INTERNATIONAL REGULATORY COOPERATION TO COUNTER THE RISKS OF FRAGMENTATION
EXECUTIVE SUMMARY

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INTERNATIONAL REGULATORY COOPERATION TO COUNTER THE RISKS OF FRAGMENTATION
The 2008 global financial crisis was a defining moment for the financial system, triggering a new era of regulatory cooperation. In particular, the Financial Stability Board, and other international standard-setting bodies assumed a key role in shaping a truly global reform of financial regulation with the aim to rebuild and safeguard overall financial stability. Ten years on, it is time to take stock, evaluate the progress thus far and identify areas where more work is needed. With national efforts to implement new global standards now in full swing, this year’s Discussion Paper of the Swiss Finance Council seeks to contribute to this debate. The central question this Discussion Paper analyses in greater detail is “Are we seeing a retreat from international regulatory cooperation, and do we run a risk of regulatory fragmentation along national borders?”

Let there be no doubt: the post-crisis international consensus on financial regulation was crucial to increasing financial stability on a global scale, and the global standard-setters are to be commended on the progress achieved. At the same time, we are today witnessing growing tendencies in some jurisdictions to question the role and legitimacy of international financial standard-setters and to contemplate a departure from supranational policy-making and -coordination more generally. Alternatives are hoped to be found in a retreat to protectionism and national rule-making, thus de facto looking for national solutions to what ultimately and increasingly are global problems. Such instances of inconsistent implementation of the agreed global standards raise important level-playing field concerns for the financial services industry. Absent a credible coordination mechanism, the obvious risk is that of a regulatory race to the bottom, which would not be conducive to financial stability or to fostering sustainable business models for the industry.

We believe that a key ingredient to changing the course of the aforementioned dynamics, is a concerted effort by national and supranational regulatory, supervisory and standard-setting authorities to restore trust in one another. At the same time, we should not lose sight of the intrinsically global dimension of today’s financial services and markets landscape. Strengthened governance in global standard-setting, stricter enforcement mechanisms as part of the implementation process, as well as deeper international cooperation are all key to achieving internationally consistent implementation of agreed reforms and to addressing potential deficiencies or undue deviations. Successful global regulation and supervision must focus on delivering enhanced regulatory coherence and convergence, based on internationally agreed principles and standards, in order to sustain global financial stability.

Based on the Discussion Paper’s case studies, as well as contributions from industry experts and distinguished members of the global regulatory community, our publication proposes three sets of recommendations that could serve as building blocks for a more efficient international regulatory cooperation framework. We trust that you will find it a thought-provoking contribution to this important debate.
National jurisdictions want to ensure that their consumers are protected, that the risks to financial stability are well managed, and that their regulation is fit for purpose in terms of economic growth. However, in today’s interconnected world where challenges are increasingly global, this approach risks creating political and economic fragmentation that can exasperate tensions, limit growth and provide the breeding ground for the next crisis. International cooperation is under pressure as we are witnessing a departure from multilateral agreements and an increasing backlash against international organisations.

Our Discussion Paper explores the challenges to achieve global regulatory cooperation and promote international standards in a fragmented world as also in the context of Brexit. To counter these risks, and build a global financial system that is resilient, sustainable and efficient, we believe that more needs to be done to increase trust among global regulators and policy makers. The key to this is improved governance of the global standard-setting and the implementation process. Looking forward, successful international cooperation must focus on delivering much improved regulatory coherence and convergence to sustain global financial stability.

Senior public officials and experts from the ECB, SRB, OECD and IOSCO have added their voice, throughout the Discussion Paper, to our call for enhanced international regulatory cooperation. The first chapter, written by David Wright, provides a comprehensive overview of the international regulatory and supervisory framework post-crisis and the current state of international financial cooperation. It shows that there are major challenges in achieving and implementing global financial standards and supervisory convergence, and much remains to be done. It argues that stronger multilateralism and internationally agreed and enforceable standards are essential to face today’s financial regulatory and supervisory challenges which transcend national borders. The European Union (EU) has a positive role to play in developing multilateral standards that are often subsequently adopted at global level.

The second chapter presents three case studies which look at the need for regulatory and supervisory cooperation and global standards. They illustrate different approaches to achieving common positions and addressing inconsistency between regulatory frameworks and diverging standards in respectively capital and prudential regulation (top-down approach), derivatives regulation (via aligning competing regulation in key jurisdictions) and in the new area of sustainable finance (bottom-up approach).

Out of these three examples with diverging ways of achieving common international standards, our Discussion Paper proposes a set of overarching policy recommendations which could serve as principles for a more effective international regulatory cooperation framework and can be usefully replicated across a set of key regulatory files.

OUR KEY POLICY RECOMMENDATIONS AT A GLANCE:
1. Improving the Functioning of Global Standard-Setting.
2. Improving the Implementation, Dispute Resolution and Data Sharing.
3. Reinforcing the EU’s Role in International Cooperation.
The global financial crisis that began in August 2007 proved to be a massive shock to the global economy. The Financial Stability Board (FSB) estimates that the damage could have been up to a 25% loss of global GDP. In the EU, financial markets, especially cross-border banking, were fragmented and there were attempts by Member States to ringfence capital as the crisis worsened. There has been about eight years of lost economic growth; an enormous increase in public debt (>30% GDP on average), years of public sector austerity, widespread unemployment (especially among young people) and severe sovereign debt Eurozone crises in Greece, Portugal, Cyprus and Ireland which in early stages threatened to derail the single currency. Italy’s public-sector debt and Non-Performing Loans (NPLs) remain extremely high to this day.

During the crisis some major banks and financial institutions were bailed out on both sides of the Atlantic fuelling deep voter resentment and serious charges of societal inequity and unfairness. So serious has this crisis been that it is difficult to imagine how any other event could
result in such damaging economic effects of this size, except war. Sir Paul Tucker warns that “…next time, if soon, governments could not contain public unrest (…)”.  

As the crisis deepened throughout 2008, the G7 countries led by the US and UK drove forward (in the Pittsburgh and London Summits) a major multilateral effort to coordinate global financial repair by creating the G20 group of countries, encompassing the major financial markets of the world. Policymakers also handed an important financial stability and global coordinating policy mandate to the FSB, flanked by the sectoral standard setters – the Basel Committee (BCBS) for bank standards, International Organisation of Securities Commissions (IOSCO) for securities, the International Association of Insurance Supervisors (IAIS) for insurance and the International Accounting Standards Board (IASB) for accounting.

There was also a wide variety of other specialised standard setters involved, such as the International Federation of Accountants (IFAC), the Committee on Payments and Market Infrastructure (CPMI) for clearing and settlement and the Financial Action Task Force on Money Laundering (FATF) under the auspices of the Organisation for Economic and Cooperation Development (OECD). The IMF’s role as the ultimate firefighter did not fundamentally change throughout the crisis period and little changed on the trade front at the World Trade Organisation (WTO) either as the multilateral trade negotiations remained paralysed in Geneva.

Membership of the G20 and the renovated FSB became contested, controversial and political. For example, developing countries felt they were under-represented in the G20 and FSB (to cope with the effects of a massive crisis they had not caused). The EU was more successful in securing its seat at the table and for the first time the World Trade Organisation (WTO) either as the multilateral trade negotiations remained paralysed in Geneva.

1.1.2 Different approaches to regulation

In the EU, policy evolved along three basic strands (subject to further analysis below):

- Translating the emerging international financial regulatory consensus into European law, led by European Commissioner Michel Barnier;
- Developing the institutions and policies to stabilise the Eurozone – among others, the Banking Union (BU), European Systemic Risk Board (ESRB), European Stability Mechanism (ESM) and Single Resolution Board (SRB) – which remain work in progress today;
- The De Larosière Committee whose important recommendations were broadly endorsed by the European Council and European Parliament in the ordinary legislative process (formerly known co-decision), resulting in the setting up of the three European Supervisory Authorities (ESAs) - the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA) - as formal treaty-based institutions. Their mandate is to develop and coordinate with national regulators the granular regulatory rules necessary for a single, harmonised European rule book, and to supervise some pan-European financial institutions directly.

The Dodd Frank Act in the US did not make radical changes to the complex financial regula-
1.1.3 Reshaping the international standard-setting process

Policymaking at the global institutional level was decided on the basis of a "sense of the room" consensus, not quite unanimity, but not far from it. This translated into two main effects. On the one hand, at times only de minimis high level principles were possible to agree. On the other, in most cases, there was insufficient granularity in the standards, none of them legally binding, in order to leave the necessary degrees of regulatory freedom to national regulators to implement them. Inevitably, given the asymmetric implementation, in certain cases (for example, clearing and swaps) cross-border conflicts of law emerged later mainly affecting the EU, the US and Japan.

During the crisis the representativeness, governance, accountability and transparency of the international standard-setting process also came under fire, for example from the US Congress or excluded developing countries and a range of Non-Governmental Organisations (NGOs). These developments forced the FSB to set up Regional Committees to explain its main policies better to its regional constituencies.

In the past, Basel capital standards did not provide sufficient callable capital in the banking system to act as a buffer in times of a crisis, or sensible rules on liquidity or limits on leverage. As a consequence, central banks and banking regulators have continued to dominate the global post-crisis policymaking agenda. They have not only captured all the chairs of the main FSB policy committees (policy, research and implementation) but also ensured that most central banks and banking regulators sit on key committees. Friction built up with securities regulators when the FSB worked mechanically towards capital-based bank-like regulation for large asset managers. The idea ended up abandoned later.

An important issue here was whether the FSB was being guided by too much 'group think' and not enough by plurality of opinion and wider capital market expertise.

IOSCO remains the most geographically representative and economically balanced of all the international standard setters (emerging market and developed economies) but became lumbered with an unwieldy board of 35 securities regulators. It played, however, an important role in shaping the global rules on derivatives, clearing, money market funds, asset management and benchmarks more widely.

The IASB continued its important work to complete the missing individual accounting standards but pushed forward without its full focus on international convergence on a single set of standards with the US Financial Accounting Standards Board (FASB) and US Generally Accepted Accounting Principles (GAAP). In effect, the IASB saw the writing on the wall – the realisation that the US would not adopt the International Financial Reporting Standards (IFRS) - so the world is stuck with two accounting systems albeit with IFRS being by far the most widely used set of standards at the global level with over 120 countries following the EU's lead to adopt them at the beginning of this century.

One unfortunate consequence of global accounting standard bifurcation is that there are two different accounting treatments for determining impaired assets which could be very serious and disruptive in the case of trying to resolve, co-operatively, a collapsing financial firm with major transatlantic footprints. Trade repositories are
The financial crisis has shown how financial markets have become inextricably interconnected and global, catalysed by rapid technological change and growing global economic and trade interdependence. Contagion and severe risks spread quickly across globally interconnected markets. Inter-bank markets froze. Bank lending in the EU dried up, damaging many Small and Medium-sized Enterprises (SMEs) severely. Massive subprime ‘assets’ were more than a US domestic problem but had infiltrated extensively bank balances and asset portfolios of firms in many different parts of the world. The demise of Lehmann Brothers was international in reach and hugely complex to resolve. Over the fateful weekend when the company collapsed all of Lehmann’s cash reserves and capital were siphoned out of London to the US for resolution purposes. The Monday morning after, the London branch had nothing.

So, the lessons of the crisis could not have underlined in starker terms the importance of national and international authorities, standard setters and regulators working very closely together to develop effective policies for regulating and supervising financial markets and actors to maintain financial stability. This is now ‘de rigueur, sine qua non’. The reality is that no financial market in the modern world can be an isolated island insulated from other markets. Inter-bank markets froze. Bank lending in the EU dried up, damaging many Small and Medium-sized Enterprises (SMEs) severely. Massive subprime ‘assets’ were more than a US domestic problem but had infiltrated extensively bank balances and asset portfolios of firms in many different parts of the world. The demise of Lehmann Brothers was international in reach and hugely complex to resolve. Over the fateful weekend when the company collapsed all of Lehmann’s cash reserves and capital were siphoned out of London to the US for resolution purposes. The Monday morning after, the London branch had nothing.

As the OECD points out in its 2016 report on international regulatory cooperation, “international regulatory cooperation facilitates the development of common language and comparability of approaches and practices” even though that on its own is far from sufficient.

The evolving global landscape of interconnected financial markets needs to be accompanied by a solid, stable institutional cooperative framework with reliable and transparent processes for drawing up international financial regulation and supervision. At the heart of these efforts should be:

- Build trust and confidence among regulators and supervisors;
- Develop and integrate countries into the global financial market place;
- Improve systemic stability, for example cooperating on cross-border resolution regimes or ensuring higher capital levels in prudential firms;
- Reduce undesirable extraterritorial effects of national/regional regulation, avoiding international spillover and contagion from poorly drafted national law (or lack of law);
- Promote fair global competition with the avoidance of dangerous beggar-my-neighbor/race-to-the-bottom regulatory competition;
- Reduce frictional dead weight regulatory costs of doing cross-border business;
- Reduce the fragmentation of essential market liquidity.

