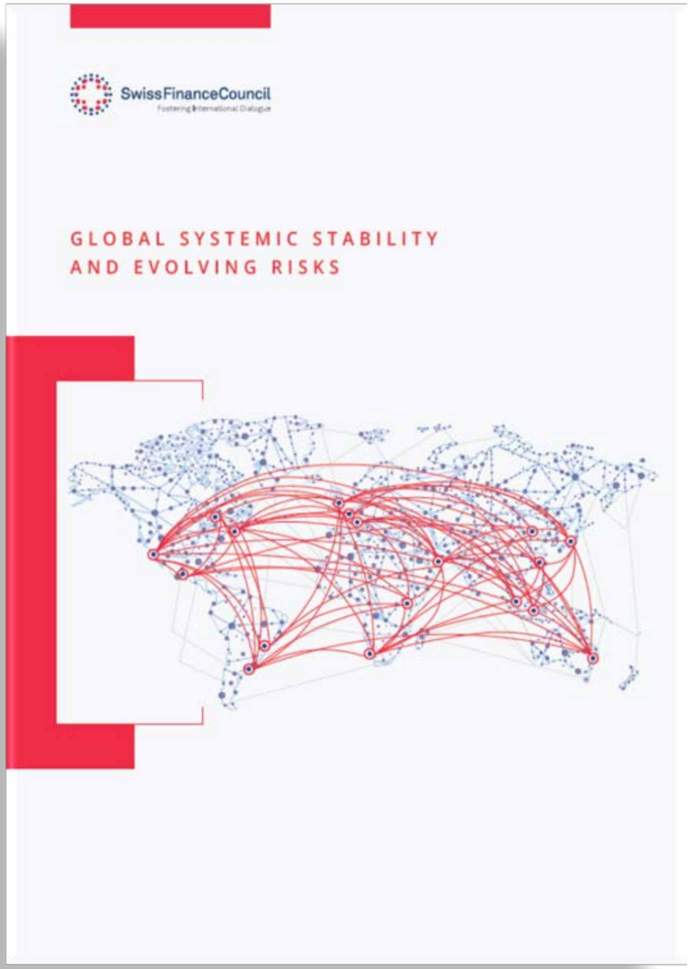
SwissFinanceCouncil
Fostering International Dialogue

Global Systemic Stability and Evolving Risks

Overview of SFC Discussion Paper 2019

Discussion paper examines extent to which the financial system has stabilised through new regulatory frameworks and highlights evolving risks requiring new forms of dialogue



I. Assess completion of regulatory reforms and impact

II. Prepare for new risks

III. Recommendations

Much stronger financial system

Banks significantly improved capital and liquidity positions, are subject to RRP and strengthened corporate governance and risk management frameworks

