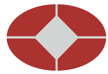

Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Levelling the playing field or: How I learned to stop worrying about market fragmentation and love global regulatory cooperation

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ASIFMA virtual event: "Best foot forward: managing regulation-driven market fragmentation in Asia"

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Introduction

Good afternoon, and thank you for inviting me to speak at this virtual event on market fragmentation.

The topic of cross-border market fragmentation – which, for the purpose of my remarks today, I define somewhat narrowly as divergences in bank prudential regulation along geographical lines – has received much attention over the past few years. In 2018, G20 Leaders stressed that "an open and resilient financial system, grounded in agreed international standards, is crucial to support sustainable growth" and that they would "address fragmentation" through "continued regulatory and supervisory cooperation".[1] To that end, the global standard-setting bodies and the Financial Stability Board (FSB) explored issues around market fragmentation the subsequent year, the findings of which were published in a report.[2] Covid-19 has further brought to the fore issues related to market fragmentation as jurisdictions pursued regulatory and supervisory measures to mitigate domestic financial stability risks.[3]

Yet discussions about market fragmentation can sometimes take too much of a "glass half empty" perspective. Put simply, if somewhat crudely, proponents of this viewpoint assert that internationally active banks and the provision of critical cross-border banking services are impeded by a patchwork of disjointed national regulatory frameworks, with detrimental implications for global financial stability. They laud the importance of a global regulatory level playing field, yet are often also convinced that they need to be "adapted" to reflect the "unique" characteristics of their domestic markets. Call it a form of regulatory NIMBYism.

I think there is a more positive story to tell, which will form the basis of my remarks today. To be clear, market fragmentation is an important topic that warrants attention: a "free-for-all" autarkic approach to prudential regulation would clearly have adverse effects on the resilience of the global financial system and hinder the robustness of capital flows. But we are thankfully far from such a world, and I will focus on the immense progress made in global regulatory cooperation over the past decade. Indeed, the extent of such cooperation has far eclipsed any concerns about market fragmentation recently (Figure 1). Call it a "glass half full", or even a "nearly full" perspective. There is certainly always scope for even closer supervisory cooperation and regulatory consistency. But such cooperation can at times be frustrated by calls to deviate from global standards at the domestic or regional level, which are perhaps the most

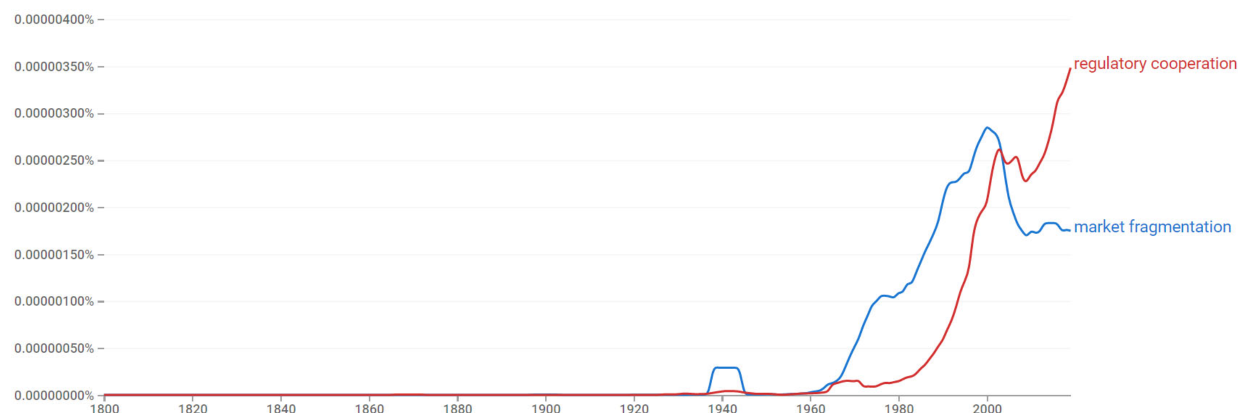
[1] G20 (2018).

[2] FSB (2019).

[3] FSB (2020).

nefarious source of fragmentation undermining global financial stability. I'll end by saying a few words about how the Basel framework and regulatory cooperation have fared thus far during the pandemic.

Figure 1: References to "market fragmentation" and "regulatory cooperation" in books[(a)]



Source: Google.
(a) Chart shows the percentage of all books written in English from 1800 to 2019 in Google Books that refer to the terms "regulatory cooperation" and "market fragmentation".

