Columbia Business School
Center on Japanese Economy and Business

CENTER ON JAPANESE ECONOMY AND BUSINESS

日本経済経営研究所

Working Paper Series

June 2017, No. 359

A New Governance Framework for Global Financial Regulation?

Masamichi Kono

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK

Draft

April 3, 2017

A new governance framework for global financial regulation?

Masamichi Kono

Adjunct Research Scholar, SIPA[1]

Abstract

Nearly ten years since the outbreak of the global financial crisis, it is high time to take stock of the progress made in terms of global financial regulatory reform and to assess the overall, cumulative effects of reform. This article, after providing a brief overview of the history of post-crisis reform, presents a set of principles to be followed in regulatory reform for the financial sector, going forward. It puts forward some ideas for improving the organizational structure and governance of the global regulatory reform process, stressing the importance of global standards as developed by standard-setting bodies such as the Basel Committee, IOSCO and IAIS, with the G20/FSB leading and coordinating the process. It goes on to suggest providing a stronger legal foundation for the entire process by making use of a treaty-based regulatory framework, while retaining sufficient flexibility at the national level. It proposes to achieve this goal by combining a principles-based legal framework with a set of technical standards that supplement and augment the principles, and provides some practical ideas to facilitate international agreement in the current political environment.

---

[1] Any views expressed in this article are strictly personal, and not attributable to any institution or organization with which the author is or was associated. The author is former Vice Minister for International Affairs at the Financial Services Agency of Japan. He was a member of the Financial Stability Board (FSB) from July 2009 to June 2016.

1. Introduction and main conclusions

Almost ten years after the global financial crisis began to unfold, the design phase of global financial regulatory reform is close to completion, and the various reform measures have been entering the implementation stage.[2] The G20/FSB (Financial Stability Board) process has enabled a very large number of reform measures to be agreed internationally in a relatively short time span.

In terms of designing the framework of global financial regulation after the most recent global financial crisis, the glass may be more than half full by now. A huge number of relevant international standards and their methodologies or guidance documents have been issued.[3] However, as the regulatory reform process entered the stage of implementation, various issues have surfaced, particularly in the cross-border context.

While it is fair to state that this has been a major achievement of the G20/FSB process, it now appears that inconsistencies, duplications and gaps in regulation are appearing among major financial market jurisdictions.[4] As we enter the implementation stage, such inconsistencies, duplications and gaps are starting to have significant effects on financial institutions and markets. In this sense, actual implementation of the reform measures may still be in a state of a glass half-empty.

As the details of some agreed reform measures are only now being issued, and adjustments are still being made, this may be the right moment to review the governance framework over the entire process of international standard-setting in financial regulation.

---

[2] The term "financial regulatory reform" is used in this article to broadly cover any new measures or revisions made to existing laws and regulations that are applicable to financial institutions and market transactions in jurisdictions, and introduced in the aftermath of the global financial crisis. As such, they include changes in regulatory and supervisory arrangements and practices that are introduced as measures to implement international standards, or as changes in national policies, but they do not include individual supervisory actions or specific cases of enforcement action.

[3] The definition of international standards heretofore follow the Financial Stability Board's definition: good principles, practices, or guidelines in a given area that are internationally and widely accepted as important for sound, stable and well-functioning financial systems. See "The Compendium of Standards", Financial Stability Board (FSB), compiled in the FSB's homepage (http://www.fsb.org).

[4] No attempt is made here to define the term "major financial market jurisdiction" here, but the G20/FSB member jurisdictions (including non-G20 members such as Hong Kong, Singapore, Spain and Switzerland) would normally qualify as such.

Recently, particularly in the US, calls have been made to halt the process of negotiating new regulatory measures at the international level[5], or to combine new regulation with measures to deregulate.[6] The outcome of such deliberations remains to be seen, and concerns have been expressed by some that too much deregulation could be counter-productive[7]. However, this may have been motivated by a certain dissatisfaction among stakeholders with the existing G20/FSB governance framework for agreeing and implementing financial regulatory standards.

It is a fact that, in the aftermath of the global financial crisis, the G20/FSB process was the main driver for carrying forward a very large number of regulatory reform measures through the development or review of international standards, which were then transposed into domestic regulation of the member jurisdictions.

While the over-arching objective of regulatory reform has always been to make the global financial safer and more resilient, and avoid the recurrence of future crises, keeping the system open, transparent, and dynamic is critical for enabling the financial system to provide adequate finance that supports sustainable growth and development.

The leaders and officials present at the G20/FSB meetings to discuss financial regulatory reform have always been conscious of this ultimate objective of supporting growth and

---

[5] See, for example, the letter addressed to FRB Chair Janet Yellen from Patrick McHenry, Vice-Chairman of the Financial Services Committee, US House of Representatives, January 31, 2017.

[6] See the US Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs, January 30, 2017, Sec. 2. It proclaims a regulatory cap for fiscal year 2017 in the form of: whenever an executive department or agency publicly proposes for notice and comment or otherwise promulgates a new regulation, it shall identify at least two existing regulations to be repealed.

[7] See, for example, the policy statement issued by the Systemic Risk Council (SRC), a private sector, non-partisan body of former government officials and financial and legal experts, "To the Ministers, Governors, Chief Financial regulators, and legislative Committee Leaders of the G20 Countries", March 1, 2017. While this author does not agree with all of the specific recommendations of the letter, many of the concerns expressed against diluting the main pillars of the reform program for system stability appear legitimate and on the whole valid. It is also noted that the same letter states, "None of this is to say that the original financial stability reform program was right in every respect…A review of the details, nationally and internationally, could make sense. It also states, "The SRC does not wish to be understood as saying or implying that everything in the global reform program is as it should be". It is, however, somewhat disconcerting where the letter states, particularly the line which states, "now is not the moment to bow to financial industry lobbyists or to short-term temptations", as such labelling could prevent a neutral discussion of the optimal level and content of regulation in jurisdictions.

development. However, particularly in the immediate aftermath of the crisis, the G20/FSB had its focus on financial stability by making financial institutions and markets more resilient by raising prudential standards and restricting excessive risk-taking.

When international regulatory standards were agreed and adopted by the standard-setting bodies (SSBs, such as the Basel Committee on banking supervision (BCBS), International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS)), they were considered to be *minimum* standards, and the tendency was to initially present drafts for public consultation which were stricter or tighter than what could have appeared to be the expected final outcome.

Subsequently, through sometimes long and heated discussions among regulators and consultations with stakeholders, they were adjusted to accommodate the needs of businesses and, in the views of some, "watered down"[8]. The end result would not have been too far off the mark in terms of striking the right balance between ensuring financial stability and supporting growth finance, but a question remained as to whether this process adequately took into account the views and opinions of "honest" or *bona fide* market participants fairly, or tended to be biased towards tougher regulation. Compromises were often made around the median point whenever there was a wide range of different views around the table.

The G20/FSB process was sometimes criticized by the public, and by members of the legislative branch as being too opaque or secretive[9]; while such criticism may have been sometimes unfair or misguided[10], the root cause for such criticism may lie in certain weaknesses in the existing governance framework of the process.

To ensure that regulatory reform measures are indeed appropriately designed and implemented for achieving those objectives, implementation monitoring is critically

---

[8] It was unfortunate that adjusting regulation to reasonable levels as a result of public consultation was often seen as favoring the industry, and thereby despised or dismissed as being too "soft". A healthier debate would be to adjust draft standards based on an objective quantitative impact study (QIS), and thereby balance the pros and cons of revising existing regulation to arrive at the optimal point.

[9] See the letter cited in footnote 3 above.

[10] There have been accusations of the process being "undemocratic", but the FSB Charter stipulates that decisions shall be taken by consensus (Article 7 (2)) of member authorities, for example.

important. The G20/FSB implementation monitoring process[11] can be enhanced and complimented by an objective review and feedback process.

Even if the design of the standards and rules in conformity with those standards are largely optimal, there is the question of how they are implemented. In implementing the agreed reforms. There is a need to ensure that any unintended consequences of reform do not unduly undermine or restrict the ability of the financial system to provide adequate finance for growth and development. Also, if the cumulative effect of reform measures become punitive or too onerous for financial institutions and market participants, adjustments should be made to the measures, as much as possible ahead of their implementation.

In this regard, assessments of the effects of reform has already started at international regulatory bodies such as the FSB (Financial Stability Board) and the BCBS (Basel Committee on Banking Supervision).[12] The G20/FSB has started a process of monitoring the implementation of post-crisis reforms, and the evaluation of their effects and effectiveness. However, these are essentially *ex post* self-assessments of the effects of reforms undertaken by the G20/FSB and the SSBs themselves, and therefore there is a very high hurdle for reviewing the agreed reforms and making adjustments as a result of the assessment. One may argue that such assessments may suffer from a lack of impartiality and from considerable delays in making necessary adjustments. This also contrasts with increasingly standard practice in many jurisdictions to conduct cost-benefit analyses of new regulatory measures before their implementation.

Some re-designing or adjustment may become necessary or desirable where the cumulative effects of reform appear excessive or distortive, and/or where unintended consequences become apparent.

There may certainly be situations in which problems start to occur ahead of implementation, due to pre-emptive behavior of the regulated entities/markets. In such cases, an effective implementation monitoring process should start functioning from the preparatory phase. Since many of the measures are still being phased-in, or are being finalized, more time and effort are needed before a comprehensive assessment can be

[11] See “Implementation and Effects of the G20 Financial Regulatory Reforms,” 31 August 2016, FSB, Second Annual Report.
[12] See *idem*. In footnote 10 above.

made, and a well-informed judgment can be made on any possible adjustment. Better feedback from the assessments, which will lead to adjustments, if necessary, can be assured by a properly functioning governance framework.

Recent shifts in public opinion are driving changes in the political steering and management of financial regulators of major countries, as well as potential changes in the regulatory framework in Europe to be caused by BREXIT appear to create considerable uncertainty in the near time to the global regulatory environment for financial institutions and markets.

Leaders and officials taking part in the G20/FSB process have always felt strong public pressure first to contain the crisis and then to pursue vigorous regulatory reform in its aftermath. The G20 Leaders' Communiques have always proclaimed the resolve and commitment of the G20 in agreeing and implementing the reform measures in a full, consistent and timely manner. Ten years after the most recent global financial crisis erupted, there is now a certain shift in such pressure.

While public anger against the behavior of bankers and other employees of the financial industry still exists, due in particular to some egregious cases of misconduct by some players, resulting in a generally negative sentiment against the financial industry, a near unanimous call for tougher financial regulation has recently been replaced by more emphasis on calls to enhance growth finance, and to increase bank lending.

Now, there seems to be an emerging sense that the post-crisis regulatory reform process could have resulted in an over-regulation of the financial industry and markets. The pendulum may have swung too far in the opposite direction, as opposed to under-regulation or "light touch" regulation just before the crisis.

One factor behind such shifts in sentiment could have been a regulatory reform process that had, in the eyes of the public, become too hasty, too piecemeal, and too burdensome for businesses as well as consumers. The internationally agreed standards and the processes for development of those standards could have become too complex, too prescriptive, and too rigid or one-size-fits-all. For non-experts in particular, the resulting regulation and supervisory arrangements could have become exceedingly enigmatic and opaque.

