FSB focuses on cross-border banking pull-back

Regulators are working with the World Bank to take a closer look at the growing exclusion of some jurisdictions and segments from transaction banking networks. By Philip Alexander

At the start of June 2015, Financial Stability Board (FSB) chairman Mark Carney and World Bank chief financial officer Bertrand Badré published a joint article warning that regulators need to pay attention to global banks disconnecting certain client types or jurisdictions from their transaction banking networks. This follows Mr Carney’s letter to G20 ministers in April in which he indicated that the FSB was working jointly with the World Bank to assess the extent of this problem, and how to respond to it. The concern among both the industry and regulators is whether higher compliance costs for controls such as anti-money laundering (AML) and combating the financing of terrorism (CFT), together with increasingly large enforcement fines, are driving banks out of certain business segments.

“The financial abandonment of whole groups of customers – or even countries – is not something that can be ignored by the members of the G20. The FSB and the World Bank are playing our part in co-ordinating efforts to prevent the loss of basic banking services needed to finance investment in some of the most vulnerable areas in the world,” Mr Carney and Mr Badré said.

The first task of the joint

Community banks sidelined in battle for Dodd-Frank

Democrats and Republicans agree that community banks need regulatory relief. But this may have to wait until deals can be struck on more controversial rollbacks. By Charles Piggott

The 216-page draft ‘Financial Regulatory Improvement Act of 2015’, released in May by US Senate Banking Committee chairman Richard Shelby would significantly reduce the regulatory burden on small banks. Indeed, Democrats agree they need relief. However, the bill, which passed a Senate Banking Committee vote on May 21, also comes as the first direct Republican assault on post-crisis US regulatory reform. Since the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by president Barack Obama in July 2010, Republican changes have only been possible as riders on other ‘must have’ legislation such as the re-authorisation of the Terrorism Risk Insurance Act and the most recent federal budget.

The Alabama senator’s bill, subtitled ‘Regulatory Relief and Protection of Consumer Access to Credit’, would give community banks exemption from a range of post-crisis regulations. Smaller banks would be subject to less frequent regulatory exams and have fewer quarterly reporting requirements. Banks with less than $10bn in assets would be exempt from the Volcker Rule’s ban on proprietary trading.

But the Republican package includes other more controversial reforms. It would give banks of all sizes safe harbour against charges of predatory lending under post-crisis ‘qualified mortgage’ rules, as long as, among
G20 still hitting obstacles to tracking systemic risk

Aggregation and standardisation pose key challenges as the Financial Stability Board seeks to close data gaps.

By Philip Alexander

The data gaps initiative, launched by the G20 nations in 2009, is set to move into its second phase, featuring full implementation of data collection, new data sets and additional country coverage. The G20 asked the International Monetary Fund and Financial Stability Board (FSB) in April 2009 to identify gaps in regulators’ data that could jeopardise financial stability. This led to 20 recommendations in October 2009, including 19 data sets that were needed plus a general work plan and strategy. The G20 approved the 20 recommendations at its Pittsburgh meeting a few weeks later.

The FSB will review progress with phase 1 – identifying what was necessary to build the 19 data sets – at its September plenary session, as well as setting priorities for phase 2. Top of the agenda is building a fuller picture of systemic risk, including cross-border exposures. The bid to develop global risk indicators has been undermined by differences between national standards for reporting financial trades and balance sheet exposures.

“People need to know the method – there need to be some guidelines on how to achieve aggregation”

Jefferson Braswell

Jefferson Braswell

Network analysis

Mr Crispini cites the example of AIG’s build-up of $400bn in credit default swap exposure, which went unnoticed by regulators. This is exactly the type of risk that was meant to be tackled by derivative reporting regimes such as the European Market Infrastructure Regulation (EMIR) in the EU and the Dodd-Frank Act in the US.

“This regime is meant to flush out where there are those kinds of concentration in exposure. It is possible for each participant to offset exposures with other positions to end up flat, but there can also be a magic circle where one counterparty in the middle is the weak point. This is why we need network analysis on all exposures and it needs to be global, which is difficult where you cross between regulatory regimes such as EMIR and Dodd-Frank,” says Mr Crispini.

The US government’s Office of Financial Research (OFR) has launched a pioneering agent-based modelling approach, designed to capture how risks interact across financial networks. “Agent-based modelling offers a unique dynamic alternative to traditional stress-testing. At the moment, we are adapting the model to simulate the transmission of risk during prior historic episodes,” says OFR associate director Rebecca McCaughrin.

Regulators are also seeking to develop a host of maps covering collateral, funding and assets, to identify the different connections. This type of data will potentially also be vital for populating agent-based models.

“There are many gaps in those maps, and if you think beyond interconnections to amplifiers such as liquidity and being able to populate liquidity metrics across markets and geographies, that is a significant task. We are still quite some way from being able to analyse the different dimensions,” says Ms McCaughrin.

The sheer volume of data being...
produced is burdening both financial institutions and their regulators. An official from the Banque de France told a meeting of data gaps initiative participants in London in April 2015 that there was a substantial workload not only from the implementation phase, but also from the running of the new systems.

“There is a tension between the general political expectation and the actual additional pressure on respondents. It requires an intensified dialogue with respondents,” the official warned.

In an effort to provide more usable exposure data more easily, industry respondents to recent consultations have suggested that banks should report position data, rather than every trade. This was the stance taken by the Global Financial Markets Association in its February 2015 response to the FSB consultation on standards and processes for global securities financing data collection and aggregation.

“If you ask a supervisor, they would say there is no proper oversight without real-time trade data. But a macroprudential regulator would want aggregated position data. For the largest players, the line between the two categories can blur, as the entity’s trades can represent a significant part of total market exposures,” says one regulator.

Global standards needed
Jefferson Braswell, founding partner of consultancy Tahoe Blue and a member of the board at the Global Legal Entity Identifier Foundation (GLEIF), says the FSB’s model of national regulators collecting data in a manner to minimise the aggregation work at the apex made sense in theory. But in practice, it assumes individual institutions will collect data consistently in a way that can be aggregated. In reality, even within one bank, data can be held in inconsistent silos in different business lines and Mr Braswell says each institution needs to be standardised internally. But it is not necessary for every institution to adopt identical standards.

“What is needed is an intermediate data standard that can be used for aggregation in a way that preserves the accuracy of the skeletal structure of the information that has been aggregated, like compressing a high resolution image down to a more manageable file format without losing the integrity of the image. It is difficult to enforce internal data standards on every institution, but you can supply a data model and methodology that allows institutions to map their internal data into a format that can be extracted in aggregate,” says Mr Braswell.

He emphasises that this approach can benefit both regulators and financial institutions. Firms will have more comprehensive insight into their full balance sheets, and an interface data model standard would enable the consistent consolidation of institutional data by regulators. The Basel Committee on Banking Supervision (BCBS) has already set out its principles for risk data aggregation in BCBS 239, with which banks were expected to start complying from January 2015.

“But people need to know the method as well – there need to be some guidelines on how to achieve that aggregation. The good news is that techniques to do so exist and have already been proven to work,” says Mr Braswell.

He adds that this does not mean changing the internal wiring of the bank for elements such as transaction pricing, but instead finding a non-invasive way to extract data and map it into a warehouse for analysis.

GLEI initiative
The first major step to providing globally coherent data was the creation of global legal entity identifiers (GLEI) and a foundation to oversee them. Local operating units (LOUs) began issuing LEIs about 18 months ago, and around 370,000 have now been issued. The GLEIF was founded in June 2014 and hired a chief executive – Stephan Wolf – in October 2014. Mr Wolf says there are 22 LOUs at present, which are actually global in practice and potentially competing, and he anticipates that this will rise toward 30 in the next few months.

Any legal entity can be assigned an LEI, and about 50% of the existing LEIs are for non-financial companies engaged in financial market trading or hedging activities. There can be many legal entities in each banking group and each investment fund in a fund management group may have a separate LEI.

“The second phase that will soon be discussed among private and public stakeholders is the establishment of ownership relations to identify if one legal entity owns others. This will have very interesting applications and discussions so far are promising,” says Mr Wolf.

National regulators effectively set the number of LEIs per country by mandating which entities need to obtain an LEI. Prior to the creation of the GLEIF, there was some inconclusive analysis of how large the total potential universe of LEIs might be and Mr Wolf wants to take this further.

