Recent regulatory developments and remaining challenges

CIV Meeting of Central Bank Governors of the Center for Latin American Monetary Studies (CEMLA)

Fernando Restoy, Chairman, Financial Stability Institute
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Outline

- The BIS and the Basel Process
- Ongoing work by global standard setters
- Some specific challenges
- Final remarks
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The BIS and the Basel Process

Monitoring & functioning of financial markets

Standard setting

Statistical & governance issues

Policy dissemination & implementation

Financial Stability Board (FSB)

Basel Committee on Banking Supervision (BCBS)

Committee on Payments & Market Infrastructures (CPMI)

International Association of Insurance Supervisors (IAIS)

International Association of Deposit Insurers (IADI)

Financial Stability Institute (FSI)
Achievements of the post-crisis reforms

- Post-crisis financial reforms well on the way to generating more resilient financial systems:
  - Large banks are more liquid, hold more capital and are more resolvable (Basel III, resolution/G-SIB framework)
  - Market transactions and infrastructures are safer (OTC derivatives/CCP reforms)
  - Toxic forms of shadow banking have lost much relevance (new rules on consolidation, leverage, liquidity mismatches...)
  - Capital markets are more able to finance the real economy

- At the same time, credit is now growing in major economies, with the cost of financing remaining low
Achievements of the post-crisis reforms (cont)

- **But there are still pending issues:**
  - Finalise policy reforms (eg Basel III, insurance)
  - Address new sources of risk (eg technology, regulatory arbitrage)

- **And we need to oversee implementation:**
  - Adoption of standards
  - Impact of implemented reforms
  - Promote good supervisory policies and practices
Outline

- The BIS and the Basel Process
- **Ongoing work by global standard setters**
- Some specific challenges
- Final remarks
Ongoing work – FSB (often in coordination with standard-setting bodies)

- Major project: assess overall impact of the reforms
- Also continue work on:
  - Resolution
    - Focus on CCPs and G-SIIs
    - Monitor implementation of G-SIB standard
  - Fintech/cyber-risk
  - Correspondent banking
  - Misconduct risks
  - Market-based finance
  - Climate-related financial disclosures
Ongoing work – BCBS

- **Key goal: finalising Basel III**
  - Standardised approaches for credit risk and operational risk
  - Leverage ratio surcharge for G-SIBs
  - Constraints on IRB banks (treatment of specific portfolios, input/output floors)

- **Other key policy initiatives:**
  - Treatment of sovereign exposures
  - Simplifying the market risk rules
  - Fintech and cyber-risk

- **And intensify work on implementation**
# Ongoing work – IAIS and CPMI

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<thead>
<tr>
<th>IAIS</th>
<th>CPMI</th>
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<tr>
<td><strong>Global insurance capital standards (ICS):</strong>&lt;br&gt;- Version 1.0 for extended field testing (2017)&lt;br&gt;- Version 2.0 for implementation (2019)&lt;br&gt;- Gradual implementation from 2020&lt;br&gt;- Implementation of higher loss absorbency (HLA) requirement in addition to ICS Version 2.0 for G-SIIs from 2022</td>
<td><strong>Continue monitoring of the implementation of the Principles for Financial Market Infrastructures (PFMI) (together with IOSCO)</strong></td>
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<td><strong>G-SIIs policy framework – working on:</strong>&lt;br&gt;- G-SII assessment methodology and designation&lt;br&gt;- G-SII policy measures&lt;br&gt;- Activities-based assessment (ABA)</td>
<td><strong>Other work areas:</strong>&lt;br&gt;- Improvements in the security of wholesale payments&lt;br&gt;- Supervisory stress tests for central counterparties (together with IOSCO)&lt;br&gt;- Correspondent banking and the use of innovative technology (ie digital currencies and DLT)</td>
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- The BIS and the Basel Process
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Some specific challenges

1. Ex post impact assessment of G20 financial regulatory reforms
2. Non-performing loans (NPLs)
3. Proportionality in regulation
4. Fintech
5. Resolution
6. Other priority areas: cyber-risk, shadow banking, correspondent banking
1. Ex post impact assessment of G20 financial regulatory reforms

- **FSB Framework for post-implementation evaluation of the effects of the G20 financial regulatory reforms**
  - Framework presented at the G20 Leaders meeting (July 2017), prepared by the FSB with SSBs
- **Questions the framework covers:**
  - Are financial regulatory reforms achieving their intended outcome?
  - Are they working together as intended?
  - Are there any unintended consequences?
1. Ex post impact assessment of G20 financial regulatory reforms (cont)

- **Preliminary plan:**
  - Review incentives for central clearing of OTC derivatives
  - Evaluate impact on infrastructure investment
  - Evaluate impact on financial intermediation by source

- **Likely focus of future work:**
  - Credit availability
  - Impact on capital market liquidity

- **Starting point: no clear evidence of significant adverse consequences**
  - On credit
    - Cost of credit is low (FSB (2017c))
    - Positive impact on output and employment, little effect on credit volumes (FSB (2015a, 2017c))
    - Only small businesses with poor credit record seem to be affected (Federal Reserve Banks (2017))
  - On market liquidity (eg Anderson et al (2015), CGFS (2017))
    - Inventories are now smaller
    - Liquidity conditions vary across markets and indicators (repo markets seem to be affected)
    - Relation with regulation (eg leverage ratio) still to be proven
    - No flash crashes on dealer-based markets (such as corporate debt)
    - Difficult to assess how liquidity will change in stressed conditions
2. Non-performing loans (NPLs)