Figure 1: Implementation of new requirements

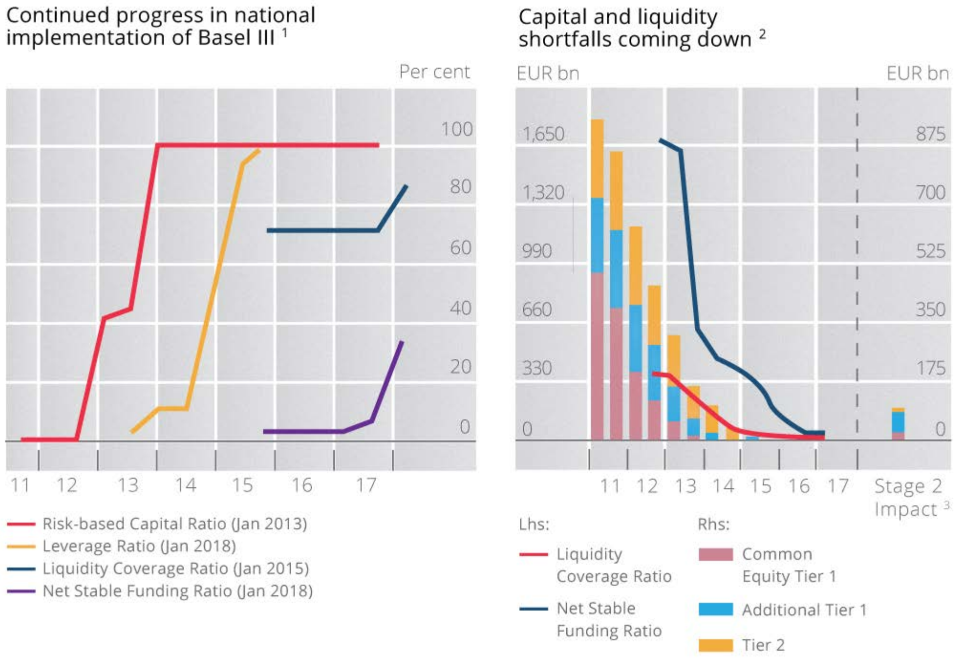
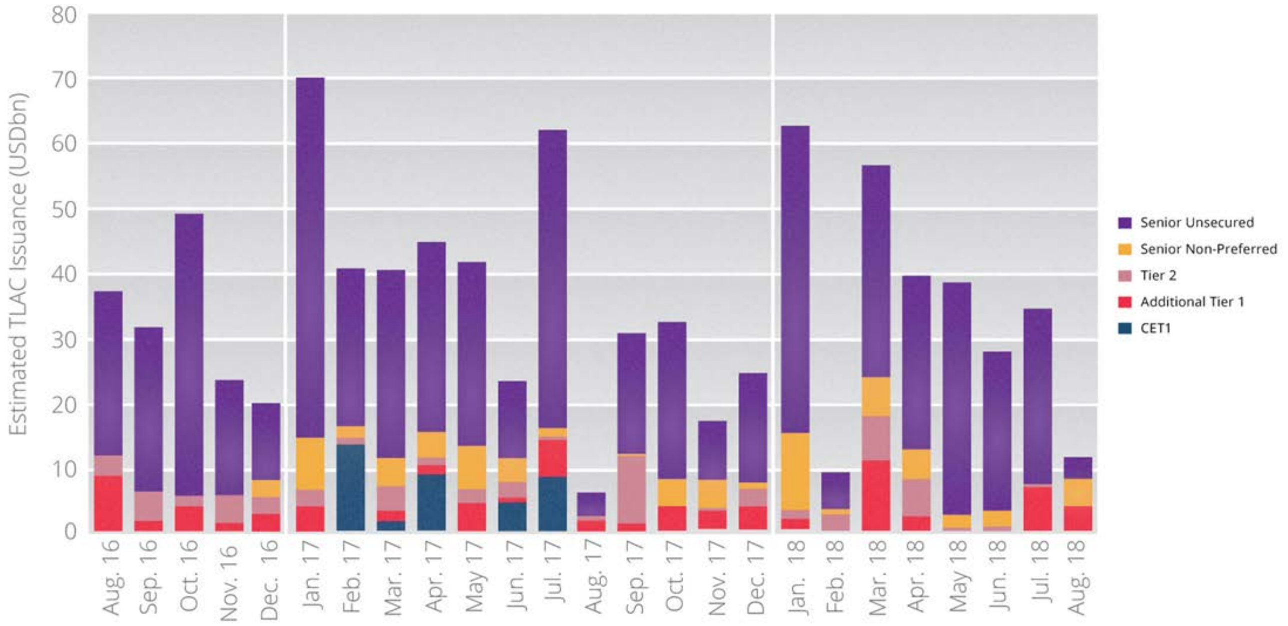


Figure 4: Estimated G-SIB issuance by eligible TLAC instrument (August 2016-August 2018)



1. Percentage of BCBS member jurisdictions in which each standard is in force; agreed implementation dates in parentheses. 2 The height of each bar shows the aggregated capital shortfall considering requirements for each tier (i.e. CET1, Additional Tier 1 and Tier 2) of capital and liquidity for the major internationally active banks monitored by the BCBS).

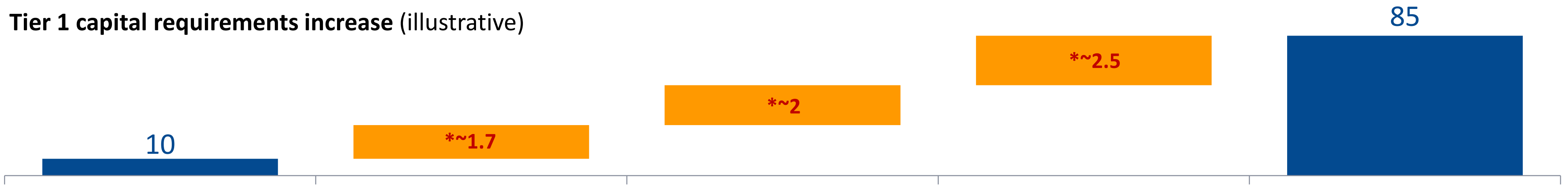
Sources: SFC discussion paper 2019 based on BCBS, Basel III monitoring report, December 2017 and March 2018; SNL; BIS calculations; Bloomberg, FSB secretariat estimates

Significantly enhanced capital requirements

Illustrative & simplified

Risk-based capital requirements have increased by a factor ~8 - 10 since the crisis…

Tier 1 capital requirements increase (illustrative)



Basel I

Absolute, effective tier 1 regulatory capital requirements
[Example starts with capital requirements of 10]

Capital quality /eligibility

Change from B1 to B3 reduced eligible capital by ~40%

RWA calibration

Change from B1 to B3 increased RWA by factor 2
[Basel 3+ revised market risk, credit risk & op risk to lead to further increases]

RWA ratio requirement

Minimum RWA regulatory tier 1 capital requirements increased by a factor of 2.5

Basel III

Absolute, effective tier 1 regulatory capital requirements (2019)
[effective capital requirements increased from 10 to 85]

