FINANCIAL REGULATION

Brisbane G20 Summit: substantial progress on the regulatory reform

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An overview

The ninth G20 summit will take place tomorrow and the day after tomorrow (15-16 nov) in Brisbane leaded by the Australian Presidency. Important advances have been achieved so far, for enhancing the resilience of the global financial stability and for addressing the roots of the crisis since the first meeting held in Washington (2008). However, there is still work to be done to accomplish the project started seven years ago.

Table 1
The essence of financial regulation in G20 summits

Year	Location	The essence of financial regulation
2008	Washington	Outline of the regulatory reform
2009	London	Official creation of the FSB. Coordination of economic stimulus and additional resources for the IMF & multilateral banks
2009	Pittsburgh	Strengthening the international financial regulatory system including first policy recommendations to address Too Big To Fail (TBTF). Wide-ranging reforms to global OTC derivatives markets were first agreed
2010	Toronto	An agreement to conclude new Basel III regime and the need for fiscal consolidation
2010	Seoul	Endorsement of the landmark agreement of Basel III and the framework to reduce moral hazard risks posed by systemically important financial institutions (SIFIs)
2011	Cannes	First G-SIB entity list. Key Attributes of Effective Resolution Regimes for Financial Institutions. Kick off of shadow banking regulation working plan
2012	Los Cabos	New focus on impact of the regulatory reform on emerging countries and financial inclusion
2013	St Petersburg	Reaffirmation of commitment to implementation of agreed financial regulatory reform. Progress and next steps towards ending TBTF
2014	Brisbane	Regulatory reform almost completed. Consultation on total loss absorbing capacity (TLAC) framework. Response to reduce excessive variability in risk-weighted assets (RWAs). First G-SIB binding list

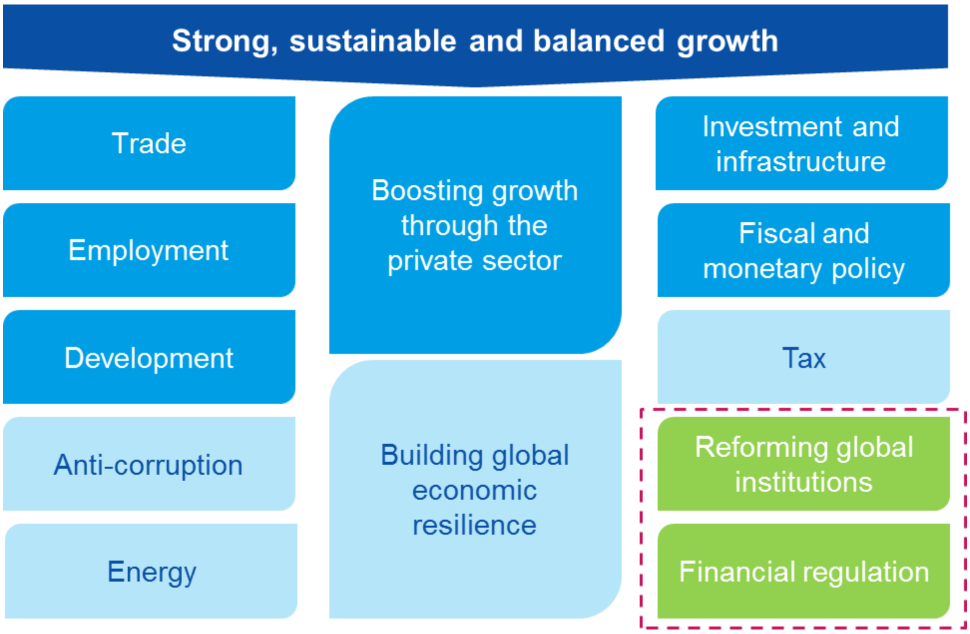
Source: BBVA Research based on G20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS)

This year, economic recovery and economic growth will be one of the most important issues of the summit amid the threat of a fragile economic recovery. In that vein, the goal is to raise the G20 output by at least 2% of the current estimated level in the 5 coming years. It will imply, approximately, an increase of USD2trn in G20 GDP and millions of new jobs. However, this is not the subject of analysis of this note.

In previous summits financial regulation and financial supervision had maybe greater weight. This year, the focus is expected to be on TLAC, on reducing excessive variability of RWAs and on the stocktaking exercise of the substantial progress made so far, after seven years of hard work, to strengthen the financial regulation. Indeed, now that the reforms are about to finish and it is time to move forward to a new stage, it is of utmost importance to keep tracking the effects of the agreed regulatory reforms to avoid unintended consequences.