JONES and KNAACK state, “(a)s international regulators look to galvanise international financial cooperation in the face of growing economic nationalism in the world’s industrialised countries, they should look to where the energy and appetite is for international cooperation”.

another area of significant discrepancy. Instead of setting up the G20 mandated aggregation of derivatives risk exposures, approximately 30 national repositories have emerged without global aggregation. Data standards are also unfinished.

1.2 THE CASE FOR ENHANCED INTERNATIONAL COOPERATION

1.2.1 The role of inter-institutional relations

The financial crisis has shown how financial markets have become inextricably interconnected and global, catalysed by rapid technological change and growing global economic and trade interdependence. Contagion and severe risks spread quickly across globally interconnected markets. Inter-bank markets froze. Bank lending in the EU dried up, damaging many Small and Medium-sized Enterprises (SMEs) severely. Massive subprime ‘assets’ were more than a US domestic problem but had infiltrated extensively bank balances and asset portfolios of firms in many different parts of the world. The demise of Lehmann Brothers was international in reach and hugely complex to resolve. Over the fateful weekend when the company collapsed all of Lehmann’s cash reserves and capital were siphoned out of London to the US for resolution purposes. The Monday morning after, the London branch had nothing.

So, the lessons of the crisis could not have underlined in starker terms the importance of national and international authorities, standard setters and regulators working very closely together to develop effective policies for regulating and supervising financial markets and actors to maintain financial stability. This is now ‘de rigueur, sine qua non’. The reality is that no financial market in the modern world can be an isolated island insulated from other markets. Had there been a unilateral ‘chacun-pour-soi’ regulatory response to this crisis, the dangerous financial situation could have become calamitous and would not have reduced the endemic panic, nor restored order and calm. Another factor that played an important and understated stability role was the WTO disputes settlement procedures that deterred governments from adopting protectionist measures which as history shows, had magnified the cataclysmic 1929 financial crash.

There is therefore an inviolable case, even a moral obligation, for countries and trading blocs to cooperate when developing financial regulations and supervisory mechanisms. Global financial standards can:
In September 2017, Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA), argued, “[b]ecause of the well-known externalities that can arise from financial services, in the areas of both prudential and conduct outcomes, the case for regulation is made both in a closed economy and as the source of assurance to enable trade to occur and thus in open economies. Effective regulation enables trade, and because of the capacity of the externalities to spill over, such trade requires good regulatory co-operation which enables sufficient harmonisation and mutual recognition. This means that effective and necessary regulatory co-operation depends upon trust between regulators. (...) [T]rust depends upon transparency of practices and consistent effective outcomes in terms of dealing with the potential for harm arising from the externalities. In other words, that trust has to be earned”.

1.2.2 The importance of international law

Ideally, international cooperation frameworks should be anchored on a framework of binding international law. As BINGHAM states in his seminal work, “(...) cross-border problems call for cross-border solutions, which can only be provided by a coherent body of enforceable international rules”.

Challenges in reaching international agreements mean that in general international law often establishes a loose framework of coordination which may, or may not be binding, to which international cooperation responds with the construction of complex supervisory and regulatory networks, engulfing national, regional and international law.

No global financial standards are binding; enforcement is based on peer pressure, coloured diagrams and prayer; and there are no binding disputes settlement arrangements for faulty or negligent implementation. This matters because of global interconnectivity, risk propagation, contagion and the propensity for cyclical periodic financial crises.

International human rights are an important example where international law has been crucial for domestic protection because they constitute a set of international rules which individuals and groups can demand certain behaviours or benefits from governments (the Geneva Conventions). The law of the sea, aviation law, commercial and intellectual property law are among other areas where international law has set international standards and impetus to cooperate.

As BINGHAM reflects, “[i]f the daunting challenge-
and cannot override US domestic law or delegated regulatory responsibility. In short, the US, never comfortable in international institutions and even less so today, is strongly opposed to delegating formal, binding financial rule-making powers to the international level.

Others, however, may be more open. The EU, an institution established by treaty is sui generis a paragon of devolved powers, multilateral by nature and far more comfortable ‘sharing sovereignty’ internationally and collaboratively with Member States. In fact, the EU is party to hundreds of international treaties, some with rule-making powers.

But the EU is not homogenous. Its Member States differ in their European and international ambitions. The United Kingdom (UK), who has benefitted enormously from the integration of EU capital markets, has decided to leave the EU and pursue a more independent, internationalist agenda – or rather internationalism without Europe. Many doubt it will be successful in negotiating a web of new bilateral trading relationships all around the world. The WTO offers no comfort for financial services market access since this part of the General Agreement on Trade in Services (GATS) is bare-boned with a prudential carve out. However, the UK outside the EU will have every incentive to seek to strengthen the international financial institutions and their rule-making, particularly because the UK has considerable influence in these bodies and holds the current chairmanship of the FSB. France and Germany, both strongly pro-European, are also internationally minded, the latter perhaps more than the former. For France, the EU comes first.

China’s multilateralist tendencies seem to be increasing as it vies to extract political advantage from the new US administration’s transactional bilateralism. The question is whether a ‘coalition of the multilateral willing’ can be assembled if the US withdraws towards pure bilateralism. One signal is that the other parties to the Trans-Pacific Partnership (TPP) will continue with the project without the US.

Chatham House argued already in 2014 that “the risks to the international order [were] real [and] nationalism [was] a potent force around the world”. This tension between globalisation, nationalism and protectionism is therefore now a core feature of future global regulatory development and cooperation. The only solution to these issues is political leadership that recognises the global common interest to cooperate with a will to build global institutions based on international treaties that are endowed with sufficient legally binding rule-making and supervisory powers to protect the common good and global commons.

1.3.2 Enforcement of standards and sanctions

International financial standards today are drawn up by a patchwork of global institutions none of which have the attributes of being formal Treaty based international organisations. Their standards and recommendations are not binding on their members nor the timeframes in which they should be adopted.

Implementation is left to each member and although there are peer-review oversight mechanisms, sometimes, but not always, weak as in the FSB case, there are no enforcement powers, no international court to appeal to or sanction mechanisms for non-conforming states.

As SLAUGHTER10 notes, national regulators are not entirely impartial actors dedicated to furthering global policy objectives. Due to concerns with the protection of national sovereignty, national supervisors are most likely to protect national interests; they can be tempted to relax enforcement of internationally agreed standards if risks can be shifted to other jurisdictions. Domestic financial markets and national supervisors have a common interest to conceal the exposure of high risks.

These are major weaknesses of the international financial regulatory system. The International Monetary Fund (IMF) is the only body that has dissuasive enforcement powers to force macro- and microeconomic structural adjustment reforms in return for financial assistance.

1.3.3 Dispute resolution mechanisms

There are no binding international dispute settlement mechanisms, formal or informal, in the global financial institutions to resolve faulty or inaccurate implementation of global standards or to deal with cross-border disputes. The WTO, however, does have a binding dispute-settlement system for WTO Contracting Parties (CPs) set up in the Uruguay Round which, ceteris paribus, has worked reasonably well. Procedurally, it is complex and has several appeal processes which mean resolving cases can take time. But it has the great merit of providing a binding mechanism available to all WTO CPs to take another party, however large or powerful, to have its trade case examined. The Caribbean banana producers, for example, won a dispute-settlement case against the EU and as a result were able to force changes in its discriminatory regime.

The WTO disputes system has faced considerable criticism and various flaws have been highlighted by critics, such as:
1.3.4 Cross-border supervision

An area of particular concern in global financial governance is the supervision and monitoring of systemic risk in global markets, especially risk originating in the shadow banking sector, and the supervision and resolution of large cross-border institutions (‘globally significant financial institutions’ or G-SIFIs) and cross-border financial groups.

Approaches to the regulation of systemic risk may differ according to national economic interest and the desire to protect key economic sectors or the domestic financial services industry. In such cases, and in the absence of a predetermined legally binding framework (I would prefer referring to “reinforced standard-setting and standard compliance framework”), domestic regulators may have very little incentive to cooperate and adopt more stringent regulatory standards or, for instance, take prompt corrective action.

Cross-border resolution policy is critical in this respect. If the regulators of systemic branches and subsidiaries are not fully informed about the financial state of firms in their jurisdiction, they will mandate and ring fence capital, liquidity and loss absorption capacity (Total Loss Absorption Capacity, or TLAC / Minimum Requirement for own funds and Eligible Liabilities, or MREL) in these firms. This is suboptimal or even dangerous in terms of financial stability and in terms of business efficiency. Essential information sharing, transparency and trust working within cross-border resolution groups is key.

1.3.5 Building strong incentives to cooperate on enforcement

In the absence of formal treaty based institutions with binding legal powers or enforceability through a court, international financial policy making only has a set of weak set of tools at its disposal – among which, peer pressure, comparability and “naming and shaming”. However, there are a few soft law tools that have led to considerable successful enforcement by cleverly aligning regulatory and supervisory incentives.

The best example of this is the IOSCO Multilateral Memorandum of Understanding (MMoU) which is now more than ten years old. It is a Cooperation and an Exchange of Information systems that standardises the process by which securities regulators who are members of IOSCO can obtain information from other members for enforcement purposes, such as tracking down market abuse or insider trading. The MMoU was used to exchange vital cross-border information in the LIBOR cases. Becoming a MMoU member requires rigorous ex-ante legal vetting by a team drawn from existing members. The examination requires proof that the candidate securities regulator complies with all aspects of the MMoU including the provision of bank and telephone records and transactions reporting. Over 110 securities regulators around the world are MMoU signatories and share essential information on over 3000 cases per year.

The beauty of the system is that it aligns incentives – everyone needs each other to get hard, verifiable evidence to bring enforcement cases before the courts. The second powerful incentive is that those outside the MMoU all want to get into the system because it is seen by international investors as a cachet of good market practice which is of considerable value. Thirdly, the more the regulators and supervisors cooperate and trust each other with sensitive information the more the system grows, as it has done exponen-
According to the OECD, international regulatory cooperation consists of nine areas that can be mapped into the cycle of regulatory governance, and involve:

- Exchange of information and experience
- Data collection
- Research and policy analysis
- Discussion of good regulatory practises
- Development of bilateral or multilateral rules
- Standards, recommendations and guidance
- Negotiation of international agreements
- Enforcement activities including imposition of sanctions
- Dispute settlement and crisis management.

International cooperation can be addressed by:

- Legally binding requirements on Member States;
- Non-legally binding instruments that can be made binding through transposition into domestic legislation;
- Cooperative mechanisms primarily relying on non-legally binding tools, such as recommendations, technical standards, MMOUs, political declarations, guidance and best practices.

An illustrative example was the EU-US Financial Markets Regulatory Dialogue which played an important part in sharing information, describing regulatory intent, listening to concerns on both sides, problem solving informally wherever possible, and building trust among participants.

It worked well but was criticised for not being transparent enough. Its major merit was that it avoided any serious transatlantic trade tension when regulators on both sides of the Atlantic were very busy legislating (the EU with its Financial Sector Assessment Programme (FSAP); the US with the Sarbanes Oxley Act). Attempts to deepen these arrangements into a EU-US mutual recognition agreement were stymied by the onset of the financial crisis.

Within these headings there are different concepts for facilitation of international cooperation: harmonisation, equivalence and mutual recognition.

Harmonisation, uniformity of standards is a desirable goal but extremely difficult to achieve internationally given different legal regime and cultures and different political timetables. One way forward is upstream coordination before implementation to agree definitions, scope, timelines to minimise divergences downstream in implementation.

Equivalence assessment, which has been the EU’s main regulatory approach to third countries so far in the financial services sphere, provides that the same regulatory goals ‘in effect’ may be achieved by using different legal approaches and not exactly equivalent language which is sufficient to allow market access.

The Commission has recently reviewed the equivalence process to make it more consistent in practice. There are, however, several endemic problems with the process. An equivalence assessment is discrete in time and requires reassessment each time the law changes. It is resource heavy and whilst it can work with a small number of jurisdictions, it remains to be seen what happens when there are far more markets to assess as more global capital markets emerge, and what to do about the timing of assessments insofar there could be competitive distortions if some countries precede others. Two other points seem significant: that EU equivalence determinations have become reciprocity-based and increasingly politicised.

The Commissions’ recent equivalence paper has stated that whilst its “overall experience as a mechanism to deal with cross-border regulatory issues may be considered broadly satisfactory,” concerns have recently emerged about the lack of coherence of these provisions in assessing third-country regulatory and supervisory frameworks to the same degree.