“We already maintain a list of existing and upcoming rulemakings that mandate LEIs, and we would like to analyse what impact this will have on the LEI population. For example, EIOPA [the European Insurance and Occupational Pensions Authority] wants to make LEIs mandatory for every European insurer, but many already have an LEI because they participate in financial transactions subject to EMIR. If we have a better idea of the target population, then we will know our success rate,” says Mr Wolf.

LEIs are only the first step, identifying the counterparties to a transaction. Regulators also need to know the product traded and the details of the trade itself. There are already a range of regulatory and industry initiatives to develop unique trade and product identifiers (UTIs and UPIs). In May 2015, the International Swaps and Derivatives Association (ISDA) launched a UTI pre-fix service to help participants generate standard UTIs. ISDA chief executive Scott O’Malia said he hoped it would make ISDA “the premiere candidate for endorsement by regulators”.

“The governance needed for UTIs and UPIs may be less complex than for the LEIs and we are already seeing different mechanisms being proposed for self-generating these identifiers. The key for UTI or UPI is that it is unique and could theoretically be used by different regulators in different jurisdictions without a philosophical debate,” says Robert Peterson, Washington-based senior advisor for international affairs at the OFR.
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working group is to ascertain the genuine scale of the problem, with much of the evidence to date largely anecdotal. Money remitters, non-profit organisations and trade finance users, especially in emerging markets, have all complained about the impact of what banks term derisking. A report by five industry groups and the Basel Institute on Governance in October 2014 suggested that correspondent banking relationships for 17 leading global banks had fallen by 7.5% since 2011, with two banks cutting back by 20%. The UK seems particularly affected, with the UK Money Transmitters Association estimating in January 2014 that 85% of UK non-bank remitters, non-profit organisations and trade finance users, especially in emerging markets, have all complained about the impact of what banks term derisking. It is surveying three groups: the public authorities in G20 countries and some other nations that are high recipients of remittances; the money service providers themselves; and the banks that cater to them.

“There is limited information from clients who have seen transaction banking services withdrawn, and that is not surprising – if they are seeking a new relationship, it is not in their interest to broadcast what has happened,” says Tod Burwell, chief executive of the Bankers’ Association for Finance and Trade (BAFT).

The second exercise is the joint FSB/World Bank workstream on correspondent banking. This is seeking data from the members of the FSB and its regional consultative group to have a mix of developed and developing countries providing information on the restriction or withdrawal of services. The project will also approach global banks directly to source aggregated data to understand better whether they have pulled back from specific regions or from specific types of correspondent banking partner.

“We also want to identify local banks that have had their correspondent banking relationships restricted by global banks, to understand what they were told, if they understand the drivers and if they have been able to find alternatives,” says Mr Pesme.

Identifying what is driving the derisking process will be particularly sensitive and difficult. Policy-makers express the suspicion that banks are using tougher enforcement actions and higher compliance costs as cover for a strategic rethink that involves cutting services to certain jurisdictions or client groups. However, Mr Burwell emphasises that it is not easy to disentangle the different causes of the trend, because many factors are intertwined.

“Banks are making structural decisions based on capital, leverage and liquidity rules and the treatment of local subsidiaries by host supervisors. What is clear is that increased compliance expectations are driving up the costs of transaction banking,” he says.

He estimates that due diligence for new clients costs between $25,000 and $75,000, with significant annual review costs and varying expenses for each transaction.

“For a global bank, the picture varies in each jurisdiction and this is very complex to manage. In the end, banks need to take a conservative view of risk; the cost of the relationship has gone up, so banks need the revenues for each client to make business sense,” says Mr Burwell.

Vesna McCreery, a managing director at compliance consultancy Exiger and former head of financial crime at Santander and Barclays, says misconduct fines and new personal responsibility rules such as the UK’s senior managers’ regime are undoubtedly focusing minds. But where there has been insufficient attention and investment on risk mitigation in the past, often the only option for a bank to respond quickly may be to exit a country or customer group. Ms McCreery believes this is rarely the best solution.

“Sometimes the cost-benefit analysis may not add up, but for global banks with large volumes, low-margin businesses like correspondent banking are crucial as part of a multi-product proposition, and there is an impact on client relationships if the bank withdraws,” she says.

New technology

In theory, new technology can help banks maintain the correspondent networks that are valuable to their franchise while handling compliance more efficiently.

The Society for Worldwide Interbank Financial Telecommunication (Swift) has launched a know your client (KYC) registry to provide quality-controlled, in-depth information confidentially to all banks involved in transaction services. It also operates a sanctions screening service that has 300 users in 110 countries.

Global Risk Regulator
Smaller client banks need to put themselves in the shoes of the largest global banks – to be transparent and make themselves easier to understand, to show that they have been through the required processes and to provide information in a standardised format and on terms that suit the bank supplying them with transaction banking services,” say Luc Meurant, head of banking markets and compliance services at Swift.

He says systems are increasingly using fuzzy logic to mitigate against the risk that names on a KYC red flag list are slightly misspelt or missing certain details. He emphasises that collaboration is vital, to develop central utilities that can keep down the cost of improving compliance processes. Swift’s KYC registry aims to include 7000 banks worldwide with around 1.3m relationships among them.

A number of regulators such as those in Nigeria and Ghana are encouraging banks in their jurisdictions to use services of this sort. Mr Pesme says improving the AML/CFT frameworks of countries that face problems from derisking – such as major remittance receivers – is an important part of the equation. This will facilitate the continued provision of transaction banking services by global banks.

“The World Bank is looking at this as part of its broader remit on governance and institution-building. That includes deep AML support to the countries that ask for it, such as laws and regulatory frameworks, capacity-building, risk assessments, training financial supervisors, and helping financial intelligence units. It is not just about having rules on the books, but about implementing them,” says Mr Pesme.

Mr Burwell says both the industry and regulators can avoid an undue compliance burden by identifying any mismatches between the perceived and actual risks of certain activities. For instance, an oftencited official number puts at 80% the proportion of money laundering in emerging markets that is conducted through trade-based activities. This has prompted many global banks to consider the need for a costly know your customer’s customer (KYCC) approach to trade finance, carrying out due diligence on the clients of their local partner banks.

“In actual fact, the money laundering almost always involves corporate structuring and cash movements, not what the industry would recognise as conventional trade finance. Banks are putting a lot of emphasis on additional checks such as negative news searches against the trade finance counterparties of their client banks, and we did one survey that showed 68% of banks had declined trade finance transactions due to AML concerns. But it turns out that regular trade finance is only rarely used for money laundering,” he says.

Regulatory clarification

The internationally agreed regulatory foundation for AML/CFT policy is the FATF risk-based approach, which was first developed in 2007, with an update process beginning in 2012. The guidance requires that more due diligence resources be devoted to higher risk clients. The FATF is undertaking work on how the guidelines should be applied to specific sectors, and a paper on money value transfer services is scheduled for publication in February 2016.

“We are emphasising that banks should not simply classify all non-profits or money remitters as high risk,” says Ms Schilling.

Regulators have also underlined that the FATF risk-based approach does not require a KYCC process. But FATF members apparently acknowledge that further clarification could be helpful, and their next plenary session in June is due to discuss this.

“There has to be a collaborative public and private sector solution to this. In particular, there is a real gap in the ability to share information. In some cases, this is due to data privacy laws within certain countries. There are limitations on what banks can share with each other, and even more so on what can be shared between public and private sector entities. That limits how effective we can be and we need to address that,” says Mr Burwell.

From 2012, FATF members agreed to carry out national risk assessments and communicate these to the private sector. These are still a work in progress.

“These are large, multi-agency qualitative and quantitative undertakings that will take time. In the interim, we would encourage national authorities to offer the private sector at least a steer, and to think about how the assessment can be communicated to avoid the unintended consequences of whole industries being unjustifiably labelled as high-risk,” says Ms Schilling.

In April 2015, the UK Financial Conduct Authority (FCA) published guidance to banks, which instructed them not “to deal generically with whole categories of customers or potential customers.” The FCA warned it would now consider whether firms’ derisking strategies “give rise to consumer protection and/or competition issues.”

“This is narrowing even further the line that a bank has to walk. Banks must take a commercial decision on the risks relative to the potential benefits, based on the available evidence. The best advice is that banks must have evidence of the process they have gone through, including how they identified the risk and set their appetite for it,” says Michael Ruck, a lawyer at Pinsent Masons who previously worked in regulatory investigations for the FCA.

He says the FCA is paying growing attention to new technologies available to improve AML processes, and may increasingly push back to banks with suggestions on new techniques they need to examine before refusing to bank certain clients.

