Solving SIFIs, regulatory regimes and shadow banking

The global financial picture may have taken a more positive appearance of late, but robust regulation must still be pursued to avoid the risk of future crises

By Lida Preyma, director, Capital Markets Research, G20 Research Group

In recent months, the finance ministers and central bank governors of the G20 have acknowledged that financial risks to the global economy have receded and that financial market conditions have improved. But the recovery is fragile and uneven, and unemployment remains excessively high.

Before 2008, everyone talked about how globalised and interconnected the world had become. But it was not until the financial crisis that it became apparent how interconnected it was – both in terms of benefits and, especially, of downside repercussions. In the ensuing years, preventing a future crisis has been the crux of all new regulation.

Transparency and effective regulation would be the way to bring much-needed confidence to the markets and to rebuild economic growth. Such new regulation would need global cooperation and coordination in order to be effective and long-lasting. The G20 was thus the proper forum for decision-making because not only do its leaders have the political will to formulate consensus, but the finance ministers and central bank governors also have the ability to implement the decisions.

Avoiding taxpayer bail-outs

The use of taxpayer money has become an unacceptable means of bailing out the malfeasance of financial industry risk-takers. Citizens want a safer regulatory regime and do not want to pay for the mistakes of others. To that end, regulating systemically important financial institutions (SIFIs) and strengthening resolution regimes have become priorities for the G20. Regulating shadow banking, which could be argued to have exacerbated the crisis, is critical in order to prevent the future crisis that may now be looming. The challenge is finding the right mix between safety and operability.

In November 2011, the Financial Stability Board (FSB) listed 29 global SIFIs (G-SIFIs), which were considered too big to be allowed to fail. Global repercussions would reverberate if the orderly unwinding of these financial institutions did not take place. This list will be reviewed each November and, starting in 2016, a capital surcharge of up to 2.5 per cent will be applied to those on the 2014 list.

To be on the list means to be guaranteed a rescue. Not being on the list means having more free capital to generate revenue. This may lead to financial institutions that actively manage their business lines in order to avoid designation. Indeed, some may even retreat into their home countries. Such a trend would have clear business consequences for international finance activities.

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The most important next step, now that the criteria have been established, is to make sure that home and host countries have the tools in place to cooperate across borders to share information and resolve the institutions. To that end, FSB members have undertaken cross-border cooperation agreements, but the process is complex and no agreements have been completed. The agreements are meant to set out a process for information-sharing covering all G-SIFIs.

Coordinated global cooperation requires an overarching body to oversee the planning work and provide guidance. In July 2013, the FSB published three papers: *Guidance on Developing Effective Resolution Strategies*, *Guidance on Identification of Critical Functions and Critical Shared Services* and *Guidance on Recovery Triggers and Stress Scenarios*. By the time of the G20 leaders' meeting in St Petersburg, the methodology for selecting and applying a supervisory regime for domestic SIFIs (D-SIFIs) will have been introduced.

Review of resolution regimes

In order to resolve financial institutions in an orderly manner without taxpayer exposure, the FSB presented 12 necessary core elements in its *Key Attributes of Effective Resolution Regimes for Financial Institutions*, released in the autumn of 2012. It took into account different national legal systems, market environments and sector-specific considerations.

The FSB's first peer review, released in April 2013, found that, in many jurisdictions, resolution authorities still lack the power to transfer assets and liabilities rapidly and to write down debt or convert it to equity. Most also lack transparent and expedited procedures for effecting foreign resolution actions. There was also inadequate operational capacity in the national authorities that are responsible for resolution.

In July 2013, the International Association of Insurance Supervisors published a methodology for identifying globally systemically important insurers (G-SIIs). They also published policy measures endorsed by the FSB as they were consistent with the FSB's key attributes.

The association identified an initial list of nine G-SIIs, which will be updated each November from 2014. Higher loss absorbency and backstop capital requirements will be finalised by the G20 summit in 2014. Implementation of the requirements will start in 2019 for those on the 2017 list.

Such peer reviews prove valuable beyond simply shaming participating members. Work and progress need to be documented for regulatory adherence to actually take place. The FSB is considering developing guidance for the transfer of powers and the quick return of client assets. Further work is also being carried out on the financial market infrastructure, using the results from a public consultation held by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions in 2012. The FSB will report this progress to the St Petersburg Summit.