Furthermore, the Commission has also noted that within the EU equivalence framework there...
is no ‘coherent answer’ as to what the role of the ESAs should be in the assessments. The Commission argues that there is not a clear distinction between the assistance provided for the initial equivalence assessment of a third country’s regulatory and supervisory framework, on the one hand, and the necessary continuous follow-up monitoring and implementation work on the other.

The US for its part takes a slightly different approach with a procedure often described as ‘substituted compliance’. The difference here is that the US approach is less a macro-assessment of broad equivalent effects of the law and more a micro-examination line by line of legal compliance, with regulators only granting waivers if the laws are de facto the same. These differences have led to some very challenging negotiations between the US and the EU.

A third and final approach is accepting regulatory differences by way of mutual recognition. While this can be conceived and applied in different ways, with regards to financial services it involves the parties mutually accepting each other’s conformity assessment of laws as equivalent to ensure compliance with prevailing regulatory and supervisory requirements. The UK will be seeking such an approach when its Brexit trade negotiations with the EU begin in 2018 but it remains to be seen whether the EU will accept this type of structure if the UK insists it is leaving both the single market and customs union.

1.5 THE EU’S ROLE AND APPROACH TO INTERNATIONAL COOPERATION

The EU engages in international cooperation in a wide array of areas, including financial services. In many ways, the EU is itself a microcosm of how international cooperation should work. The Union of 28 countries is treaty-based; it draws up legislation and rules according to the modalities of the Treaty of the EU, usually through ordinary legislative process; and has the European Court of Justice (ECJ) to interpret community law, to enforce correct implementation and to sanction recalcitrant or nonconforming Member States if necessary.

In the international financial services space, the EU participates in all the major fora mentioned above (including the G20, G8, FSB) but rather rarely speaks with one voice. In the Basel Committee, Member States jealously guard their seats. In IOSCO, ESMA is not yet a full member. In the G20 the President of the ECB and the European Commissioner for Economic and Financial Affairs are side by side at the plenary table. This is not satisfactory and does not conform with the ECJ’s AETR judgement which provided that once there is applicable EU law covering the subject matter there is ‘Community competence’, including the ability for the Commission to negotiate externally on behalf of the Union with agreed negotiating mandates.

For trade in goods the Commission leads negotiations, but for trade in services there is mixed competence with the Member States which is messy and complicates negotiations and ratification of trade agreements. Some argue nevertheless that the EU has been able to impose its distinct and collective preferences on international standard-setting over and beyond the global financial crisis period. With the undermining of multilateralism underway it is crucial that the EU refines its approach and steps up more to an international leadership role in its long-term interest.

The EU invests widely in its bilateral relations, including holding regulatory talks on financial regulation with key economic partners, including the US, Japan, China, India, Russia and Brazil. The Commission and EU governments hold regular high-level meetings on financial services regulation to discuss, among others, convergence towards international standards, possibilities of mutual recognition of standards and coordination of the implementation of the G20 roadmap. For Switzerland, financial services, however, have not featured prominently in formal Swiss-EU relations, despite the significant proportional size of the Swiss financial sector. There is no bilateral service agreement covering cooperation on financial services. The only formal service accords cover non-life insurance and the free movement of persons.

Therefore, Swiss financial services depend largely on multiple EU equivalent regulatory regimes, in order not to have to resort to the establishment of subsidiaries in financial services centres across the EU to conduct cross-border business with Member States. For this reason, Switzerland has embraced a continuing process of dialogue and alignment of its regulatory frameworks to ensure that the country remains closely connected to the EU to the extent necessary.

In future, the ESAs will play a stronger role in financial relations with third countries including equivalence determinations. This framework is built into an integrated network of national and EU supervisory authorities, moving some pan-EU sectoral supervision to ESA’s level, as well as establishing greater harmonisation and coherent
application of rules across the EU. The sum of these policy orientations is to deal with a fundamental weakness where “there was insufficient cooperation and information exchange between national supervisors, where national solutions were most often the only feasible option in responding to problems at the level of the Union, and where different interpretations of the same legal text existed”.

In this context, the ESAs, particularly as their mandate is being revisited, have the potential to reshape how the EU engages with international financial governance. As MOLONEY states, this engagement affords the ESAs the opportunity to strengthen their capacity and institutional position with a degree of freedom by providing a natural channel through which the ESAs can strengthen their capacity and credibility as experienced forums of pan- and cross-border coordination.

The Commission’s plans to review the equivalence system and potentially reinforce the powers of the ESAs (particularly ESMA’s) therefore take on even greater relevance. The ESAs could see their administrative powers with respect to supervisory cooperation and coordination in international financial governance strengthened. This could include the facilitation of information exchange and cooperation agreements between Member State and third-country regulators. Exchanges of regulatory personnel within the EU but also with third countries should be encouraged. If so, the EU’s effectiveness in influencing international financial governance will increase.

Mention finally needs to be made of EU development policies which, when aggregated together with those of the EU Member States, are among the largest in the world and have played an important role with developing and emerging countries to provide technical assistance for local financial market development.

The considerations above show that a multilateral approach is essential to face today’s financial regulatory and supervisory challenges which transcend national borders. Furthermore, with many new nations aspiring to build their own capital markets to finance their economies in the future and irreversible digitalisation to link and connect financial markets together, deeper international cooperation is essential to avoid poor regulation, inadequate and weak supervision and risk contagion.

Based on these findings, and the illustrations we provide with three case studies in the next chapter, we propose at the end of our Discussion Paper a number of policy recommendations that could serve as principles for a more effective international regulatory cooperation framework.
Ladies and gentlemen,

Today we can look back on nearly a decade of rule-making. Following the financial crisis of 2008, almost no stone was left unturned – at least in the field of banking regulation.

But this wave of re-regulation didn’t just focus on banks; rules were put in place to increase consumer protection and regulate the derivatives business, central counterparties and rating agencies.

In many countries these changes were accompanied by institutional changes – new authorities were set up to deal with financial risks, and they were given new powers and instruments to mitigate these risks.

Authorities gained a whole new set of tools for macro-prudential oversight.

The reforms were far-reaching in many countries, and in particular in the major financial centres.

And I am convinced that this overhaul will contribute to future financial stability.

There are two main reasons for this.

First, deregulation and light-touch supervision were a significant cause of the financial crisis in 2008.

In the early 2000s many believed in the self-regulation of the financial market – so restricting the entrepreneurial freedom of financial market participants was not at the top of governments’ to-do lists.

This all changed with the financial crisis, which was costly for banks, their investors and the taxpayers in many countries. In addition, the crisis was followed by an economic recession.

Banks, for example, now have to comply with a strict set of rules – they have to hold more and better capital than they did ten years ago. Their capacity to absorb losses has increased significantly. Banks are better prepared for a potential drying-up of liquidity sources, as the quantitative and qualitative requirements regarding liquidity management have risen significantly.

This makes banks more resilient to potential economic downturns or major unexpected events.

And supervision has changed quite dramatically, too. Many supervisors have been given greater powers to act pre-emptively; the set of supervisory tools and resources has expanded considerably. Supervisors are therefore able to pick up on deficiencies in banks, risky trends and misbehaviour earlier and more decisively than before the crisis.

Does this mean that there is no room to improve the current rules?

Definitely not.

There may be some topics which we have not yet addressed or which might need addressing because changes in the regulatory environment are always met with evasive manoeuvres.
One example is the shadow banking sector. When regulation is tightened in one area, incentives are put in place for other intermediaries to step in.

When certain business activities are pushed out of the banking sector, it does not necessarily mean that the risks for financial stability increase, but nor does it mean that these activities will not pose risks if they are handled by other market participants.

So developments in the shadow banking sector warrant our close attention.

Furthermore, we have to regularly assess whether the stated objectives have been fulfilled with the new set of rules. The Financial Stability Board (FSB) is currently evaluating the recent reforms, so this will give us an indication as to whether there have been any unintended consequences and whether we need to adapt some of the rules – although I do not expect a need for huge amendments.

As I mentioned, there is a second reason why I think that the reforms have made financial markets safer.

The standards were set at the global level, by the FSB and the global standard-setting bodies. This addressed one of the lessons learnt from the last crisis – financial markets and financial institutions are much more closely interconnected than most people realised.

There is no such thing as a national banking sector. The banking sector has become global. Many banks operate not just in one country, but in dozens of countries. And almost all banks do at least some business with banks from outside their own country.

Such a global banking sector is a good thing. It facilitates global trade and investment; it unlocks new sources of funding for the economy; and it improves the way capital and risks are allocated across countries.

And because the banking sector is global, the standards need to be global too, to contribute to financial stability in the major financial centres. So I hope that the latest package of global banking standards – Basel III – will be completed this year. And I am still confident that this will be the case.

After finalising Basel III, we need to focus on implementing the standards. I worry that some financial centres might not implement significant parts of the agreed framework.

And that would be a great mistake.

Without consistent implementation, the common standards will remain fragmented, leaving the door wide open to a race to the bottom in regulation, regulatory arbitrage, higher risks and future crises. At the same time, banks would not compete on a level playing field, and that would weigh on efficiency.

Ladies and gentlemen, the reforms that followed the financial crisis of 2008 were far-reaching, and they placed a burden on the financial sector – of that there is no doubt.

Do the reforms offer a full insurance contract to prevent each and every risk to financial stability? Well, no; such rules do not exist.

But there is no doubt that they help to make the global financial sector a safer place. They make it less likely that we will experience a second financial crisis of the same magnitude.

Looking ahead, we should not forget that we live in a globalised world. And any attempt to turn back time, any attempt to isolate one country from the rest of the world is not only a pipe dream; it is a perilous dream.

That is particularly true in the case of finance and banking.

So, instead of building walls, we should come together to discuss how we can deal with a global banking sector, how we can reap the benefits and keep the risks in check. That is the only way forward. Walking backwards will only lead us to where we came from: another global financial crisis.

Thank you for your attention.
The first chapter provided a comprehensive overview of the international regulatory and supervisory post-crisis framework and the current state of international financial cooperation and the challenges it faces. In this second chapter, we present three case studies which look at the need for regulatory and supervisory cooperation and global standards to avoid fragmentation and the creation of barriers for doing business which will ultimately hamper the financial sector’s contribution to economic growth.

• Our first case study focuses on international prudential regulation which has traditionally taken a “top-down” approach. The collapse of Bankhaus Herstatt triggered the establishment of the Basel Committee on Banking Supervision (BCBS) in 1974. Even since, the BCBS has played an important role, setting standards for bank capital adequacy with particular consequences for European banks. There is no formal EU membership and the EU applies these standards to all banks, even though they were originally thought to apply only to large banks. For these reasons, the Basel standards sometimes encounter a certain level of skepticism at EU level which could be addressed by enhancing the governance process of the Basel Committee.

• Our second case study addresses the conundrum that global banks face in navigating the EMIR-Dodd Frank regulations. It illustrates the difficulties that arise from aligning competing regulation in key jurisdictions. Both regulations seek to improve the transparency and oversight of OTC derivative markets by implementing the commitments made by the G20 leaders during the 2009 Pittsburgh Summit. Both the US and the EU regulations repeatedly stated their intention to address the problems in timing, substance and capital treatment which subsequently arose from the limited coordination between regulators implementing the G20 commitments. Ex-post transatlantic negotiations have been intensive with controversies over extraterritoriality and warnings about the negative consequences that could flow from a failure to reach an agreement. Our case study illustrates the need for a stronger ex-ante mechanism of regulatory coordination and cooperation which is an essential tool to promote adherence to global standards.

• Our third case study focuses on the emergence of sustainable finance and yet another regulatory approach which could be described as ‘bottom-up’. Our case study describes the initiatives both by the industry and regulators seeking to address the challenges posed by climate change and the pressure to upgrade social and governance standards. The developments have been driven by a large number of private actors, institutional stakeholders as well as regulators. There is clearly a need for greater standardisation to help develop sustainable finance globally. The challenge is to ensure that the search for new standards does not inhibit innovation and the temptation to impose “green finance” through the wrong instruments such as regulatory capital requirements.
Banks are regulated and supervised at national level. National authorities develop the prudential measures they believe are adequate for the safety and soundness of firms in their jurisdiction. In turn, national authorities are accountable to their respective government, parliament and general public according to a range of mechanisms that vary locally. Because capital flows and financial stability are matters that go beyond national interests, regulators have developed standards that are as consistent as possible across jurisdictions. This cooperation takes place at the Basel Committee on Banking Supervision.

The Basel Committee was created in 1974 following the failure of German Bankhaus Herstatt, which generated serious disturbances in international currency and banking markets. International cooperation was a welcomed response in a context of increasing internationalisation and interconnection of banking and financial markets. Over time, the Basel Committee progressively became the authoritative, though informal, grouping for international regulatory policy development. Efforts in international collaboration have been sustained through a regular strengthening of standards, and also by the expansion of the Committee’s membership in 2009 and 2014.