“It is helpful for regulators to maintain a conversation, to understand how each bank operates and to indicate what checks they think the bank should put in place, what methods other banks are implementing and whether the bank needs to go further,” says Mr Ruck.

Mr Meurant says regulators can help by being clearer on what banks are expected to do to comply. Inevitably, there is a reluctance to draw the line too precisely because this could play into the hands of those who want to circumvent AML controls.

“It would also help if regulators standardise their own information. For example, there are more than 30 different sanctions lists that a global bank may have to comply with. Aligning them in a single format would create better data quality, which would not only be easier for the banks but would also make the sanctions more effective,” he says.
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other things, banks hold loans in their own portfolio or sell them to another firm that holds the loans on its balance sheet. It would also force regulators to re-assess the impact of regulatory capital rules on mortgage servicing assets, establish an insurance advisory committee at the Fed, prohibit the government from selling stock in Fannie Mae and Freddie Mac without congressional approval, revise the Financial Stability Oversight Council’s (FSOC’s) designation process (see p23), force greater transparency on the Fed and create a commission to study potential further restructuring of the Fed.

Perhaps most controversially, it would raise the automatic threshold at which banks are deemed systemically important from $50bn to $500bn in assets, instead allowing the FSOC and Fed to determine whether banks under the threshold need enhanced regulation.

Party split

The bill has split Democrats and Republicans down party lines. All 12 Republicans on the Senate Banking Committee voted in favour of Mr Shelby’s bill and against a rival bill launched by the top Democrat on the panel, Sherrod Brown. And all 10 Democrat senators on the committee voted against Mr Shelby’s bill in favour of Mr Brown’s bill, which more narrowly targets community banks and consumers.

Karen Shaw Petrou, managing partner of Federal Financial Analytics, cautions against reading too much into the partisan stand-off. “Despite the fact the vote on Mr Shelby’s bill was split down party lines, bipartisan regulatory reform is very much alive. This is a game of poker played by master tacticians and these bills are just Messrs Shelby and Brown’s opening bids. Mr Shelby is aware that if he separates out the easy-to-pass reforms from his bill, the reforms will become harder and less likely to get done.”

Democrats from across the party are rallying to protect the Dodd-Frank Act. Speaking in Iowa on May 19, Democrat presidential candidate Hillary Clinton described the Republican package for community bank relief as “a trojan horse for rolling back protections from consumers and rolling back the rules on the biggest banks... We should call this what it is: a cynical attempt to game the system for those at the top.”

Backed by the promises of a presidential veto of any attempt to weaken post-crisis Wall Street reforms, Democrats from both the Senate and House of Representatives joined together on June 3 to stem the Republican push for wide-ranging regulatory rollbacks. Mr Brown and his Democrat counterpart on the House Financial Services Committee, Maxine Waters, announced unanimous Democrat support for rival legislation more narrowly focused on community bank relief, which has now been introduced in both committees.

Michael Barr, a law professor at the University of Michigan Law School and former assistant secretary of the treasury, says: “This is no way to provide bipartisan help to community banks. Instead of focusing on helping community banks, Republicans on the Senate Banking Committee have voted for a wide-ranging bill that hurts consumers, exposes taxpayers to new systemic risks from large financial institutions, and rolls back key provisions of Dodd-Frank.”

Mr Barr, one of the architects of the Dodd-Frank Act, says: “Just a few examples of consumer rollbacks include increasing the threshold for consumer supervision by the Consumer Financial Protection Bureau to $50bn, eliminating the ability to repay requirement for all portfolio lenders, eliminating consumer protections for large numbers of high-cost manufacturing loans. On the prudential side, the bill would put sand in the gears of federal oversight of the largest financial firms, blind regulators to risk in the system for all but the very largest institutions, and stymie the development of global rules dealing with insurance risk. The list could go on.”

Mr Shelby’s bill will start a process of political horse trading over how much of Dodd-Frank can be rolled back. Ms Petrou says: “The really hard work starts now with back-and-forth negotiations. We could still see a bill go to the Senate this year, possibly even before the August recess, but more likely in September.”

Isaac Boltansky, policy analyst at Compass Point Research & Trading - remains “cautiously optimistic” over the prospects of regulatory relief – including a change to the systemically important financial institution (SIFI) bank threshold – passing into law in the current Congress.

More difficult legislative changes are also a possibility. Hester Peirce, senior research fellow at the Mercatus Center at George Mason University, says: “There is common ground between Republicans and Democrats, and not just on community bank relief.” Areas where the far left and far right tend to agree include, for example, the need for Fed reform and an end to government bail-outs.

To pass a Senate floor vote, Mr Shelby may have to soften key areas of the draft proposal. If Republicans reduce the proposed $500bn automatic SIFI threshold and narrow the proposed exemptions on mortgage lending standards, Mr Boltansky says “Republicans have a chance of getting support not just from moderate Democrats on the committee, but also from the top Democrat on the panel”.

“Our view remains that the fate of the regulatory relief legislation is squarely in the hands of the moderate Democrats on the Senate Banking Committee – Mark Warner [Virginia], Jon Tester [Montana], Heidi Heitkamp [North Dakota] and Joe Donnelly [Indiana] – as their support would ease the path to securing the Democratic votes necessary for passage on the Senate floor,” he says.

“Mr Brown is also a dealmaker,” adds Mr Boltansky, who credits the Ohio senator with getting legislation clarifying the Fed’s oversight of insurance companies past the Senate in 2014. If, however, Democrats keep shutting the door on a Republican reform bill, Mr Shelby will probably take elements of his bill and include them as riders on the next government appropriations bill.

A potentially large stumbling block for the Republican bill is the proposal to raise the $50bn threshold at which banks are automatically designated as systemically
important to $500bn. Mr Shelby’s propos-
al would instead give the Fed and FSOC
discretion to decide whether banks falling
under the $500bn threshold should be
regulated as systemically important.

Chris Wheeler, a London-based US
bank analyst at Atlantic Equities, says
that raising the automatic threshold to
$500bn would be a “massive attack” on
Dodd-Frank. “The question is whether
regulators are putting so much pressure
on banks that it’s impacting their ability to
do their job,” he says. “If that is the case,
jogging backwards out of [Dodd-Frank]
would have to be done very carefully not
to lose that higher degree of confidence
regulators have created in the system.”

Financial reform lobbyists have hit
out against the proposal to raise the SIFI
threshold. “It’s a real bait and switch to
talk about community banks and then use
them as cover to try to get regula-
tory relief for multi-hundred-billion-dollar
banks,” says Marcus Stanley, policy direc-
tor for coalition Americans for Financial
Reform. “We’re talking about banks of
$50bn and up – that’s 34 of the largest
banks in a country of almost 7000 banks.
Excluding banks the size of Washington
Mutual or Countrywide, which were
at the centre of the crisis, is not a good
idea,” he adds.

Mr Stanley says Mr Shelby’s proposals
would create huge legal uncertainties over
the Fed’s enhanced supervision of large
firms, requiring each and every large bank
to be individually designated as systemic
important – a process that could take
years.

However, there is support for a more
moderate SIFI threshold in other quarters.
Ms Petrou says: “The predicated policy
rationale for the systemically important
threshold is that the failure of an institu-
tion would have systemic negative exter-
nalities. I do not see how that can be the
case for any of the institutions in the low-
er range of the existing threshold, assum-
ing they’ve kept to traditional businesses.”

Mr Brown presented himself as open
to discussions over raising the threshold.
Furthermore, earlier this year Fed gover-
nor Daniel Tarullo told lawmakers that he
also supports a higher threshold, partly
because it has been hard to scale down
enhanced regulation including stress tests
for smaller banks.

Since both parties remain open to ne-
gotiations – and the fact that Mr Shelby
can still turn to the appropriations pro-
cess should his reforms fail at the com-
mittee stage – Mr Boltansky thinks there
is a 60% chance of a change to the SIFI
threshold in 2015.

Jeffery Harte, a principal at investment
firm Sandler O’Neill, believes an increased
SIFI threshold would be a welcome break
for the industry. “Rising regulatory costs,
slow loan growth, low interest rates and a
rate curve that is not particularly friendly
make it a tough environment, one that
would normally lead to mergers. Raising
the $50bn threshold [for enhanced Fed
regulation] could spur the development of
a new crop of ‘super regional’ banks,” he
says.

