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Boundaries, Data Sharing and Liquidity: The Next Frontiers for Financial Regulation

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The post-crisis experience indicates the international regulatory policy process is under stress. Many reforms have been implemented, but domestic implementation has varied widely (covered bonds, derivatives, CCPs). A number of reforms have not yet been implemented (LEI, Net Stable Funding Ratio, cross-border resolution). Policymakers continue to bicker over technical details[1] while wielding equivalency determinations and subsidiarization requirements as negotiating tools.

Difficulties in implementing the prescriptive post-crisis reforms raise real questions about the credibility of cross-border regulatory standards[2] at a delicate historical moment.[3] The situation creates sub-optimal outcomes.

Disputes among regulators compromise cooperation even when agreement exists. Regulatory uncertainty complicates compliance while imposing significant costs on firms subject to different (sometimes conflicting) standards. New systemic risks may emerge while policymakers are distracted arguing about how to address systemic risks that arose ten years ago.

These difficulties should not be permitted to impose impediments on growth-enhancing intermediation. The answer is not a retreat behind national borders. Even if a nation's regulatory system were able to retreat, systemic risk would not be eliminated. It would still exist inside a more concentrated domestic market constrained in terms of size and composition of market participants.

Two key lessons point towards the next set of policy priorities: barriers to information sharing and lack of adequate liquidity. In other words, boundaries and liquidity matter.

Lesson 1: Boundaries Matter

The AIG and Lehman Brothers failures and the EuroArea sovereign debt crisis illustrated a deep truth regarding systemic risk: cross-border economic interdependence generates risks as well as benefits. When it materializes, systemic risk imposes material fiscal costs regardless of the country of origin. Consequently, informal international consensus cannot substitute for -- or impose obligations on -- national governments. Even legally binding cross-border economic frameworks stop do not impose open-ended obligations on national governments.[4]

The post-crisis experience suggests that global articulation of top-down, technical regulatory rules may create more problems than it solves due to a mismatch of authorities. International entities articulating global minimum regulatory standards are not authorized to impose binding requirements. Simultaneously, the scale of the crisis and the scope of reform initiatives shifted the center of gravity

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[1] *Global Bank Capital-Rule Revamp Postponed as Europe Digs In*, Bloomberg (3 January 2017).
[2] *In the balance: global regulation walks a tightrope*, RISK.net (12 September 2017). *Asia caught in the Basel crossfire, says Andrew Sheng*, RISK.net (31 August 2017).
[3] Anti-globalization sentiment remains elevated globally. Anti-EU sentiment remains elevated in some EuroArea Member States. Populist and nationalist political movements remain active.
[4] For example, the Maastricht Treaty prohibits fiscal transfers inside the European Union. The IMF Articles of Agreement also limit the liabilities assumed by members providing emergency funding to other members through a range of mechanisms.

into national political arenas where financial stability is defined and implemented *domestically*. The current populist era creates additional constraints on the international policy process, particularly if it would impose burdens on politically powerful domestic constituencies.

The crisis also created significant deficits in trust among regulators precisely because they acted in accordance with national mandates. The subsequent proliferation of technical regulatory standards inadvertently increased exponentially the areas for divergence, further eroding cross-border regulatory relationships. Nowhere is this more evident than in the architecture for the counter-cyclical buffer. [5]

The first lesson of the post-crisis era, then, is that boundaries matter. The hard work must begin now to re-build trust so regulators can support welfare-enhancing cross-border economic interdependence rather than retreat behind national boundaries.

One way to protect against systemic risk is to encourage information sharing. By its nature, systemic risk is a "big data" problem. It can only be identified if a sufficient number of observations from different perspectives can be collected. The G20 Data Gaps Initiative[6] thus attempts to increase cross-border data sharing, but it does not go far enough.

If "data is the new oil"[7] in a world where data privacy is a top political priority, then regulators must urgently find cooperative ways to share information now…before their ability to identify systemic risks has been compromised. However, domestic laws currently constrain regulatory data sharing even when Memoranda of Understanding (MOUs) exist. The new generation of MOUs in the FinTech sector may provide useful templates for how new cooperation mechanisms can be crafted.