National interests have always influenced negotiations over internationally agreed standards of financial regulation, but they have become more conspicuous in the standard-setting process, sometimes preventing agreement within the committed timeframe.[13]

Disagreements have always appeared in discussions of regulatory standards, but public display of discords was normally avoided, and when deadlines were missed, a new deadline was indicated. There now seems to be a departure from such practice, leading to higher uncertainty in the regulatory environment in the near term. Unless the domestic political environment in the major financial market jurisdictions improve towards generating support for international standards and regulatory (and supervisory) cooperation, the existing G20/FSB framework could face severe headwinds, going forward.

In the domain of financial regulation, internationally agreed standards were generally considered as *minimum standards* applicable to internationally active financial institutions and to cross-border activities/transactions. As discussed below, a proliferation of national rules has become a serious issue lately, with the result that compliance with international standards do not necessarily guarantee international consistency or convergence of rules applicable across different jurisdictions. There may therefore be a need to apply certain understandings to prevent cases in which national rules that supersede the agreed international standards do not undermine the significance of those international standards as global regulatory benchmarks.

With some hindsight, the timeline for implementation of those standards has been unrealistic in some instances, and had to be reset after lengthy negotiations.[14] This

---

[13] The recent postponement of a meeting of the GHOS (BIS Governors and Heads of Supervision) which oversees the (BCBS) Basel Committee on Banking Supervision) is reported to be a result of a clash of views over an element of bank capital standards with direct implications for the required minimum level of regulatory capital between the US and European members. (See, for example, Financial Times newspaper, 4 January, 2017.) The Basel Committee did not reach final agreement in its March 2017 meeting. (See the press release, “The Chairman of the Basel Committee reaffirms commitment to finalize post-crisis Basel III reforms”, March 2, 2017.) Nevertheless, the G20 Finance Ministers and Central Bank Governors stated on March 17-18: “We confirm our support for the Basel Committee on Banking Supervision’s (BCBS) work to finalize the Basel III framework without further significantly increasing overall capital requirements across the banking sector, while promoting a level playing field”, without giving a specific deadline for final agreement.

[14] One example is the G20 deadline for OTC derivatives market reform, which was initially set for end-2012 at the G20 Pittsburg Summit of November 2010, but had to be delayed

created significant uncertainty over the content and timing of the applicable measures in the financial markets. The process for developing international standards has become very resource-consuming, and burdensome for regulators as well.[15]

One of the major reasons for such discrepancy may have been the complex, lengthy, and unpredictable rule-making processes of major jurisdictions. Furthermore, this was exacerbated by the fragmented organizational structure of regulatory (and supervisory) authorities/agencies of the major jurisdictions. In the US, even the G20 Leader (=the President) did not have full legal authority to guide the policies of the numerous regulatory agencies such as the FRB, SEC, and CFTC, for example. In the EU, there is a system of mixed competence, whereby, the ECB and the European regulatory agencies (The European Supervisory Authorities (ESAs), namely the EBA, ESMA, and EIOPA) would often need to confer and coordinate with national central banks and regulatory agencies in each EU Member State in developing and implementing financial regulation. In such cases, the G20 Leaders applied political pressure and moral suasion, but could not always dictate the results.

Conclusive evidence of market fragmentation, and more broadly, that on any unintended negative effects of regulatory reform is hard to obtain.[16] However, it seems clear under the current economic, financial and political environment that, a growing fragmentation of global financial systems and markets is becoming an imminent and growing risk. Regulatory reform efforts appear to be exacerbating this risk in some cases.[17]

---

subsequently. The implementation of margin requirements for non-centrally-cleared OTC derivatives transactions had to be extended twice, due to a need to secure more time for preparation on the part of market participants. Subsequently, the Board of IOSCO issued a statement on February 23, 2017, calling on members of IOSCO consider taking appropriate measures to ensure fair and orderly markets during the introduction and application of variation margin requirements from March 1st, due to delays in preparation of some market participants. See “Statement on Variation Margin Implementation”, Board of IOSCO, February 23, 2017. Also see, for example, “Variation Margin Exchange under the EMIR RTS on OTC Derivatives”, February 23, 2017.

[15] Some regulators have cautioned against a proliferation of regulation having its own momentum in contradiction to the G20 Leaders’ collective intent. See, for example, the speech by Nobuchika Mori, Commissioner of the Financial Services Agency of Japan (JFSA), October13, 2015.

[16] See, for example, Tobias Adrian, Michael Fleming, Or Shachar, and Erik Vogt, “Market Liquidity after the Financial Crisis”, Federal Reserve Bank of New York, Staff Reports, No. 796, October 2016, Revised January 2017.

[17] Figures compiled for international capital flows at the Bank for International Settlements (BIS) show recent declines in cross-border capital flows.

In the face of such uncertainties, it is reported that financial institutions often responded by exiting from non-core activities or less-profitable businesses. Markets allegedly responded by regulatory arbitrage and/or avoidance, resulting in less liquidity or more volatility in certain markets, for example.[18]

To the extent that cross-border consistency and avoidance of regulatory distortions and arbitrage are essential for a globalized financial system/market, a regulatory reform process that is increasingly disintegrated, less transparent, and more divergent across jurisdictions would not be appropriate, and most likely not be sustainable in the longer run.

Inadequate coordination and information sharing between different regulators both within a jurisdiction and across jurisdictions has also been an issue, leading to suboptimal implementation and inconsistencies of regulations across markets and between multiple jurisdictions. It seems increasingly important to try to address those apparent deficiencies of the current governance framework as early on as possible.

The importance of supervision must not be understated. Due to the nature of micro-prudential supervision, and to safeguard the independence of the supervisor against possible conflicts of interests, the G20/FSB framework has been less prescriptive as regards supervision, indicating guidance or best practices for effective supervision, and fostering and strengthening close coordination and cooperation between supervisory authorities.

In the exercise of micro-prudential supervision on a day-to-day basis, bilateral (including small-group) and case-by-case cooperation is still the norm, and it should remain so in the foreseeable future.

In the aftermath of past crises, more intrusive supervision including requirements for rigorous periodic stress-tests combined with supervisory authority over dividend payouts/executive compensation/share buy-backs had considerable effects on bank behavior and business strategies. They may also have been major sources of pro-

[18] As previously mentioned, hard evidence of regulatory reform bringing about volatility or other anomalies in financial markets is hard to obtain. Anecdotal accounts are, however, abundant, for example in the case of OTC derivatives markets in which regulatory divisions have more or less led non-US market participants to divide transactions with US persons and those with non-US persons into two separate markets.

cyclicality, putting pressure on banks to be risk-averse in cyclical downturns. However, apart from indicating guidance or best-practice principles, international standards have maintained a relatively reserved stance towards the day-to-day operations of supervisors.

By nature, international standards could not do much more than provide guidance or present best practices in effective supervision, when adopting a principles-based approach. While this should remain so in the foreseeable future, the development of international standards for effective supervision should be placed under the same level of governance as international regulatory standards. This is because the legal authority to exercise supervision over financial institutions and markets is derived from the laws and regulations of the jurisdiction, and the supervisors are required to exercise their authority in conformity with those laws and regulations. When international supervisory standards provide guidance and best practices, they cannot supersede nor override the contours of the domestic laws and regulations.

Another aspect is that for supervisors to exercise their authority in conformity with international standards, they need to procure sufficient supervisory resources, in the form of a budget and required personnel. In jurisdictions, those resources are allocated by the national budget, or their procurement is overseen by the government. It is therefore required that the use of supervisory resources is placed under a governance framework which renders the supervisors accountable and transparent towards the national legislature or government, while maintaining operational independence from undue outside pressures.

It may be noted that, while the intensity of communication between authorities of different jurisdictions increased substantially during and after the crisis out of necessity, cross-border coordination of supervisory actions (or joint action) was generally weak, often missing. By way of international standards, such deficiencies may be remedied to a considerable extent.

Part of the difficulty in international coordination between supervisors could have come from very different political standings of national supervisory authorities, with some authorities more exposed to political pressures and public opinion than others. The governance structure of each supervisory agency mattered a lot in defining their ability to coordinate internationally. Legal constraints to the sharing of supervisory information were prevalent, and sometimes severely constrained the ability of supervisors to coordinate.

Such limits to international coordination among supervisors could be remedied by the formal adoption of well-crafted international standards. Those international standards, however, would need to be developed and implemented through a process overseen by an effective governance framework. Otherwise, the independence of the supervisor, while necessary and appropriate, could prevent it from coordinating with its peers in making themselves comply with the standards.

The lack of a formal coordination mechanism was easier to overcome when global contagion of systemic risk was occurring or was imminent, and when public opinion supported tough actions based on closer coordination between supervisors of different financial institutions and markets. Now, there seems to be a shift in public opinion as the crisis receded, and a need for building a stronger foundation for effective coordination between supervisors going forward.

There also seems to be a growing sense that some of the supervisory actions such as mandatory stress tests and the consequent supervisory actions/guidance could have become excessively intrusive as the immediate impacts of the crisis receded. Conformity with international standards could make them more transparent and accountable.

Even when regulators and supervisors worked in the best interests of the taxpayer, they were sometimes seen as exercising too much power over the business decisions of private financial institutions. To the extent that stress-tests were conducted on the basis of fictive scenarios, they were seen sometimes as overly rigorous or deliberately designed to be harsh on the banks. Basing the supervisory stress tests on internationally agreed standards could make them less prone to shifts in public opinion, and make them more transparent and accountable.

Looking at such issues and the growing pressure to review the post-crisis regulatory reforms, it appears that a more stable, accountable, and transparent governance framework for setting and implementing financial regulatory and supervisory standards across jurisdictions may be called for. Governance arrangements have been formalized and strengthened over the years at the FSB and at the SSBs, but their internal deliberations remain largely undisclosed, and key decisions are normally made by "consensus".[19]

As already mentioned, the G20/FSB deserves credit for enabling a huge number of regulatory reforms agreed internationally and implemented in a relatively short time span. However, some weaknesses in the governance framework over the international standards have surfaced, and the process is now facing headwinds from public opinion in many jurisdictions. The SSBs have no legal authority to enforce the implementation of standards, and they rely on their members to implement the agreed standards.[20]

The fear is that if such weaknesses are not addressed in some form, including starting to design a stronger governance framework at the global level for the future, regulatory divergence and lack of coordination between national regulators (and supervisors) in jurisdictions could exacerbate the already feared fragmentation of financial markets and at the global level.

The inefficiencies and distortions that such fragmentation could entail may not be evident yet, particularly in a relatively benign market environment. However, once external shocks or severe market stress comes about, market liquidity could easily dry up, and a sharp rise in market volatility could result.

One should also bear in mind the non-negligible risk that international banking activity could be significantly reduced, due to increasing regulatory uncertainty, in addition to the already more uncertain economic, social and political environment. Such fragmentation, if materialized, would most surely undermine the ability of financial systems and markets to provide necessary funding and services for the global economy.

Global economic recovery could be hampered by more costly and inefficient financial systems and services. If over-regulation is inflicting undue costs or causing inefficiencies

---

[19] Initially, at the FSB and SSBs, due process and transparency arrangements were informal, not clearly documented nor made public. Minutes of the meetings were not disclosed. Some improvements have been made over the years, but the level of transparency is still relatively low, compared to domestic rule-making processes in the major jurisdictions. Arguably, it was possible to side-step some of those processes in the most demanding times in the aftermath of the global financial crisis because of the urgency of the situation. The term "consensus" was also considered as not synonymous to unanimity, introducing an element of ambiguity in the decision-making of the SSBs.

