Financial Stability Board (FSB)

First FSB report on implementation and effects of the G20 financial regulatory reforms

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On Monday November 9th the Financial Stability Board released its first report on the implementation and effects of the G20 financial regulatory reform after the financial crisis of 2008. This is an important report that has been expected for over a year by G20 leaders and is essential to evaluate the impact of regulation on the economy.

We review the report from the perspective of the four core elements that the FSB was established to coordinate since its foundation in 2009. Under each section we summarize the stance of implementation and highlight the main impacts that the FSB has identified.

The importance of this report is that it is a first impact analysis of the whole financial reform agenda by the FSB. Follow up reports have been announced and should improve on the analysis as more data is available and the reforms are fully implemented.

The FSB highlights that the main effect of the financial reform agenda has been to make the banking sector more resilient without having a negative impact on the overall provision of credit to the real economy. However it does recognize that it is important to follow closely the impact on emerging markets and on market liquidity.

We understand the difficulty in identifying clearly the impact of regulation as their implementation has been phased in and other multiple factors have had a simultaneous impact on global markets (eg. expansive monetary stance, credit cycle). It is fundamental to repeat these impact analyses systematically and improve on the methods used, so as to better isolate the cumulative impact of financial regulation and recalibrate accordingly.

Table 1
An overview of the implementation and effects of the regulatory reforms

Core elements	Implementation	Impact
Building resilient financial institutions	Advanced stage and close to being finished	Higher capital ratios, improved funding profile, lower bank returns and shift towards market-based finance
Ending too-big-to-fail	Complete for banking. Pending other sectors	Capital surcharges and additional debt requirements for systemic banks (TLAC)
Making derivatives markets safer	In motion, but speed is slower than expected	Higher transparency and greater use of trade repositories and central counterparties
Transforming shadow banking into resilient market-based financing	Lagging, much more needs to be done	Decrease in complex securitizations and dependence on leverage and short-term wholesale funding

Source: BBVA Research based on the FSB.

1. Building resilient financial institutions

The FSB highlights the improved resiliency of the financial system as the "most important and tangible" effect of the global financial reform agenda.

Implementation is at an advanced stage and close to being finished:

- All 24 FSB jurisdictions have implemented Basel III risk-based capital rules, and all but two jurisdictions have issued final liquidity rules (Liquidity Coverage Ratio, LCR).
- Final rules on higher loss absorbency requirements for global systemically important banks (G-SIBs) have been issued in 9 out of 10 jurisdictions where G-SIBs are headquartered.
- Almost half of the market in FSB's jurisdiction (45%) has issued methodologies and final rules for domestic systemically important banks (D-SIB) higher loss absorbency requirements.
- All large international active banks meet fully phase-in risk-based capital requirements and 80% meet or exceed the fully phased-in LCR and Net Sable Funding Ratio (NSFR)
- Implementation among 19 FSB jurisdictions that were assessed, 59% were either compliant or largely compliant with Basel's Committee on Banking Supervision (BCBS) risk-based capital rules. However a little over a third (36%) were found to be materially non-compliant.
- On the liquidity front the assessment of FSB jurisdictions has only covered five (representing 6% of the market), but they are all largely compliant with LCR.

The main effect has been to raise bank capital ratios and make the sector more resilient:

- In general, the FSB mentions that all jurisdictions have larger and better quality capital buffers than before the crisis. According to the FSB there has not been a significant sacrifice of loan growth in the process.
- The funding profile of G-SIBs in advanced economies has improved as they depend less on short term wholesale funding, have greater emphasis on deposits and hold more liquid assets.
- The FSB recognizes that returns on bank equity has decreased compared to pre-crisis levels, but highlights that additional financial regulation has not been the only cause. Weak post-crisis growth, credit losses, low interest rates, misconduct fines and pressure from investors for banks to reduce leverage have also contributed.
- There is a shift toward market-based finance, especially in the real economy, which is seen positively by the FSB as it advances competition. However, the FSB mentions that measures must be taken to assure that systemic risks do not build up.
- Financing to the real economy has expanded in all regions but at differential rates. Much of the growth has come from corporate bond financing or lending by non-bank financial institutions, especially in advanced economies.

2. Ending too-big-to-fail

The FSB points that *success in ending Too Big To Fail may never be absolute because all financial institutions cannot be insulated fully from all external shocks*.