Standards developed by the Basel Committee have no legal force. Jurisdictions have to translate them into law or regulation to be binding. Apart from a charter adopted in 2012 in which Basel Committee members commit to adopt standards agreed among themselves, no other formal governance mechanism provides guidance in this area. In practice, standards published by the Basel Committee are largely adopted by member and non-member jurisdictions, and also serve as a benchmark for the IMF and the World Bank, for example, when carrying out their respective jurisdictional assessments. De facto, Basel Committee standards are the global reference in banking regulation, and rightly so if we accept the fact that national experts from members and non-member jurisdictions are well placed to develop those standards. That process includes public consultations, which allow interested parties to provide their views on matters of shared interest.

Because Basel Committee standards are akin to a public good, the processes and governance arrangements that guide their development are important to understand. Starting from the top, the Group of Governors and Heads of Supervision (GHOS) is the oversight body of the Basel Committee – as noted in the Basel Committee charter. The GHOS was created in 2009 following the steps of an informal group of governors (the central bank Governors of the Group of Ten Countries) that would meet at the Bank for International Settlements (BIS) and acted as the moral caution to the activities of the Basel Committee. It is expected that each Basel Committee member institution is represented on the GHOS, but that information is not public. Neither a public charter nor policies and procedures are available in which one could find the mandate of the GHOS, its activities, legal status, process for its chair’s appointment and mandate extension, membership, observer status, or how decisions are taken and documented. GHOS meetings, which are not public, are generally announced some days before they take place and neither agendas, nor working documents, nor minutes are publicly available. Important decisions are communicated by way of press releases or press conferences. Absent of transparency, the public accountability of the group and that of the Basel Committee to the GHOS is therefore unclear.

As an example, the quantitative requirements and phase-in arrangements for Basel III were approved by the GHOS on 12 September 2010, and endorsed by the G20 leaders on 12 November 2010; a G20 Leaders’ endorsement was not sought for the finalisation of Basel III last December, while it presents both a major conceptual change in the way banks are regulated and triggers additional capital requirements compared to 2010.

Similarly, the Basel Committee’s transparency mechanisms have been limited to publishing consultative documents but also more recently dates of meetings, some directional elements of a work programme, member organisations, and few working groups.

There is no public consultation on a medium-term work programme, nor timely and systematic disclosure of planned policy develop-
ment activities for the coming year, including scope, timing, approach and objectives, except broad and succinct elements in the BIS’ annual report.

While member and observer organisations are listed on the BIS website, there is no disclosure about individuals representing these organisations, be it at the level of the Basel Committee or at working group level. In the same vein, meeting agendas or working documents prepared for discussion or decision are not publicly available.

Quantitative impact studies have been advertised for some time, but the public does not have access to input data or to methodologies. Those impact studies are limited in scope and, unless exceptionally, do not clearly identify intended and unintended consequences for the regulated sector and the broader economy.

Finally, other than for public consultations, it is generally unknown which organisations, public or private, representing specific interests or broader ones, interact with the Basel Committee or its representatives.

### 1.2 TRANSLATION OF THE INTERNATIONAL REGULATORY FRAMEWORK IN THE EUROPEAN UNION AND IN THE UNITED STATES

The translation of Basel Committee standards into jurisdictions like the European Union and the United States follows a different process.

In Europe, the Capital Requirements Directives (CRD) and Capital Requirements Regulations (CRR) are the central tools to translate non-binding internationally agreed standards into a legal framework. The various stages of the legislative process are those described in European treaties and related texts. By involving the European Commission, the European Council and the European Parliament, the process ensures that a large palette of stakeholders is consulted and sufficient time allocated to consider various options. The CRR is directly applicable to banks and their supervisors in the EU, unlike the CRD which requires EU Member States to enact legislation conforming to the requirements of that directive. Failure to enact national legislation is immediately sanctioned by an infringement procedure. In general, the regulatory capital and other prudential requirements form part of the Regulation, while the directive among other things calls for Member States to entrust their supervisory authorities with certain powers, for example in order to establish specific capital requirements for items not covered in the Regulation. In this process, the EBA provides expert technical advice to the European institutions during the legislative process, develops various technical standards (Binding Technical Standards, or BTS), guidelines and other reports for the implementation of the capital requirements directive and the capital requirements regulation.

In the United States, the authority to regulate and supervise banks and bank holding companies rests with the federal banking agencies within the scope of their jurisdiction. The hierarchy of prudential regulation in the United States follows three tiers:

- Federal statutes and legislative mandates, authorising the federal banking agencies to establish minimum capital requirements, capital adequacy standards, and safety and soundness standards.
- Regulations and reporting requirements that set out the capital adequacy rules and safety and soundness requirements issued by the federal banking agencies.
- Policy statements, interpretations, supervisory guidance and manuals that address significant prudential policy and procedural matters.

### 1.3 THE REVIEW PROCESS

Stakeholders rightly welcomed the Basel Committee’s Regulatory Consistency Assessment Programme (RCAP) when it was launched in 2012. That process provides insightful information on progress made by Basel Committee member jurisdictions in adopting the Basel III standards, on consistency of domestic (national or regional) banking regulations with the Basel standards and further analyses the prudential outcomes of those regulations. The RCAP reviews members’ implementation of standards as minimum requirements as agreed by the Committee. Compliance and deviation are scrupulously identified and publicly reported. These public reports are an incentive for jurisdictions to demonstrate their acceptance of standards agreed internationally.

The RCAP delivers three types of reports: monitoring report, jurisdictional assessments, and thematic assessments. Monitoring reports intend to assess the status of adoption of all Basel III standards. The objective is to ensure that standards are transposed into national law or regulation according to the internationally agreed time frames. Jurisdictional assessments evaluate the extent to which local regulations are consistent
with the Basel Committee requirements. These help identify gaps in such regulations. Finally, thematic assessments analyse the implementation of the Basel Committee requirements at bank level. They seek to ensure the consistency of capital ratios calculations by banks across jurisdictions to improve comparability of outcomes.

RCAP methodologies are presented in a public document, the *handbook for jurisdictional assessments*. It contains guidance and principles for assessors, assessed jurisdictions and any interested parties looking for information on issues and implementation topics. This transparency is slightly offset by the general approach provided, though it is understood to aim at accommodating differences across jurisdictions.

### 1.4 CONCLUSION

National regulators have recognised that effective international cooperation in developing a regulatory framework is a prerequisite of a stable financial system. Without international cooperation, a fragmented international regulatory framework is inevitable, with the costs and inefficiencies that can be associated with it.

International cooperation must go beyond good intention; it must be effective and inclusive. Financial stability is in the interest of all stakeholders: regulators, investors, banks and the public at large. Regulations that differ from one jurisdiction to another only serve narrow and short-term interests, while financial stability by definition only matters if it is sustained in the long run.

A process with enhanced governance mechanisms – more transparency and reinforced accountability – and that systematically includes impact studies can contribute to achieving public policy objectives more efficiently. By involving all stakeholders at an early stage of international negotiation in a systematic and structured manner, discussions can focus early on what matters and promote better, more consistent adherence to global standards.
One of the guiding principles of bank resolution from the outset, both in the EU and globally, has been to provide an appropriate degree of convergence and avoid regulatory arbitrage, capitalising on international cooperation. This was part of the G20 decision in 2008 to end “too-big-to-fail” by making all banks - no matter their footprint – resolvable. To this day, it remains the only valid way to achieve the resolvability of internationally operating banks. The G20 granted the Financial Stability Board (FSB) the mandate to steer the reform process, and its ‘Key Attributes of Effective Resolution Regimes’ from 2011 and subsequent standards have also served as the blueprint for the European resolution framework (BRRD) and the SRMR for the Banking Union (BU).

The SRB, as the central resolution authority in the BU, is responsible for achieving the resolvability of banks within the BU, together with its partners, the national resolution authorities. While establishing harmonised conditions in the BU is crucial, we must also be mindful that the individual bank’s structure and business model require a tailored approach, for example regarding resolution strategies or the mandatory loss absorbing capacity (MREL). And of course, proportionality has to be respected.

Our experience with the legal framework since 2015 has revealed areas where we need changes to make a good system even better. These issues are currently being discussed by the European co-legislators and the principles of convergence and proportionality are once again key. Three particularly relevant examples are:

1. The European co-legislators are currently preparing the integration of the FSB’s international TLAC standard for global systemically relevant banks into the BRRD, thereby promoting global convergence. Here the challenge is to avoid any cliff effects with other significant European banks with often similar characteristics and a similar systemic footprint in the Union.

2. Insolvency procedures in the EU are still national, though bank resolution may be considered as a special case of insolvency, with the resolution authorities only stepping in where a regular liquidation cannot sufficiently protect the public interest. Bank insolvency procedures are not equally structured in all member states and should be elevated to a common best standard and practice, not least to eliminate wrong incentives and to clarify the line between resolution and insolvency. The counterfactual “no-creditor-worth-off” evaluation should provide the same outcome in all BU member states.

3. In this context, bank creditor hierarchies are not fully aligned between the national laws, which impedes in particular on the execution of cross-border resolution cases. We therefore need a harmonised hierarchy, to give transparency to investors and to facilitate in particular the “no-creditor-worth-off” evaluation.

In its day-to-day work, the SRB and other resolution authorities are facing a double challenge – progressing our work in line with current standards while keeping in mind eventual regulatory changes to come.

In 2017, the SRB’s first resolution case revealed other issues where the conditions for resolution need to be improved: the missing option of a moratorium tool for resolution authorities suitable to carry us to the next weekend, the challenge of having sufficient liquidity during a resolution and, furthermore, the ad hoc availability of a bank’s liabilities data, to mention only three topics.

Other crisis cases in 2017 revealed the need to reconsider the preconditions for state aid in both resolution and national bank insolvency procedures. The misaligned incentives must be avoided and – given the progress of the resolution framework – the 2013 Banking Communication of the European Commission regarding state aid, more tailored to the pre-BRRD times, should be reviewed and if need be aligned with the BRRD.

Finally, we need to consider that banks are only part of the financial system; they interact with other market participants, like CCPs. The SRB strongly supports the implementation of a European Resolution Regime for CCPs in line with guidance from the FSB, the global standard setter.

Global cooperation is indispensable for achieving resolvability on equal terms for all banks. Since 2008 significant progress has been made. We must not lose momentum but maintain these multilateral efforts in Europe and internationally.
Globally active financial institutions face a challenge in navigating the implementation of the US Dodd-Frank Act (DFA) and the European Market Infrastructure Regulation (EMIR), both aimed at improving transparency and regulatory oversight of OTC derivatives markets. Although many similarities exist between the two regulatory frameworks, there are significant differences between how the two jurisdictions – the United States and the European Union – have chosen to implement the commitments made by G20 Leaders during the Pittsburgh Summit in September 2009 (see Box 1). These include notable differences in the date of application of new regulations, in the substance of the requirements and in capital treatment. In a market that is global, these differences have made it particularly challenging to enter into cross-border OTC derivatives transactions that satisfy both sets of rules.

Both US and EU regulators have stated their intention to address the issue by acknowledging ‘comparable’ regulatory regimes, notably of jurisdictions that adhere to the principles set out by the G20, BCBS and IOSCO. For such regimes, regulators have promised a path to substituted compliance or equivalence, which would allow global firms to follow one set of regulations, rather than multiple.

In recent months, new progress has been made to find mutually supportive solutions to avoid potential duplicative or conflicting requirements. For example, in October 2017, the European Commission (EC) and the CFTC reached an agreement on the equivalence and comparability of their respective margin requirements for uncleared OTC derivatives as well as a common approach regarding certain EU and CFTC authorised derivatives trading venues. This is a critical development, as otherwise US and European firms would have encountered extreme difficulties when attempting to trade certain OTC derivatives between the two jurisdictions.

Accordingly, on 5 December 2017, the EC recognised certain trading venues authorised by the CFTC as eligible for compliance with the new EU trading obligation for derivatives provided under the Markets in Financial Instruments Regulation (MiFIR). This decision ensures that EU counterparties will be able to trade OTC derivatives contracts that are subject to the new MiFIR trading obligation (i.e. certain classes of interest rate swaps and credit default swaps), on CFTC-authorised Swap Execution Facilities (SEFs) or Designated Contract Markets (DCMs) in the United States. On 8 December 2017, the CFTC announced the issuance of an order to exempt certain multilateral trading facilities (MTFs) and organised trading facilities (OTFs) authorised within the European Union from the requirement to register with the CFTC as SEFs.

Without additional efforts to reach substituted compliance/equivalence across all rule sets and jurisdictions, global derivatives markets will become fragmented, liquidity will deteriorate and the costs to farmers, insurers, pensions, airlines, and a host of other middle market participants who rely on derivative contracts to hedge business risks, will become needlessly high.
It is only then that regulators have considered how to harmonise or reconcile their prescriptive rules to make sure that they operate in a comparable way. This ex-post approach leads to situations where regulators have to address issues, problems and challenges only once these have already emerged.