[20] See, for example, a speech by William Coen, Secretary-General of the Basel Committee made as introductory remarks to the public hearing of the French Senate, February 22, 2017.

not justifiable by the merits of regulation, there is a need to review the existing rules, and to fix them where necessary or appropriate. A proper feedback system is required as an essential part of a governance framework for regulatory reform.

It is often argued that a safer financial system with result in fewer financial crises, and will be much less costly for the real economy over the cycle. To the extent that a financial crisis could inflict heavy losses and damages to economic agents that could not be subsequently recovered in full, the benefits of reduced incidences of crises should be substantial.

However, such long-run benefits are hard to see while the short-term costs are often readily visible. Those who directly bear the costs of tougher regulation and more intrusive supervision will tend to speak out loudly, while the long-term benefits will not have strong advocates apart from academia and the official sector.

The existing G20/FSB framework certainly understood the difficulty in balancing the short-term costs and the longer-term benefits.[21] There is also some empirical work that suggest Basel III reforms should be expected to yield sizable net marginal macroeconomic benefits.[22] However, it was recognized by some work that the reduction in the probability of a financial crisis associated with increasing capital levels will begin to level off at some point, thereby creating diminishing benefits for tighter capital standards. It was also recognized that discussion continued over the right type and levels of capital requirements, and, more generally, over whether the right mix of policies had been applied.[23]

It is therefore not fair to state that the existing G20/FSB processes failed to recognize such issues.[24] However, a more explicit and effective feedback system could make such

---

21 Earlier work by the official sector on the subject includes, “An assessment of the long-term economic impact of stronger capital and liquidity requirements”, BIS, August, 2010.

22 See, for example, Ingo Fender and Ulf Lewrick, “Adding it all up: the macroeconomic impact of Basel III and outstanding reform issues”, BIS Working Papers No.591, November, 2016. There is also work that states the Basel III capital benchmarks are below optimal capital requirements. See, “Benefits and Costs of Higher Capital Requirements for Banks”, William R. Cline, Working Paper WP 16-6, Peterson Institute, March 2016.

23 See, the remarks by FRB Governor Daniel Tarullo, entitled “Financial regulation since the crisis” December 2, 2016. In those remarks, a number of articles are cited such as Jihad Dagher, Giovanni Dell’Ariccia, Luc Laeven, Lev Ratnovski, and Hui Ton, “Benefits and Costs of Bank Capital”, IMF Discussion Note SND/14/04, IMF, March, 2016.

24 The FSB has been developing a consistent and comprehensive framework for evaluating

trade-offs more explicit and accountable.

For such a feedback mechanism to function properly, there is a need to institutionalize, at the international level, a process that considers both the short-term and the longer term to strike the right balance between the true costs and benefits of regulatory reform. It should build on past achievements of regulatory reform, and not start from repealing or discarding existing international standards altogether.

As discussed earlier, the G20/FSB process can be reinforced by a new and stronger governance framework. Revamping the existing framework would be unwise in that the achievements of post-crisis reform up to now could be lost in the process. Even as deregulation or roll-back of regulation and supervision since the crisis may be justified in certain cases, one should not ignore the long-term benefits derived from fewer incidence of financial crisis in the future. The issue therefore should not be one of undoing the post-crisis reforms, but of how to identify areas in which adjustments may be necessary, and to strike the right balance between stronger regulation and de-regulation.

To the extent that trust and confidence are key for financial systems and markets to function properly, deregulation is not always the key to success if it undermines public trust and confidence in the system.

In fact, businesses may find it more difficult to win back the trust of their clients if they lower ethical standards or appear less sound.[25] For example, market liquidity can increase by applying tougher regulation, if confidence is restored and participants are willing to bear the extra cost.

To maintain confidence in the financial system and markets over the longer term, better regulation, or, smart regulation, which combines stronger prudential norms and market

---

the post-implementation effects of the reforms. The framework is due to be published before the G20 Summit in July and will be subject to a consultation. This work underscores the importance the FSB places on effective evaluation and impact assessments to the FSB's policy review process. However, it may be seen as limited in scope, and the timing of evaluation of the effects is limited to post-implementation. It therefore remains to be seen whether this process would lead to actual review of agreed reform measures and standards. See the Press Release, "FSB assesses implementation progress and effects of reforms", 28 February, 2017, FSB. Also see the FSB "Chair's letter to G20 Finance Ministers and Central Bank Governors ahead of their Baden-Baden meeting", March 17, 2017.

[25] This is another reason why longer-term interests are hard to assess, but must also be taken account of in a proper feedback process.

conduct rules with more freedom in terms of market access and strategy must be the key to success.

A simplified theorem often presented[26] is that bank capital regulation should not be eased while structural regulation requiring structural separation of a bank's businesses, such as the Volker rule may be repealed. It is, however, a more delicate question if one takes into consideration the difficulty of appropriately calibrating bank capital rules, or of designing exemptions for certain activities such as market-making from rules requiring separation of businesses.

It is far from evident whether a compromise agreement between regulators would achieve the optimal level/degree of regulation. If the repeal of a certain rule undermines public confidence in the system, or if the consumer cannot be certain that the financial intermediary is acting in their best interests, businesses and market liquidity could suffer. With the digitization of financial markets, and the advent of Fintech, liquidity can dry up instantaneously.

Summary of the main conclusions:

- This article argues that the G20/FSB process has been successful until recently in rapidly taking forward an extremely wide range of reforms international regulation of financial institutions and markets world-wide. However, going forward, a more robust governance framework, which will nurture a stronger sense of national ownership and establish better accountability than currently exists may be needed.

- Such a framework should be designed to restore public trust and confidence in the regulatory reform process internationally in the current environment. To this end, this new governance framework for global regulatory standard-setting may need to have a stronger legal foundation than what is currently available.

- It must be understood that building a new governance framework on an international scale is no easy task, and may consume significant energy and time of the regulators (and supervisors) around the world. A pragmatic approach is

[26] See, for example, the Economist magazine, February 10-17, 2017.

called for, and using existing or future free trade agreements (FTAs) as a means for agreeing and establishing such a governance framework may be a possible and useful step forward.[27]

- A treaty-based approach does have its own weaknesses, such as taking more time and political capital to arrive at basic agreements among parties. However, it will have the merit of forming a legal foundation for re-building public trust and establishing accountability, as the agreements will be formally approved and ratified by national legislatures.

- This has hitherto not been the case for international standards agreed through the G20/FSB process.[28] Stated differently, the existing G20/FSB framework can thus be equipped with a more formalized standard-setting process which would be more transparent, more accountable and more inclusive than the status quo.[29]

- In such a treaty or set of treaties, the following three components could be incorporated: i) a set of international common principles for financial regulatory reform could be inscribed, followed by ii) a list of internationally-agreed standards, most of which are already existing and implemented by the relevant SSBs such as the BCBS, IOSCO and IAIS.[30] Newly agreed standards will be added to the list. It will then be followed by iii) specific commitments of participating jurisdictions providing details of how jurisdictions will implement the international

---

[27] A similar proposal was made by David Wright, Secretary-General of IOSCO. See, for example, "Remarks by David Wright" at the Atlantic Council, Washington DC, December 10, 2012. In those remarks, it is suggested that the global institutional framework have some enforcement authority, binding dispute settlement and sanctioning possibilities. The remarks also state, "The role of this framework would not be to try to enforce a one-size-fits-all harmonized set of rules – but rather to ensure and, if necessary legally require, that the basic globally agreed policy principles are properly implemented by all jurisdictions who are signatory to the treaty arrangements". The author of this article generally concurs with this proposal to build a global institutional framework of the kind described in those remarks, but considers some aspects such as enforcement authority and binding dispute settlement mechanisms as being too ambitious, at least in the near term.

[28] As discussed later, this framework does not have to be agreed by a large number of jurisdictions i.e. multilateral from the outset, but could start as a set of bilateral trade agreements containing provisions concerning financial regulation and supervision. Such a framework, once constructed between the major trading partners, could be extended to a broader group, and then absorbed into a multilateral agreement.

[29] Note that the effectiveness and usefulness of the existing G20/FSB process, as well as the independent yet accountable standard-setting activities of the SSBs, are not undermined but enhanced by this proposal.

[30] See "The Compendium of Standards", Financial Stability Board (FSB), cited in footnote 2.

standards; i.e. if jurisdictions wish to deviate from internationally agreed standards, reservations/limitations to their commitments would be inscribed in the schedule of specific commitments for the jurisdiction, which will form an integral part of the treaty.

- Going forward, the G20/FSB could start by agreeing the set of international common principles for financial regulatory reform to be enshrined in the treaties as they are negotiated and concluded in the near future.[31] Once this set of core principles is agreed at the international level, it can be used as a "module" for each treaty to transpose. This would provide a legal foundation for those agreed principles to be ratified by the legislatures of G20 and other jurisdictions.[32]

- The ultimate goal should be consistent and converging rules applicable in as many jurisdictions as possible, making use of international standards developed by SSBs, as governed by internationally agreed principles and overseen by a transparent and accountable governance framework with a solid and sound legal foundation.

- An additional element for reforming the international regulatory framework in the future should be to streamline the organizational structure of the relevant authorities in each jurisdiction, and create a body that monitors systemic risk and sets regulatory reform policies across sectors. The precise organizational structure would necessarily differ from jurisdiction to jurisdiction, and the form and status of a cross-sector body could also differ across jurisdictions. However, the current system of fragmented regulatory agencies should be reformed, as a matter of urgency.[33]

---

[31] This set of principles is distinct from the existing core principles at the SSBs or that issued by individual jurisdictions. It is meant to be a set of guiding principles for international standard-setting, and therefore a governance framework for regulatory and supervisory reform at the global level.

[32] This framework in no way infringes upon the "sovereignty" of any jurisdiction, as it requires formal ratification of the treaty in the legislatures of participating jurisdictions. The standard-setters will be given formal mandates to agree and monitor implementation of international standards within their competence, but the standards are not directly enforced by any supra-national body. It will in fact make the standard-setters more accountable to the legislatures. The creation of a dispute-settlement body is not proposed here, but a body can be created under the treaties for governments or any other bodies to discuss and possibly adjudicate over disputes that could arise under the treaties.

[33] Organizational reform at the level of SSBs is not considered a priority so long as the members of those bodies monitor and improve their governance, transparency and

2. <u>A quick history[34] of post-crisis regulatory reform</u>

The crisis exposed huge and fatal flaws in pre-crisis financial regulation and supervision.

The G20 described the root causes of the global financial crisis in the following manner (as per the G20 Declaration at the Washington DC Summit on Financial Markets and the World Economy, November 15, 2008). For a political statement of G20 leaders, it may be read as unusually candid and self-reproaching.

"3. During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. <u>Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions</u>." (Emphasis added)

It then goes on to state the following:
"4. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption."[35]

---

accountability continuously.

[34] See the FSB's annual reports and the reports on the implementation and effects of the G20 financial regulatory reforms, as well as the FSB Chair's reports to the G20.

[35] FRB Governor Daniel Tarullo raises the following factors contributed to the unsustainability and fragility of the pre-crisis financial system, in addition to inadequate regulation and supervision, in his remarks cited in footnote 17, "Financial regulation since the crisis" December 2, 2016: Large banking firms had insufficient levels of high-quality capital; excessive amounts of short-term, wholesale funding; too few high-quality, liquid assets; and inadequate risk measurement and management systems. Systemically important nonbank financial firms whose failure could threaten the stability of the financial system were effectively outside the regulatory perimeter. Governments did not have resolution regimes that could provide for an orderly resolution of a systemically important financial firm. Shadow banking--which was funding long-term assets with short-term wholesale liabilities--exposed the financial system to a system-wide liquidity run. One may add to this long list, the fragility of OTC derivative markets, and financial market infrastructures.