Lending standards
To gain moderate Democrat support, Mr
Shelby’s package will likely have to be so-
ftered in other areas, particularly the pro-
posal to grant ‘qualified mortgage’ (QM)
protection to loans kept in banks’ own
portfolios or sold to another firm which
retains the loans on its balance sheet.
Under Dodd-Frank, banks receive auto-
matic ‘safe harbour’ protection against
charges of predatory lending for QM loans
that meet higher lending criteria, including
a five-year affordability test, a debt-to-
income test and a cap on loan fees. Rival
Democrat legislation would also grant
similar QM protection for loans kept on
banks’ balance sheets, but only for institu-
tions with assets of $10bn or less. Despite
public outcry from a wide range of con-
sumer advocacy groups, the two parties
may reach a compromise.

On May 21, Mr Brown’s office circulated
written warnings from dozens of consumer
advocacy groups and trade unions. Among
them, the American Federation of Labor
and Congress of Industrial Organizations,
the largest federation of US unions, wrote:
“The draft legislation removes critically
needed protections against high-risk, high-
fee loans and the practices that allowed
abuses in the mortgage lending process
that led to the 2008 crisis.”

Another concern by commentators
is that a rule that forces banks to hold
mortgage assets even when they become
distressed may have unintended negative
outcomes. At the same time, legislators are
under growing pressure to ease mortgage
lending rules that apply specifically to banks,
not just to increase credit supply, but to
stem a flood of business into the shadow
banking system. Among other things, Mr
Shelby’s bill would also force regulators to
re-assess the impact of regulatory capital
rules on mortgage servicing assets.

Mr Boltansky says: “With increasing
non-bank involvement in mortgage ser-
vicing, perhaps lawmakers should soften
the rules in the hope that banks will keep
the loans they originate rather than ship-
ning them off to non-bank players such as
Ocwen, Nationstar, Walter Investment
and others that have emerged since the
 crisis.”

Fed reform
The most far-reaching issue raised by the
Republican bill, however, is reform of the
Federal Reserve. Acknowledging grow-
ing pressure for greater transparency and
structural reform of the Fed, Mr Shelby’s
bill calls for a commission to consider
structural changes.

Ms Peirce says: “The Fed is getting a
lot more attention, not just because of its
increased post-crisis regulatory powers,
but also because we are in such an unusual
period of monetary policy. And pressure
for reform is growing.”

Mr Wheeler says: “The lack of a sin-
gle regulator is a problem. With so many
regulatory organisations to deal with –
the Office of the Comptroller of the
Currency, the Federal Deposit Insurance
Corporation, the Securities Exchange
Commission, the Fed and the Commodity
Futures Trading Commission – it’s a very
difficult situation and on that is overdue
for a far-ranging review.”

Community banks will hope they do
not have to wait for Congress to agree on
Fed reform before granting relief to small
banks. According to former Fed chair Paul
Volcker – who recently said the time has
come to consolidate US financial regula-
tors – the structure of US banking regula-
tion has been the subject of 25 official en-
quiries since the Second World War, with
little agreement or change.

Hester Peirce
“We are in such an unusual period of
monetary policy”
Transatlantic rift on clearing houses runs deep

Despite a fresh promise from US and EU regulators to agree a deal on equivalence for central clearing counterparties, divides appear quite fundamental.

By Philip Alexander

A brief joint statement from European commissioner for financial services Jonathan Hill and US Commodity Futures Trading Commission (CFTC) chairman Timothy Massad in early May promised a deal on one of the most important pieces of cross-border regulatory coordination “by the summer”. The European Commission already postponed new capital charges for bank exposures to derivatives central clearing counterparties (CCPs) twice, most recently in June 2015. They are now due to enter force in December 2015, to give time for an agreement with the US on mutual recognition. That fresh deadline is still approaching with no deal yet on what the US CCPs or their regulators might need to do to achieve equivalence with the European Market Infrastructure Regulation (EMIR).

“As home to the world’s two largest derivatives markets, we are committed to financial stability by ensuring an appropriate treatment of risks, as well as ensuring market participants can operate cross-border in a global marketplace. Discussions are constructive and progressing. They have been mutually satisfactory on the issue of the ability for both sides to potentially defer to each other’s rules,” Mr Hill and Mr Massad said in their joint statement.

Such conciliatory language, however, masks deep divides that remain around the EMIR regime for CCPs and its US counterpart under the Dodd-Frank Act. With talks going to the wire, clearing members and their clients are left with a real dilemma about how to respond in the meantime. Mr Hill told a hearing on EMIR in Brussels in late May that he expected the first central clearing obligation under EMIR (for interest rate swaps) to enter into force in April 2016.

“The frontloading provision of EMIR means that, even though the start date for the equivalence rules has been pushed back, banks still have to make decisions now about whether to clear trades with a US CCP, because they may need to change the clearing house for that trade if no equivalence is granted,” says Phil Lloyd, head of regulatory impact for Europe in the RBS corporate and institutional banking division.

Crucially, if the European Commission cannot rule that the US clearing house regime is equivalent to EMIR, banks will face much higher capital charges on the margin they post to US CCPs and on their default fund contributions. This could make the cost of clearing through US clearing houses uneconomical for EU participants in the derivative markets.

How much is enough?

One of the most thorny issues concerns differences in the margin requirements for EU and US CCPs. EMIR requires clearing members to post margin to cover two days of potential risks, netted for each client. EU dealers typically work on a principal basis, with clients required to post margin to the dealer as soon as they trade. By contrast, Dodd-Frank requires only one-day margin posting, but on a gross basis. US futures commission merchants (FCMs) typically operate on an agency basis, with the client required to post margin to the CCP on a T+1 basis.

In a hearing at the European Parliament’s economic and monetary affairs committee in May, Mr Massad recognised that “all other things being equal,” the two-day margin rules require 41% more margin than one-day posting. European market participants certainly believe business might migrate to US CCPs if they are deemed equivalent with the current margin requirements.

But the equation is not that simple, owing to the US gross margin requirement. Mr Massad said the CFTC had studied the nine largest clearing members at a US CCP, using actual data for a seven-day period, and calculated what the two-day net and one-day gross requirements meant in practice.

“What we found was that one-day gross was substantially higher than two-day net for each clearing member and for each day. That is, the total amount of customer margin under one-day gross was as high as 421% of the amount under two-day net, and was never less than 160% of that amount,” said Mr Massad.

European regulators led by the Bank of England apparently made a recent attempt to provide their own analysis of how two-day net versus one-day gross margin requirements played out in terms of margin required, but this seems to have made little difference to moving the debate forward. There is a growing sense among market participants on both sides of the Atlantic that the divide is partly political, tied up with other questions around regulatory deference and which non-financial institutions are exempt from the requirements.

Timothy Massad

“Discussions are constructive and progressing”

Steven Maijoor

“To what extent can we accurately assess the supervision undertaken by foreign jurisdictions?”

The EU continues to hold up the US equivalence determination over the single issue of differing initial margining standards for clearing houses. By contrast, the European Commission recently granted ‘equivalent’ status to several jurisdictions in Asia, including Singapore, which has the same margin regime as the US,” Terrence
Duffy, the president of the CME Group said in testimony to the US Senate in May 2015. However, European institutions are also uncomfortable with the US approach. Even if the CFTC considered the European regime to be equivalent, EU clearing houses would still have to go through a fresh registration process in the US.

“There is a sense of unease in Europe about the CFTC regime under which non-US CCPs must register as a designated clearing organisation in the US to provide clearing to US persons. That is in quite stark contrast to the European concept of recognition, under which the EU regulator is saying we will defer regulation of you to your home regulator if the US regime is deemed equivalent,” says Matthew Dening, a partner in the derivatives group at law firm Sidley Austin in the UK.

Moreover, US entities must clear through an FCM (even if that might be the US subsidiary of a European dealer). This means US clients would never clear on a principal-to-principal basis with a European bank.

“The US feels strongly that the FCM regime protects customers, but elements like the individual segregation rules under EMIR also provide a very high standard of protection,” says Mr Dening.

Other obstacles

However, the margin rules are not the only element of difference between the two regimes. US CCPs feel that EMIR over-regulates clearing on a number of provisions. The first is the rule in Article 28 that clearing houses must take measures to avoid procyclical margin requirements.

“This shall include avoiding when possible disruptive or big step changes in margin requirements, and establishing transparent and predictable procedures for adjusting margin requirements in response to changing market conditions,” the article states.

Techniques proposed include a 25% buffer over margin requirements that can be exhausted at times of rising market volatility, allocating a 25% weighting to the level that margin reached during look-back periods of market stress or ensuring that margin is not lower than it would be using volatility estimates for a 10-year look-back period.