The remarkable resilience of global regulatory cooperation

One of the constants over the past 15 eventful years in finance has been the close and effective cooperation among Basel Committee members. When the world was grappling with the Great Financial Crisis (GFC) of 2007-09 and its aftermath, central banks and supervisory authorities quickly came together and agreed on a comprehensive strategy to address the shortcomings in the banking system.[4] While individual jurisdictions were rightly focused on safeguarding their banking systems – recall Mervyn King's observation that "most large complex financial institutions are global – at least in life if not in death" – these same authorities were furiously cooperating to enhance global financial stability and set the foundation for robust international regulatory standards.

In a record-beating period of just over a year, the Committee issued its first set of proposals to revamp the regulatory framework, which set the foundation for what is now referred to as Basel III.[5] These standards form the bedrock of the global community's response to the GFC.[6] G20 Leaders have subsequently repeatedly reaffirmed their commitment to ongoing regulatory cooperation and to implementing Basel III in a full, timely and consistent manner.

The Committee hasn't looked back since when it comes to global cooperation. When the merits of multilateralism were being questioned against a backdrop of growing populism, we retained a steadfast commitment to pursuing the Basel III reforms and maintaining a close and constructive supervisory dialogue. While some voices started to question the role and importance of international organisations,

[4] BCBS (2008).

[5] BCBS (2009a,b).

[6] Borio et al (2020).

the Committee confounded some doubters and completed the full set of Basel III reforms in 2017.[7] Time and again, the Committee has shown its ability to work collectively in a timely manner to strengthen the resilience of the global banking system.

Our track record of effective and close cooperation is not due to serendipity, but reflects one of our core principles.[8] Financial stability is a global public good. The cross-border spillovers of financial distress can result in an underinvestment in financial stability by individual jurisdictions. So an open global financial system requires a global baseline of prudential standards. Just like how monetary policy may face a "macroeconomic trilemma", one can think of a "financial trilemma", whereby any two of global financial stability, financial integration and national financial policies can be achieved, but not all three.[9] Global regulatory cooperation is therefore an imperative as long as we value the first two of those objectives.

The degree of regulatory convergence in banking – by means of a minimum level playing field for internationally active banks thanks to the Basel framework – is even more remarkable when compared with other industries. The number of non-tariff measures (NTMs), which include differences in regulations, has risen significantly over the past few years.[10] Sectors such as agriculture, textiles, machinery and electrical equipment have become more protected over time as a result of NTMs.[11] And, as we are seeing during this pandemic, the approval and distribution of Covid-19 vaccines is subject to different national and regional health regulations. Far too often this relative context is missed in the debate around bank regulatory fragmentation.

But global cooperation need not mean global harmonisation in bank prudential regulations. As you know, the Basel framework comprises a set of minimum standards for internationally active banks in member jurisdictions. Members are free – and encouraged – to apply additional standards to reflect additional risk characteristics of their banking system. Indeed, it would be somewhat odd to expect a jurisdiction with a banking system that is several multiples of its GDP in size to have the exact same risk tolerance as a jurisdiction with a much smaller banking system. Moreover, jurisdictions are free to adopt a proportionate regulatory framework and adopt standards for other banks that are broadly consistent with the principles of the applicable Basel standards.[12]

So the prudential regulatory framework will, and should, comprise three broad elements: minimum global standards, ongoing supervisory cooperation, and domestic "add-ons" that are motivated by financial stability concerns. Indeed, recent research suggests that it is unlikely that no (ie zero) fragmentation corresponds to the highest degree of financial stability.[13] In my view, market fragmentation can undermine the robustness of this framework primarily by weakening the foundation of global standards.

[7] BCBS (2017).

[8] Hernández de Cos (2019a).

[9] Schoenmaker (2011).

[10] UNCTAD (2019).

[11] Gunessee et al (2018).

[12] BCBS (2019).

[13] Claessens (2019).

From Basel to home: the rise of fragmentation

From both my current perspective as Secretary General and former perspective as a Basel Committee member, a recurring source of fragmentation arises as a result of the domestic transposition of global standards.