As can be seen from the above, a comprehensive approach to addressing the policy failures was deemed necessary by the G20 from the very start of the reform process.[36] In terms of financial regulation and supervision,[37] the focus was on regulatory reform that prevented excessive leverage and risk-taking. Reforms to correct the misaligned incentives and to require proper risk management and transparency were considered key. Building safer and liquid markets was also an important objective.[38]

Quick and powerful contagion across multiple jurisdictions and markets of systemic risk testified to the strong and complex interconnectedness of global financial systems. It unequivocally demonstrated the need for internationally coordinated efforts towards major reform in financial regulation and supervision across jurisdictions and markets.[39]

Since 2009, the G20 process has led the international financial regulatory reform process. The G20 action plans developed a comprehensive menu for reforms, and have been hugely successful in reaching agreement on a large volume of reform measures in a relatively short time span.

However, some areas have been left untouched or incomplete.[40] There are signs that regulatory arbitrage has been occurring, as the players try to avoid regulatory cost.

---

[36] See the report of the Financial Stability Forum (FSF) (reorganized as the FSB in April 2009), "Enhancing Market and Institutional Resilience". This report already laid down many of the elements of regulatory reform subsequently put on the G20/FSB agenda.

[37] A comprehensive discussion of macroeconomic policies and structural reforms is beyond the scope of this article, but such policies/reforms and financial regulatory reform instigated by regulators are closely inter-related. One of the focuses of recent FSB work is macro-prudential policy, which transcends this boundary.

[38] The Action Plan annexed to the Washington DC Leaders' Declaration gave a comprehensive list of reform measures to be taken for the next few years.

[39] For a succinct summary of the main driving forces of reform and the main achievements, see, for example, remarks by Daniel Tarullo, entitled "Financial regulation since the crisis" December 2, 2016, cited in footnote 17.

[40] See the SRC policy statement cited in footnote 6. It lists the following as areas of reform which are incomplete: the work to put in place effective resolution regimes and plans for clearinghouses is incomplete; the credibility of the resolution plans for large and complex banks and dealers also needs to be put beyond doubt; the regime for those "shadow banking" activities and intermediaries that represent a risk to stability remains underdeveloped; the accounting and prudential rules requiring banks and others to recognize expected losses promptly, thereby avoiding the hazards of forbearance, are still uneven across jurisdictions; and the role of government-guaranteed agencies and intermediaries in creating risks to stability via distortions in credit markets has yet to be addressed by the reform agenda.

On balance, it would be fair to state that post-crisis regulatory and supervisory reform efforts have made significant progress so far, and the existing internationally agreed standards now being implemented are generally necessary and appropriate. While there is a need to constantly revisit and adjust certain portions of the reforms, or to complete unfinished parts, it will be probably unwise to discard or revamp the entire set of standards on a major scale. (See below, a tentative scorecard for the four major pillars of regulatory reform as agreed by the G20.)

The ultimate overall score of the G20/FSB reform process would depend on where we stand in the balance between building a stronger and more stable financial system vs. ensuring finance for growth and development. Not surprisingly, the FSB's own assessment has been overall positive up to now.[41]

The stated objectives of regulatory reform were; mitigate systemic risk, reduce moral hazard, and enhance transparency. Full implementation of agreed reform measures does not automatically ensure an appropriate balance to this effect, even if individual measures are correctly conceived, and have been subject to a rigorous test on a cost-benefit basis before implementation.

In international standard-setting for financial regulation and supervision, it has been repeatedly stated that building a level playing field and ensuring comparability across jurisdictions were essential. However, in a background of large discrepancies in the actual structures and conditions of financial systems and markets, a one-size-fits-all approach may be distortive, and could even exacerbate an un-level playing field.

In other words, prescriptive and granular standards can be appropriate only when the underlying structures and conditions of financial systems and markets are very similar between different jurisdictions.

Even as financial systems and markets have become closely interconnected, and even as we refer to "globalized" financial systems and markets as a result, it is still a fact that each financial system, and each financial market has its own idiosyncratic features, and are most often delineated by legal jurisdiction. This is a result of many underlying differences between jurisdictions, but lack of uniformity in legal systems, currencies, and

[41] See the FSB Report cited in footnote 7.

business practices, for example, is still important.

Synchronizing the timing for implementing the necessary reform measures is also important, as such issues of consistent and coordinated implementation of measures across the major jurisdictions has always been an important objective.

Even if jurisdictions applied identical rules or closely similar rules, disconcerted implementation of those measures could result in distortions and regulatory arbitrage.

Apart from the issue of additional compliance costs for financial institutions and market participants, discrepancies in the timing of implementation across jurisdictions could distort markets and create un-level playing fields. First-mover advantages (disadvantages) were cited in some areas, such as OTC derivatives regulation. In this case, market liquidity may have tended to flow to the well-regulated markets, but tighter regulation could have resulted in less liquid and more fragmented markets. At least, concentration of liquidity in a small number of advanced markets could be the result.

As the focus shifts from design to implementation of the various reforms, a need for assessing progress as well as the overall effects of reforms has arisen.

The FSB is now working to improve its evaluation of the effects of the G20 financial regulatory reforms. However, measuring progress in reform efforts is challenging, and will inevitably take a long time.[42]

In the meantime, market practitioners and industry, as well as consumers would need to be vigilant, and be ready to point out, if the cumulative effects of the various reform measures are hindering the proper functioning of markets. They should demand an adjustment or revision of existing measures, if and where deemed necessary.

Recent developments in the US and elsewhere appear to be favorable to a fundamental review of post-crisis regulatory reform measures. However, there needs to be some caution in rolling back major pillars of the reforms already agreed or undertaken, as a hasty or broad-brush review could unduly bring back risks into the system and make future crises more probable and serious.

---

[42] *Idem*.

3. An assessment of where we are with reform

As stated above, conducting a fair and objective assessment of where we are in terms of achieving the goals of reform is a precondition for drawing the future course of reform. A quick assessment of where we are for each of the various strands of reform follows. In virtually all the four major reform areas, divergences in the implementation of reform measures are becoming apparent. Here is a tentative and simplified scorecard:

I. Bank capital and liquidity (Basel III)

The main framework is now complete. However, some well-known divergences, as well as "gold-plating" have appeared. Calibration cannot be perfect, and sometimes deceiving.

The end-2016 deadline for completion of post-crisis reform measures was missed. There is no easy answer to the commitment of "no significant increase in the overall level of required bank capital".

Pressures towards ever-higher capital and liquidity standards seem to have eased lately, and political pressures towards de-regulation have now emerged. There is, however, a legitimate argument that bank capital rules should not be eased, if one believes that a more resilient banking system is desirable not just for preventing failure and maintaining lending even in stressed times, but also for maintaining confidence in the markets and support adequate financing for growth and development.

II. Ending too-big to fail (TBTF)

It is probably fair to state that regulators have made a lot of progress in addressing the issue of TBTF. Examples are: agreements on key principles for orderly resolution regimes, additional capital requirements (core equity capital surcharges and total loss absorbing capacity (TLAC) requirements) and enhanced supervision applied to G-SIFIs (global systemically important financial institutions). The G-SIFIs are identified by a set of agreed risk metrics and an internationally agreed list is published once every year.

However, as an example of remaining work, the "bail-in" mechanism, which is a key component of an orderly resolution mechanism that would enable an orderly resolution of TBTF institutions without taxpayer support may still be “too good to be true”; i.e. there may still be considerable uncertainty about whether the designed framework would work well in practice.

Major challenges could be: the appropriate and stable investor base for TLAC-eligible instruments, how to enable coordinated triggering of bail-in provisions between different classes of debt, how to perform a timely evaluation of the fair value of those instruments, etc.

In sum, it is still too early to state that reforms are complete in this area. Too-big-to-fail institutions may be still too-big-to-fail, despite progress in resolution planning and streamlining their structures.

III. OTC derivatives

The objectives of reform are conceptually clear and simple, but agreement on detailed elements of reform measures is proving to be difficult to devise and implement, particularly in the cross-border context.

Gaps are now appearing across jurisdictions in the implementation phase – and making good on the commitment of an outcomes-based approach to regulatory equivalence, and deference of regulatory authorities to one another are proving hard to achieve

As to regulation applicable to cross-border transactions, more global convergence, and eventually, harmonization of insolvency regimes would definitely be required. International standards have been developed for financial market infrastructure (FMIs), but national rules have diverged in the course of implementation, and difficulties have arisen in reconciling differences of applicable rules in the major jurisdictions.[43]

IV. Shadow banking[44]

---

[43] A recent example is the application of margin requirements for non-centrally-cleared OTC derivative transactions. Differences in the technical detail for requirements regarding the calculation and posting/settling of margins as well as in the dates of entry into force between the major jurisdictions have surfaced in the course of their implementation.

[44] To depict credit intermediation outside the banking system, the term “shadow banking” has been used by the G20/FSB throughout the reform process. There has been some

A FSB international framework has been developed for monitoring of risks emanating from market-based financing, but regulatory differences across jurisdictions are very large. Very difficult to monitor and apply adequate regulation and supervision across multiple jurisdictions, due to an acute shortage of data and limited regulatory/supervisory coverage.

V. Other items

Some important strands of other work include: macro-prudential policies, data gaps, deposit insurance systems, credit rating agencies, financial benchmarks (LIBOR, EURIBOR, TIBOR etc.), legal identity identifier (LEI) systems, risk disclosures, market conduct, risk management and compensation, accounting and audit issues, and international capital standards for insurers. The degree of progress is varied across the very wide range of reform items, but in general, there has been good progress on many of those items.

4. Assessing the cumulative effects of reform

Apart from monitoring the implementation of each strand of reform as summarized above in the tentative scorecard, it is important to conduct a comprehensive assessment of the overall, combined, cumulative effects of reform. This is crucial in enabling a well-informed exercise to review the appropriateness of agreed regulatory reform measures and in making adjustments, if and where necessary.

In conducting such an exercise, there is a need to carefully analyze the intended and unintended effects of reform. A clear distinction between the two effects is by no means clear-cut, but a balance must be struck so as to enable systems and markets to function properly while avoiding excesses. It is also necessary to distinguish between one-off or transitional effects as opposed to permanent effects.

Making the distinction between the intended and unintended effects of reform is more difficult than one may like to think. If the intended effect of reform was to make banks safer by raising capital requirements and reducing excessive leverage in the system,

---

criticism and suggestions to use an alternative such as “market-based finance” due to a certain pejorative connotation, but it is retained here due to its widespread use.

some declines in market liquidity and less leverage were at least partially the “intended” effects of reform. The question is therefore striking an appropriate balance between ensuring the safety and soundness of the system, and maintaining liquid and well-functioning markets.

With regard to “one-off” versus permanent effects, the example of effects on bank lending from tougher capital and liquidity requirements comes to mind. While the industry often argues that higher capital requirements dampen or discourage bank lending because of higher funding costs, it is likely that the effect is more of a transitional nature, as higher capital and liquidity in the longer term enable the banks to lend more even in stressed times. There has not been clear evidence that higher capital requirements actually caused bank lending to be more subdued than otherwise.[45] This of course does not necessarily imply that there has been no effect, but it may show that the dominant cause for slow growth in bank lending was lower loan demand and growing alternative funding opportunities on the part of the prospective borrowers.