Regulation of shadow banking

One of the hardest areas to regulate is shadow banking, yet some progress has been made. This $67 trillion sector not only exacerbated the last financial crisis, but may in fact lead to the next one. The FSB is working on a two-pronged approach: the regulation of banks' interactions with shadow-banking entities (exposure/risk and indirect regulation) and the regulation of shadow-banking entities (hard rules for some activities and transparency in others).

Traditional banks have been selling assets to non-bank financial groups to improve their capital ratios and meet regulatory requirements to reassure their own lenders that they are resilient. The lack of regulation and regulatory requirements on non-banks provides much incentive to be a shadow bank.

China is currently criticised for the increased activity in its shadow-banking sector. Aside from curbside lenders and pawn-shop financiers, the biggest problem may be the regulated trust companies, whose trusts are sold as wealth-management products and regulated by the China Banking Regulatory Commission. Although the commission approves every product, the trust company must honour its commitment to investors to avoid losing its licence.

When projects default and payments cannot be made, trust companies create new products to sell in order to pay old investors. Curbside losses are absorbed by entrepreneurs, but funding often comes from personal lines of credit and internal financing. When loans are called, the reverberations will be felt in the traditional financial sector and the interconnected global economy.

Shadow banking is an important part of the financial system. It enables loans to be provided to those who are unable to borrow from traditional sources. The FSB will offer policy recommendations for oversight and regulation of this sector to the G20 leaders gathered at St Petersburg.

At the G20 summit, the leaders should commit to moving forward with legislation. They should not allow complacency, as a consequence of present non-emergency circumstances, to slow that movement down. It is easy not to adhere to timetables during periods of calm. The leaders must continue to push the priorities assigned to the relevant bodies to complete the tasks that they set out at previous summits. After all, the target of preventive, meaningful and appropriate regulation is never to have to find out how effective that regulation is – because it will never need to be called upon. ■

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G20 finance ministers and central bankers met in Moscow in July 2013. The focus on tighter regulatory regimes must continue in order to prevent future global turbulence

Why we continue to believe global standards are important

Christian Mouillon,
EY Global Vice Chair – Assurance

During and in the immediate aftermath of the global financial crisis, there was tremendous support for globally coordinated policy action and global standards. These were seen, rightfully so in our view, as necessary for the response to be effective. However, in the ensuing years and particularly as countries have struggled to address their national economic challenges, the appeal of global action and global standards seems to have diminished.

The momentum and support for International Financial Reporting Standards (IFRS) is one example at hand. Following the financial crisis, the G20 leaders called for a single set of high-quality accounting standards to be used around the world, and pressed the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) to complete their project to converge IFRS and US Generally Accepted Accounting Principles (GAAP). Nevertheless, despite the intensive efforts of the respective boards, the two standard setters have not been able to complete convergence, although substantial positive progress has been made.

The broader issue, however, is not about accounting standards, but rather it is about the tension that exists between national imperatives and globalisation more generally.

Globalisation, as a trend, is moving at a fast pace and seems likely to continue in most walks of life. We see it in capital market flows, trade and economics to name only a few. Although countries have adopted different approaches, the trend has been a strong one of increasing interdependence and integration and seems irreversible to us. It is market and demand led.

A globalised world demands greater coordination and consistency in financial regulation and corporate governance, and a single global language for accounting and auditing standards. Global business, global investors and global markets require global standards. They are inevitably both a need and consequence of globalisation. Global standards have developed to support many if not all market sectors, including accounting, auditing, banking supervision, and securities regulation.

Global standards are generally developed by international groups or bodies of standard setters, regulators, or others, working together to cooperate, share information, and oversee global market activity. For example, bank supervisors have long coordinated their activities through the Basel Committee on Banking Supervision. Europe's sovereign debt crisis has led to an increase in pan-European banking supervision. Securities regulators continue to work together through the International Organization of Securities Commissions (IOSCO). Indeed, it was IOSCO that first called for a set of global accounting standards to aid in making global markets consistent and comparable. The G20 has repeated this call many times since the financial crisis. And all of these groups now work together and with representatives of national governments and others in the Financial Stability Board.

Yet with the trend toward globalisation and perhaps in part because of it, we are seeing an opposing trend – a push or move for nationalism in these matters – as countries realise what they may stand to lose by being only a part of a larger, interconnected world.

