European Financial Services Round Table

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EFR PAPER ON TRANSATLANTIC RELATIONS AND GLOBAL REGULATORY ISSUES

Introduction

Since his inauguration as the 45th President of the United States of America, President Donald J. Trump has introduced a step change regarding the financial services policy. Following nearly a decade of increased regulations, the U.S. Administration, encouraged by the U.S. Congress, embarked on reviewing and potentially "dismantling" domestic financial regulations, most notably the Dodd-Frank Act. The U.S. Administration is also evaluating its involvement in international standard setting institutions such as the Financial Stability Board (FSB), and thereby questioning the legitimacy of global standard setting by the FSB.

This position of the United States highlights a clear divergence in perspective between the United States and Europe in regards to global standards, and therefore, sheds a different light on transatlantic relations. Whereas the United States and Europe have worked closely together for many years through international forums, one can now observe diverging statements on global standards and new financial regulations. This is highly relevant for global financial groups as represented by the European Financial Services Roundtable.

Against that background, this paper sets out briefly the history of global standard setting as well as the industry's experience, and makes suggestions for further discussion.

International financial groups: creating value for all stakeholders

The European Financial Services Round Table (EFR) brings together Chairmen and Chief Executives of leading European banks and insurance companies with operations across the globe. These international financial groups have businesses and customers in markets across different continents and are led by senior management and employees of different nationalities and backgrounds and have a globally-distributed investor base. The benefits of being an international financial group include diversification, access to talent, ability to leverage scale, capabilities and resources, international reputation and exposure to global thinking, as such creating value for all stakeholders.

Box 1 – Advantages of international financial groups

Firstly, an international group profits from diversification through a reduced risk profile, increased resilience, and a more stable operating performance over time. In addition, it can also become a better known name internationally, making it easier to access a broader (long-term) investor base. Secondly, an international group is also more attractive to talent who want to work in an international environment and benefit from international mobility opportunities. Thirdly, international groups are able to scale, capabilities and geographic footprint in different business lines and supporting functions. Fourthly, an international group with global presence, strong ratings and well-recognized international brand(s) has a strong appeal with institutional and retail customers, particularly in emerging markets and there may also be some benefits from a strong international reputation in dealing with regulators. Fifthly, exposure to global thinking captures a number of different, often more intangible benefits of being part of an international group such as innovation. Most importantly, the aforementioned advantages result that consumers and small and medium-sized enterprises will benefit from strong competition among the international financial groups as well as between international financial groups and domestic institutions resulting in cost-efficiency and a variety of services and products for our customers.

Development of global standards: four decades of experience

International banks have extensive experience with a global standard: the Basel Accords. These Basel standards were named after the Basel Committee, established by the central bank Governors of the Group of Ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets. The mission of the Basel Committee is to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters.

Over the last few decades, banking regulatory capital requirements have changed substantially. In 1988, the first Basel Accord introduced an international standard to compute regulatory capital (referred to as Basel I). In June 1999, the Committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord, leading to the Basel II Accord, established in 2004, making the capital framework more risk sensitive. The aim of Basel III, agreed upon in 2013, was a fundamental strengthening of the capital framework which was deemed necessary after the 2008 financial crisis. Today, nearly 30 years after the first Basel Accord, the Basel Committee has, after long and painful negotiations, finalized its latest package concluding the post-2008 reforms: Basel 3.5.

> ***Box 2 – Basel 3.5***
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> Basel 3.5 is the most recent version of the Basel Accords and is still to be implemented in legislation. It reflects a significant change in the thinking of the Basel Committee shifting towards simplicity and making the capital requirements less risk-sensitive. Like all Basel Committee standards, Basel 3.5 consists of minimum requirements which apply to internationally operating banks. Members are committed to implementing and applying standards in their jurisdictions within the time frame established by the Committee. The Basel 3.5 reform comprises - among other issues - reforms of the standardized approach for credit risk, the internal ratings-based (IRB)-approach, the quantification of credit valuation adjustment risk, operational risk approaches and last but not least the final calibration and design of the output floor.

With regards to insurers, global standards are currently being developed. The International Association of Insurance Supervisors (IAIS) announced its plan to develop the Insurance Capital Standard in October 2013 in response to a request by the FSB that the IAIS produce a work plan to create "a comprehensive group-wide supervisory and regulatory framework for Internationally Active Insurance Groups." The IAIS has held several consultations and has undertaken quantitative field testing processes with volunteer insurance groups beginning in 2015. Each year, the IAIS uses the results of Field Testing to further the development of the ICS. The ICS is scheduled to be implementation-ready starting in 2020.

A significant regulatory change in the insurance space in the past decade has been the introduction of Solvency II: a new, harmonized EU-wide regulatory regime replacing 14 EU insurance directives. Some markets in Africa and Asia are looking to adopt rules mirroring Solvency II, while others are taking somewhat different approaches to developing risk-based capital schemes.

