The G20-FSB Post-Crisis Regulatory Reform Agenda: Implications for Hong Kong

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G20 Financial Regulatory Reform Agenda

- Capital, leverage, liquidity and procyclicality
- OTC derivatives
- SIFIs and resolution regimes
- Compensation arrangements
- Expanding the regulatory perimeter: Shadow banking
  - Credit ratings and credit rating agencies
  - Hedge funds
  - Securitisation
- Accounting standards
- Macroprudential frameworks
- Adherence to international standards: Monitoring and enforcement

Basel III

- 2013
- Pillar I, II, III
- Capital: 8% (min. 6%) + 2.5 (capital conservation) + 0-2.5% (countercyclical) + 1-3.5% (SIFI)
- Liquidity: 2015, 2018
- Leverage
- Procyclicality
- Systemically important financial institutions (SIFIs)

Leverage: Objectives

- Constrain the build-up of leverage in the banking sector, helping to avoid destabilising deleveraging processes which can damage the broader financial system and the economy
- Reinforce the risk based requirements with a simple, non-risk based "backstop" measure

Leverage ratio

- Average of the monthly leverage ratio over the quarter based on definitions of capital and total exposure
- Capital: Tier 1
- Test: 2013-2017: 3%
- 2017 final for 2018 implementation

Liquidity

- No pre-crisis international standard: wide variance
- Basel III: Two minimums plus monitoring / supervision

Objectives

- Promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high quality liquid resources to survive an acute stress scenario lasting for 1 month: Liquidity Coverage Ratio (LCR) – 2015
- Promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis: Net Stable Funding Ratio (NSFR) – 1 year, sustainable maturity structure of assets / liabilities – 2018

OTC derivatives regulation

- Risk management: pre-crisis
- Regulation: pre-crisis
- Regulation: post-crisis

Regulation: Pre-crisis

- Generally: left to private ordering
- Sophisticated participants only
- Capital adequacy / Basel II

Regulation: Post-crisis

- Prohibition
- Transparency
- Clearing / settlement
- Exchange migration
- Private ordering

G20 (Sep. 2009)

- “All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Noncentrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”

SIFIs and G-SIFIs

- “too big to fail”
- G-SIFIs: initial list (Nov. 2011); insurance companies (2012/2013)
- SIFIs?
- Options:
  - No failure: regulation
  - No SIFIs / G-SIFIs: break-up
  - Volcker , Vickers
  - Resolution arrangements

G-SIFIs: G20/FSB Nov. 2011

- Bank of America, Bank of China, Bank of New York Mellon, Banque Populaire CdE, Barclays, BNP Paribas, Citigroup, Commerzbank, Credit Suisse, Deutsche Bank, Dexia, Goldman Sachs, Group Crédit Agricole, HSBC, ING Bank, JP Morgan Chase, Lloyds Banking Group, Mitsubishi UFJ FG, Mizuho FG, Morgan Stanley, Nordea, Royal Bank of Scotland, Santander, Société Générale, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group, Wells Fargo
- End 2012 application

Cross-border financial institution insolvency: Options

- Treaty: EU
- Model Law
- Multilateral MoU
- Memoranda of Understanding (MoUs)
- Domestically capitalised subsidiaries

Consumer protection

- Depositors v investors v insurance customers
- Deposit insurance
- Investor compensation: segregation
- Insurance compensation: assets

Credit ratings and CRAs

- Regulation of CRAs
- Regulation through CRAs
- Use of ratings

Compensation (G20)

- Firms' boards to play an active role in the design, operation, and evaluation of compensation schemes;
- Compensation arrangements, including bonuses, to properly reflect risk and the timing and composition of payments to be sensitive to the time horizon of risks, with payments not finalised over short periods where risks are realised over long periods
- Firms to publicly disclose clear, comprehensive, and timely information about compensation
- Supervisors to assess firms’ compensation policies as part of overall assessment of soundness and where necessary intervene with responses that can include increased capital requirements

Shadow banking

- Scope
- Financial regulatory structure
- Financial conglomerates

Regulatory Structure: Options

- Sectoral (Mainland China, US)
- Institutional (HK and majority of jurisdictions worldwide – sectoral + institutional for banks)
- Functional (Australia)
- Consolidated (UK, Japan, Singapore)
- Twin Peaks (Netherlands, France)

Other proposals

- Volcker Rule
- Vickers

Volcker Rule

- 2008 G30 study
- General (s. 619): prohibits depository institutions and their affiliates form engaging in proprietary trading, or acquiring or retaining an interest in a hedge fund or a private equity fund or sponsoring a hedge fund or private equity fund
- Scope: US banks in any location, non-US banks in the US, activities outside US involving US residents

“Proprietary trading”

- Definition: engaging as a principal for the trading account of a banking organisation or supervised NFC in “any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, or contract, or any other security or financial instrument” that regulators may determine by rule
- Essence: prohibition on buying / selling securities as principal for the entity’s trading account

UK

- Regulatory structure: twin peaks, FSMA amendments, EU implementation
- Vickers Commission: “ring-fencing”
- Walker review: bank corporate governance - http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/walker_review_information.htm

Context

- Global GDP (market exchange rates): approx. US$ 70 trillion (2011) (IMF)
- Global trade (goods and services): approx. US$ 36 trillion (2011) (WTO)
- Global financial system: approx. US$ 240 trillion (2010) (FSB)
- Shadow banking system: approx. US$ 60 trillion (2010) (FSB)
- Daily global foreign exchange turnover: approx. US$ 4 trillion (2010) (BIS)
- OTC derivatives outstanding (end-2011): US$ 648 trillion (notional), US$ 27 trillion (replacement)

Global finance and crises: Analytical framework

- Crises
  - Currency
  - Banking / financial
  - Debt
- Liquidity / solvency
- Private / sovereign

Prevention

- Financial infrastructure: payment / settlement – plumbing (OTC derivatives)
- Well-managed financial institutions: licensing, risk management, corporate governance, market discipline
- Information
- Financial institution safety and soundness: prudential regulation

Addressing crises

- Liquidity provider of last resort: central bank
- Financial institution resolution mechanisms, including insolvency
- Consumer protection: deposit insurance etc

Looking forward

- Leverage
- Pillar II / III
- Infrastructure
- SIFIs (especially resolution)
- Cross-border mechanisms

References

- R. Buckley & D. Arner, *From Crisis to Crisis: The Global Financial System and Regulatory Failure* (Kluwer 2011)
- Arner: SSRN