new credit and operational risk standardized charges, all have the potential (if wrongly calibrated) to disproportionately increase capital requirements, weighing on the ability of banks to finance the economy. A bias towards more developed financial systems and against emerging markets in many of the proposed calibrations further compounds this problem.

Our preferred approach is to ensure that capital measures are appropriately designed and calibrated, that the banking industry and regulators collectively take up the challenge to improve models, so that risk sensitivity is preserved.

Preserving market liquidity and ensuring the appropriateness of existing policies

Market liquidity continues to raise concerns in both public and private sectors, given that a range of indicators are signaling impairment in some key markets—as extensively documented by the recent IIF/GFMA-commissioned PwC Global Financial Liquidity Study. While provision of market liquidity is shifting from principal market-making to a hybrid system, the sustainability of these shifts is yet to be tested under changed market conditions—particularly during periods of stress, when lack of liquidity can add to volatility and market disruption. More broadly, there is unanimity about the importance of assuring adequate liquidity for effective market functioning. Efficient allocation of capital and risk in markets not only promotes proper allocation of economic resources but enhances the effectiveness of monetary policy and ultimately of financial stability measures.

The IIF is committed to analyzing market liquidity developments and continuing dialogue with policymakers on the best policies and decisions needed to support adequate market liquidity. We exhort policymakers to: consider carefully any pending policies that could alter the outlook for market liquidity; look closely the balance between measures needed to sustain banking sector stability and those that would encourage market liquidity; and to ensure the coherence of market infrastructure regulation, prudential capital, liquidity, resolution and other requirements, including bank structural reforms, so that the end result does not significantly hamper the financial market liquidity that is essential to support investment and growth.

Ensuring a sound framework for systemic risk outside the banking sector

As the FSB and national authorities continue to consider potential systemic risk in the insurance and the non-bank/non-insurance sectors, the IIF supports a focus on underlying activities and avoidance of firm-specific measures. We support the recent decision by the FSB and IOSCO to expand their inquiry and take additional time to consider developing a framework focused exclusively on potentially systemic activities. Such analysis will be most powerful if based on hard data and evidence, collected with adequate participation from the industry; the IIF would be pleased to offer all support needed in this regard. As the final framework for higher loss absorbency for systemic insurers is developed, the focus should remain exclusively on activities that could give rise to systemic risk. This policymaking process should be conducted so that the final framework does not unduly constrain the important economic and systemic benefits of a prosperous and resilient insurance sector.

More broadly, as technology and the entry of new players changes the landscape for financial services—including via the use of blockchain and new payments technologies, as well as alternative lending platforms and advanced data analytics—it is important for industry and policymakers to work together to understand these new developments and potential associated risks.

Turning to current macroeconomic and market developments, we highlight current key areas of concern to the private-sector financial community:

Need for drivers of growth, particularly in emerging markets

As you will be aware, the post-crisis years have been marked by deceleration in global GDP growth, from an average of 3-3.5% in 2010-11 to around 2.5% at present. Reasons for this weakness include the marked slowdown in world trade; still-rising corporate debt particularly in EM countries, in tandem with diminishing returns to new borrowing; aging populations in many countries; and a continued decline in productivity growth. As EM economies have been a mainstay of global growth in recent years, weaker EM demand growth may ultimately impact growth prospects in mature economies—indeed, there are signs that this is beginning to happen already.

Against this backdrop, and as the Federal Reserve contemplates raising U.S. interest rates, greater risk aversion and spikes in volatility have been evident. As the ECB and the Bank of Japan extend quantitative easing, divergence in monetary policies continues to create uncertainty and volatility in financial markets; at the same time sustained ultra-low rates and heavy central bank presence in markets continues to create distortions. For emerging markets—also hard hit by a decline in demand from China and sustained weakness in commodity prices, this has resulted in a particularly unhealthy dynamic.

Emerging market currencies have fallen nearly 30% since the beginning of 2013, meaning a sharp drop in purchasing power and hence import demand. However, in a low-growth world, currency weakness has done little to help EM exports, which are down over 8% year to date. Moreover, dollar strength and the rising risk premium demanded by investors have pushed up the costs of debt servicing and borrowing in international markets. With some 15% of emerging market non-financial corporate debt now denominated in U.S. dollars, this will hurt.

Additional recommendations

Given the concerns outlined above, finding ways to revitalize growth—particularly in emerging markets—is imperative. Drawing on the perspectives of our broad global membership, we highlight four specific recommendations:

1. **Move resolutely to complete trade agreements**. The historic Trans-Pacific Partnership agreement reached this month will bring far-reaching benefits for the global economy, and should be ratified quickly. Building on this success, completion of TTIP and TISA would substantially boost world trade volumes—which are now declining year-on-year for the first time since the 2008-09 financial crisis—and lend vital support to embattled emerging market economies.
2. **Galvanize investment in infrastructure**. The important work of the Global Infrastructure Initiative, the Global Infrastructure Facility, the multilateral development banks and new initiatives such as the AIIB in mobilizing infrastructure investment should be leveraged to support immediate and concrete action. Taking advantage of ultra-low long term rates, national authorities should incorporate infrastructure spending into capital budgets wherever feasible. Such public sector financing should aim to catalyze private sector participation, developing a range of instruments with different risk/return features. Establishment of a sound framework for infrastructure investment, protection of investor rights—often the single biggest risk for private sector investors—and establishment of a tradeable asset class in infrastructure debt will also help.
3. **Prioritize structural reforms**. Investors worldwide have made it clear that progress on productivity-enhancing structural reforms—e.g., of labor and product markets, financial sectors, and governance—is a key determinant of emerging market growth prospects. A very high premium is placed on good policies and effective implementation.
4. **Emphasize financial inclusion**, which is essential for ensuring that the benefits of growth are spread to lower-income groups and hence serve a vital source of growth and stability for emerging economies. The private sector has played a key role in promoting financial inclusion, and is likely to be increasingly important in harnessing new financial technologies. To maximize the ability of firms to facilitate inclusion, it is important to rethink policies that may provide disincentives to trade finance and remittances—in conditions where they are most needed.

We hope you find this brief summary of industry perspectives helpful. As always, the private sector financial community stands ready to work with the official sector towards achieving our mutual goals in support of global financial stability and sustainable economic growth.

Sincerely,

cc: G20 Finance Ministers and Central Bank Governors