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FINANCIAL CRISIS REFORMS: DRIVING DIVERGENCE RATHER THAN COLLABORATION?

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The 2008 global financial crisis introduced an avalanche of regulatory reforms to counter the perceived failures of the global financial system. While regulators have been ready (and eager) to collaborate on principles and standards, they have not always implemented them in the same way, creating friction in cross-border transactions and contributing to market fragmentation. Here Clifford Chance experts assess the issues.

In the aftermath of the crisis, G20 policy makers agreed new global standards for financial markets to address what were seen as the causes of the crisis. These included the introduction of new regulation for derivatives markets, such as clearing, trading and risk mitigation requirements, and other prudential measures including the introduction of bank recovery and resolution regimes and enhanced capital and liquidity requirements under Basel III.

More than a decade on, there is clear and overwhelming global acceptance of the G-20 standards on trading, clearing and margining of over-the-counter derivatives, which have the aim of making the market safer and more transparent. However, jurisdiction-specific implementation of these globally agreed standards differs in often small but significant ways, creating friction in cross-jurisdiction transactions and encouraging market fragmentation. Because the post-crisis global standards tended to take the form of general frameworks, they left room for divergence in national and regional implementation. In some cases, differences in the scope, substance and timing of implementation across jurisdictions has left firms grappling with inconsistent and overlapping requirements.

In turn, this has been a contributing factor to market fragmentation, which can reduce or trap liquidity, limit firms' ability to diversify and manage risks across borders and impair financial stability. A fragmented approach to regulation also increases the compliance burden for firms as they may need to comply with multiple similar regulations which differ in small but important ways.

International standard-setting bodies such as the BCBS, FSB and IOSCO do carry out reviews of how relevant standards have been implemented globally. However, more may be needed to promote consistent global application of these standards in a way that fosters and supports global financial markets.

Types of divergence

We have seen differing implementation of global standards causing challenges for firms and driving market fragmentation in a number of ways.

- **Duplication**

  The extraterritorial application of derivatives clearing, trading and risk mitigation requirements leaves many firms subject to multiple rule sets. For example, firms entering into derivatives transactions via a branch may be subject to rules in the jurisdictions of both their head office and the local branch. Issues can also arise where each of the counterparties in different jurisdictions are subject to different local requirements. These issues may be particularly acute in the case of the derivatives trading and clearing obligations, where parties may find they are unable to satisfy their different obligations on the same trading venues and CCPs. Equivalence and substituted compliance regimes go some way to ease these challenges, but they are not available across the board.

- **Discrepancies**

  There are various examples of discrepancies, where the detailed rules implementing global standards differ from jurisdiction to jurisdiction. For example, the content and format of derivatives transaction reports, as well as the scope

of intragroup and other exemptions from derivatives clearing, trading and risk mitigation requirements, are not consistent across different jurisdictions. This means that firms subject to requirements in multiple jurisdictions may need to build different systems to comply with each set of requirements, increasing the implementation and compliance burden. Another important discrepancy arises from the inconsistent implementation of the Basel capital and liquidity standards, leading to global groups having to use one set of rules and models for the consolidated group and another for a subsidiary outside the home jurisdiction.

- **Competition**

In some cases, policy makers and regulators have taken action to keep resources or activities local. This is often driven by concerns around the ability of regulators to effectively supervise offshore activity that may impact the stability of local financial markets. For example, some jurisdictions require certain derivatives transactions to be cleared at local CCPs (e.g. Japan in relation to yen-denominated trades executed in Japan). In the EU, EMIR 2.2 also introduces the possibility for ESMA to de-recognise non-EU CCPs in certain circumstances.

- **Desynchronisation**

Finally, while global standards generally set out common implementation deadlines, different jurisdictions may implement requirements on different timescales. In many cases, new global standards require the introduction of new primary legislation which can also impact the timing of implementation. For example, the US introduced swap execution facilities under the Dodd-Frank Act several years before the EU introduced its derivatives trading obligation under MiFID2. Again, this can leave firms subject to different rulesets in different jurisdictions and temporarily upset the playing field.

Impact on financial markets and possible solutions

The Japanese G20 Presidency, FSB and IOSCO have been examining potential adverse effects of market fragmentation arising from regulation, and what actions could be taken to address them. In June 2019, the FSB[1] and IOSCO[2] published reports on their work in this area.

These reports recognise that market fragmentation can have both positive and negative drivers and consequences. For example, some types of market fragmentation may arise from measures to improve domestic resilience and in some cases may have a positive effect on financial stability, by reducing the risk of transmitting economic shocks between jurisdictions. There is a balance to be struck between enabling cross-border financial activity and market access on the one hand, and a need to tailor local regulatory frameworks to reflect domestic policy mandates, risks and responsibilities on the other. The reports therefore identify and focus on areas where reducing regulatory-driven market fragmentation may have a positive impact on financial stability or improve market efficiency without adversely impacting financial stability.

The FSB report focuses on trading and clearing of OTC derivatives, banks' cross-border management of capital and liquidity and the international sharing of data and other information. It identifies potential ways of enhancing international cooperation and helping to mitigate negative effects of market fragmentation in these areas on financial stability, including increased cross-border information sharing and communication among regulatory authorities via supervisory colleges and crisis management groups. The IOSCO report also considers the role of supervisory colleges in strengthening collaboration and cooperation between regulators and identifies this as an area for further work.

1 FSB Report on Market Fragmentation published 4 June 2019 and available at https://www.fsb.org/wp-content/uploads/P040619-2.pdf

2 IOSCO Report on Market Fragmentation & Cross-border Regulation published 4 June 2019 and available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf

Both the FSB and IOSCO reports also examine existing approaches to cross-border regulation, including recognition and deference mechanisms, which may take various different forms such as exemptions, substituted compliance, equivalence and passporting. The IOSCO report recognises that deference may not be appropriate in all circumstances, but proposes that IOSCO could serve as a forum for exchanging information about approaches to cross-border regulation and good practices around deference tools. Similarly, the FSB proposes carrying out further work on exploring where and how to enhance the clarity of deference and recognition processes in OTC derivative markets.

At an international level, the Japanese G20 Presidency has identified market fragmentation as a critical issue affecting the global economy, and both the FSB and IOSCO are continuing their work on addressing market fragmentation. However, we still see various trends towards national policy makers and regulators pursuing a domestic agenda and financial stability at the national or regional level rather than prioritising cross-border financial activity.

Therefore, we may see a more nuanced approach to the development of global standard for financial regulation emerging from the ongoing FSB and IOSCO work, which aims to strike a balance between setting global standards and allowing for national tailoring of regulations in a way that enhances rather than undermines global and national financial stability.

“We need ‘smarter globalisation’ of financial regulations, an approach to differentiate the degree of expected cross-border consistency depending on the nature of the regulation.

We have designed and implemented international regulatory standards assuming global consistency is usually a good thing. Each regulatory area, however, has different reasons for cross-border consistency and different needs to be tailored to national specificities. There are many good and bad reasons for setting standards globally and also for tailoring regulations nationally.”

Ryozo Himino, vice minister for international affairs, Financial Services Agency, Japan (October 2018)

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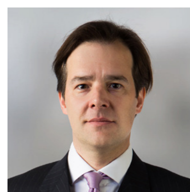

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