The limited or lack of ex-ante coordination between regulators in implementing the OTC derivatives reforms has led to differences in timing, substance of requirements and capital treatment such as in the case of EMIR and DFA. These differences are detrimental to global capital flow as they may cause market fragmentation and increase legal and operational complexity.

2.2.1 Differences in timing

From the outset of the implementation process of the G20 derivatives reform agenda, substantial differences in the date of application of new regulations have emerged, giving rise in some cases to regulatory arbitrage or to some trading flow movements away from certain jurisdictions. For example, while US regulation for clearing obligations went into force in 2013, mandatory clearing became effective in the EU three years later, and in Hong Kong four years later. Differences in timing of the introduction of margin requirements would have potentially affected the behaviour of some market participants. As noted in the FSB 12th Progress Report on Implementation of OTC Derivatives Market Reforms (June 2017), one jurisdiction saw some indications of market participants shifting activity away from US, Japanese or Canadian counterparts after margin requirements came into effect in these jurisdictions on 1 September 2016 as internationally agreed, potentially raising costs. Likewise, different timing of mandatory trading requirements could lead to market fragmentation.

2.2.2 Differences in substance

Even though EMIR and DFA affect the same types of entities, there are major differences in the actual approach to implement the G20 commitments.

For example, while the EMIR obligations are determined by the counterparty classification as financial and non-financial entities, DFA defines specific entities that must register as ‘Swap Dealers’ or ‘Major Swap Participants’ according to their trading activity. To be more precise, this means that some companies might be obliged to clear their OTC derivatives under EMIR while under DFA they do not.

As regards the application of the clearing mandate, the EU and US product scope (covering certain Interest Rate Swaps, or IRS and Credit Default Swaps, or CDS) includes some overlap and differences, and the EU has been the only jurisdiction to introduce the frontloading requirement that will now likely be removed in the context of the EMIR review in view of the unnecessary difficulties that its implementation caused.

Concerning the margin requirements, the exchange of variation margin (VM) is required for physically settled Foreign Exchange (FX) forwards as these are defined as financial instruments under the Markets in Financial Instruments Directive (MiFID II), while the US, Japan, Canada, Singapore, Australia, Switzerland, Hong Kong and South Korea excluded these instruments from VM requirements.

With respect to the application of the reporting obligation, under DFA only one of the parties to each swap (designated as the “reporting counterparty”) can assume responsibility for reporting at the time of the transaction and throughout its life. Whereas under EMIR, both counterparties are required to report trades; this creates a further challenge to match the data submitted by two separate counterparts, which may not even have reported to the same trade repository.

Additionally, each regulator requires a minimum set of data fields to be reported. Even though there is an overlap, more details are required under EMIR than under DFA. Also, under EMIR, counterparts must report exchange-traded derivatives (ETDs) as well as OTC transactions whilst DFA requires only OTC transactions to be reported.

Differences between the EU and US regime for CCPs led to protracted negotiations (of approximately four years) between the European Commission and the CFTC with respect to the EU equivalence determination of the CFTC regime for US CCP. Eventually an agreement was reached subjecting the EU equivalence and recognition decision regarding CFTC-registered US CCP to a number of conditions (see Box 2). However, the protracted nature of the negotiations created lots of uncertainty and concerns in the market as failure to reach an agreement on US CCP regime equivalence would have led to IRS and CDS market fragmentation since, in such case, EU firms could not abide by their EMIR clearing obligation on US CCPs.
Finally, different capital treatment led to an uneven playing field regarding the provision of corporate derivative hedging products as the EU decided to scope out corporates from the Basel III Credit Valuation Adjustment (CVA) capital charge add-on, whereas the United States and Switzerland did not.

Market participants need early regulatory visibility, clarity and certainty as regards both the substance and timing of new regulations. Earlier and more visible coordination between regulators is needed so that market participants can prepare appropriately the implementation of regulatory changes. Uneven implementation, different timing of the reforms, or a lack of coordination (e.g. with respect to clearing or trading mandates) create a direct risk of regulatory arbitrage and/or market fragmentation as market participants face duplicative, different and/or conflicting rules and therefore unnecessary additional implementation costs and complexities.

Box 2
Conditions for US CCPs seeking recognition in the EU

- Clearing Members’ house accounts for ETDs: Initial margin must be collected in view of a 2-day liquidation period (instead of 1-day as per US standard) calculated on a net basis.
- Anti procyclicality measures for ALL derivatives: US CCPs must adopt measures to limit procyclicality which deliver stable and conservative margins, and are equivalent to at least one of the options provided by EMIR.
- Default resources based on the ‘cover 2 principles’ for all CCPs: The US CCP should have sufficient pre-funded available financial resources to withstand the default of at least the two clearing members to which it has the largest exposures.

2.3 REGULATORY INCONSISTENCY AND EXTRATERRITORIALITY CREATING FINANCIAL MARKET FRAGMENTATION RISK

It is premature to identify the long-term market impacts of the implementation of the G20 derivatives reforms as, due to the scale and complexity of the reforms, implementation has taken much longer in most jurisdictions than the originally intended end-2012 deadline. In the EU, the EMIR clearing obligation went live for the large dealers (category 1 counterparties) only in June 2016 for certain IRS and February 2017 for certain CDS indices, and the MiFID II on-venue trading obligation for derivatives came into effect only in January 2018.

However, some market concerns and/or reactions in anticipation of, or in response to, the implementation of new regulation have nevertheless clearly emerged as a tangible sign of the actual risk that inconsistent and extraterritorial regulation may pose to the efficiency and stability of financial markets:

- Two major damaging consequences were avoided very late thanks to the ultimately successful cooperation between the European Commission and the US CFTC as regards (i) the equivalence of the US CFTC regime for US CCPs for the purpose of the application of EMIR clearing obligation (e.g. the recognition on 14 June 2016 of CME, the first CFTC-registered US CCP to be granted recognition by ESMA, came just in time for the IRS clearing obligation go live in the EU on 21 June 2016), and (ii) the equivalence determination of US CFTC authorised trading venues for the purpose of the application of MiFID II derivatives trading obligation. Delay or failure in reaching an equivalence agreement would have had significant market implications as EU derivatives market participants would have been shut out of the US market to clear and trade OTC derivatives subject to EMIR clearing obligation and MiFID II on-venue trading obligation. Such a situation would have had a very major impact on liquidity and trading patterns.
- The introduction of the US SEF regime in October 2013 appears to have clearly affected the liquidity pools of euro-denominated IRS. According to research by the International Swaps and Derivatives Association (ISDA), an average 94.3% of regional European interdealer volume in euro IRS was traded between European dealers between July and October 2014, versus 73.4% in Q3 2013, before US SEF trading rules came into force. Under the SEF rules, any electronic venue providing access to US persons must register as a SEF with the CFTC and many non-US platforms decided not to register so that US persons cannot trade on those platforms to abide by the SEF trade mandates. Hence, to avoid having to trade on a CFTC-registered SEF, non-US market participants would avoid trading SEF mandated products with US persons. The extraterritorial reach of the SEF rules would thus have moved the trading of the vast majority of Euro-denominated IRS off-SEF to Europe, between EU dealers, limiting US participants’ access to the deepest liquidity pools for euro IRS.
• The introduction of MiFID II in the EU on 3 January 2018 with its new trade transparency requirements for non-equity instruments and position limits regarding commodity derivatives, would have – as reported in the press - influenced the decision by Intercontinental Exchange (ICE) to move the trading of hundreds of energy futures contracts from its UK-based derivatives exchange, ICE Futures Europe, to its US-based derivatives exchange, ICE Futures US. The new MiFID II transparency and position limits regime would be viewed stricter and more restrictive than the cor-responding US requirements.

The above examples are only some factual illustrations of the well-established and recognised fact that the lack of regulatory consistency and cooperation may lead to regulatory arbitrage and fragmentation of global liquidity pools. An enhanced cross-border regulatory dialogue appears even more important to prevent and address the unnecessary complexities and uncertainty created by the extraterritorial reach of some domestic financial regulations as well as to provide an efficient platform for the timely adoption of equivalence or substituted compliance decisions allowing deference to comparable regulatory regimes.

2.4 CONCLUSION

As the implementation of the OTC derivatives market reforms is progressing, it is important that regulators further engage bilaterally and in multilateral fora in order to ensure the effective-ness of the reforms, resolve cross-border issues and prevent unintended detrimental conse-quences for market participants, such as in particular the reduction in the depth or fragmen-tation of liquidity.

Regulatory dialogue and coordination between regulators must take place at an early stage, already when they develop (implementing) rules in order to ensure a consistent regulatory approach; otherwise the purpose of agreeing common regulatory principles at international level as well as developing international stand-ards will be undermined by inconsistent implemen-tation across jurisdictions. Likewise, regula-tors should give early consideration to the extraterritorial impacts of their proposed rules to limit and prevent these to the extent possible. We recognise challenges to early stage collaboration given regulators’ instinctive ‘penchant’ for regulatory sovereignty as well as the need to tailor their rules to the specifics of their jurisdict-ion.

Effective regulatory and supervisory cooperation requires therefore trust and strong commitment. Some tangible willingness and useful progress in this respect – though still insufficient - can be noted with the establishment in 2011 of the OTC Derivatives Regulators Group (ODRG) which is seeking to identify and is committed to resolve cross-border issues raised by the implementa-tion of the G20 OTC derivatives reform agenda such as conflicts, inconsistencies, gaps and duplicative requirements. In this vein, the ODRG members have sought to develop a framework for early consultation among authorities on mandatory trading determinations. They are also considering how regulatory and supervisory deference should work in practice in the context of equivalence assessments and substituted compliance determinations as per the G20 commitment at the St Petersburg summit in September 2013 that “jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulato-ry and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulatory regimes”.

Moreover, authorities must be sensitive to possible impacts of their regulatory reforms (e.g. impact on liquidity or trading costs for market participants). They must also be committed to addressing cross-border challenges in imple-menting the reforms, and to taking forward international regulatory and supervisory cooper-ation. Examples of progress in this area include the work on harmonisation and aggregation of Trade Repositories data, and cross-border resolution arrangements for CCPs that are systemically important in more than one jurisdic-tion. As regards the location of euro-clearing post-Brexit, in order to prevent a forced reloca-tion decision which would lead to market fragmentation and increased trading costs to the detriment of EU derivatives users, the superviso-ry oversight of UK CCPs deemed of ‘substantial’ systemic importance to the EU will require a much deeper cooperation between UK and EU regulators.

Finally, the development of consistent rules should be encouraged at political level in order to facilitate regulators’ deference to each other’s rules and enable smoother, faster and more efficient equivalence/substituted compliance procedures. While G20 Leaders agreed to imple-ment reforms in a manner consistent with international standards, differences do occur, and in some cases, they are substantial due to the complexity and extent of reforms and varying legal and regulatory contexts across jurisdic-tions. However, regulatory authorities should aim
to achieve consistent outcomes. Ultimately, given the global nature of OTC derivatives markets, it is important to have effective regulatory cooperation to implement deference mechanisms which may help to minimise the potential for regulatory arbitrage and market fragmentation.

To conclude, our aim is a more streamlined and coordinated regulatory approach, with which we can encourage more trading, boost new investments, and promote access to integrated global markets. Therefore, regulators should holistically review how their rules might apply extraterritorially. In particular, we encourage meaningful regulatory coordination to address possible competitive disparities and market impacts and the adoption of a consistent approach to regulatory deference by countries that adhere to the G20 commitments, BCBS and IOSCO Principles.
The World Federation of Exchanges has recently made public a paper on “Financial Markets and International Regulatory Dissonance”. How can it be that we are today confronted with a new trend that seems to slow down, if not contradict, 15 years of continuous progress towards a more robust international architecture of financial market supervision and consistent system of regulation?

In the aftermath of the Asian crisis in 1997, on the basis of Hans Tietmeyer’s report, the G7 set up the Financial Stability Forum (FSF). It brings together all the international organisations involved in regulation and supervision of financial markets, at the micro, meso and macroprudential levels. The FSF serves both as a coordinating body and a high-level secretariat for the G7/G8 countries. For the first time, bank, insurance and securities regulators are working together in order to identify systemic risks, and foster regulatory convergence and consistency. The “Joint Forum” was to implement this sectoral cooperation, while the relevant organisations were encouraged to develop common objectives, principles and standards for their members (as this had already been the case for the Basel Committee and as IOSCO did, starting in 1998). The demise of the Long-Term Capital Management (LTCM), the internet bubble and the early 2000 accounting and auditing scandals (Enron et al…) encouraged the FSF and its member organisations to speed up the process of convergence. Hence, inter alia, the reform of the International Accounting Standards Committee (IASC) into the IFRS Foundation and the objective of “a single set of high-quality accounting and financial reporting standards”, the adoption by IOSCO of a “multilateral MOU” for international cooperation on enforcement, and a number of standards adopted in the banking, insurance and securities sectors emerged. In the years ahead of the financial crisis, countries were encouraged by the G7/G8 to endorse these standards and improve cooperation. The EU Financial Services Action Plan was fully consistent with these evolutions and one could be fairly optimistic with regard to the progress made.