Lesson 2: Liquidity Matters (But In Unexpected Ways)

The post-crisis reform agenda also sought to address systemic risk by increasing bank funding liquidity and collateral liquidity.[8] Where access to liquid trading markets generated inappropriate incentives (securitization, derivatives, market making), bank participation was severely constrained or prohibited.

Systemic risk was addressed by lowering the velocity of intermediation. This goal may have been achieved, at a cost:

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[5] Basel III, Section IV (Countercyclical buffer)(June 2011); *ESRB Handbook on Operationalizing Macroprudential Policy in the Banking Sector*, European Systemic Risk Board (March 2014). National regulators can impose add-ons for exposures in foreign countries based on country-specific considerations. In other words, if a regulator is uncomfortable with the regulatory or economic policy choices made by a foreign regulator it can increase the regulatory capital required for domestic institutions regarding all exposures emanating from that foreign jurisdiction.

[6]See *Second phase of the G20 Data Gaps Initiative (DGI-1): Second Progress Report*, Financial Stability Board (21 September 2017).

[7] The Economist (6 May 2017).

[8] In the process, policymakers inadvertently created a new kind of systemic risk by centralizing default waterfalls within central clearinghouses previously not subject to extensive direct regulation. Policymakers currently are struggling to define orderly liquidation procedures for these entities.

- Lack of access to securitization markets exacerbated European banks' non-performing loans (NPLs) overhang, constraining their ability to underwrite new lending that could generate growth.[9]
- In trading markets, regulatory reform coincided with a range of shifts (electronification, deleveraging, changes in expectations regarding returns, upgraded internal risk management), making it difficult to determine whether -- or how much --regulatory reforms contributed to market fragmentation.[10] Even if no single cause can be pinpointed, the reality is that capital market transaction costs are increasing and dealer liquidity support for corporate bonds is decreasing.[11]
- Perhaps relatedly, online (non-bank) marketplace lending has begun to occupy markets left vacant by regulated firms, providing new mechanisms to fund small-scale growth, accelerating disintermediation trends.
- The composition of international intermediation has shifted away from capital markets (cross-border capital flows have decreased -65% since 2007) and towards foreign direct investment (FDI), which has skyrocketed after the crisis. [12]

The post-crisis regulatory framework may increase bank funding liquidity, but both trading and regulated credit markets no longer have the liquidity necessary for growth-enhancing maturity transformation. Lower and slower levels of financial intermediation may thus be generating suboptimal economic growth trajectories that help feed political extremism and create new systemic risks as firms chase higher yields.

Regulatory simplification can help address this problem.

European policymakers took an important step in this direction this year with new rules to support "simple, safe securitization." The BIS General Manager recently indicated that "it may be appropriate to apply simpler standards to banks with simpler business models."[13] Simpler standards may also decrease compliance costs, facilitating increased credit intermediation without adversely impacting systemic stability. Various regulatory simplification initiatives also are underway in the United States.[14]

Conclusion

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[9] European policymakers recently rectified this situation by completing legislation that permits banks to participate in "simple, safe, securitization."
[10] *Market Liquidity after the Financial Crisis*, Federal Reserve Bank of New York Staff Report No. 796 (October 2016, revised June 2017).
[11] *Id.*, p. 3.
[12] *The New Dynamics of Financial Globalization*, McKinsey (2017).
[13] *Challenges for regulators and supervisors after the post-crisis reforms*, Opening Address by Mr. Jaime Caruana, General Manager of the BIS, at the FSI Conference on "Supervisory policy implementation in the current macro-financial environment – a 'cross-sectoral journey'" (18 September 2017).
[14] The U.S. Treasury Department will release its reform recommendations in October 2017. The Commodity Futures Trading Commission is undertaking a significant simplification initiative. The Board of Governors of the Federal Reserve System has suggested a range of regulatory simplifications, some of which require legislative action by the Congress. Finally, the House of Representatives has passed the CHOICE Act which incorporates a number of regulatory simplification requirements in addition to rolling back a number of post-crisis reforms.

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Enhanced information sharing designed with the data revolution in mind and regulatory simplification may provide a solid foundation to rebuild badly battered regulatory relationships while enhancing regulators’ ability to address systemic risks in a proactive manner.