An example of the global vs national dynamic in accounting standards was the recent House of Lord's inquiry into banking in the UK. At the heart of the inquiry was the question whether UK GAAP was better than IFRS and thus, in essence, whether UK banks failed because they moved from UK GAAP to IFRS. We submitted evidence to support our view that this was not the case. Indeed, in many respects, UK GAAP was the same as IFRS. It is also inescapable that certain countries that applied IFRS did not witness a failure of their major banks or banking system (such as Australia), while others that did not apply IFRS *did*.

But let's look beyond accounting. We have seen recent moves for countries to develop their own standards on auditing, fraud and ethics. In each case there is an international reputable body that sets such standards. For the same governance reasons as apply to the IASB, these international bodies undertake a deliberative process to reach consensus and consider how the standards they put forth can be applied around the world. They are frequently criticised for being slow. One response to this is to 'go it alone' and 'do it yourself'.

In the face of this trend towards nationalism, the question is whether the costs to individual countries and individual people of 'going it alone', and even perhaps of losing some national sovereignty, are worth the benefits of a more connected world even if it were realistically still possible to 'go it alone'.

Independent standard setters

In our view, the answer is a clear yes – provided those charged with setting global standards are both independent and accountable to the broad stakeholder communities they serve.

For people to have confidence in global standards, and for the standards to be accepted around the world, the standard setter must be independent, and the standards must be set following full due process, with appropriate governance arrangements. This necessarily involves considerable outreach, deliberation and consultation. A consequence and, therefore, a cost of globalisation, is that standard setting may take additional time. But, is it really more time than it takes many national standard setters each developing their own standards and the time for companies, auditors and others to assimilate the myriad of standards?

In the case of IFRS, the standard-setter is the IASB. In recent years, the IASB's governance has been modified substantially to take into account the responsibility it has to be both independent from undue political pressure on the one hand and accountable to the stakeholders who use the standards (investors, creditors, preparers, regulators) on the other. The governance model has been expanded to include an Accounting Standards Advisory Forum of regional and national standard-setters. It is evidence of the IASB's understanding that increased stakeholder involvement is essential for its standards to be accepted globally.

Another consequence of global standard-setting is that not every person, or country, gets what they want, even after their views have been heard. This is because global standard-setting is necessarily a process of compromise and consensus. The standard-setter, while taking all views into account, must, in the end, determine the highest possible quality answer for global applicability. Very few transactions are unique to any one country. There will always be some pragmatism, so that applying the standards is not overly burdensome, but in the end, the standards must be of a high quality.

Of course, quality means different things to different people. For some countries, quality means setting broad principles and sticking to those rigorously. For others, it means writing detailed application guidance on how to apply the principles. For others, it means 'we liked it the way we used to do it and we don't want to change'. This latter point is naturally prevalent and valid – changing from what one knows and believes to be good to something different and possibly unproven is a challenge for most people. It is simply a human reaction.

In our view, standards of good quality are those that are based on clear principles, incorporate adequate application guidance and can be implemented without undue cost or burden. In the case of accounting standards they should also ensure that the transactions upon which they report are reported faithfully and transparently. We do not support calls for changes to standards that would artificially smooth earnings, shield losses or create provisions as profit buffers for future periods. Financial stability is the role of prudential regulators. Transparent financial reporting is the role of preparers, using appropriate accounting standards.

Some countries resist moving to global standards because they worry about a loss of national sovereignty. In many cases, however, being part of a global process enhances the impact that an individual country can have on the global standard. In the case of accounting standards, most countries have developed safeguards to address their concern about a loss of sovereignty. However, the safeguards need to be at the highest possible level – not at the 'we don't like it because we always did it our way' level. Nor should they be for reasons of vested interest or to avoid transparency.

We acknowledge that global standards may not be perfect and may not always give everyone what they want. Accounting standards can be enhanced in certain areas – and the standard-setters are in the process of doing so.

In an interconnected world, however, we believe that global standards are ultimately beneficial, provided the governance surrounding the way they are set is appropriate in the circumstances and the output of the standards is of an acceptable quality.