More generally, if the problem is identified as primarily a question of transitional cost, a longer timeframe for implementation, and/or appropriate transitional arrangements would be the solution, whereas more permanent issues must be resolved by design, in the form of adjusting the calibration of quantitative requirements, for example.

Areas requiring close attention in conducting the assessment, according to the FSB, are: market liquidity, the effects of reform on EMDEs, and maintaining an open and integrated global financial system (including the need for action on correspondent banking as recognized by the FSB).

There is no disagreement that those areas are important in monitoring the overall, cumulative effects of reform, but they are very broad and too general when identifying areas for review. Going back to the importance of the ability of financial systems and markets to provide adequate finance for growth and development, one should prioritize areas in which the immediate conceivable effect on such ability may be affected by regulatory reform. For example, the combined effect of the leverage ratio on banks and

[45] For example, see Chair Janet Yellen, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 14, 2017. In the Q&A session, she referred to the fact that bank lending has expanded overall and also to small businesses despite tighter regulation.

the application of the set of regulation on interest-rate swap transactions may be priority areas for monitoring when it comes to liquidity in markets.[46]

5. Developing principles of sound and effective regulation and supervision

Regulatory and supervisory principles and their methodologies have been developed by international standard-setting bodies (SSBs) such as the Basel Committee, IOSCO and the IAIS.[47]

While those principles contain important principles for ensuring the independence, accountability, resourcing and legal protection for supervisors, for example, they do not directly apply to the governance of the SSBs developing international regulatory and supervisory standards.

Those core principles do not have any legal status, but are adhered to by the G20/FSB and other jurisdictions by way of peer pressure and political commitment. International Organizations conduct regular assessments and reviews based on those principles.

Peer reviews are conducted regularly and the results made public regarding the status of implementation of those principles. The IMF and World Bank also conduct periodic assessments and evaluations based on internationally agreed criteria.

However, these principles are typically sector-specific, as well as being general and qualitative, since no one-size-fits all solution exists which would be appropriate for all sectors, and across all jurisdictions.[48]

---

[46] For more on the issue of liquidity, see, for example, "Is there a liquidity problem post-crisis?", remarks by Stanley Fischer, Vice Chairman, FRB, November 15, 2016. As regards the Volcker Rule's effect on market liquidity, FRB staff wrote a discussion paper pointing to deleterious effect of Volcker Rule implementation on corporate bond liquidity and dealer behavior, resulting in significant costs of the proprietary trading ban in the Volcker Rule. See, Jack Bao, Maureen O'Hara, and Alex Zhou, "The Volcker Rule and market-making in times of stress" FRB Finance and Economic Discussion Series, 2016-102. It is interesting to note that the same study rules out that the effects were due to the implementation of Basel III in conjunction with CCAR requirements.

[47] An example of national principles focused on protecting national interests was the US Presidential Executive Order on Core Principles for Regulating the United States Financial System, February 3, 2017.

[48] The US Presidential Executive Order of February 3, 2017 can also be interpreted as an exclamation of resistance to a one-size-fits-all approach to financial regulation. It is noted, however, that it does not necessarily advocate a complete departure from internationally

Existing international regulatory and supervisory standards have attempted to be more granular and quantitatively prescriptive. It has also been understood that those standards are “minimum” standards, and jurisdictions have always retained the freedom to apply stricter rules where they saw it appropriate.

Domestic political pressure and sometimes lengthy legislative procedures forced jurisdictions to deviate from internationally agreed standards.

To a certain degree, this was an inevitable result of the international reform effort being driven by non-legally-binding agreements. The organizational structure and legal status of regulatory and supervisory authorities in each jurisdiction mattered a lot.

But arguably, the urge on the part of international standard-setters towards more granular and prescriptive standards, combined with often rigid timelines for implementation, as well as huge pressures on the processes for developing and agreeing those standards may have contributed to the resulting large discrepancies across jurisdictions, particularly in the implementation phase of those rules.

It is obvious that strong pressure from the G20/FSB enabled a very swift agreement and implementation of the various reform measures, as discussed above. However, this could have led to creating domestic pressures to deviate from international standards where they were not seen as flexible or catered to the specificities of each jurisdiction. The principle of “proportionality” could also have been cited when jurisdictions wished to deviate from agreed international standards. However, how to apply this “proportionality test” has never been clarified. Attempts to clarify how this would apply in the real world context were hampered by allegations against some jurisdictions using this to justify a delay or non-conformity with agreed international standards. It may therefore be useful if jurisdictions, whenever they wish to deviate from internationally-agreed standards, make explicit reservations in a transparent manner and therefore be subject to accountability.

In conceiving core governance principles for agreeing and implementing international standards for financial regulation and supervision, striking the right balance along the

---

(negotiated and) agreed standards.

following dimensions would be needed, for example. Some preliminary ideas for important elements to be incorporated in such principles are listed below under each heading[49,50,51].

1) Regulation must be necessary and proportionate

It seems obvious that the necessity of regulation comes first in a list of principles for designing international regulatory standards. However, more often than not, most new regulation could be argued as necessary in some way or another. Therefore, the necessity criterion may need to be qualified by: i) not more burdensome to stakeholders than necessary to fulfil the objectives of the regulation; ii) the benefits outweigh the costs; and iii) proportionate to the risks involved (proportionality).

From the principle of necessity and proportionality, a risk-based approach to regulation would entail, as opposed to a non-risk-based approach. For example, the use of the leverage ratio for bank capital requirements is justified as a complement to a risk-based capital ratio which captures the riskiness of bank assets, but could sometimes be only approximations. There may be cases in which larger or more systemic financial institutions need to be placed under more onerous requirements, or closer supervision than smaller or less risky firms. (so-called tiering)

2) The objectivity and transparency of regulation must be ensured

Regulation should be based and implemented according to objective and transparent criteria.

---

[49] Those are possible agreed principles for international regulatory and supervisory standard-setting, and are distinct from core principles issued by the standard-setters such as the BCBS, and from national political leadership in the context of domestic regulatory reform.

[50] The General Agreement on Trade in Services (GATS) at the WTO Article VI Section 4 contains similar wording for disciplines as they apply to domestic regulation, but is worded as an obligation to aim for such objective.

[51] It should be noted that GATS Article VI Section 5 (b) stipulates a need to take account of international standards of relevant international organizations when determining whether members are in conformity with the obligation to establish disciplines that aim to ensure objectivity, transparency, etc. for qualification requirements and procedures, technical standards, and licensing requirements. The term “relevant international organizations” is defied in a footnote of the agreement as “international bodies whose membership is open to the relevant bodies of at least all members of the WTO.

While maximum transparency would in principle beneficial for the markets, it would have to be balanced with the costs of providing transparency, and with the need to protect proprietary information. In times of market stress or failure of financial institutions, panic may entail from immediate and full disclosure, so it would be extremely important to ensure that disclosure rules allow for flexibility in exceptional circumstances, so that there is sufficient time to ensure that the content of the disclosure is accurate and post-disclosure reactions are accounted for. Fair disclosure, i.e. making sure all recipients of sensitive information are treated fairly, is required among various stakeholders and market participants.

3) The right balance between a principles-based approach and a rules-based approach must be struck

The appropriate degree of prescriptiveness and granularity of a piece of regulation is hard to define. Calibration of quantitative rules is also a challenge. In any case, appropriate regulation and supervision would be an issue of balancing between the interests of various stakeholders (e.g. shareholders vs. debt-holders) or between public and private interests.

A principles-based approach is called for where it is either desirable not to prescribe a requirement or when it is not possible. A prescriptive rules-based approach is considered harmful and too intrusive if businesses should retain the freedom to establish best practice, or the application of market discipline is more appropriate. However, a pure principles-based approach could lack transparency, comparability and consistency across jurisdictions. A level playing field is hard to achieve under a pure principles-based approach.

Therefore, a “best mix” of principles and rules should be aimed for. The preferred approach may be different according to the sector or market in question. For instance, as regards financial institutions, a principles-based approach may allow firms to develop their own internal risk management regimes and associated incentives in accordance with the characteristics of their businesses, and therefore may be the preferred approach. For market regulation, a more rules-based approach may be necessary, as conduct rules would need to be precise, especially when infractions lead to heavy fines and other penalties.

Whenever there is a market-based solution, regulators/supervisors should do their best in helping the markets function properly through a principles-based approach. Correcting incentives and reducing moral hazard are important objectives, but taking decisions on behalf of private sector's business management should not be the job of the regulator or supervisor in a free market economy.

4) The best use of an entities-based/sector-specific approach vs. an activities-based/market-wide approach should be made

Removing inconsistency as much as possible would apply to both, but ultimately, the same kind of activity should attract the same kind of regulation and supervision, regardless of who conducts the activity. As discussed above, priority should be placed on international consistency of transaction-based regulation and supervision.

5) The best use of micro-prudential vs. macro-prudential + market prudential tools would need to be considered

The recent trend towards use of macro-prudential policies[52] is a necessary and useful evolution, given that prudential regulation could play a role in maintain the integrity and stability of the financial, system as a whole. It also has the merit of being forward looking, if deployed in an appropriate and timely manner. Cross-border coordination of such policies is also discussed, which could make the individual policies more effective with concerted action. But there would need to be some caution in counting too much on the effectiveness or the efficiency of such measures overall, and hence not rely too much on macro-prudential tools when fiscal and/or monetary policy should be the appropriate tool to be deployed.

6) A preference for cross-border/international standards, but with appropriate national discretion

A robust international standard is always better for all parties involved, as it would ensure cross-border consistency, deter regulatory arbitrage and would therefore be more

[52] The FSB in consultation with the IMF and the BIS has been promoting the development and use of macro-prudential policies in jurisdictions, and conducting peer reviews as a means to induce national authorities to follow suit. Arguably, however, the effectiveness of such policies in actually containing systemic risk and preventing financial crises is not yet

effective. Ideally, there should be an agreed set of international standards for all sectors and activities. However, to the extent that financial systems and markets differ substantially across jurisdictions, some elements of national discretion will be necessary. On the other hand, for transactions-based regulation and supervision, national discretion would result in inconsistent rules applying to the two or more ends of the same transaction, and can be harmful and confusing.

Another issue is what to do with jurisdictions applying national rules that goes over and above the requirements of international minimum requirements. This issue is discussed separately below, but some understanding of the limits to gold-plating may be required, if one should aim to achieve consistency and convergence of rules applicable across jurisdictions.

7) *The merits of ex post* vs. *ex ante regulation should be weighed*

Financial services involve risk-taking, and if regulation and supervision were tightened to such an extent that all possible sources of systemic risk is suppressed by *ex ante* regulatory or supervisory measures, risk-taking will become virtually impossible. Structural separation of certain risky activities are currently introduced in the national context, and there is a reason for this treatment. Some caution against pre-emptive regulation and supervision which may unduly hamper healthy risk-taking may be warranted.

Prevention of future crises requires a forward-looking view of risks to financial stability, but reform efforts post-crisis tend to look at preventing the previous crisis. There would need to be a framework that enables the adaptation and evolution of standards based on constant feed-back, going forward.

Ideally speaking, for each financial activity/market, striking the right balance across each of those dimensions would need to be considered.

The post-crisis regulatory and supervisory reform process, understandably could not, at least up to now, provide much time and space for a broad and deep consideration of the desired balances. It may therefore be useful to develop such core principles at the G20/FSB, drawing on past experience and identifiable best practices.