Put simply, the implementation of global standards is far too often treated as a two-legged football game. After the first "away" game in Basel, a second "home" game takes place, where banks and trade associations actively seek to reopen elements of the global framework. A litany of arguments are put forward as to the imperative need to take into account the idiosyncrasies of a bank's business model or the structure of a domestic financial product or market. This second leg, perhaps with the added "home advantage" benefit, has resulted in cases where the national implementation of Basel III has not been fully compliant with the Basel framework.[14]

This source of market fragmentation is particularly surprising for three reasons. First, as I mentioned earlier, the Basel framework is designed and calibrated to serve as a minimum level playing field. We seek to find a common baseline that already reflects jurisdictional heterogeneity. In finalising our standards, the Committee conducts a wide range of empirical analysis to quantify the impact on banks across our member jurisdictions.

Second, the Committee has a comprehensive and transparent approach to consulting with a wide range of stakeholders when designing its standards.[15] This approach was recently described as "one of the most procedurally sophisticated" processes among standard-setting bodies and international forums.[16] Since 2007, the Committee has consulted no fewer than 110 times on a wide range of standards. The Committee places great weight in reviewing and discussing the inputs it receives during these consultations. Our finalised standards are often a compromise to reflect differences in views across our members and the outcome of our extensive consultation and empirical analyses.

Third, deviations from these global standards are sometimes cited as having a fragmentary effect by market participants themselves.[17] Put differently, attempts to apply a "bespoke" adoption of international standards can have a detrimental impact if the resilience of a domestic banking system is called into question as a result of non-compliance with global agreements.

In short, global regulatory standards are a compromise that already seeks to reflect differences across regions, jurisdictions and banking models. They are designed to serve as a minimum level playing field. And the views of stakeholders are actively sought during the design phase at the global level.

Covid-19, regulatory cooperation and future initiatives

Let me end by saying a few words about the role of regulatory cooperation during the pandemic and over the coming years.

Since the outbreak of Covid-19, the Committee has continued to demonstrate its unwavering commitment to cooperation. We have met (virtually) no fewer than 24 times over the past year. The

[14] BCBS (2020c).

[15] Hernández de Cos (2019b).

[16] Viterbo (2019).

[17] FSB (2019).

Committee quickly adopted a set of measures in March and April last year to respond to the pandemic.[18] And the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed the Committee's decision to defer the implementation of the outstanding Basel III standards by one year.[19] Importantly, all GHOS members unanimously reaffirmed their expectation of full, timely and consistent implementation of all Basel III standards based on the revised timeline.

As the Chairman of the Basel Committee noted: "History has shown that collective measures to tackle global problems reinforce individual countries' efforts. This time is not different: ongoing global cooperation is key to ensuring a safe banking system that supports the economic recovery. Combatting infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries."[20] More recently, the GHOS has further underlined the need to "preserve a global level playing field and to avoid regulatory fragmentation".[21] To that end, the Committee is actively monitoring the implementation of temporary adjustments by our members to mitigate current risks to their banking system, with a view to ensuring that they are consistent with the objectives of the Basel framework and are unwound in a timely manner.

More generally, Committee members are closely cooperating in monitoring the risks and vulnerabilities to global banking system as the crisis continues to unfold. Importantly, banks now have tools in their hands to navigate the choppy waters and ensure that they do not become part of the problem. Most notably, the Basel III capital and liquidity buffers are a powerful lever for banks to absorb shocks and maintain lending. Since the start of this crisis, the Committee has publicly reiterated its position that a measured drawdown of buffers to meet these objectives is appropriate, and that supervisors will allow sufficient time for banks to restore these buffers.[22]

Looking ahead, regulatory cooperation will continue to be critical to address the global challenges posed by topics such as climate-related financial risks, cyber risk and operational resilience, and the digitalisation of finance. Given the cross-sectoral nature of many of these issues, this cooperation will need to broadened even further and involve a wide range of public authorities and stakeholders. To give just one example, regulatory and supervisory measures to mitigate climate-related financial risks need to draw on inputs from a wide range of stakeholders, including governmental authorities, accounting and auditing standard setters, private sector initiatives and the general public. The Committee is actively engaged in such discussions, and will continue our relentless focus on enhancing the resilience of the banking system through close and effective cooperation.

[18] Hernández de Cos (2020).

[19] BCBS (2020a).

[20] Hernández de Cos (2020).

[21] BCBS (2020d).

[22] BCBS (2020b).

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