The tools for ending the "Too Big To Fail" issue in the banking sector have been finalized. The next step should be ending it also outside the banking sector:

- G-SIBs and global systemically important insurers (G-SIIs) have been designated and implementation of higher loss absorbency requirements, in the form of additional common equity tier 1 (CET1), is well under way for G-SIBs. Reporting and disclosure is proceeding in a timely manner.
- In order to ensure that G-SIBs have sufficient loss-absorbing capacity in case of resolution, the FSB has published the final standards on the Total Loss-absorbing Capacity (TLAC) that is complement to the bail-in tool. This new requirement should be in place in January 2019, allowing G-SIBs to gradually adapt their funding structures to this new requirement.
- Regarding the rest of the resolution framework, all G-SIBs have recovery plans and Crisis Management Groups (CMGs), but it is necessary to make more efforts to make resolution strategies and plans operational.
- Nine of ten FSB jurisdictions that have G-SIBs (all except Japan) have issued their final rules. The implementation of higher capital buffers, reporting and disclosure requirements is according to schedule. Final rules for domestic systemically important banks (D-SIBs) have also been issued in 14 FSB member countries.
- Nine global systemically important insurers (G-SIIs) have been identified and the assessment methodologies for non-bank non-insurer G-SIFIs (such as CCPs) will be completed after FSB work on financial stability risks from the asset management sector is finalized.

3. Making derivatives markets safer

An increase in transparency and coordination is being achieved.

The implementation of the over-the-counter (OTC) derivatives reform is in motion. However, its speed is lower than expected and there is still work to do. The most significant advance has taken place in the major markets.

- Trade repositories (TRs) and central counterparties are getting increasing relevance and spreading. In that vein, an agreement has been reached amongst member jurisdictions to allow authorities access to trade repositories for reporting complete information by June 2018.
- The next steps should be: i) bolstering cooperation to address duplicative or overlapping obligations, and ii) finishing the design and implementation according to the Principles for Financial Markets Infrastructures[1]

[1] By the Committee on Payments and Market Infrastructures (CPMI) and International Organization of Securities Commissions (IOSCO).

4. Transforming shadow banking into resilient market-based financing

Where the most work remains to be done.

The implementation is still in its infancy. Only money market funds and risk alignment in securitizations rules have been recently finished. Therefore, it is still early to know their consequences.

- Empirical evidence indicates that complex securitizations and dependence on leverage and short-term wholesale funding have significantly decreased with a growth in market-based financing.
- The framework for securities financing transactions will be completed in the short-term. Numerical haircuts for non-centrally cleared transactions between non-banks will be released filling the last gap (for non-centrally cleared transactions).
- The remaining challenge would be promoting alternative sources of funding while at the same time achieving a level playing field that avoids activity-shifting towards the less regulated sectors. That is is a long-term and complex process.

5. Progress in other reform areas

Significant progress has also been made in other reform areas such as: i) registration and requirements for **hedge funds**, ii) establishment of the framework to close the **data gaps** identified in the crisis, iii) registration and oversight of **credit rating agencies**, iv) improvement of interest rate **benchmarks** and v) **risk disclosures and vi) macroprudential policies,** that are increasing their relevance as they contribute to a more forward-looking approach, capturing current and not yet materialized risks**.**

6. Challenges on implementing reforms in EMDEs

The main challenge that EMDEs face in implementing the financial reform agenda is an adequate calibration and pace of implementation

- EMDEs that are members of the FSB are in the process of implementing the reforms according to the agreed timetables. Other EMDEs are also implementing some of the reforms, depending if they are relevant for their financial systems.
- Limited size of local markets and level of development of financial markets raise the cost of implementing some reforms. Resource constrains can be a challenge too.
- Flexibility within the international standards during implementation will be essential. These include observation and phase-in periods, calibrating parameters, national discretions and proportionality.
- Impact of the reforms is mentioned by the FSB as being of a qualitative nature due to the early stage of implementation.
- However, they recognize that some spillovers arise on host country subsidiaries when home jurisdictions implement the reforms. For example due to measurement of risks and assignment of credit.
- Additional reforms such as the structural bank reform measures in the U.S. and Europe can create negative spillovers in EMDEs. However, these are not part of the internationally agreed reforms.

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