Recent developments suggest that trust and confidence in free, fair, global markets has clearly diminished. This may not be a direct consequence of a flawed regulatory system post-crisis, but since one of the major objectives of regulatory and supervisory reform was to restore confidence in the system and markets, failure to achieve this objective, at least in public perception, must bear part of the blame.[53]

A review of the governance framework for global regulatory reforms now appears warranted, to restore trust and confidence among the public and in the markets. With the recent changes in regulatory policy in the US and UK, and in other countries, this work seems to have assumed some urgency.

Until recently, stricter rules and enforcement/penalties driven by political pressure have been prevalent, but a certain backlash seems to be occurring, with deregulation of bank regulation under the Dodd-Frank Act is advocated in the US most recently. A concomitant rise in regulatory uncertainty is affecting markets, potentially undermining financial stability. Volatility in the markets appear to be on the rise. Going forward, pressure will increase on regulators and supervisors to address those concerns and adjust existing agreed rules.

It should be noted, however, that a hasty roll-back or wholesale revamp of existing standards would not necessarily be positive for economies, nor advantageous for businesses or for consumers. A longer-term vision for post-crisis regulatory reform is needed.

Regulatory stability and allaying of regulatory uncertainties should be important considerations in exploring the need to make adjustments to the agreed standards, and in taking forward ongoing discussions to finalize post-crisis regulatory reforms. Therefore, before undoing the regulatory reform measures agreed and now being implemented, there is now an acute need to develop a longer-term regulatory vision, based on a sound, impartial assessment of the effects of reform as agreed and implemented.

For the development of a long-term vision, the G20/FSB process may need to evolve into a stronger and more accountable and transparent governance framework.

---

[53] See, for example, the letter cited in footnote 4.

While conducting self-assessment is a necessary element in any standard-setting and implementation process, the existing G20/FSB process is vulnerable to criticism from both businesses and consumers as well as academics that it is biased towards desiging more and stronger regulation, and leading to a self-justification of agreed reform. An alternative process and governance framework may be needed to establish public trust and foster a sense of ownership among domestic constituents.

Monitoring the likely effects of reform ahead of implementation should be conducted to the extent possible. As concrete evidence of the effects of reform cannot be obtained in the form of numerical data, inferences would need to be made for rules that are not yet implemented, but are scheduled to be implemented in the near future.

It is noteworthy that there is a lot of criticism against regulation and supervision that are not yet fully implemented. Financial institutions tend to pre-empt implementation of new rules and would try to adjust ahead of, and over and above, the regulatory and supervisory requirements, out of competitive and reputational motives. It is therefore not sufficient to conduct full analyses of the effects of reform post-implementation. Monitoring exercises should be sensitive to signs of preemptive moves by financial institutions and markets to measures that have been announced but not yet implemented.

6. <u>How to address the need for a longer-term regulatory vision</u>

If one wishes to ensure regulatory consistency and efficiency across jurisdictions, and maintain a level-playing field between financial institutions/markets of different origin, the use of international standards is critical in ensuring consistency of regulation in an inter-connected global financial system.

It must be noted, however, that the standards as well as the SSBs developing them currently lack legally binding status, relying on domestic transposition and rule-making in each participating jurisdiction. This may be making them more vulnerable to political pressures and shifts in public opinion more generally.

This is of course not to state that they have not been effectively implemented, as peer pressure, and a credible threat of discriminatory treatment of foreign financial institutions/markets have put strong invisible pressure on jurisdictions to apply the agreed standards on a full, timely and coordinated basis. However, it must be acknowledged that they have been exposed to criticism that accountability and transparency of the development process as well as the implementation and enforcement of the standards are insufficient or lacking.

It should be fair to state that the international standard-setting and implementation process has been hitherto entirely reliant on the domestic legal standing and accountability of each national regulator and supervisor exercising their best efforts. The international standards are not directly subject to any domestic process involving stakeholders, and therefore not directly accountable to any democratic process.[54]Some may therefore argue that this regime of indirect accountability is not sufficient nor appropriate, as the international standards themselves are not subject to a domestic rule-making procedure, and not exposed to scrutiny by the legislature.

Making them directly subject to domestic legal procedures and political pressures may make it difficult for standard-setters to agree, or may render the standards simply ineffective. The existing G20/FSB process has enabled the reform process to proceed without much of those procedures or pressures slowing down the reforms. This insulation, however, is also the source of criticism of the SSBs from of national legislators and the public.

Standard-setting bodies (SSBs) are doing their best to promote the use of the standards and conduct peer reviews, but they are generally under-resourced, and are prone to criticism over their governance and accountability.

In order to overcome any criticism of non-accountability and lack of transparency, standard-setters have been stepping up efforts to enhance communication with the public, and making use of public consultation processes. But, most often, no detailed explanation is given of the reasons for either adopting or not adopting suggested modifications in the consultation processes. Therefore, at the very least, transparency and communication with the public need be further improved to make the standard-setting process more transparent, and enhance a better understanding of what the standards can do, or cannot do.

---

54 Again, this is not to state that indirect pressure and accountability have not had significant effects on the international standard-setting and implementation processes, but national regulators and supervisors have worked to provide accountability and transparency while insulating the decision-making at the SSBs from direct intervention or scrutiny of national legislatures.

However, it now seems necessary that a concerted effort to enhance the governance framework for the development of the standards, thereby improving their coverage and effectiveness may be needed. If left unmodified, the existing standards could be undermined by the rising tide of prioritization of national interests by the major jurisdictions participating in the standard-setting process. National discretion should be permitted at least to a certain extent, but not so much as to undermine the original intent in developing international standards, i.e. to ensure comparability, consistency, and effectiveness.

A distinction between entity-based regulation and transaction-based regulation when working towards convergence and harmonization.

To streamline the standard-setting process and to prioritize areas requiring consistent international standards for markets to function properly for growth finance, it will be useful to identify areas in which prescriptive international standards are unnecessary and even harmful. Divergence or national discretion should be permitted where a one-size-fits-all approach is inappropriate, or developing a set of internationally harmonized rules is not realistic or achievable in the near term. An overly prescriptive set of standards can actually invite pressures to deviate across jurisdictions or national discretion.

Cross-border coordination/harmonization is critical, for transaction-based regulation, as cross-border transactions could not take place without consistency between rules applicable to one end of the transaction versus those applicable to the other end.

On the other hand, regulation and supervision of cross-border activities of internationally-active financial institutions would require coordination between the home and host regulators, but some differences could be tolerated if they are not directly in conflict with each other.

This is because entity-based regulation could accommodate some differences across jurisdictions, to the extent necessary or justifiable in view of the different conditions and environments prevailing in each jurisdiction. They must also not be unduly distortive or excessively costly. This tolerance, however, does not apply to transaction-based rules for which consistency between the rules applicable to the two (or more) ends of the same transaction need to be ensured.

The development of international standards which can gain support from stakeholders in all jurisdictions requires a transparent, accountable, and stable governance framework.

Domestic support for such a framework is essential if one wishes to ensure the applicability of international standards in jurisdictions. A weak governance framework would endanger the credibility of the standards, and could even encourage discrepancies and inconsistent application across jurisdictions. In the existing G20/FSB framework, domestic political support cannot be taken for granted, and the transposition of international standards into the domestic legal frameworks is not guaranteed.

Securing some form of pre-commitment on the part of national authorities to negotiate international standards could be helpful in ensuring the adoption and applicability of international standards.

In past occasions, the development of international standards itself was sometimes hampered or delayed by a lack of authority and commitment on the part of members of international standard-setting bodies.

An agreed international governance framework embedded in an international treaty may provide a more sound and stable basis for developing and implementing international standards going forward. This can work to secure the pre-commitment of national authorities to agree with and implement the international standards.

7. Drawing lessons from past crises

When considering the design of a new governance framework for international standard-setting, one important consideration is whether we have truly learnt the lessons of past financial crises, and what measures are needed to prevent a recurrence of past mistakes.

In all fairness, the existing G20/FSB process actually enabled rapid progress in agreeing enhancements to international standards to address the major fault lines that appeared during the crisis. Even as some critics maintain that many of the measures did not squarely correct the misaligned incentives or suppress moral hazard, the agreed measures were appreciated as being more or less necessary and appropriate in achieving the objectives of reform.

On the other hand, when it came to dealing with the immediate aftermath of the crisis in terms of cleaning up the banks' balance sheets, they were largely left to national supervisors to require the necessary adjustments and surgical measures.[55] In terms of cleaning up banks' balance sheets, two most commonly cited lessons from past banking crises are listed below in simplified form:

i. Identify problems early, and take swift action: Fully account for the losses on the asset side of the balance sheet, and dispose of the non-performing assets as much as possible and as quickly as possible.

ii. Early recapitalization of financial institutions, orderly and efficient resolution, and excellent crisis management are essential: If, in implementing 1) above, a need arises to recapitalize the financial institution, make maximum effort to this effect, using market-based means of recapitalization.

One could also add the following, although there may be disagreement on whether taxpayers could be exposed to losses, even as a last resort.

iii. Use of public funds requires understanding of public opinion, and measures to prevent moral hazard: Market-based solutions should always be given precedence over any measures requiring the use of official support including the deployment of public funds. If, however, a systemically important financial institution is unable to recapitalize itself through market-based means, making use of public funds[56], as necessary but under stringent conditions, should not be ruled out.

When using public funds, make sure to apply conditions such as management overhaul, pursuit of civil and criminal responsibilities of managers, as well as measures to hold shareholders and certain debtholders responsible to prevent moral hazard. Also, make sure the funds are procured in the markets, and any eventual losses borne by the

---

[55] The G20/FSB functioned as information sharing platforms and encouraged closer coordination and cooperation among regulators and supervisors, but did not have a role in decision-making and enforcement.

[56] Loss-bearing forms of public support would include direct subsidies, injections of capital, and guarantees by the government or public resolution agencies such as the deposit insurance corporation. A broader definition would include emergency liquidity provisioning as enabled under Title II of the Dodd Frank Act in the US.

industry and shareholders/bondholders. Such measures are also essential in gaining public understanding in the deployment of public funds. This is particularly important when changes in legislation and/or budgetary allocations are required to operationalize the deployment of public funds.

iv. A robust safety net to protect small depositors, such as deposit insurance pre-funded by the industry should be in place.

In addition to the above, tools such as securitization and business-turnaround operations are needed to support a quick balance-sheet clean-up. Market discipline needs to be strengthened through improvements in disclosure, risk management, and internal controls, as well as enhancement of corporate governance.

Some critics argue that a situation in which overly leveraged and greedy players take the upside of the risk equation while losses are borne by the taxpayer is intolerable. In past crises, every time public funds were mobilized to pre-empt severe crises or deal with the aftermath of failure of major financial institutions, an uproar of public anger was observed in any jurisdiction.

It is certainly necessary to avoid as much as possible the use of taxpayers' money in bailing out private financial institutions, but, arguably, the use of public funds in extreme conditions as a last resort could not be excluded to the extent that the severity and cause of future financial crises could not be predicted with any certainty, and private sector, market-based solutions such as bail-in are not foolproof.[57]

Instead, while leaving the possibility of recourse to public funds, it may be useful to devise a deposit insurance fund or other type of fund that will be financed and replenished by the financial industry in the form of premiums or special levies. Measures to prevent moral hazard would need to be clearly indicated *ex ante*, including pursuing civil and criminal responsibilities of management through litigation and prosecution.[58]

---

[57] As Tim Geithner argues in "Are we safe yet? – How to manage Financial Crises", Foreign Affairs, December 12 2016, "The right regime should recognize that successful crisis management requires allowing the government and the central bank to take risks that the market will not take and absorb losses that the market cannot absorb. It should allow the government to act early, before a panic gains momentum. And it should establish an overarching goal of preserving the stability of the whole system and restoring its capacity to function – not avoiding the failure of individual firms."