Therefore, with much of the work completed, it is expected that next Turkish Presidency of G20 will change its focus from purely design of standards to implementation and addressing of new risks. The Turkish Presidency will also look at a more important role of emerging countries. In this vein, the FSB is examining its representation structure to better react to the increasingly significant role of emerging markets in the global economy and financial system.

Figure 1
Top priorities of the G20 agenda



Source: G20

Progress made so far in financial regulation and supervision: Deliveries for the summit

As commented before, financial regulation and supervision have played a key role in previous summits and they will still be among the top priorities of the G20 agenda. They are a cornerstone to restore confidence in markets and in financial institutions, promoting a more transparent and a less risky financial system, which is essential to foster global financial stability.

1. Building the resilience of financial institutions through the implementation of Basel III standards:

Overall, there has been an improvement in capital, leverage and liquidity. Banks are now more capitalized and the capital they have is of higher quality; in this vein, most global active banks already meet Basel III capital, liquidity and leverage ratios.

- On 12 November, the Basel Committee on Banking Supervision (BCBS) released two reports to G20 Leaders:
  1. On implementation of the Basel III regulatory reforms. It updates on the steps taken by Basel Committee member jurisdictions for the incorporation of the Basel III standards and the banks' progress in reinforcing their capital and liquidity positions. The document also emphasizes on specific challenges on implementation.
  2. On reducing excessive variability in banks' regulatory capital ratios. The Committee's response to excessive variability in banks' regulatory capital has centered around three areas: policy, disclosure and monitoring.
     I. **Policy**: developing prudential proposals to:
        a. improving the standardised, non-modelled approaches for calculating regulatory capital
        b. using standardised approaches as the basis for the use of floors and benchmarks. The Committee intends to publish for consultation towards the end of this year a revised capital floor based on the standardised approaches
        c. undertaking a more fundamental review of modelling practices: (c.i) specific policy proposals to reduce excessive variability in the IRB approaches to credit risk (c.ii) measures related to banks' market risk modelling practices (c.iii) measures related to banks' operational risk modelling practices.

     II. **Disclosure**: strengthening the disclosure requirements related to risk weights by amending Pillar 3 of the Basel framework.

     III. **Monitoring**: ensuring proper implementation by monitoring outcomes of risk-weighted asset variability through Hypothetical Portfolio Exercises (HPEs) under the Committee's Regulatory Consistency Assesment Programme (RCAP).
- On 31 October, the BCBS published the final version of the Net Stable Funding Ratio (NSFR). It is, together with the Liquidity Coverage Ratio (LCR), one of the main components of the Basel III liquidity framework.

2. Reducing the risks and impacts of when systemically important institutions fail ("ending too-big-too-fail"):

Overall, we have a new paradigm whereby impact on taxpayers will substantially decrease as institutions will be obliged to maintain enough capital to absorb losses through bail-in instead of bail-out.

- On 14 November, the Financial Stability Board (FSB) released a report to the G20 on progress in reform of resolution regimes and resolution planning for Globally Systemically Important Financial Institutions (G-SIFIs). Its main priorities for 2015 year are:
  I. completing the total loss-absorbing capacity (TLAC) framework

II. contractual recognition of the temporary stays in early intervention and with non-compliance of cross-default rights and ending the effective cross-border recognition guide

III. developing new guides to support home and host authorities in resolution planning and

IV. promoting and extending the full implementation of the resolution regimes requirements for global systemically important insurers (G-SIIs) and Financial Market Infrastructures (FMIs).

- On 10 November, the FSB launched a draft consultation on the principles and characteristics of a minimum (TLAC) requirement. This is a milestone in the new resolution regime as banks must have enough liabilities with loss-absorbing capacity. According to the FSB, the TLAC should consist of instruments that can be legally, feasibly, effectively and operationally written down or converted into equity in case of resolution, in an amount that doubles the capital and leverage requirements (the highest of 16% of RWA or 6% of leverage assets).
- On 6 November, the FSB and the BCBS released essential information on global systemically important banks (G-SIBs):

I. The FSB published a new *update of the global systemically important banks (G-SIBs) list* using end-2013 data. It must be highlighted that:

a. this will be the first binding list being used to determine G-SIB buffers starting from January 2016

b. the list gets expanded by one new member up to a total of 30 G-SIBS

c. the list reflects a few changes with respect to the 2013 list due to better data, changes in some banks activity and supervisory judgment

II. The BCBS also published the following information relevant to the G-SIB identification exercise:

1. a technical summary on the methodology,
2. the denominators used to calculate banks' scores, and
3. the cut-off scores used to allocate the banks to the different buckets

3. Addressing shadow banking risks fostering transparency and regulation:

Some progress has been achieved on identification and regulation, but much remains to be done especially because of the heterogeneity of shadow banking activities across countries.