“The EU could look to grant equivalence to a US regime if an individual CCP rulebook requires some kind of procyclicality buffer or they might look at everything in the round and say a US CCP is broadly equivalent. It is not clear yet what route the EU will take, but if Europe requires rulebook changes to address procyclicality, US CCPs will need to be notified to take action,” says Mr Dening.

Moreover, while non-financial companies are exempt from clearing requirements in the US, they are in scope in the EU if they trade over a certain volume of derivatives (known as NFC-plus). According to Mr Duffy of the CME Group, this is driving US NFCs away from derivative trading, to avoid crossing the NFC-plus threshold. Mr Duffy called on the CFTC to end no-action relief granted to European designated clearing organisations if the EU does not grant equivalence for US CCPs.

A broader approach

Understandably, most market participants are keen to find a way to defuse this dispute. The concept of ensuring the regimes are broadly equivalent, rather than haggling over precise margin or scope rules, seems a logical way forward in theory. But it is rather more complicated in practice.

“Potentially, what needs to be looked at before we can start talking about equivalence of outcomes is the default processes of CCPs, in terms of returning collateral to an underlying client, dissolving a defaulting clearing member and, if required, novating the client to another clearing member. If we can reach more standardisation in those processes across CCPs, that would be helpful,” says Andrea More of BNY Mellon’s collateral management team.

She adds that broker-dealers may sometimes choose a clearing house based not on the collateral set it will accept, but on other parameters around whether a client trade can offset existing house positions on that CCP. This is because bank capital charges on CCP default fund contributions can have a significant impact on the economics of clearing the trade.

Steven Maijoor, chairman of the European Securities and Markets Authority, suggested at a hearing on EMIR organised by the European Commission in May that the EU should examine an even more radical approach. The hearing is intended to feed into a review of EMIR implementation that the commission must undertake within three years of the legislation being passed into law (which was in 2012).

“I fully support the concept of regulators relying on each other’s supervision; that is very important in a global market. At the same time, we could have a debate about whether the current binary system – you are either equivalent or you are not – is the best way to progress in this area. Should we have a more granular system for these provisions, and to what extent can we accurately assess the supervision undertaken by foreign jurisdictions?” Mr Maijoor asked the audience.

If all else fails

So far, in addition to the 16 registered EU CCPs, 10 foreign clearing houses have been recognised by the commission. Another 31 are awaiting a decision, most of them in the US. In the meantime, derivative markets have already begun to fracture – although the US swap execution facility (SEF) rules are also a contributing factor (see GRR, May 2015, page 1). Ms More says clearing is already relatively bifurcated between the US and EU by its nature, and any failure to agree on CCP equivalence should not have a dramatic immediate impact.

“What we do not know is whether, when you combine this with the new margin rules for uncleared derivatives and the start of quantitative easing in the eurozone, there could be a collateral squeeze at some point in the future,” she says.

But other market participants are much less sanguine. Kenneth Kopelman, a partner in the derivatives practice at Sidley Austin in New York, says it would be "absurd" for the two most developed derivatives markets in the world not to recognise each other’s clearing house regimes.

“While market participants have started to get used to bifurcated liquidity, that does not mean it is healthy for the markets; regulators do not think it is a positive development. A fundamental principle of global derivative markets is to allow participants to trade and transfer risk in a portable way,” says Mr Kopelman.
EU mulls second consultation on non-cleared derivatives margin

As the EU and the US prepare to finalise rules, it is vital to ensure that participants do not face conflicting margin requirements.

By Philip Alexander

The European Commission is apparently considering an extra consultation paper as it seeks to finalise rules on margin requirements for over-the-counter (OTC) derivatives that are not cleared through a central counterparty. Market participants were anticipating the publication of this consultation in May, but it is still awaited. The final rules are now scheduled for completion in September 2015.

In January 2015, the Basel Committee on Banking Supervision (BCBS) and International Organisation of Securities Commissions (Iosco) postponed the start of their proposed global phase-in for collecting and posting margin on non-cleared derivatives from December 2015 to September 2016. This reflected the slippage in the timetable for implementing rules in key jurisdictions, especially the US and EU. However, the EU is now running about six months behind its original schedule on implementing these rules in its own jurisdiction, consuming most of the extra preparation time that was provided by the BCBS/Iosco delay.

“While this has taken longer than expected, we have achieved a great degree of consistency in standards globally, and this should smooth the operation of global markets and reduce the risks of regulatory arbitrage,” European commissioner for financial services Jonathan Hill told a hearing on the European Market Infrastructure Regulation (EMIR) in May 2015.

The extra consultation by the commission would apparently focus on the key areas of potential difference between the EU regime and those elsewhere, especially in the US.

“The basic approaches to uncleared swaps margin by the US regulators and the EU regulators are the same. They are both based on the BCBS/Iosco standards and to the extent there are differences they should not be insurmountable. But the two jurisdictions have to get this right – market participants require certainty, and the same entity should not face two different sets of rules for posting margin on the same trades,” says Kenneth Kopelman, a partner in the derivatives practice at Sidley Austin in New York.

Different thresholds

The BCBS/Iosco final margin requirements for non-cleared derivatives, published in September 2013, specified a threshold for an individual group to post initial margin. Any entity exceeding €6bn in aggregate month-end average notional amount of non-centrally cleared derivatives, based on a three-month period from June to August, will be subject to the rules from December 1 that year to November 30 the following year.

However, the EU deviated substantially, with indications from regulators that they considered the threshold too high to preserve financial stability. Instead, the threshold is $3bn, based on a daily average for the three-month June to August period the previous year. US market participants are pushing for a higher threshold in line with the EU and the BCBS/Iosco standards. Kenneth Bentsen, chief executive of the US Securities Industry and Financial Markets Association (Sifma) called on the US Commodity Futures Trading Commission (CFTC) to defer applying this different threshold in his November 2014 response to the proposals.

Phil Lloyd

“Physically settled foreign exchange swaps and forwards are excluded from all margin requirements in the US”

The position in the US is further complicated by the aim of setting the threshold at a group rather than a legal entity level, while potentially bringing inter-affiliate swaps within a group into the calculation. In June 2015, three US trade associations including Sifma wrote to US regulators warning that the inclusion of inter-affiliate swaps could “interfere with the ability of covered swap entities to manage their risks on a centralised, group-wide basis, reduce available liquidity and increase interconnectedness.”

The group-level threshold and the definition of an affiliate may pose particular problems to investment managers, warns Mr Kopelman. An affiliate is defined based on the level of control by the group.

“It is difficult to calculate voting interests in many fund structures. Also, if a manager runs several different funds, those are not really affiliates that should be viewed as a single group, which should be made clear. The definition of affiliate should conform with the reality of the economics of the structure,” says Mr Kopelman.

Different targets

The EU rules, however, have some distorting cross-border effects of their own. In particular, they bring into scope entities not covered in the US. Phil Lloyd, head of regulatory impact for Europe, Middle East and Africa at RBS in London, says some of the differences between EU and US rules are potentially profound.

“Physically settled foreign exchange swaps and forwards are excluded from all margin requirements in the US, but in scope for variation margin in the EU. That brings into scope many smaller counterparties that only trade FX,” says Mr Lloyd.

Moreover, the European treatment of non-financial counterparties (NFCs) varies depending on their location. Inside the EU, the rules will apply only to so-called NFC-plus firms that are above the
threshold. But EU participants will have to collect margin from counterparties below the threshold (NFC-minus) if they are based outside the EU.

Matthew Dening, a partner in the derivatives practice at Sidley Austin in London, says another important priority for the European Commission in the second draft will be to re-examine the rules that require EU entities to collect margin from non-EU counterparties, but not necessarily to post it.

“Of course, two-way posting could be done through contractual negotiation between an EU bank and a non-EU counterparty. But the absence of any requirement for an EU bank to post margin to a non-EU entity does not help negotiating processes, or the BCBS/Iosco intent to look at risk on a global basis,” says Mr Dening.

In his November 2014 response to the CFTC’s proposed rulemaking, Stephen O’Connor of the International Swaps and Derivatives Association (ISDA) suggested an alternative approach. Each regulator should specify rules for collecting margin from participants outside its own jurisdiction, but not the rules for posting margin cross-border. Hence in each jurisdiction, both local and foreign participants would be subject to one set of rules only, rather than facing conflicting requirements from home and host regulators.