[58] Such arrangements are also required to gain public support for the use of public funds,

More recently, it is argued that cleaning up balance sheets and building safety nets are not sufficient in enabling finance for growth.[59] Financial stability itself could be undermined in a no-growth deflationary environment.

It has been observed that the adjustments required for banks' balance sheets has been fast and relatively advanced in the US, while being delayed in Europe. The Japanese financial crisis in the late 1990s and early 2000s is often invoked when slow action by authorities is seen as the cause for prolonged economic downturns. However, this is not unique to Japan.

Since the legal framework and budget allocations for safety nets to be invoked in such circumstances is often absent in jurisdictions when crises hit, the domestic political process always strongly affects crisis management in any crisis-hit jurisdiction. In a globalized financial system and market, cross-border coordination and cooperation is essential in containing financial crises. There have been many examples of swap arrangements between central banks, and coordinated action in the provision of liquidity among them. It has proven more difficult when there was a need to arrange loss-sharing among deposit insurance systems, or to coordinate recapitalization by public funds of financial institutions operating cross-border.

It is therefore sensible and advisable to establish permanent safety nets on the basis of internationally agreed standards, if one were to avoid future confusion and spillovers in containing future financial crises. Memoranda of Understanding or other agreements between regulators, supervisors and resolution authorities of different jurisdictions are necessary to enable orderly resolution of G-SIFIs.

In the past, the domestic process for enabling state intervention was almost always not entirely in the hands of the regulator/supervisor, but were subject to sometimes very lengthy and painful legislative procedures. Going forward, an internationally agreed framework could pre-commit jurisdictions to equip themselves with a well-designed and internationally consistent safety net arrangement. Constructing such a framework inevitably requires the involvement and commitment of national legislatures.

---

but should be formalized in normal times to avoid politically motivated excessive punishments.

[59] See, for example, a speech by Nobuchika Mori, Commissioner of the JFSA, October 20, 2015, entitled "Lessons from the Japanese Banking Crisis".

The G20/FSB process has developed a set of key principles for the resolution of systemically important financial institutions (SIFIs)[60], but its implementation in jurisdictions is still ongoing and not yet complete.

Supervisory stress tests were applied very differently among the major jurisdictions. Combined with uncoordinated national regulatory measures and divergent enforcement of conduct rules across jurisdictions, uncertainty over the viability of banks' business grew across jurisdictions.

In some cases, the unpredictability of fines and other penalties imposed on banks became a major issue in the market valuation of bank shares.

If there had been better coordination in applying internationally agreed rules on compensation, on infractions of market conduct rules and supervisory stress testing, a lot of uncertainty over bank business and profit outlooks could, arguably, have been alleviated. The issue of why jurisdictions imposed a large number of national rules which often had major impact on banks' businesses is discussed next.

8. The challenges of national measures amid stronger misgivings against international standard-setting

Domestic political pressures against binding international standards have always existed, but apparently were less visible in the wake of the global financial crisis.

Countries were not prevented from raising standards above and beyond the scope of international standards, and there is by now a whole universe of national measures, i.e. measures that are tighter than or are not based on any international standard or understanding.

The most well-known of those national measures not based on any agreed international standards are the Volcker Rule and the UK ring-fencing rules, as well as similar but different structural measures introduced in Europe. Such measures had, arguably, even greater impact on banks' business models than the applicable international standards

[60] The Key Attributes of Effective Resolution Regimes for Financial Institutions (the 'Key Attributes' KA), FSB, October 2014 (initially issued October 2011).

such as Basel III. Taxes and other national regimes also impacted financial services providers quite significantly.

More recently, with the global financial crisis becoming part of history for many, a resurgence of political pressures against alleged “supra-national” bodies and standards appears to have emerged. This could lead to further divergence of national measures from agreed international standards.

National measures not in conformity with international standards, combined with divergent application of international standards could seriously distort markets and create un-level playing fields. While their effects are hard to measure, some evidence is found.[61]

As a means of reconciling differences in applicable national measures, and in avoiding direct extra-territorial application of those national measures, some jurisdictions have been making use of “equivalence tests” or “substituted compliance” regimes which determine that compliance with the rules of other jurisdictions as having the same regulatory effect and consequence as that of domestic rules.

They may be, to a certain extent, useful and effective tools for regulators of different jurisdictions, leading eventually to mutual recognition, and deference of regulation and supervision to each other between regulatory authorities. It is more efficient and less costly for businesses as well as regulators than duplication and inconsistent application of rules in different jurisdictions.

As the G20 agreed, such determinations of equivalence should be made based on an outcomes-based approach, and lead to mutual deference of regulation and supervision between jurisdictions.

By way of such an approach, a rule-by-rule comparison of national rules became unnecessary, and could lead to substantial cost-savings on the part of both businesses and regulators.

While deference to each other by authorities should lead to lower regulatory cost and

[61] See, for example, the article by FRB staff cited in footnote 30.

efficiency in the longer run, the process for establishing equivalence or substituted compliance can be extremely lengthy and burdensome. They are also often politicized.

Negotiations between the US and EU over cross-border regulation of OTC derivatives markets became very politically heated and took a very long time to conclude.

Multilateral approaches are still desirable in terms of efficiency and effectiveness. A level playing field is not assured by a multitude of bilateral equivalence determinations.

There is sometimes a perception that bilateral negotiations could lead to resulting benefits which are more advantageous for the interests of a particular jurisdiction, but the overall benefits from a successful multilateral negotiation would normally outweigh any result of a bilateral negotiation. The burden of negotiating bilateral deals with a large number of partner jurisdictions cannot be underestimated. Even for the most developed jurisdictions, it would take an extremely long time and strenuous effort to conclude bilateral agreements with a large number of significant trading partners.

9. New topics requiring closer international coordination

New challenges requiring more international coordination in regulation and supervision include:

i. Enhancement of cyber security
ii. Financing of initiatives to cope with climate change
iii. Coping with an apparent decline in correspondent banking and other cross-border banking services
iv. Developing more effective and efficient ways and means to deal with market misconduct
v. Improving governance and forging proper risk culture – Incentivizing ethical behavior

It is not intended here to discuss in any detail those new issues relevant for the international regulatory community, and which require close coordination between authorities to deal with. However, it is probably worth emphasizing that, by their nature or with the advent of new technologies, the issues transcend national borders, and a jurisdiction-by-jurisdiction approach would be inefficient and ineffective in monitoring and coping with those issues. If appropriate regulatory responses are to be crafted and implemented consistently and effectively across jurisdictions, close cross-border cooperation and coordination between the relevant authorities are crucial.

10. The way forward - some suggested steps to be taken to improve the governance framework for international standard-setting and implementation process

Drawing on the lessons of the past, there seems to be a need to improve the existing G20/FSB framework for developing and implementing international regulatory standards are to be kept effective and robust for the future.

An important element in improving the governance framework could be to streamline as much as possible the organizational structures of the relevant authorities both domestically and internationally – the current patchwork of rules and authorities is inefficient and creates risks of its own. It is not sustainable if one wishes to prevent the contagion of systemic risk and the recurrence of large-scale systemic financial crises in the future.

The larger number of independent authorities involved in financial regulation and supervision in the US[62] is often raised as a primary example, but in many of the major jurisdictions, the prudential supervisor, the market regulator and the policy-making body[63] are housed in separate departments/agencies.

Another may be to take immediate steps to enhance the accountability and the transparency of the standard-setting bodies.

Disconcerted action, open disagreements, failure to share relevant information on a timely basis amongst relevant regulatory and supervisory authorities would all lead to confusion and uncertainty. Market confidence is all-important, and can only be restored in a crisis unless authorities coordinate in taking “whatever measures necessary” to maintain the integrity and stability of the financial system. Only collective action by

---

[62] For the prudential regulation and supervision of banks, the Fed (FRB and the District Federal Reserve Banks), the FDIC, and the OCC have mixed competence. The two market regulators, the SEC and the CFTC divide responsibilities over derivative market regulation and supervision. Then there are the State regulators, such as the New York State DFS.

[63] In many jurisdictions, the Ministry of Financial or the Treasury Department has responsibility over policy-making and drafting of legislation in the financial sector.

relevant authorities in multiple jurisdictions would stabilize the situation in a global crisis.

Cross-border contagion of crises must be prevented. Given the close integration of financial systems and markets across jurisdictions as it exists today, effective prevention of contagion and cross-effects requires much closer cross-border coordination in regulation and supervision than currently exists.

This would point to a need for building a stronger governance framework than currently exists which would enable closer international coordination and cooperation in both rule-making and implementation of the rules.

11. A treaty-based governance framework for international standards in financial regulation and supervision

In terms of building a stronger and more robust international framework for developing and implementing international standards, an option exists between: aiming for a legally binding treaty-based arrangement that will pre-commit national authorities to the standard-setting and implementation process.

In reality, many times in the past, international bodies called for building an ideal world in which a rules-based approach prevailed.[64] A single set of binding granular standards applying to all financial institutions and markets across all jurisdictions. The G20/FSB post-crisis reforms also aimed at this ideal, albeit by agreeing non-binding rules and implementing nationally under the powers and jurisdiction of each participating authority. The G20/FSB process did enable quick and effective designing of international financial regulatory reform measures across multiple jurisdictions. As stated earlier, we are now entering the phase of implementation, and difficulties are now surfacing as to their effectiveness.

This is in stark contrast to the existing system relying largely on informal standards for regulation as agreed by the relevant international bodies. The effectiveness of the standards was ensured by a political commitment at the G20/FSB, which enabled collective concerted action based on goodwill.

[64] A proposal to establish a World Financial Services Organization was made around the time of the Uruguay Round of financial services negotiations in the mid-1990s.

The existing process however carries an inherent weakness of being legally non-binding, and not directly accountable to domestic democratic processes, including national legislatures.

It also lacks an agreed set of overarching principles governing the process of regulatory and supervisory standard-setting, and do not have a legal basis for ensuring consistent regulation and supervision across the global financial systems and markets.[65] Jurisdictions are not pre-committed to consistent and timely application of international standards.

Those weaknesses could have led to a weaker sense of ownership of the international standards on the part of national authorities. Often, the use of international standards in domestic regulation and supervision was perceived as perpetrating losses of or creating threats to national sovereignty, not as a collective effort for the benefit of all.

In the face of difficulties faced by multilateral treaties that legally bind member jurisdictions to free trade in goods and services, it seems unrealistic to aim for a comprehensive and detailed international treaty that contains schedules of commitments regarding financial regulation and supervision. It may also be inappropriate if it becomes too prescriptive or one-size-fits-all.

An alternative may be to start by agreeing a set of core principles and start work to develop a new governance framework for international standards which would place the standard-setters in a more accountable and transparent setting, enabling stronger coordination and consistency in regulation and supervision across jurisdictions.

There may be conceptually two options for building such a framework:

i. One option is to resort to bilateral or small group negotiations and agreements, and embed a governance framework in those agreements.