> ***Box 3 – Insurance Capital Standard (ICS)***
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> In November 2017, the IAIS released a "unified path to convergence," a plan for how the IAIS envisions the ICS will be implemented across jurisdictions from 2019. The IAIS agreed that the future ICS version 2.0 will be implemented in two phases:
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> - ***Phase 1 - mandatory confidential reporting.*** The first five years is a monitoring period when the ICS will be used for confidential reporting to the group supervisor and for discussions in supervisory colleges using prescribed valuation methodologies. The IAIS intends to consider whether alternative approaches should be incorporated into the ICS by the end of the monitoring period. The IAIS will also examine whether the developing US aggregation valuation method for group capital should be recognized as an "outcomes-equivalent" approach for implementation of the ICS.

- ***Phase 2 – implementation as a "Prescribed Capital Requirement".*** At the end of the five year monitoring period, and along with any agreed alternative and outcomes-equivalent approaches, the ICS will be implemented as a "Prescribed Capital Requirement" (PCR). A PCR is theoretically a suitable basis for triggering supervisory action, though it remains to be seen how the ICS will interact with, or sit alongside, existing capital standards, such as Solvency II. The ICS will, in any case, require implementation in each national jurisdiction for it to be in effect.

Another focus of the FSB after the 2008 financial crisis is macro-prudential supervision for banks and, more recently, insurers. This includes the framework of Systemically Important Financial Institutions (SIFIs), which are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system. The objective of the SIFI Framework is to address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as too big to fail.

Four decades of experience: observations from practitioners

The history of global capital standards and macro-prudential framework setting at a global level as outlined above shows that its development takes a long period of time and the discussions are inherently very complicated, particularly considering that the jurisdictions involved in these discussions can have very differing views. Some observations to share.

- International standards can level the playing field for financial companies being active in different markets. A level playing field is not only fair, but also increases competition, and thereby benefits consumers.
- Regional and global rules and standards can strengthen financial stability. With such rules, for instance in the context of European financial regulation, it would be easier for European banks to transfer saving funds from one EU Member State to another.
- International standards can also make it easier for supervisors to cooperate and share information about supervised entities, both in 'going concern' as well as 'gone concern' situations.

However, there are constraints as to how far reaching international capital standards and macro-prudential supervisory measures can be. Based on the experience to date, the following areas can be identified as areas where international standards are not necessarily beneficial:

- Even internationally operating financial groups have local aspects of their businesses where global standards do not fit. In particular, retail markets are not uniform. Applying global capital standards to local retail markets may result in standards that do not recognise the local nature of markets and, relatedly, the local regulations already in place. Recent examples concern the restrictive effect that the risk insensitive Basel 3.5 proposals have on mortgages sold by financial institutions in Northern Europe and insurance contract boundaries in Asia.
- Reflecting on the aforementioned discussions about capital standards and macro-prudential frameworks at a global level, most often it was the local aspect, mostly raised by national government representatives, complicating discussions arriving at such standards. This makes sense as those officials represent elected governments (i.e. politicians) who are incentivized to look after the interests of their constituencies, which may be different for the international bodies made of supervisors e.g. the Basel Committee and the IAIS.
- Global regulation can only be effective as long as it takes into account the differences in the nature of financial institutions. In recent years there has been increased recognition that banks and insurers are different and it appears that policymakers are also recognizing these differences, as demonstrated by the different approaches to addressing systemic risk in banking, insurance and asset management.

Clearly, the aforementioned constraints are amplified in an era where the jurisdictions involved are minded to diverge rather than converge. Whereas the last four decades showed that regulation was increasingly accommodating the globalisation of finance, particularly banks, one can observe today signs of protectionism, most notably in the United States with an increasingly inward looking focus.

Recommendations

Both banks and insurers have extensive experience with global financial regulation and support global standards – both macro-prudential policy measures and, albeit at different stages, capital standards. With Basel 3.5 still to be endorsed and a global capital standard for insurers under development, we believe the following considerations merit further discussion:

- Regulatory cooperation at global level is vital. Internationally operating financial groups benefit from global standards providing added value to their customers through efficiency gains and increased competition as a result of an international level playing field. Therefore, it is important that following the adoption of global standards, the jurisdictions involved in those discussions continue to exchange views and perspectives educating about the characteristics of one another's jurisdictions.
- While finance has become increasingly globalised over the past four decades, financial firms need to take into account local aspects of the markets they operate in, particularly in the case of retail banking and insurance. Global standard setters and national authorities implementing these standards should be mindful of that when introducing conduct as well as prudential standards proportionally (e.g., by being more transparent and conducting ex-ante impact assessments). Additionally, accountability of global standard setters can also be improved through embedding ex-post impact assessment, building on EU call for evidence exercise and US Treasury report.
- Elected representatives have an important role to play in weighing the advantages of global standards against local market characteristics, and in building and defending the legitimacy of regulatory frameworks. Therefore, it is essential, that national representatives (and regional, where relevant, including in the European Parliament) have a clear role in the process of designing, implementing and transposing global regulatory frameworks, taking into account, where required, regional or national characteristics.

The European Financial Services Round Table (EFR) was formed in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with headquarters in Europe. EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

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