There was nonetheless a big failure in the reasoning that was the paradigm of the global analysis: we totally missed the issue of externalisation of risks outside the banking sector and, to a less extent, the insurance sector and we wrongly considered that dissemination of risk was a proper way to manage and prevent it globally.

When the crisis blew up, mid 2007, and following Lehman Brothers’ demise, the first and welcome reaction was to speed up the process of cooperation and convergence. The transformation of the G7/G8 into the G20 and the reform of the FSF into the FSB as well as the finalisation of Basel III and the focus on the “shadow banking sector” were evidence of the leaders’ willingness to consolidate international consistency and cooperation, as shown in the London and Pittsburgh communiqués of the G20. Unfortunately, as the crisis developed into a sovereign crisis, national interests re-emerged and divergences of strategies started to blossom. Basel III was not implemented the same way and its further development was controversial and continues raising questions. Business models were a matter for dispute. The convergence on the road towards global accounting standards was slowed down by the US standstill (although most other jurisdictions have adopted or are on the way to adopt IFRS, at least for listed companies, while the US recognises IFRS for foreign registrants). Dodd-Frank and EU regulation diverge on a number of issues. US extraterritoriality has developed, while there has been no progress on the way to international enforcement and dispute resolution. Brexit adds to this uncertainty.

This evolution is unfortunate. The case for global markets and consistent international regulation, supervision and enforcement does not have to be demonstrated. In terms of capital optimal allocation, investors’ protection, cost reduction, fair competition and systemic stability, multilateralism is the best answer. Today, leaders need to reverse a perverse trend that might lead to fragmentation and divergence, and which would give way to the worst consequences of protectionism.

[IN PRAISE OF MULTILATERALISM]

Written by Michel Prada, Chairman of the IFRS Foundation Trustees, former Chairman of IOSCO
CASE STUDY 3
Sustainable Finance: Considering New Global Trends Which Will Trigger a Regulatory Response

3.1 INTRODUCTION

This case study aims to describe the industry and regulatory response to sustainability in finance, an emerging trend of the past few years. As opposed to the regulatory reform and the industry’s corresponding adjustments of the past decade, sustainable finance was not born out of a crisis, and the issues at its core are not such that they primarily concern the functioning of the financial sector, but rather the whole global economy and society. Hence, it is not surprising that the developments associated with sustainable finance have not been driven solely in a top-down approach by regulators and supervisors, but by the industry itself – not least because the developments are not only related to risks, but also to significant business opportunities.

Sustainable finance in general refers to finance being aligned with environmental, social and governance standards (ESG), and has increasingly been brought into the context of promoting the 17 UN Sustainable Development Goals (SDGs) that were agreed in September 2015, including ending poverty, fighting inequality and injustice and tackling climate change.

However, the most predominant theme, when speaking of sustainable finance, has been the environment and, in particular, climate change. In November 2015, ahead of the agreement reached at the Conference of Parties (COP21) in Paris to limit global warming significantly below 2°C Celsius, the FSB agreed to consider the implications of climate-related issues for the financial sector.

They identified a complex set of potential risks to the financial sector covering the three areas of (i) physical risks; (ii) liability risks; and (iii) transition risks.

In the report ‘Better Growth, Better Climate’, the Global Commission on the Economy and Climate estimates a volume of USD 93 trillion would be needed in the period from 2015 to 2030 to transform the world’s infrastructure into a sustainable and ecological one, as opposed to USD 89 trillion if no carbon emission reduction goal had to be reached.

Despite the significant capital needs, the G20 Green Finance Study Group set up during China’s G20 Presidency in 2016 showed there is a substantial upside potential in the area of green investments:

- Only 5-10% of bank loans are ‘green’ in the few countries where national definitions of green loans were available.
- Less than 1% of total bond issuance are so-called green bonds.
- Less than 1% of holdings by global institutional investors are green infrastructure assets.

While in some areas, eligible investments and stocks of capital were not explicitly labelled as green, this still goes to show that further efforts are needed to reorient the capital allocation towards green investments across the economy.

Broadly, there are six areas of action where both the industry and policymakers may influence the overall framework for sustainable finance to varying degrees (see table 1).

### Table 1

<table>
<thead>
<tr>
<th>WHAT</th>
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<td>Removing regulatory hurdles</td>
<td>Regulators</td>
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<tr>
<td>Availability of data / disclosure</td>
<td>Industry &amp; regulators</td>
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<td>Product standards &amp; labelling</td>
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<td>ESG integration / due diligence / fiduciary duty</td>
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<td>Prudential measures</td>
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3.2 INDUSTRY-DRIVEN INITIATIVES

A major issue identified early on by the industry is the lack of clarity as to what constitutes sustainable finance activities and products (such as green loans and green bonds) in many markets and countries. Furthermore, there is no common approach as to how to assess investments in terms of sustainability indicators. There are no standards on how to provide relevant data for such assessments. This constitutes an obstacle for investors, companies and banks seeking to identify opportunities for greening their activities. Without appropriate definitions of sustainable finance, it is difficult for financial institutions to allocate financial resources for green projects and assets.

Several industry-driven initiatives seek to improve the availability of data and the consistency of product standards. This had to be done while balancing the trade-off between a high degree of standardisation, which may not adequately reflect differing contexts and priorities in different countries or markets, and a high degree of customisation, which may render it very costly to compare definitions across institutions and markets. Two of the arguably most significant initiatives are presented below: the International Capital Market Association (ICMA) Green Bond Principles and the FSB Task Force for Climate-related Financial Disclosures.

3.2.1 ICMA Green Bond Principles

In an attempt to promote integrity in the development of the green bond market, in 2014, ICMA developed Green Bond Principles (GBP, see Box 3) as voluntary process guidelines for the issuance of a green bond. They have since been reviewed and further developed, most recently in 2017. The GBP recommend a clear process and disclosure for issuers, which investors, banks, investment banks, underwriters, placement agents and others may use to understand the characteristics of any given green bond. The framework consists of the following four components:

- **Use of Proceeds:** The cornerstone of a green bond is the utilisation of the proceeds of the bond for green projects which should be appropriately described in the legal documentation for the security. All designated green project categories should provide clear environmental benefits, which will be assessed and, where feasible, quantified by the issuer. Among others, green projects could fall under categories such as renewable energy, pollution prevention and control, biodiversity conservation, clean transportation, sustainable water management, climate change adaptation, as well as eco-efficient products, production technologies and processes.

- **Process for Project Evaluation and Selection:** The issuer of a green bond should outline: (i) a process to determine how the projects fit within the eligible green projects categories identified above; (ii) the related eligibility criteria; and (iii) the environmental sustainability objectives.

- **Management of Proceeds:** The net proceeds of green bonds should be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer in an appropriate manner and attested to by a formal internal process linked to the issuer’s lending and investment operations for green projects.

- **Reporting:** Issuers should make, and keep, readily available up to date information on the use of proceeds to be renewed annually until full allocation, and as necessary thereafter in the event of new developments. This should include a list of the projects to which green bond proceeds have been allocated, as well as a brief description of the projects and the amounts allocated, and their expected impact.

### Box 3

**ICMA Definition of Green Bonds**

Green bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects (see section 1 Use of Proceeds) and which are aligned with the four core components of the GBP. Different types of green bonds exist in the market. These are described in Appendix I. It is understood that certain green projects may have social co-benefits, and that the classification of a use of proceeds bond as a green bond should be determined by the issuer based on its primary objectives for the underlying projects. Bonds that intentionally mix green and social projects are referred to as ‘sustainability bonds’, and specific guidance for these is provided separately in the ‘Sustainability Bond Guidelines’.

3.2.2 Task Force for Climate-Related Financial Disclosures

While standards and labelling for specific products, are one of the challenges to re-allocating assets towards a more sustainable economy,
data availability for comprehensive risk analysis is another.

Following-up on the conclusion that climate change risks for the financial sector need to be considered, in December 2015 the FSB set up an industry-led Task Force on Climate-related Financial Disclosures (TCFD) under the chairmanship of Michael Bloomberg. Modeled after the Enhanced Disclosure Task Force with members from banks, insurers, asset managers, industrial firms and other practitioners and experts, the TCFD aims to promote more effective climate-related disclosures that (i) enable more informed investment, credit and insurance underwriting decisions about reporting companies and (ii) enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system’s exposures to climate-related risks.

The challenge for the TCFD was to deliver a standard that allows a comprehensive, forward-looking risk analysis, as opposed to existing tools such as carbon footprinting, which merely provide a snapshot of current emissions and are not the right tool to pilot investments.

The final recommendations were released on 29 June 2017 and presented at the G20 summit on 7-8 July 2017. They are adoptable by all organisations and can be included in financial filings designed to solicit decision-useful, forward-looking information on the financial impact and have a strong focus on risks and opportunities related to transition to lower-carbon economy. The following four areas are covered:

- **Governance:** The organisation’s governance around climate-related risks and opportunities.
- **Strategy:** The actual and potential impacts of climate-related risks and opportunities on the organisation’s businesses, strategy, and financial planning.
- **Risk Management:** The processes used by the organisation to identify, assess, and manage climate-related risks.
- **Metrics and Targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The mandate of the Task Force was extended to at least September 2018 with a focus on promoting and monitoring adoption of the TCFD’s recommendations by companies and evaluating the extent to which the recommended disclosures are meeting the needs of users. This will be documented in an implementation monitoring report. Meanwhile, financial sector firms are collaborating on further developing the framework for consistent implementation across the industry, such as through the United Nations Environment Programme – Finance Initiative (UNEP FI) and the International Institute of Finance (IIF).

### 3.3 GOVERNMENTAL AND REGULATORY ACTION

While industry initiatives were rather fast in gaining traction, some governments have followed suit in an attempt to actively shape the mandatory policy and regulatory framework to further promote sustainable and in particular green finance. For example, mandatory disclosure requirements for information related to climate change is emerging, as can be seen from the climate change risk disclosure required by the Energy Transition Act introduced in France in 2015, and to some extent also the European Union’s 2014 Non-Financial Disclosure Directive that is currently being implemented at national level across the Member States.

#### 3.3.1 EU Sustainable Finance Strategy

The EU is aiming to become a leader for sustainable finance. The integration of sustainability into EU financial regulation is a key pillar of the EU’s sustainable finance strategy. Furthermore, measures to promote the mobilisation of capital for a sustainable economy are a priority. These trends, covering almost all areas of action mentioned in the introduction to this case study, are apparent in recent EU legislation and targeted proposals by the European Commission, ahead of the Action Plan on Sustainable Finance (publication of which is expected in March 2018) which builds upon the final recommendations of the High-Level Expert Group (HLEG, see Box 4):

- **European Supervisory Authorities (ESAs):** The EC proposed in September 2017 that ESMA, EBA and EIOPA promote sustainable finance by integrating ESG criteria into their supervisory work.
- **Fiduciary Duty:** The HLEG recommended a single set of principles of fiduciary duty across EU legislation. In November, the European Commission consulted on whether and how a clarification of the duties of institutional investors and asset managers in terms of sustainability could contribute to a more efficient allocation of capital and to sustainable and inclusive growth.
- **Disclosure:** The EU Prospectus Regulation, which entered into force in July 2017, requires
disclosure of ESG circumstances which can constitute specific and material risks for the issuer and its securities. The EU Securitisation Regulation, published in October 2017, introduced new transparency requirements including disclosures of environmental performance of the underlying assets. The HLEG final report also recommends integrating the FSB TCFD recommendations into EU law in a way that advances EU leadership in these areas, while avoiding possible commercial risks and maintaining a level playing field globally.

- **Green Supporting Factor/Brown Penalising Factor**: While the HLEG final report refers to Pillar 1 capital adjustments as an area for further consideration, a recent European Parliament amendment to the EU Risk Reduction package introduces a ‘green finance supporting factor’ and a supporting factor for the financing of social enterprises.

- **EU classification system for sustainable assets**: The HLEG final report recommends an EU system of classification of financial products that captures all acceptable definitions of ‘sustainable’, taking into account existing principles.

- **Other measures**: Further measures to promote the mobilisation of capital for a sustainable economy have been proposed, such as green/-sustainable labelling of products, and building ‘Sustainable Infrastructure Europe’, a dedicated ‘matchmaking’ facility between private investors and public authorities seeking to build and finance infrastructure.