- Relevant issue in several jurisdictions (mostly but not exclusively in Europe)
- Recent guidance by BCBS (2017a) and ECB (2017) for SSM banks are very timely
- FSI Insights (forthcoming) shows quite heterogeneous practices across jurisdictions
  - Definitions of NPAs and forborne exposures
  - Asset classification system
  - Consideration of collateral for classification and provisioning; collateral valuation requirements
  - Provisioning requirements

- On provisioning requirements, prudential backstops have been used in Asia and are now being considered in the SSM (FSI Insights, forthcoming)
- Baudino and Yun (FSI Insights, 2017) analyse different NPL resolution tools and strategies, stressing the importance of the economic and legal framework
## 2. Non-performing loans (NPLs) (cont)

### NPL resolutions in selected jurisdictions (main resolution instruments)

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<th>Crisis episode</th>
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<th>Main NPL resolution instruments</th>
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3. Proportionality in regulation

- Under review in several jurisdictions (notably, EU and US)
- Complexity in regulation (in particular disclosures, market risk, remuneration, counterparty credit risk, liquidity framework)
  - Has led to a higher administrative burden for banks
  - Small banks may bear disproportionate costs
- Critical preconditions
  - Ensure application does not affect financial resilience
  - Minimise competitive distortions
- Two broad approaches in practice (Castro Carvalho et al (FSI Insights, 2017)), both offering merits
  - Categorisation approach (CAP): BR, JP, CH
  - Specific standard approach (SSAP): EU, HK, US
- Going forward
  - Careful calibration needed in applying proportionality
  - Compensate simplicity possibly with additional stringency
4. Fintech

- Relevant contributions by BCBS (2017b) and FSB (2017b)
  - Balance risk monitoring with promoting sound innovations
  - Monitor technology-related risks: eg cyber-risk, outsourcing risk
  - Need for cross-sectoral (consumer protection, data protection, AML) and cross-border cooperation, as well as cooperation with the private sector (innovation hubs, regulatory sandboxes)
  - Adjust supervisory resources: new technologies, new required expertise

- So far, cautious approach by regulators
  - Fintech generates efficiency gains (eg DLT for securities settlement, regtech, cloud computing)
  - Fintech also mitigates some risks (eg big data for credit assessment, DLT to reduce credit or counterparty risk)
  - Do not see significant financial stability concerns
5. Resolution

- **Recent developments**
  - *Guidance on Central Counterparty Resolution and Resolution Planning* (FSB, 2017e)
  - G-SIBs are implementing the TLAC standard – expect them to be ready to meet the January 2019 implementation deadline

- **Some concerns remain**
  - Slow progress in resolution planning for G-SIIs
  - More progress needed on cross-border resolution
  - Uneven implementation of the Key Attributes across jurisdictions and sectors: bail-in tool is available only in few jurisdictions
  - Ongoing debate in US on DFA’s Title 2 (Orderly Liquidation Authority), particularly on the use of public funds under the Orderly Liquidation Fund regulation
  - Key implementation challenges in the EU: liquidity support for banks under resolution (Popular), compatibility with domestic insolvency regimes (Venetian banks)
6. Other priority areas

- **Cyber-risk**
  - Recent developments: CPMI and IOSCO (2016) for FMIs, IAIS (2016) for insurance sector; FSB to publish stocktake on regulatory approaches
  - Main issues (Crisanto and Prenio (FSI Insights, 2017)):
    - Degree of specificity and prescriptiveness of regulation
    - Development of “intelligence-led” and “threat-informed” mechanisms

- **Shadow banking**
  - Recent developments: FSB (2017c) – toxic activities have shrunk; FSB (2017a) – policy recommendations for asset management activities
  - Continue monitoring collective investment schemes (in particular their liquidity transformation potential)

- **Correspondent banking**
  - Recent developments: FSB (2017d) – continued decrease in correspondent banking relationships
  - Continue developing four-point action plan (FSB (2015b)), in particular:
    - Continue clarifying regulatory expectations with respect to AML requirements
    - Continue supporting capacity-building in affected jurisdictions
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- **Response to the risks that emerged during the GFC**: post-crisis regulatory reforms almost completed, at least for banks, but...

- **Reform fatigue**: there is a risk of missing out on completion and implementation; this could trigger a pernicious fragmentation of the financial system

- **Shift in focus**: from standard setting to implementation

- **New risks**: need to continue monitoring for re-emergence of concerns in familiar areas of risk (capital, liquidity, risk transformation), but also new areas (e.g., new technologies). Also monitor impact of high indebtedness, overcapacity in some jurisdictions and potential for regulatory arbitrage.
References

- Castro Carvalho, A, S Hohl, R Raskopf and S Ruhnau (2017): “Proportionality in banking regulation: a cross-country comparison”, FSI Insights on policy implementation, no 1, August.
- _____ (2015b): Report to the G20 on actions taken to assess and address the decline in correspondent banking, November.
- _____ (2017c): FSB Chair’s letter to G20 Leaders – building a safer, simpler and fairer financial system, July.
- International Association of Insurance Supervisors (2016): Issues paper on cyber risk to the insurance sector, August.