**Different collateral**

The items that are expected to dominate any extra consultation by the European Commission are around the definitions of eligible collateral for posting as margin, rather than the thresholds. There would be cross-border implications if the EU and US specify different collateral definitions, which would make managing collateral pools extremely difficult for global institutions. At present, one of the key divides is over the use of cash as collateral and the ability to segregate it legally.

“The idea of segregated initial margin, which is fundamental to the Basel/Iosco framework, obviously takes a lot of liquidity out of the system. The concept of an omnibus segregated account held with a third-party custodian for all of a dealer’s counterparties has not yet been fully considered or tested. There is a ramp-up period, but this is still going to be a real challenge for custodians, dealers, clients and for creating appropriate documentation,” says Mr Kopelman.

For US dollar swaps, the US rules would only allow cash as variation margin. However, the US recognises pledges of cash or alternatives such as placing funds into a money market fund, which is then treated as a securitised line item in the event of a counterparty default. From a Basel liquidity coverage ratio perspective, this is not treated as punitively as holding cash on balance sheet.

The EU rules, as currently drafted, allow participants to post securities for both initial and variation margin. Even so, European institutions want the possibility of posting cash collateral, especially to tackle any temporary difficulties in the custodial system. But ownership of cash is not treated the same way as for financial securities under EU rules. This means title transfer or pledges of cash are not possible as the rules are currently drafted and cash collateral would have to stay on balance sheet, with the associated implications for the liquidity coverage ratio. A number of industry working groups are currently trying to find ways to address some of these questions, for instance from an insolvency law perspective.

Moreover, the EU has set a concentration limit of 50% for any individual name (most likely a sovereign issuer) in non-cash margin posting. No such limit exists in the US, and this is likely to be a key component of the additional EU consultation paper. The introduction of limits was understandable in the context of the eurozone sovereign debt crisis, but the first draft of the rules does not specify that the limit would apply only to lower-rated rather than the highest quality government debt.

“To say that a counterparty cannot put 100% of their collateral basket into G7 country debt such as US Treasuries or German bunds seems unusual, because that is considered very safe collateral. The concentration limit would require a much broader range of assets to qualify as collateral,” says Mr Dening.

The alternative is that participants will need to hold more cash collateral in the EU as well as the US. Mr Lloyd says banks are usually comfortable posting cash for variation margin.

“But it is much less favourable for other counterparts such as pension funds, which is also one of the reasons they are pushing for exemption from central clearing. The EU concentration limits for non-cash collateral could require pension funds to hold some cash, and managing and monitoring to that level of detail can be cumbersome,” says Mr Lloyd.

Another area the industry is hoping the EU will take a fresh look at is draft rules concerning currency mismatch. If participants post collateral in a currency that differs from that of the derivative transaction, the European Commission has proposed that this will be subject to a mandatory 8% haircut. In an article published by ISDA in April 2015, Mary Johannes, who coordinates ISDA’s response to the BCBS/Iosco margin requirements, expressed understanding for the risk of a currency mismatch in the event of a counterparty default and derivative close-out.

“But by introducing a haircut, the rules force the poster to hold more collateral, which creates additional credit risk. We would prefer to take the currency risk into account in the initial margin calculation so that it can be segregated,” said Ms Johannes.

The US rules for initial margin (which can be posted in the form of securities rather than cash) do not include a currency mismatch haircut, which raises questions over a potential unlevel playing field. The US rules also contain a separate complication. Banks cannot accept as initial margin collateral any paper issued by an entity in which the collateral provider holds a controlling stake of more than 20%.

“There is no central database of ownership positions from which to add information easily to a collateral eligibility set. But this is part of the regulations so the industry is discussing how feasible something like that would be and whether there should be an onus on the secured party to disclose if their collateral eligibility set needs to change due to a material change in their ownership of shares in other companies,” says Andrea More of BNY Mellon’s collateral management team.
Government guarantees 60% of financial liabilities

THE Federal Reserve Bank of Richmond has warned that 60% of the liabilities of the US financial system are subject to either explicit or implicit protection from loss by the US government. According to its annual ‘bail-out barometer’, the safety net provided by the US government has “grown considerably” since the first estimate in 1999.

“Despite efforts to end ad hoc bail-outs, the financial safety net that protects certain firms remains large under current government policies,” said the Richmond Fed, announcing its research.

“When creditors expect to be protected from losses, they will overfund risky activities, making financial crises and bail-outs like those that occurred in 2007-08 more likely,” it warned. “Over time, shrinking the financial safety net is essential to restore market discipline and achieve financial stability.”

The estimate includes implicit protection inferred from past bail-outs and government statements. For example, it includes: Federal Deposit Insurance Corporation-insured deposits; liabilities of the four largest banks (less insured deposits already included); short-term liabilities (such as Fed funds, repurchase agreements, commercial paper and other short-term liabilities); and uninsured domestic deposits at banks with assets of more than $50bn.

According to the Richmond Fed, the US government’s promise to provide capital if needed to the largest 19 banks during the 2008 and 2009 financial crisis has encouraged a view that all liability holders of these firms would be protected. The report said that market participants are likely to expect that banks larger than $50bn in assets designated as systemically important financial institutions (SIFIs) would not be allowed to enter bankruptcy because it seems “ill-suited” to handle the failure of SIFIs. Holders of SIFI’s short-term liabilities and uninsured depositors are therefore likely to expect to be bailed out, particularly given previous bail-outs.

The bail-out barometer also includes Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) liabilities, which since 2008 have been in government conservatorship and subject to a Treasury commitment to ensure they maintain a positive net worth. Pension fund liabilities covered under the Pension Benefit Guaranty Corporation and money market mutual funds (MMFs) are also included following the government protection granted to MMFs in 2008.

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The Bailout Prevention Act would limit the Fed’s emergency lending powers by requiring lending programmes to be broad-based, involving five or more institutions to participate; lending to solvent institutions only; and lending to be provided at a penalty rate. Emergency lending that does not comply with these restrictions would need congressional approval within three days.

The proposed legislation would also close a loophole that allows Goldman Sachs and Morgan Stanley to engage in “nearly unrestricted activities” with physical commodities.

Announcing the bill on May 13, Mr Vitter said: “It’s no secret that Too Big to Fail is still around. If another financial crisis happens tomorrow — and that’s still a real risk — nobody doubts that megabanks would be calling on the federal government to bail them out again. Our legislation makes common sense reforms to the Fed’s emergency lending powers to protect taxpayers the next time the megabanks lead us into another crisis.”

“If big financial institutions know they can get cheap cash from the Fed in a crisis, they have less incentive to manage their risks carefully, which further increases the chance of another financial crisis,” said Ms Warren. “This bill would make our financial system safer and help level the playing field between the megabanks and their smaller competitors.”

Hester Peirce, senior research fellow at the Mercatus Center at George Mason University, said that Ms Warren and Mr Vitter are reacting to concerns that there need to be additional constraints on the Fed over how it uses its emergency powers.

Says Ms Peirce: “The crafters of...
Dodd-Frank tried to put limits on section 13.3 of the Federal Reserve Act [which gives the Fed wide-ranging emergency lending powers] to make it harder for the Fed to make one-off bail-outs. But the Fed, in its proposal, retains a lot of discretion and doesn’t spell out how it would act in a bail-out situation. This gives a lot of room to make further bail-outs in the future.

Marcus Stanley, policy director of Americans for Financial Reform, said the Federal Reserve’s proposed emergency lending procedures have been “completely unsatisfactory and fail to place any real limits on the Fed’s ability to engage in indiscriminate bail-outs in the future.” He welcomed the Warren-Vitter bill to prevent bail-outs.

“In another example of Democrats joining Republicans, Ms Warren and Mr Vitter introduced legislation on May 7 that would force the Fed’s seven-member board to vote formally on all enforcement actions against banks involving fines of $1m or more.

David Vitter
“If another financial crisis happened tomorrow, nobody doubts that megabanks would be calling on the government to bail them out again”

Harvard study warns of non-bank mortgage activity spike

POST-CRISIS bank regulation is driving banks out of the mortgage market, sparking a boom in non-bank mortgage activity. This is the warning given in a June 1 paper released by Harvard Kennedy School’s Mossavar-Rahmani Center for Business and Government.

According to the study entitled What’s Behind the Non-Bank Mortgage Boom?, non-banks accounted for 42% of total mortgage origination in 2014 compared with just 12% in 2010. “Worth $9.8tn outstanding as of year-end 2014, residential mortgages constitute one of the largest financial markets in the US. They are not just big in size; they are big in controversy.”