### 3.4 CONCLUSION

The developments and initiatives described above show that for an emerging trend like sustainable finance that is related to both significant risks as well as business opportunities, shaping the functioning of respective markets can rely both on extensive bottom-up industry initiatives as well as top-down regulatory action. Given the fact that both private and public sector action may shape the global sustainable finance framework as described in table 1, these actions may be closely intertwined and interdependencies can be observed between various projects (e.g. the FSB setting up the industry-driven TCFD, which in turn inspired the HLEG to suggest integrating the TCFD recommendations into EU law).

For this reason, it is important that regulators and policymakers closely engage with the industry when planning to introduce additional regulatory requirements, taking into account that industry-driven initiatives may in some cases be more efficient to introduce and maintain, on the one hand, and provide better cross-border...
applicability and global comparability, on the other hand.

Hence, the primary focus at this point in time should be on removing regulatory hurdles to a more sustainable and greener financial system, as well as engaging in the promotion of a sound framework for internationally comparable data provision and product labelling to enhance trust and potentially help avoid greenwashing. However, the search for global standards should not inhibit the further development of new and innovative products and methodologies. Moreover, any measures related to mandatory disclosure or stress testing should be based on data and metrics that are meaningful and material to making a forward-looking assessment of risks.

Further action to employ prudential regulation of environmental risk may be premature until the aforementioned steps have been completed. Furthermore, as not all countries’ policymakers and regulators show the same degree of interest in moving from ‘soft law’ to ‘hard law’ by establishing new regulatory requirements, it is crucial that these bodies seek ways to coordinate internationally to ensure a level playing field.
Enabling an orderly transition to a low-carbon global economy that is sustainable for the future is increasingly an urgent matter for all mankind. The recent OECD report presented to the G20 last year, Investing in Climate, Investing in Growth emphasises that countries can achieve strong and inclusive economic growth while reorienting their economies towards low-emissions, climate-resilient development pathways consistent with the Paris Agreement targets. A package of strong fiscal and structural reform combined with coherent climate policy can increase long-run GDP by up to 2.8% on average across the G20 in 2050 relative to a continuation of current policies, across developed and emerging economies. If the positive impacts of avoiding climate damages are also taken into account, the net effect on GDP in 2050 rises to nearly 5%.

But to enable such a transition, and to avoid humanitarian and environmental disaster expected as a result of no-action, we need to urgently and significantly upscale low-carbon, climate-resilient infrastructure investment and shift away from high-carbon investment in the next decade. This shift and upscaling needs to be underpinned by ambitious policies that support the required low-carbon investments: policies targeted to combat climate change such as carbon pricing; and policies directed at making broader investment conditions conducive to low-carbon investments by eliminating misaligned incentives, removing fossil fuel subsidies, and improving transparency and disclosure to ensure risks are priced as correctly as possible.

An integrated approach to climate and growth requires, as a core element, financing for enabling the necessary investment. The OECD launched the Centre on Green Finance and Investment in October 2016 to help catalyse and support the transition to a green, low-emissions and climate-resilient economy through the development of effective policies, institutions and instruments for green finance and investment. The Centre leverages the OECD’s systematic reach across relevant branches of governments and provides a global platform for engagement among stakeholders in both the private and public sectors.

The money is there to tap: some 54 trillion US dollars of assets are managed by institutional investors in OECD countries. However, only a fraction of these assets – for example, less than 1% of large OECD pension funds’ assets - are allocated to direct investment in green infrastructure. The OECD has recently found that the market for green bonds has been expanding rapidly in recent years, but it is still a fraction of the entire global bond market. In addition to identifying the barriers to policy actions for further developing the green bond market, the OECD report Mobilising Bond Markets for a Low-Carbon Transition provides quantitative analysis of how the bond market may evolve in the future to provide increased financing for low-carbon projects.

The benefits that green bonds can potentially offer are multiple. For issuers, they provide a more diversified investor base, enhanced credibility of the issuing firm’s environmental strategy, and possibly more advantageous fund-raising opportunities. For investors, green bonds provide environment-friendly investments without sacrificing return, more transparency about the issuer, and the ability to hedge climate risk in the low-carbon transition. It is important to note that green bonds naturally lend themselves to better climate risk management for both issuers and investors, which will become increasingly important. Extreme weather events are already starting to take a toll on many economies, both advanced and emerging.

Obviously, a number of challenges remain, including how policies can help lower the barriers to the development of green bond markets. There are calls from some stakeholders to introduce more internationally harmonised standards for green bonds, but having overly stringent standards could hinder the development of the markets by increasing the costs of issuance and transactions.

The OECD, through its Centre on Green Finance and Investment, is seeking to help governments and other stakeholders develop coherent and sustainable strategies for further upscaling green finance and investment, and is actively looking for potential partners and sponsors. We welcome the interest of all those involved or interested in enhancing finance for sustainable growth and development to take part in this global endeavour. There is no alternative if we wish to leave a sustainable global economy for future generations.
The considerations made in the previous chapter show that if we want to achieve a global financial system that is resilient, sustainable and efficient we must do more to increase trust among global regulators and policy makers. The key to this is improved governance of the global standard-setting and implementation process. Looking forward, successful international regulation and supervision must focus on delivering much improved regulatory coherence and convergence to sustain global financial stability and competitiveness.

Based on the case studies, contributions and findings, our Discussion Paper proposes three sets of recommendations that could serve as principles for a more effective international regulatory cooperation framework. These recommendations are practical and focus on areas where action is needed.

First, we recommend improving the governance of the global standards-setting process by enhancing transparency, predictability and stakeholders’ involvement. Actors that are closely and fairly involved in the setting of global standards will be more committed to apply the agreed rules in a consistent manner.

Second, we recommend ways to facilitate and encourage multilateral implementation and compliance processes. Tools such as enhanced information sharing, stronger dispute resolution mechanisms and MoUs should lead to a situation where supervisors are trustful that crisis situations will be dealt with in an open, fair and transparent manner. These tools should help to encourage trust among policy makers and regulators. They would also help deliver open frameworks which would counter the risks of fragmentation.
Third, our recommendations focus on the European Union which should pool its resources and skills and speak with one voice in global committees. Sound global standards, swift and coherent implementation and open information sharing should facilitate the EU equivalence assessment process thereby demonstrating that Europe is open for business.

Finally, our recommendations are illustrated by two concrete examples: the first example makes suggestions of how the governance process of the Basel Committee can be enhanced, and the second example highlights the threat that growing fragmentation and national ring-fencing poses to successful bank resolution and to financial stability.

1.1 Developing Ex-Ante and Forward-looking Coordination of Policy- and Rule-Making

International cooperation in regulatory policy development is essential for financial stability, and regulations affecting the financial services sector globally will continue to be strengthened and revised as markets evolve. It is therefore crucial for effective cross-border regulatory and supervisory cooperation that discussion among relevant authorities takes place at early stages of the policy-making process. The effects of proposed regulation on market stability and the compliance challenges facing institutions operating cross-jurisdictionally must be analysed early and carefully. The more ex-ante dialogue there is at an early stage, the less likely conflicts of law appear. Our second case study on the inconsistency between EMIR and DFA clearly demonstrates the need for more ex-ante dialogue. The lack of ex-ante coordination led to differences in timing, substance of requirements, and capital treatment of OTC derivative trading. Hence a stronger ex-ante mechanism is the best tool to promote adherence to standards.

1.2 Promoting Greater Transparency, Accountability and Stakeholders’ Involvement

Stakeholders’ expectations and the need for global standards have evolved since the Basel Committee was set up. International regulators and authorities must mirror these changes and embrace mechanisms that promote enhanced transparency, accountability and predictability to improve the development of regulation, facilitate understanding of policy objectives, build trust and ensure policy-makers ultimately meet their commitments. Rejecting improvements to the governance of international bodies will prevent fostering a sense of trust and responsibility and will set the grounds for fragmentation and national ring-fencing attitudes. Early dialogue with the industry and thorough impact assessments are key for smoothing the process. Lessons could be learnt from the banking and derivatives’ regulations when addressing emerging trends like sustainable finance. The EU’s Better Regulation principles could be a good starting point for triggering changes and the approach could be replicated at international level (also see the Box below “Examples of how to enhance the governance process of the Basel Committee”).

1.3 Strengthening Bilateral and Multilateral Diplomacy Channels

Regulators must seek to build on successful bilateral and multilateral diplomatic efforts to continue to form creative, flexible ‘coalitions of the willing’. The US, the EU, Switzerland and other willing actors can address regulatory and trade related issues in international fora and private bodies. By beginning with a small number
of participants willing to work towards common approaches it is possible to engage more participants and achieve greater buy-in over time. As set out in our second case study (EMIR and DFA) tangible and useful progress has been made through the establishment in 2011 of the OTC Derivatives Regulators Group which is seeking to identify and is committed to resolve cross-border issues raised by the implementation of the G20 OTC derivatives reform agenda such as conflicts, inconsistencies, gaps and duplicative requirements. ODRG members also seek to develop a framework for early consultation among authorities on mandatory trading determinations. They are also considering how regulatory and supervisory deference should work in practice in the context of equivalence assessments and substituted compliance. Finally, developed financial markets should endeavour to offer technical assistance, training and personal exchanges to those emerging market countries that are developing their capital markets.

2. IMPROVING THE IMPLEMENTATION, DISPUTE RESOLUTION AND DATA SHARING

2.1 Incentivising Consistent Implementation

Improved governance in the standard-setting process is the key to a consistent implementation of standards that are not binding by nature. Stakeholders that contribute to the design of standards will be much more committed to their implementation. Systematic and transparent impact studies (including methodologies) that consider intended and unintended consequences are another tool to foster voluntary compliance. Tracking implementation and impact studies helps to provide the evidence needed to support the evaluation of the effectiveness of such standards. In addition, policymakers and regulators must encourage and support compliance with the substance and form of international standards. The adoption and implementation of international standards require action at both international level – where standards are developed – and national level – where they are usually meant to be applied and enforced. At national level, it is important that governments, regulators and national standard setters place international convergence as a priority on their agendas and into their national mandates. Moving in this direction will facilitate rapid and transparent equivalence decisions which are key for market access and for entitling investors to choose from a global offer.

2.2 Facilitating Dialogue and Building Stronger Dispute Resolution Mechanisms

Effective cooperative mechanisms that facilitate the global dialogue are the starting point for avoiding disputes. These mechanisms could primarily rely on non-legally binding tools, such as recommendations, technical standards, MMOUs, political declarations, guidance and best practices. The creation of platforms for a formal regulatory dialogue in financial services between the EU and its main partner countries also helps build the necessary trust between regulators and supervisors. But it would be an illusion to think that there will be no disputes. So far none of the international organisations have effective dispute settlement, formal or informal, to ensure the correct implementation of agreed standards. This is a major weakness. If a formal procedure is beyond the realms of possibility, then informal supervisory dispute settlement mechanism should be established. Its rulings would not be binding but would put considerable pressure, through reputational risk, on a Member State found to be at fault. This mechanism could be modelled after the formal WTO system.

2.3 Promoting the Sharing of Information and Data

International regulators should define and implement a far more ambitious approach to financial data collection and sharing. There are two dimensions here: firstly, to urgently complete the work on data harmonisation and definitions; secondly, to build real-time data systems using new technologies like the blockchain. This will greatly improve global financial risk monitoring and enhance regulatory and supervisory cooperation. In addition, sharing information on cyberattacks with other regulators is essential to help draw up efficient international coordination and prevention regimes.
3. REINFORCING THE EU’S ROLE IN INTERNATIONAL COOPERATION

3.1 Calling on the EU to Speak with One Voice

Europe lacks a clear strategy and vision for positioning itself and together with potential partner countries in global fora such as the G20, the FSB and the Basel Committee. Based on the characteristics of its financial services market, the European Union should develop a forward-looking strategy for a global agenda. Once agreed, the EU must speak with one voice and refrain from putting national interest ahead of European interest. Proceeding in such a coordinated manner is the only way that the EU can have its economic and political importance adequately reflected in the global decision-making process. This will help sustain the EU’s competitiveness and openness in the global economy and push for a truly global level playing field.