The benefits of global standards include efficient capital flows between different markets, greater comparability and consistency of reported information, greater confidence in that reported information, efficient use of human capital (once a person is trained in a field in any country they can easily transport their skills to other countries), greater efficiency and lower costs – standards are set once – avoiding multiplication of effort; training can be developed anywhere in the world and used by anyone who has been accredited in the particular field where there are global standards – and so on.

Change is a difficult process but it can be appropriately managed. Economic and social times are tough. If ever there was a time to pull together and move forward rather than retreating to nationalism, it is now.

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Dealing with derivatives

Controlling market volatility and cross-border financial flows has been a priority of G20 leaders since 2009, but areas of unhealthy risk remain

By Chiara Oldani, lecturer in economics, University of Viterbo 'La Tuscia'

Emerging and developing economies will largely be the drivers of global growth in 2013, and probably in 2014, because the United States is still recovering and the euro area is still slowing down. Since the global financial crisis turned into an economic one, the importance of financial stability has captured the attention of policy makers and leaders. G20 leaders have acted since 2009 to restore stability and enhance the soundness of financial markets, but further improvements are needed, especially in terms of standardising the rules for non-financial operators, strengthening the fight against money laundering and eliminating the tax evasion that fuels cross-border financial flows, renders macroeconomic policies powerless and helps unbalance public spending.

Managing financial flows

The unconventional expansionary monetary policies undertaken by many G20 members have contributed to sustaining financial trading and flows, but create the basic conditions for new financial risks in the future. Some financial sectors, such as the equity and credit markets, have been negatively affected by the economic downturn, by delays in reforms and by regulatory uncertainty. These sectors have strong relationships with growth, and thus should be helped to recover. The dramatic economic data recently registered on economic growth, employment, public spending and debt have confirmed the fact that when financial flows are mismanaged and poorly monitored, the entire economy is damaged, via investors' confidence. Emerging economies and Middle Eastern countries are financially fragile and exposed to the negative impact of excessive volatility of cross-border financial flows. G20 leaders at St Petersburg should coordinate their positions in order to overcome national limits. Their agenda should be filled with steps to eliminate regulatory asymmetries and create the conditions for stable economic and financial growth.

Improvements in derivatives trading

Nevertheless, the financial crisis did not hit the derivatives market in a lasting way. In December 2012, financial derivatives traded over the counter (OTC) reached $638 trillion, with no sign of contraction (see table). This nominal figure is still nine times larger than global gross domestic product, similar to the situation in 2008. A recent relevant structural innovation in the global derivatives market is the introduction of the central counterparty (CCP) system, which came into force in the European Union in 2012. It strongly reduces counterparty and liquidity risks, strengthening stability. Opaqueness, lack of data and unclear trading were responsible for the excess volatility and risks that damaged the global economy, and the CCP system will reduce such anarchy. The costs of the system will be more than compensated for by its benefits, but only if most of the global market is centrally cleared. However, in the coming years there could be asymmetric effects, because not all domestic financial systems have declared that they will adhere

Table: Over-the-counter derivatives, $ billion

	June 2010	December 2010	June 2011	December 2011	June 2012
National amounts outstanding	582,685	601,046	706,884	647,777	638,928
Gross market values	24,697	21,296	19,518	27,278	25,392