[65] The WTO GATS agreement contained a set of legally binding principles applicable to domestic regulation in Article VI, but the G20/FSB process relied on each SSB to develop their principles which were collated into a compendium of international standards. The international standards thus collated were then used for peer review by the relevant international bodies including the sector-specific standard-setters (such as the BCBS, IOSCO, and IAIS), the IMF, World Bank and the FSB itself.

While this route may be the more realistic route in the near term, the limits to this approach are clear, and the process can prove to be extremely costly and slow.[66] It is also less viable in an environment in which emerging market economies play a larger role in the global economy as well as in the global financial markets.

ii. Another option may be to provide the existing standard-setting bodies with a stronger legal foundation by recognizing their roles in international treaties and inscribe the basic procedures and principles for standard-setting therein. Such an approach would pre-commit jurisdictions to participate in the standard setting and to implement the final standards once agreed. As the treaties will need to be passed by the legislative processes of each jurisdiction, it may foster a sense of ownership among domestic constituents.

The practical aim of having a domestic legal foundation for participation in the international standard-setting and implementation process would be to ensure a stronger involvement of national legislatures in the process. This treaty may either be a stand-alone international agreement or part of a free trade agreement taking the form of a legally binding international treaty.

Such a framework agreement could contain basic principles for agreeing on technical standards in areas such as bank capital and liquidity, capital market regulation, resolution framework and planning, and non-bank financial services to be agreed in detail by the existing stand-setters. The standard-setter will be given formal legal authority as provided by the framework agreement.

The agreement could contain provisions stipulating the principles of regulation and supervision such as, transparency, accountability, proportionality (i.e. regulation should be proportionate to the risks involved, and not more burdensome than necessary to business and consumer), and efficiency (not more costly than the expected benefits). There should also be a provision that ensures appropriate phase-in arrangements and adequate transition periods.

While applying such an approach may require substantial time and effort at the outset, it will most likely foster a stronger sense of ownership among participating jurisdictions,

[66] It will be interesting to see what kind of arrangements would come out of the negotiations over Brexit between the EU and UK authorities.

and make the rules more stable.

In fact, there is already a possibly useful framework under the WTO in the form of the General Agreement on Trade in Services (GATS). The GATS, however, did not function as effectively setting international standards of financial regulation and supervision, due in large part to the “prudential carve-out.” The existence of this provision essentially reduces the value of the legally binding commitment under the GATS by allowing discretionary treatment of foreign financial services providers gaining market access and/or enjoying national treatment in other jurisdictions.[67] Any future attempt at reinforcing the status of international standards in financial regulation and supervision would need to overcome this shortcoming of a blanket “carve-out”.[68]

An explicit feedback system of evaluating the costs and benefits of reform which is directly accountable to national legislatures of participating jurisdictions could be useful. Such a system could be incorporated in a new governance framework for international standard-setting and implementation.

Arguably, a global regulatory drive which resulted in attempts to quickly agreeing on prescriptive rules and short implementation timelines could be at the heart of the current pushback towards deregulation and overhaul of the post-crisis reforms.

An understandable approach by regulators and supervisors of jurisdictions in such circumstances would be to resist changes to existing agreements and already implemented rules. The G20 has up to now consistently made political commitments to implement the agreed reform measures fully and on a timely basis.

---

[67] Only a few cases that concern issues related to financial services have been brought to the WTO dispute settlement mechanism, so far. It has also been pointed out that financial services liberalization commitments under the GATS did not result in actual liberalization at the margins, but rather simply bound the status quo. Since legally binding the status quo would make it difficult for members to backtrack or roll-back the existing level of liberalization, it will not be valueless, but would still be less than ideal in an exercise of further liberalizing financial services trade.

[68] Article IV of the GATS applies binding regulatory principles to all committed sectors, but are general and qualified by terms such as “shall aim to”. During the WTO negotiations on financial services trade liberalization, financial regulators and supervisors argued for the prudential carve-out in order to maintain their discretion over measures to protect stakeholders and to maintain the integrity and stability of the financial system and markets. The need for such discretion may become relevant and acute in times of crisis, but would have less ground in normal times.

However, it is feared that, unless a stronger sense of ownership is nurtured among stakeholders, including the legislative branches of national governments across jurisdictions, regulatory stability and reduced uncertainty could become harder to achieve. For example, the US has started a review of existing regulation which could have direct implications for the international standards and the SSBs that house those agreed standards.[69] Even on such issues as transparency and consumer protection, there can be pushbacks or backtracking, unless those who bear the costs of such rules are convinced of their benefits.

As a practical matter, instead of starting an entirely new international process for developing such a governance framework, one could envisage having relevant provisions in existing free trade agreements or investment treaties pertaining to international standard-setting in financial regulation and supervision.

International treaties establishing each of the standard-setting bodies would also be conceivable, but has the obvious disadvantage of not being applicable across sectors and not being useful in coordination and cooperation between regulators and supervisors of different institutions/markets.

Regardless of which of the above options are adopted, it is suggested that the G20/FSB start discussing core principles for international regulatory and supervisory reform, and work to review the current governance framework for international standard-setting in those areas.

While some may be reluctant to discuss such a fundamental and broad subject in the already heavy agenda at the G20/FSB, it should be noted that any such discussion can be taken forward only in “normal” times. When the next crisis hits, it will be already too late to consider such long-term issues, and extremely difficult to draw visions for the future.

---

[69] See the Presidential Executive Order cited in footnote 31 which requires the relevant US regulatory agencies to report to the President within 120 days of the date of the order (and periodically thereafter) on “the extent to which existing laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other Government policies promote the Core Principles and what actions have been taken, and are currently being taken, to promote and support the Core Principles.”

12. Conclusion

In sum, while the G20/FSB process has been useful and effective up to now in strengthening the global financial system and markets, *going forward*, there seems to be an increasing need to rebuild public trust and confidence in the international regulatory and supervisory reform process.

To this end, there may be a case for developing a more solid legal foundation and fostering a stronger sense of national ownership in the major jurisdictions for international standard-setting and implementation in financial regulation and supervision.

To this end, building a new governance framework could be useful for global regulatory and supervisory standard-setting, to enable consistent and timely implementation of agreed international standards in the major jurisdictions. To do this, however, is no easy task, and may consume significant energy and time. It may therefore be argued that using existing or future free trade agreements (FTAs) as a means for agreeing the guiding principles and the process for such a governance framework may be a useful step forward. [70]

Such an approach has its own weaknesses, but could still form the basis for re-gaining public trust and establishing accountability for standard-setters which are presently vulnerable to criticisms of lack of transparency and accountability. Some may question the wisdom of taking this route when the multilateral treaty-based trading system itself is facing severe pressure from the new US administration and elsewhere.

A more pragmatic approach may be to make maximum use of the existing framework and process for global financial regulatory reform, while strengthening their governance and accountability.

Instead of attempting to build an entirely new treaty-based governance framework, the G20/FSB could start by agreeing a set of international common principles for financial

[70] As discussed later, this framework does not have to be multilateral from the outset, but could start as a set of bilateral trade agreements containing provisions concerning financial regulation and supervision. Such a framework, once constructed between the major trading partners, could be extended to a broader group, and then absorbed into a multilateral agreement.

regulatory and supervisory reform in the near term.[71]

Through the development of such principles for global regulatory reform, the G20/FSB could also set the course for developing a new governance framework of the kind discussed above. This groundwork could then be transformed into a formal treaty to be ratified by the legislatures of G20 and other jurisdictions.

It is reiterated that the G20/FSB process is a net improvement from the days of the G7 and G10 in terms of inclusiveness. In practice, the process has involved a larger number of jurisdictions than the 20 major jurisdictions: i.e. jurisdictions with large financial markets such as Hong Kong, Singapore, the Netherlands, Spain, and Switzerland participate in the meetings of the FSB, for example. However, non-FSB jurisdictions have recently become important regional players, particularly in Asia and Latin America. The G20/FSB process has created mechanisms to involve none-G20/FSB jurisdictions in its work, but the current membership arrangements would need to be enhanced, if the standards are applied to all jurisdictions with significant stakes in their financial systems and markets.

In the suggested approach of a multilateral treaty-based governance framework, those jurisdictions wishing to join the process will be invited to join. The G20 has been vulnerable to claims of exclusiveness or restricted access, and this may be an opportunity to make room for improving the inclusiveness of the process, again, going forward.

Through such work, the existing G20/FSB framework could be augmented by a more formalized standard-setting process which can be more transparent, more accountable and more inclusive than the current system at the G20/FSB.[72]

For internationally agreed standards to be implemented domestically, the involvement of the legislatures and the executive branches of jurisdictions is necessary and unavoidable.

---

[71] An additional merit of such work is to eliminate the need to negotiate for long hours to craft detailed language concerning financial regulation and supervision in the G20 communiques at future meetings. The G20 Leaders need only to reconfirm their commitment to the agreed framework.

[72] It should be noted that the above argument is certainly in support of stronger accountability and involvement of the national legislatures in the international regulatory and supervisory reform process, but it should not in any way undermine the independence of monetary policy in each jurisdiction.

This is because regulatory and supervisory reform for the financial sector requires various levels of policy-making, enacting of legislation, and executive rule-making, which cannot be done without their close involvement. This is therefore distinct from monetary policy for which the central bank in each jurisdiction is normally granted independence in their policy-setting and day-to-day operation.[73]

While it is unrealistic and most likely harmful to involve the legislature in the technical detail of financial sector regulation and supervision, developing a more transparent and accountable governance framework would be timely and useful for international standard-setters in accomplishing their tasks and fulfilling their mandates. The status quo does not bode well for those standards to be agreed and implemented consistently and on a timely basis across jurisdictions, as cracks are starting to appear in the international standard-setting process.

[73] The commentary by Wolfgang Münchau in the Financial Times newspaper of February 20, 2017 appears not to distinguish between the two categories of independence, and assimilates regulatory and supervisory authorities with Central Banks. This may be somewhat misleading, for the reasons cited above.

References:

(Other than those cited in the footnotes above)

Financial Stability Board, "First Annual Report" January 29, 2015 and subsequent Annual Reports.

Timothy F. Geithner, "Stress Test – Reflections on Financial Crises" 2014.

International Monetary Fund, "Global Financial Stability Report" October, 2015 and other editions.

(Background material by the author)

"Opening Markets in Financial Services and the Role of the GATS" (1997, WTO, co-authored with Patrick Low, Mukela Luanga, Aaditya Mattoo, Maika Oshikawa, and Ludger Schuknecht)

"How Does Financial Services Trade Affect Capital Flows and Financial Stability?" in "The Internationalization of Financial Services – Issues and Lessons for Developing Countries", edited by Stijn Claessens and Marion Jansen (2000, World Bank-WTO, co-authored with Ludger Schuknecht)

"Financial Services", in "Guide to the GATS – An Overview of Issues for Further Liberalization of Trade in Services" edited by WTO Secretariat (2001, WTO)

"Dissecting regional integration in financial services from the competition policy and trade policy perspectives" (October 2008, BIS papers 42, Asian research program conference paper, co-authored with Mamiko Yokoi-Arai)

"Overview of international work towards OTC derivatives markets reform and remaining challenges" in Financial Stability Review, No. 17, Banque de France (April 2013, Banque de France)

Ver. 5

“Financial services liberalization and regulation in Japan: implications for future negotiation on market access and domestic regulations” in “WTO Domestic Regulation and Services Trade” edited by Aik Hoe Lim and Bart De Meester (March 2014, Cambridge University Press, co-authored with Koichi Iwai and Yoshitaka Sakai)