… On top came stringent additional standards

+ Leverage ratio
Non-risk based additional capital constraint

+ Basel 3+ floor
Limit on model-based RWA, likely to further increase RWA

+ Stress testing
Complementing capital requirements

+ TLAC
Gone concern requirements on top of going concern requirements

Greatly increased systemic stability

Source: SFC analysis

Regulatory Complexity

	Pre-crisis	Today
Capital requirements	✓ Simple risk-based requirements	✓ Enhanced risk-based requirements ✓ Leverage ratio ✓ Stress-testing
Liquidity requirements	✗ No consistent requirements	✓ LCR ✓ NSFR
RRP / TBTF	✗ No requirement	✓ Recovery plans ✓ Resolution plans ✓ TLAC
Derivatives	✗ No consistent requirements	✓ Reporting ✓ Central clearing ✓ Margining
Corporate and risk governance	✗ Weak principles	✓ Good governance principles ✓ Standards on sound compensation practices

But…

Conflicting rules and adverse effects

- Risk-based capital requirements, leverage ratio and stress-testing cover the same risks
- Requirement to hold HQLA under LCR, but penalizing capital treatment under LR for holding these
- Liquidity key in resolution, but requirements currently unaligned
- Incentives and requirements to centrally clear OTC derivative, but capital requirements increasing cost of clearing services and disincentivinzing it
- New systemic risks created in CCPs due to their high market concentration

Regulatory complexity and fragmentation

- While many rules were agreed internationally, there are divergences in timing and scope of implementation

Significantly improved regulatory framework since the crisis, but new challenges from complex and multi-level regulation

Cybersecurity

Management of cyber-risks as key focus of industry and regulators. Successful attack on bank could cause shock across markets. Policymakers, regulators and private sector need to work in close alignment

Regulators

- Cybersecurity high on agenda. However, different approaches and limited consensus across jurisdictions on appropriate level of detail and specificity of the rules

- Cybersecurity risks and impact to be considered specifically when introducing new regulations
- Consistency in national regulatory measures and international collaboration

Financial institutions

- Particularly exposed to cyber-risks with high reliance on IT infrastructure and strong interconnectedness
- Recognise they represent attractive targets; cybersecurity a standing agenda item for boards

- Cybersecurity culture as organisational priority
- Awareness to be focused on 'people-centric security' and move beyond reliance on security policies and technical controls

- **Common infrastructure and intelligence sharing:** Banks to collectively assess and protect shared infrastructure
- **Consumer protection**: Employees, clients and third-party workers as attractive point of entry for cyber-attackers
- **Corporate Governance**: Board level involvement essential
- **Regulation**: Regulatory efforts aimed at higher user convenience to consider the consequences for cyber-risk
- **Cross-border standards**: Regulators to act consistently and collaborate in relation to incidents

Climate change risk (1/2)

Importance of systemic role of financial system in mitigating or exacerbating climate change

Summary:

Financial institutions and industry responses	• Potential effects of climate change on financial institutions: • physical risks • liability risks • transition risks	• Largest European banks aware of climate-related risks and opportunities (e.g. UK PRA/ShareAction); need for further improving risk assessment/management • Full extent of risks not yet understood, more work needed on methodologies/scenarios, incl. macro level
International initiatives	• Addressing climate change from a systemic perspective: • increasing data availability and transparency • improving risk assessment methodologies • establishing common understanding of what is 'green'	• G20 Green Finance Study Group • FSB Taskforce on Climate-related Financial Disclosure • Network for Greening the Financial System • EC Sustainable Finance Action Plan • UN Environment Finance Initiative

Turning sustainable finance into an opportunity for more integrated financial markets:

- **More integrated and liquid financial markets** by making sustainable investing products more commonly understood
  - establish common definitions;
  - address cross-border marketability issues;
  - calibrate investor protection rules appropriately
- **Innovation** is the key role of individual institutions in this field apart from improving risk management

Climate change risk (2/2)

Addressing climate change risks in the financial system while embracing opportunities for innovation:
90% of studies find sustainable/impact investments match returns of ordinary investments

Recommendations:

Removing regulatory hurdles	• New rules must not harm innovation • Focus on making regulation conducive to growth in climate finance • Close dialogue between policymakers and industry required
Consistent implemen-tation	• Cross-border regulatory collaboration and global alignment • Avoid harming cross-border liquidity and accessibility of sustainable/climate finance products • Taxonomy: ensure easy applicability across jurisdictions
Common understan-ding of scenarios	• Need for consistent macroeconomic data and climate change impact scenarios • Collaboration of governments/central banks and academia • Smart use of technology

Need for close collaboration to address climate change risks and foster opportunities

Concluding policy recommendations

1. Acknowledge completion of prudential reforms, assess impact and develop a forward-looking approach

- Updating the quantitative impact study of past reforms to account for cumulative effects
- Removing inconsistencies, outdated legislation and closing regulatory gaps
- Developing a new form of global regulatory dialogue

2. Delivering financial stability in an efficient manner

- Ensuring consistent implementation, and avoiding excessive ring-fencing and fragmentation
- Improving the operationality of the agreed regulatory framework
- Extracting the benefits of new technology

3. Ensure new engagement model to better prepare for evolving risks

- Reduce regulatory complexity
- Take cybersecurity to the next level
- Need for close collaboration to address climate change risks