According to the study entitled What’s Behind the Non-Bank Mortgage Boom?, non-banks accounted for 42% of total mortgage origination in 2014 compared with just 12% in 2010. “Worth $9.8tn outstanding as of year-end 2014, residential mortgages constitute one of the largest financial markets in the US. They are not just big in size; they are big in controversy.”

Badly underwritten mortgages were at the heart of the recent subprime crisis that triggered a global financial meltdown. The report urges policymakers to embrace non-banks but also address unintended regulatory factors that are driving depository institutions out of the mortgage market. Although the authors Marshall Lux and Robert Greene acknowledged that the “sluggish” US mortgage market would be much less vibrant without growing non-bank participation, they also warn that non-banks’ growing involvement in riskier non-prime Federal Housing Administration (FHA)-insured origins is a concern.

They suggest that implementing bank-like standards for non-banks is not the best strategy to substantially mitigate risks in the housing system and could stunt innovation. Instead they urge reform of the government-sponsored entities, such as Fannie Mae and Freddie Mac and FHA insurance.

The report concludes that despite some positive developments such as the disappearance of “deep subprime origins” and growth of innovative non-bank technologies, in the event of a housing market downturn, “an excessive proliferation of risky FHA-insured loans to non-creditworthy borrowers could result in system-wide risk.”

Fed U-turn on high quality liquid assets

THE Federal Reserve has proposed adding certain state and municipal bonds to the assets that banks can use to meet the liquidity coverage ratio adopted by US bank regulators last September. The proposed rule, released on May 21, would allow banks to hold a much wider range of high quality liquid assets (HQLA) to meet liquidity requirements introduced after the financial crisis.

The proposed rule would allow investment-grade US state and municipal bonds to be counted as level 2B HQLA up to certain amounts so long as they meet the same liquidity criteria applied to corporate securities. Limits on the amount of a state or municipal bonds that could qualify would be based on the specific characteristics of each bond.

US regulators originally omitted US municipal securities from HQLA because they were concerned that banks might not be able to liquidate municipal securities rapidly enough during a crisis. However, the Fed said its subsequent study suggested certain state and municipal bonds should qualify “because they have liquidity characteristics sufficiently similar to investment-grade corporate bonds and other HQLA asset classes.”

During the Fed's earlier rule-making, market participants had protested that municipal securities trade more often and in greater volumes than some corporate debt included as HQLA and that their exclusion could lead to higher funding costs for US municipalities.

However, law firm Sullivan & Cromwell warned that unless the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, which were part of the original rule-making follow the Fed’s acceptance of muni bonds as HQLA treatment, any rule change may have only limited impact.
Six months after the European Central Bank took charge of bank supervision in the eurozone, its division of powers with national authorities and international organisations is still being defined.

By Philip Alexander

Danièle Nouy, chair of the single supervisory mechanism (SSM) at the European Central Bank (ECB), has made clear the ambitious agenda for harmonisation that the SSM will pursue, and the difficulties of achieving it. In a letter to members of the European Parliament in May 2015, Ms Nouy said the “application of the different national laws is hampering the achievement of a level-playing field and further integration in the banking sector,” which is a key objective of the eurozone banking union.

EU directives can be interpreted at the national level based on each country’s legal system. Ms Nouy said this unavoidably led to “divergences” in the way rules such as the Capital Requirements Directive had been implemented.

“These are differences relating to both detail and scope. Furthermore there are cases where it is not clear whether certain national provisions implement or complement the directive, which gives rise to legal uncertainty whether, having regard to the provisions of the SSM regulation, the ECB is competent to exercise the power directly or instruct the national competent authority to decide,” said Ms Nouy.

Since November 2014, the SSM has been responsible for directly carrying out prudential supervision at the eurozone’s largest banks – currently 123 in number – and for indirectly overseeing smaller banks through the national authorities. For directly supervised banks, on-site supervision is now carried out by multinational joint supervisory teams (JSTs) based in Frankfurt.

“The ECB is moving rapidly to harmonise supervisory techniques. The JSTs are almost a revolution, because the head of the team will never be from the bank’s home country, which is an important cultural change. One of the main challenges for the new supervisor will be how to prioritise its actions and react swiftly to the questions from the banks to have a smooth relationship,” says Marie-Anne Barbat-Layani, chief executive officer of the French Banking Federation.

At present, directly supervised banks are still sometimes receiving information requests from local supervisors, and it is not always clear if this is on their own initiative or at the behest of the ECB. On the flip side, the ECB may also stray into areas that are theoretically still in the hands of national authorities.

“The ECB does not have a mandate on consumer protection, anti-money laundering or payments. But there have been some grey areas where the directly supervised banks have asked for clarification. In particular, the ECB has sometimes made direct enquiries on the payments system and security issues, even though banks are meant to be reporting to the local supervisor for this information,” says Reima Letto, head of banking prudential regulation at the Federation of Finnish Financial Services.

National discretion

Alongside the three directorates general consisting of JSTs, the SSM also has a fourth directorate general (DG4) under the former head of group risk at Germany’s Commerzbank, Korbirin Ibel. This has responsibility for providing specialised services across the whole SSM, including quality assurance, assessing banks’ internal capital models and developing new standards and policies. DG4 will be crucial to the harmonisation process within the banking union.

The SSM has already issued guidance on payout ratios for dividends, and to what extent banks can include interim profits in their Tier 1 capital. The regulator has indicated that its next priorities include national discretions on the definition of capital, especially the inclusion of deferred tax assets or goodwill, and the review of internal models.

“This is the first sign of evidence that the SSM wants to move quickly, and to ensure a level playing field; objectives that we totally support,” says Bertrand Lussigny, director of bank supervision at the French Banking Federation, and a former prudential regulator at the Banque de France.

The ECB has identified 154 national discretions that it is examining, and it calculated in the comprehensive assessment that these add up to a total of €126bn in capital — with the inclusion of deferred tax assets in the capital base a major contributor to this figure. Consultancy Deloitte has produced a six-month report card on the progress made by the SSM, which notes that three countries — Germany, Spain and Italy — account for half the sum.

“The concern is that higher capital needs could affect economic growth, but the response from SSM executives is that more credible definitions of capital will help boost confidence and bring down funding costs, so banks will not lose out overall,” says Clifford Smout, a partner in Deloitte’s centre for regulatory strategy in London.

Proportionate burden

This does not mean all national discretions will be removed. If the SSM believes there are grounds to take a proportionate approach, then some discretions could be retained. But to ensure a level playing field, Mr Smout says they would need to...
be open to all 19 members of the banking union. The question of proportionality also feeds into the wider discussion about how the arrival of the SSM will affect the thousands of smaller indirectly supervised banks.

“We would not expect the examination of the financial position of indirectly supervised banks to be as intensive as the comprehensive assessment. But the ECB remains ultimately responsible for the supervision of these smaller banks, and they will not want to adopt an approach that is transparently inconsistent with what they do with the larger banks. Any differences will have to be justified in terms of proportionality,” says Mr Smout.

However, Mr Letto says the SSM is already having an impact on indirectly supervised banks, because it has assumed responsibility for their licence approvals from the local supervisor. He says this has become very time-consuming, with large numbers of applications queuing up at the ECB even for mergers between small, highly capitalised Finnish co-operative or savings banks that have no cross-border operations.

“The local supervisor also seems to be willing to extend decisions addressed to directly supervised banks in a copy-and-paste manner to the indirectly supervised institutions, such as how far interim profits can be included in the core Tier 1 capital ratio,” says Mr Letto.

Business model scrutiny

Another potentially far-reaching innovation from the SSM is the adoption of business model analysis. This tool is already used by UK supervisors, but it represents a significant innovation in some eurozone jurisdictions. It may have strategic implications for certain banks.

“There are initial indications that the ECB may have reservations about certain business models, although the methodology has not settled down yet and we do not know how it will feed through to Pillar 2 capital add-ons. The SSM is very clear that it is not for them to mandate business models, but rather to discover what the potential weaknesses are,” says Mr Smout.

The analysis of business model weaknesses is particularly complicated. For instance, reliance on wholesale funding could make a bank more susceptible to failure or it could be the symptom of rapid balance sheet growth that is itself the source of vulnerability. Nonetheless, the need to ask such questions is clear, following the poor performance of Italy’s popolare co-operative banking sector during the comprehensive assessment. The Italian government has now introduced legislation to allow restructuring and changes to the popolare ownership system to ease recapitalisation of these banks.