- On 30 October, the FSB released its *Fourth Global Shadow Banking Monitoring Report*. The total estimated volume of shadow banking in 2013 is USD75trn (+7% YoY) according to the FSB's broad measure[1]. Advanced economies have a much bigger weight in the shadow banking sector than emerging markets; however, shadow banking in emerging markets is raising very fast (from a small base). Furthermore, for the first time, it published a comprehensive dataset by jurisdiction and by institutions. In this vein, it has to be pointed that monitoring and surveillance are required for making shadow banking more transparent and for a better understanding of the risks that this less regulated activity implies.
- On 13 October, the FSB launched the *first regulatory framework on collateral rules for non-centrally cleared securities financing transactions (SFTs)*. Furthermore, the FSB aims at capturing non-bank to non-bank transactions by asking for comments to apply them numerical haircuts.

1: It captures all non-bank financial intermediation where shadow banking-related risks to the financial system might potentially arise; MUNFI: the Monitoring Universe of Non-Bank Financial Intermediation. The estimated volume decreases to USD35trn (2.4% YoY) if filtered out entities that are not part of a credit intermediation chain and those that are prudentially consolidated into a banking group.

4. Making derivatives markets safer:

Control over OTC derivatives has increased as derivatives transactions have to be reported in a trade repositories and some of them have to be centrally cleared (interest rate and credit derivatives).

- On 7 November, the OTC Derivatives Regulators Group (ODRG) issued its last report to the G20 (the previous one was released in September) *on cross-border implementation issues*. Its goal is solving persistent frictions, inconsistencies, gaps and duplications in requirements. In that vein, members are still working on implementing equivalence and substituted compliance, clearing determinations and risk mitigation techniques for non-centrally cleared derivatives transactions (margin), and data in trade repositories and its barriers to reporting to trade repositories.
- On 19 September, the FSB published a feasibility study on approaches to aggregate OTC Derivatives data. It presented three possibilities for aggregating trade repositories (TRs) data: (i) a physically centralised aggregation mechanism, (ii) a logically centralised aggregation mechanism or (iii) the collection of raw data from individual TR databases by individual authorities that then aggregate the data themselves within their own systems. Principles of sound data management are considered of utmost important.
- On 18 September, the FSB released a report to the G20 on jurisdictions' ability to defer to each other's OTC derivatives market regulatory regimes. The report aims at helping authorities and stakeholders to understand the legal capacities and processes of the jurisdictions have in place or have proposed to defer to one another in cross-border contexts. Jurisdictions should defer to each other whenever it is justified.

Besides the substantial progress achieved in the four areas previously commented, it is noteworthy that on 12 November, the FSB released an updated report on the monitoring the effects of agreed regulatory reforms *on emerging market and developing economies (EMDEs).* It points out that estimated impacts are qualitative because the implementation of the reforms is in an incipient phase and it is difficult to isolate the effects of the reform from macroeconomic and financial variables. It also has to be mentioned that no significant negative consequences of the implemented reforms have been reported.

A new stage: so what now?

- Firstly, now that the financial reform is well advanced, the focus should shift towards making the implementation of the already existing measures easy and consistent at a global basis. Moreover, we should now to improve the estimation of regulation impacts through quantitative studies.
- Secondly, over the past seven years, the focus of regulation has been on ensuring and protecting financial stability. Now that the global economy has the challenge to foster economic growth, it is time to better analyse the trade-off between financial stability and the efficiency of the financial system, so the financial industry is resilient enough to serve economic growth.
- Thirdly, promoting international coordination and cooperation, especially on cross-border issues, is key to achieve that the already implemented measures have the desired results.
- Fourthly, given the fact that risks and vulnerabilities of the financial system evolve, we must not discard the possibility of future regulatory adjustments and also to deal with unintended consequences.
- Finally, it has to be mentioned that in 2015 the FSB will produce a consolidated annual report on the implementation of the reforms and their effects. In addition to that, the FSB and other international institutions will publish information summarising their developments and implementation evaluation.

All in all, it is our opinion that the global financial regulatory reform is notably contributing to make financial institutions more resilient and banks better capitalised, derivative markets safer and shadow banking is -little by little- coming into the light.

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