3.2 Encouraging the EU to Lead in Global Standards on Emerging Trends

As part of the European vision for a global agenda, the EU should continue and step-up its engagement in international fora promoting globally consistent standards and open markets. When developing new international standards in emerging issues, the EU should work with partner

BOX 5
Example of how to enhance the governance process of the Basel Committee

The Basel Committee provides a good example of how our recommendations can be put into practice. Standards of the Basel Committee are not legally binding, and members voluntarily commit to adopt them. In the absence of a true enforcement mechanism, members must have an incentive to implement agreed standards in a consistent manner. Such an incentive will be created when making the standard-setting process fully transparent and when involving a wide range of stakeholders at an early stage to enable them to be better prepared for anticipating changes. This is already good practice in the respective member jurisdictions. Basel and GHOS member jurisdictions are subject to much stricter accountability and transparency rules. Similarly, the European Union is continuously improving its “Better Regulation” approach. Stakeholders expectations have evolved since the Basel Committee was set up in 1974, and so should its governance. The members of the Basel Committee and the financial services industry will be much more committed to consistently implement and apply standards that result from modern governance procedures. In a non-exhaustive list of improvements, we recommend the following:

Work programme and activities:
- Public consultation on a medium-term work programme;
- Disclosure of planned policy development activities for the coming year, including scope, timing, approach and objectives;

Membership, Committee work and working groups:
- Disclosure of individual participating Committee members and observers;
- List of all active working groups, including their detailed mandate, members and chairs;
- Disclosure of meeting agendas, working documents prepared for discussion or decision;
- Minutes of meetings, basis for conclusions and dissenting views on agreements reached;
- Clarify the distinction between member and observer in the decision-making process;
- Clarify how consensus-based decision-making is implemented and how dissent is managed;

Impact studies:
- Implement systematic and transparent impact studies (including methodologies) that take account of intended and unintended consequences for the regulated sector and the broader economy;

Interactions:
- Regular, scheduled and transparent interactions with industry participants.
3.3 Countering the Risks of Fragmentation: Pillars for a European Vision

The EU should take the lead in reversing the trend of fragmentation and ring-fencing (also see the Box on “The risky business of ring-fencing - An example of growing fragmentation”). Within the boundaries of sufficiently high-level global standards and enhanced cross-border cooperation in supervision and resolution, banks should be allowed to freely allocate capital and liquidity as a result of market demand. Loss absorption capacity must be distributed in a manner that supports effective group resolution either based on a Single Point of Entry (SPE) or a Multiple Point of Entry (MPE) strategy. Rules trapping loss absorption in national jurisdictions are the enemy to successful global crisis management. Moving in such a direction would be beneficial to the sustainability of the financial system and to growth, but requires more trust among regulators. A new crisis would be disastrous in this regard. Therefore, more emphasis should be put on the monitoring of risk in global markets, especially risk originating in the shadow banking sector.

countries to facilitate effective and consistent implementation. In this regard, it should lead by example and contribute to the (re-)establishment of trust across different jurisdictions and among regulators and policy-makers. It is essential that regulators and policy-makers closely engage with the industry when planning to introduce additional regulatory requirements which might impact issues that are only emerging on the policy agenda. In our Discussion Paper of last year on digital banks and investors, we for instance called for such EU leadership and enhanced cooperation in cybersecurity, and more generally in the digital area, taking into consideration industry-driven initiatives and continuous innovation. This year, in our third case study, we highlight that sustainable finance would benefit from a similar bottom-up approach and cooperation at all levels given the many interdependencies that exist between private and public actions. Because the primary focus of any public intervention in sustainable finance should be to remove unnecessary regulatory obstacles to a more sustainable and greener financial system, it is important that regulators and policy-makers engage with market participants when planning to introduce new rules and requirements. As we explain in our case study, industry-driven initiatives, sometimes initiated by public authorities, may in some cases be more efficient to introduce and maintain and they may provide better cross-border applicability and global comparability.
One recent driver of fragmentation has been the compartmentalization or ‘ring-fencing’ of global banking groups. This is a subtle but important trend: it restricts the free flow of internal capital, leading to inefficient capital allocation, reduced diversification, and ultimately to a higher risk of bank failure.

Bank structure has been a major theme of the post-crisis reforms, including many proposals for some form of ‘ring-fencing’ designed to make banking safer. Some advocate segregating certain products in separate units, such as UK ring-fencing to protect retail activities. Others propose geographic separation, which has become popular of late in the US and EU31. There is even a movement for ring-fencing inside the EU, where an incomplete Banking Union has led to some regulatory impediments to the free flow of capital between subsidiaries of the same group (see below).

Geographic partition can seem useful at first glance, but does it actually make banking safer? A working paper published last year finds that the repercussions of ring-fencing can be surprisingly large and adverse32. The paper applies a Merton-style framework to a simplified ‘model bank’ to quantify the risk of failure under various ring-fencing rules. It finds that extensive ring-fencing can increase the risk of banking and hurt the very jurisdictions that enact these rules (see chart)33.
At first, ring-fencing seems to work. There is a big advantage for a single ring-fencer if other jurisdictions do not match that move. The first ring-fencer benefits from both a) local capital and b) the ability to tap a large central reserve (see case 2 in the chart). However, trapping capital for local entities reduces the resources for others and their risks increase. If other countries adopt countervailing ring-fencing, then the benefit of a pooled ‘central reserve’ is lost. Eventually, all jurisdictions become worse off.

If ring-fencing becomes pervasive, the likelihood of failure can increase by 5x or even 15x (see cases 3 and 4 in the chart) compared to an Integrated Bank where internal capital is fully mobile. This is caused by ‘misallocation risk’ – the risk that a bank has enough capital resources overall, but cannot get those resources to the right subsidiary in time to avoid a local failure. The risk figures for a real-life bank or a more refined capital allocation rule might produce different outcomes than our model. But even if the model overstates the impact of ring-fencing by 2x, it still suggests that it is a major problem.

The analysis shows that the ultimate outcome for a ring-fencing host country will be far worse than when it started, if retaliation is widespread. This is a kind of ‘prisoner’s dilemma’, an economic paradox where each participant seeks a local benefit, but ends up worse-off when others also pursue their own incentives. If local incentives are sufficiently strong, a negative outcome can seem inevitable. But the rules of the actual ‘prisoner’s dilemma’ stipulate that the participants cannot cooperate to achieve a better outcome. In real life, bank regulators can cooperate and build mechanisms to share in the global gains from a more enlightened approach.

In 2008, cross defaults (or structural negligence) often pushed all subsidiaries into a crash-landing collapse when the parent failed; there was no pre-planning, no TLAC resources and no special legal authority to manage bank failure. But today, group failure will look fundamentally different. Under FSB resolution mechanisms, failure does not lead inexorably to multiple local-entity bankruptcies but instead triggers a recapitalization, funded by bailing-in pre-placed TLAC resources. Bail-in resources have already been scaled to approx. $1.5 trillion (on top of larger equity) – a huge amount of on-call capital and fully sufficient to address the problems of a 2008-scale scenario.

This creates a pathway for better, more cooperative outcomes to the challenge of cooperation. Bail-in resolution provides funding to support home-host cooperation and protect local subsidiaries and their critical functions. A solution that exploits the new resolution architecture can achieve a far better result for all.

In our Discussion Paper, we argue that the solution for cross-border banking is improved regulatory ‘trust’, but it is also critical to base that trust on a firm foundation of mutual, enlightened self-interest. The working paper proposes an initial ‘strawman solution’ that recommends transparent rules to support such an approach. It looks to move away from a dystopia of trapped capital by preserving a large, mobile ‘central reserve’ of loss absorbing capacity held at group level, which can be deployed to the point of stress, for the benefit of all. It also proposes protections for hosts, buttressed by strong incentives to ensure compliance. By building a resilient international framework, we can upgrade from ring-fencing gridlock to a broader framework, and work together to ensure both host protection and stronger global resilience.
ABBREVIATIONS

AETR  Accord Européen sur les Transports Routiers (European Agreement Concerning the Work of Crews of Vehicles Engaged in International Road Transport)

BCBS  Basel Committee on Banking Supervision

BIS  Bank for International Settlements

BRRD  Banking Recovery and Resolution Directive

BTS  Binding Technical Standards

BU  Banking Union

CCP  Central Counterparty Clearing House

dcd  Credit Default Swap

CFTC  Commodity Futures Trading Commission

COP21  Conference of Parties

CPMI  Committee on Payments and Market Infrastructure

CRD/R  Capital Requirements Directive/Regulation

CVA  Credit Valuation Adjustment

DCM  Designated Contract Market

DFA  Dodd-Frank Act

EBA  European Banking Authority

ECB  European Central Bank

ECJ  European Court of Justice

EIOPA  European Insurance and Occupational Pensions Authority

EMIR  European Market Infrastructure Regulation

ESA  European Supervisory Authorities

ESG  Environmental, Social and Governance

ESM  European Stability Mechanism

ESMA  European Securities and Markets Authority

ESRB  European Systemic Risk Board

ETD  Exchange-traded Derivatives

FASB  Financial Accounting Standards Board

FATF  Financial Action Task Force (on Money Laundering)

FCA  Financial Conduct Authority

FSAP  Financial Sector Assessment Programme

FSA  Financial Stability Board

FSF  Financial Stability Forum

FSOC  Financial Stability Oversight Council

FX  Forex / Foreign Exchange

G-SIFIs  Globally Significant Financial Institutions

GAAP  Generally Accepted Accounting Principles

GATS  General Agreement on Trade in Services

GBP  Green Bond Principles

GDPR  General Data Protection Regulation

GHOS  Group of Governors and Heads of Supervision

HLEG  High-Level Expert Group

IAIS  Association of Insurance Supervisors

IASC  International Accounting Standards Committee

ICE  Intercontinental Exchange

ICMA  International Capital Market Association

IFAC  International Federation of Accountants

IFRS  International Financial Reporting Standards

IFIF  International Institute of Finance

IMF  International Monetary Fund

IRS  Interest Rate Swap

ISDA  International Swaps and Derivatives Association

IOSCO  International Organisation of Securities Commissions

LT7CM  Long-Term Capital Management

MiFID/R  Markets in Financial Instruments Directive/Regulation

MMoU  Multilateral Memorandum of Understanding

MPE  Multiple Point of Entry

MREL  Minimum Requirement for own funds and Eligible Liabilities

MTF  Multilateral Trading Facility

NGOs  Non-Governmental Organisations

NPLs  Non-Performing Loans

ODRG  OTC Derivatives Regulators Group

OECD  Organisation for Economic and Cooperation Development

OTC  Over-the-Counter

OTF  Organised Trading Facility

RCAP  (Basel Committee) Regulatory Consistency Assessment Programme

SDG  Sustainable Development Goals

SEC  Securities and Exchange Commission

SEF  Swap Execution Facility

SMEs  Small- and Medium-sized Enterprises

SPE  Single Point of Entry

SRB  Single Resolution Board

SRMR  Single Resolution Mechanism Regulation

TARP  Troubled Asset Relief Programme

TCFD  Taskforce on Climate-related Financial Disclosures

TLAC  Total Loss Absorption Capacity

TPP  Trans-Pacific Partnership

UNEP FI  United Nations Environment Programme Financial Initiative

VM  Variation Margin

WTO  World Trade Organisation

WTO CPs  World Trade Organisation Contracting Parties
ENDNOTES

1 Writing in a personal capacity.


7 Bingham, supra, page 129.

8 Bingham, supra, page 112.


13 IOSCO, IOSCO to progress reform agenda under new leadership, 1 April 2013.

14 OECD, supra.


17 European Commission, supra.


19 The finalisation of Basel III took place in the meantime.


21 http://isda.link/marketfragendyear2014

22 The ODRG includes Principals of the following regulatory authorities with responsibility for regulation of OTC derivatives markets: the Australian Securities and Investments Commission, the Brazilian Comissao de Valores Mobiliarios, the European Commission, the European Securities and Markets Authority, the Hong Kong Securities and Futures Commission, the Japanese Financial Services Agency, the Ontario Securities Commission, the Autorité des marchés financiers du Québec, the Monetary Authority of Singapore, the Swiss Financial Market Supervisory Authority, the US CFTC, and the US SEC.


28 Banco de Mexico, the Bank of England, the Banque de France and Autorité de Contrôle Prudentiel et de Résolution, De Nederlandse Bank, the Deutsche Bundesbank, Finansinspektionen of Sweden, the Monetary Authority of Singapore, the People’s Bank of China.

29 For more information on the OECD Centre on Green Finance and Investment, visit: www.oecd.org/cgfi or contact: Robert Youngman (robert.youngman@oecd.org) and Timothy Bishop (timothy.bishop@oecd.org).


31 See, for example, the Intermediate Holding Company (IHC) rule in the US, and the Intermediate Parent Undertaking (IPU) proposal in the EU, which both require foreign banks to ring-fence their domestic activities.


33 The model bank consists of 4 equally-sized geographic subsidiaries and estimates the likelihood of failure under different rules for capital allocation in the face of stress. Failure is triggered if net assets (capital) drop to a specified minimum threshold. Asset values are varied by a Monte Carlo process, and parameters are set to approximate current market levels. Intuition can be gained by analogizing these results to an out-of-the-money put option on bank assets struck at a solvency threshold. An integrated bank (case 1) has a lower risk of failure than a specific subsidiary (case 3) because the consolidated bank is better diversified (less volatile). Case 4 shows an even larger impact, because solo failure is not only more likely, but can also result from the collapse of any sister subsidiary.