source: BIS Quarterly Review, June 2013

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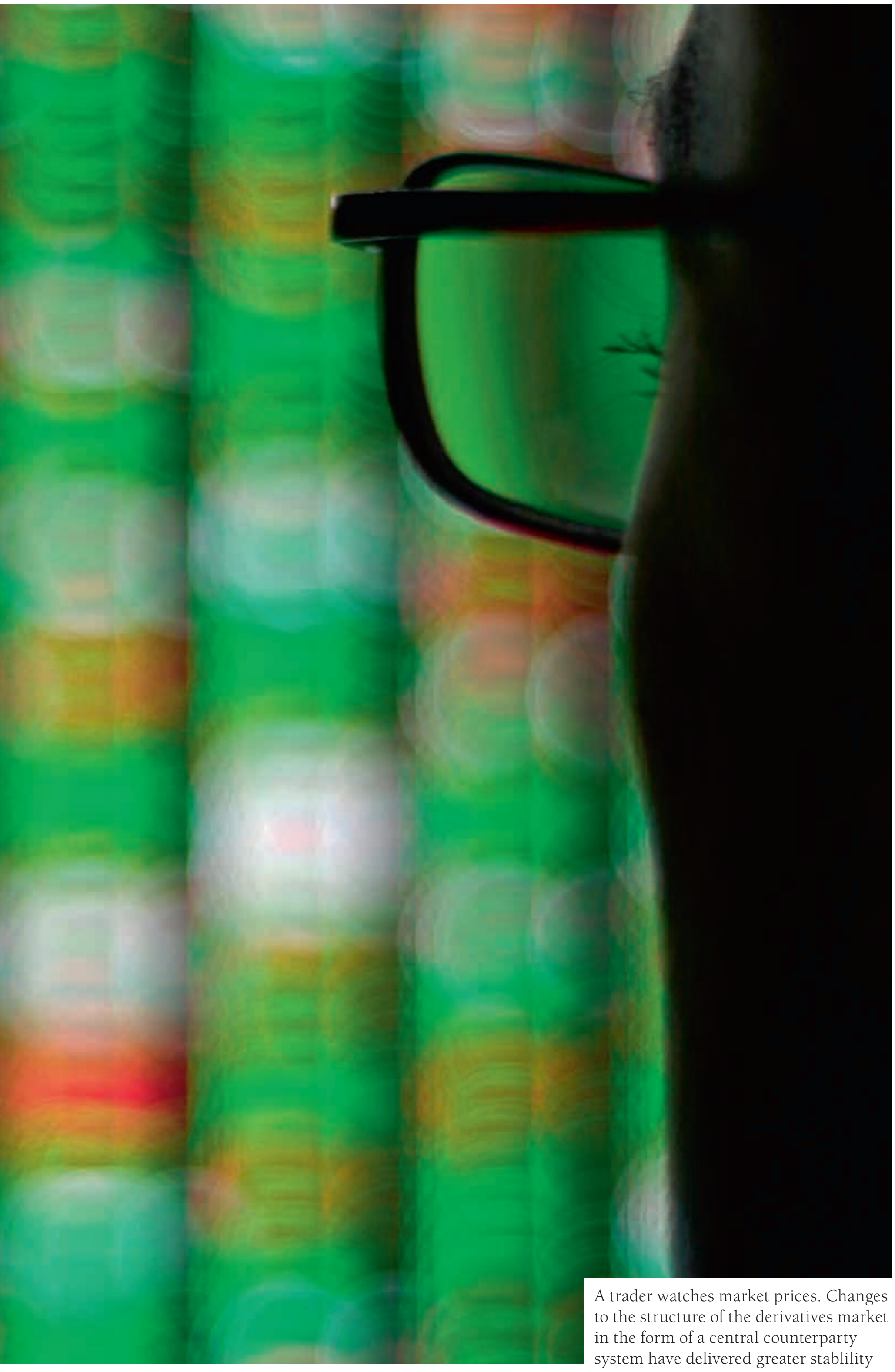

A trader watches market prices. Changes to the structure of the derivatives market in the form of a central counterparty system have delivered greater stablility

to it. Europe's biggest financial centre, the United Kingdom, will not clear OTC derivatives centrally, creating the conditions for unfair financial competition and reducing the effectiveness of the CCP system itself. The British position is difficult to manage for the European authorities that are working to create a common market, banking union and homogenous rules.

Global stability cannot be damaged further if leaders want to restore growth and employment. The G20 should address a source of asymmetry – and thus volatility – other than the one addressed by the CCP system: the uncontrolled growth of non-financial operators. Such non-financial operators include governments, corporations and, most of all, private investors whose funds are uncertain in terms of both origin and final destination. Their share of the derivatives markets had already reached 10 per cent in December 2012, according to estimates from the Bank for International

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Settlements, yet monitoring and supervision are completely absent. Non-financial operators concentrate on the opaque swap market and prefer interest rate products; capital and collateral are not required for non-financial operators, but global players in the energy and industrial sectors can have larger portfolios than those of commercial banks. The weak monitoring of OTC transactions together with the lack of control and capital of non-financial players fuel volatility and damage confidence and growth.

With regard to the pathology of finance, the G20 has already called for a further reduction in tax evasion and an increase in efforts to fight money laundering, since those financial flows can boost market volatility and further impede fair competition, proper supervision and effective monitoring. Greater transparency in the OTC derivatives market would contribute to a large extent to achieving this broader goal, because increasing resources are invested there. ■