“The ECB’s business model analysis will feed into the shake-up that is already happening. In Austria for instance, federal guarantees are being removed from the hypotheken banks, which will need to rebuild. Hypo Alpe Adria is being broken up, and the banks that have a central and eastern European focus are reconsid- ering their geographic footprints. We can also see that the Raiffeisen organisational structure is making it more difficult to raise additional capital,” says Josef Christl, an independent consultant who was previously head of bank supervision at the Austrian National Bank.

International sphere

One vital question on which the SSM regulation is largely silent is the role it will play in international regulatory discussions, in particular at the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS). Ms Barbat-Layani says the SSM is powerful because it represents 19 different countries without being tied to one particular national authority. She believes its credibility has been further enhanced by the success of the comprehensive assessment exercise in 2014.

“We have had the unsettling episode of the EU introducing the bank resolution and recovery directive, and then just a few months later the [total loss absorbing capacity] initiative was launched by the FSB. These things need to be more coherent, and one of the ways that can be done is for the ECB to play an important role in putting forward the interests and specific characteristics of the eurozone in global discussions on banking supervision. French banks support the banking union as this corresponds to their criteria of rigorous risk management,” she says.

Mr Smout says the ECB is also in a strong position to influence the discussions on the consistency of risk-weighted asset calculations. It has direct access to a larger sample of banks than the BCBS, and as a supervisor rather than a coordinating body it can also make deeper enquiries to get behind the numbers.

Daniel Trinder, global head of regulatory policy at Deutsche Bank, says studies by the BCBS suggested that about 75% of risk-weighted asset (RWA) variation was due to actual differences in risk, with a significant portion of the remaining 25% down to differing supervisory interpretations in each jurisdiction. He believes DG4 will play a central role in addressing these variations.

“The Bank of England and Federal Reserve both have a large number of global banks to benchmark and compare against. Most individual eurozone regulators never had that before. The SSM now permits peer review supervision. It has a division with a specific remit for peer and horizontal review, to ask searching questions about RWA consistency and other supervisory issues across the whole banking union,” says Mr Trinder.

A more immediate concern will be the SSM’s relationship with the other pillar of the banking union itself. The single resolution board (SRB) is already recruiting its staff, which will ultimately number 270. It will begin full operations from January 2016, based at the European Commission in Brussels, rather than with the ECB in Frankfurt.

The SSM has its own crisis management team and Mr Smout says there is the potential for this team and the SRB to require different information from banks on resolution planning. Mr Christl believes the real acid test of the whole banking union concept will be the ability of the two different boards in different cities to handle a crisis management situation.

“It is still too soon to judge the long-term success of banking union. The day-to-day supervision seems to be working well so far and supervisory standards in general are improving, but the complex organisational structure could be a major impediment to taking quick, difficult decisions,” says Mr Christl.
Ukraine tests IMF’s new sovereign debt restructuring policy

The International Monetary Fund unveiled a new approach in 2014 to countries whose debt burden might not be sustainable. Now Ukraine’s creditors will test that commitment.

By Philip Alexander

As the International Monetary Fund (IMF) prepared its June 2015 review of Ukraine’s emergency assistance programme, the Ukrainian government was locked in negotiations with creditors over the restructuring of sovereign Eurobonds. This process is a crucial test of the IMF’s credibility, because its board approved proposals in June 2014 that would tighten up its lending policies where a sovereign’s debt sustainability is in doubt (see GRR September 2014, pp10-11).

The change is intended to avoid a repeat of the 2010 programme for Greece, where money provided by multilateral institutions was used to service debt owed to private creditors for two years until the IMF insisted on a private sector debt restructuring. The new policy encompasses three choices: no restructuring if the sovereign faces a pure liquidity crisis; immediate restructuring if the debt is not sustainable; and an extension of maturities beyond the duration of the IMF programme if the sovereign’s debt is judged “sustainable, but not with high probability”.

“The IMF bent its criteria somewhat in August 2014 to grant Ukraine very large access to fund resources without a repossession, saying the debt was sustainable with high enough probability. Since then, further fighting in eastern Ukraine and the exchange rate sell-off meant that the IMF made restructuring a condition for the first review. The IMF might have wanted to make it a condition for approving the arrangement in the first place, but there was no time to do so because the National Bank of Ukraine was running out of reserves,” says Jakob Christensen, a senior economist at illiquid asset brokerage Exotix who previously worked on the Greek debt restructuring at the European Commission.

Four bondholders – BTG Pactual, Franklin Templeton, TCW Investment Management and T. Rowe Price – have declared holdings of $8.9bn in Ukrainian Eurobonds and formed a creditor committee. They announced in May that they had submitted a proposal to the Ukrainian ministry of finance that would not involve a principal reduction. This is essentially the IMF reprofiling concept, pushing both maturities and coupon payments beyond Ukraine’s four-year IMF extended fund facility programme.

The IMF for its part specified in March 2015 that any treatment of Ukrainian sovereign debt to the private sector would need to produce $15bn in savings during the programme period and bring the government and government-guaranteed debt to gross domestic product ratio under 71% by 2020.

“In order to achieve these goals, Ukraine’s debt restructuring must include a combination of maturity extension, coupon reduction and principal reduction,” finance minister Natalie Jaresko said in May 2015, announcing a debt moratorium bill that would enable the government to stop payments on its bonds if no deal is agreed with creditors. Ukraine has suffered an economic and exchange rate collapse since conflict flared in the eastern Donbass region in April 2014. The moratorium was passed while an IMF review mission was in Ukraine for discussions with the government, suggesting the government has the support of the IMF for its stance.

“A $15bn debt reduction is just about achievable by maturity extensions alone, but the IMF seems to implicitly assume that a 30% principal and some coupon reduction will be necessary,” says Mr Christensen. Fair restructuring principles

In an earlier critique of the creditor committee, Ms Jaresko called on them to abide by the principles for stable capital flows and fair debt restructuring, which were approved at a meeting of G20 governments in 2004. These principles include the importance of good faith negotiations by both sides.

A group of trustees coordinated by the Institute of International Finance (IIF) monitors adherence to the principles for fair debt restructuring. At the time Ms Jaresko invoked them, the creditor committee was in breach of one of the principles because it had not yet disclosed its membership.

“The principles emphasise the need for transparent negotiations on both sides and we are pleased to see that the bondholder committee has now disclosed its membership. The other key principle is for non-discriminatory treatment of different classes of creditors to the sovereign debtor,” says Hung Tran, executive managing director at the IIF.

In May 2015, a creditor committee representing about 30% of sovereign-guaranteed Ukrreximbank bonds agreed to a seven-year maturity extension and coupon uplift offered by the bank. If accepted by the requisite majority of bondholders, this offer will have the effect of avoiding a face-value write-down for investors. This is precisely the type of deal that the sovereign bondholders are now demanding.

“An agreed restructuring versus a default represents carrot and stick for both sides – the agreed restructuring is better for both because it will make it easier for Ukraine to re-access the markets and for creditors to control the write-down,” says Mr Tran.

Lee Buccheit is a partner at law firm Cleary Gottlieb who has represented sovereigns including Greece and Argentina in restructuring negotiations. He is not involved in the Ukraine negotiations, but on this occasion he has some sympathy with the creditor standpoint.

“How can one possibly design today a restructuring that addresses Ukraine’s needs? Those depend on how long the conflict continues and how much damage is done to the country’s infrastructure, and any deal today is likely to under- or overestimate what is needed. It is possible to achieve $15bn in savings by deferring payments for the next four years and then the timing may be right to discuss a principal haircut,” says Mr Buccheit.
Prospectus Directive presents best prospect for capital markets union

Amid a huge range of responses to the European Commission’s green paper, the importance of equity and infrastructure finance stand out. By Philip Alexander

A consensus is emerging around changes to the EU’s Prospectus Directive in the context of the capital markets union (CMU) proposal of financial services commissioner Jonathan Hill. In addition, ensuring the level 2 legislation (delegated acts) for the Solvency II Directive on insurance regulation is compatible with long-term infrastructure investment would also draw widespread support. These could represent the best opportunities for the commission to achieve early successes in its plan.

“People want us to be ambitious for the capital markets union, but they also want us to make quick progress where we can. One of the strongest messages to have emerged from the consultation supports our view that getting the Prospectus Directive right will be an important early priority,” Mr Hill said at a public hearing on the CMU in Brussels in June 2015.

At the time of going to press, the European Commission was about to publish the 425 responses it has received to the CMU green (consultation) paper released in February 2015. Many significant respondents have already released their comments directly. Notable among them was a joint declaration from eight industry associations, including the European Banking Federation, the Association for Financial Markets in Europe (AFME), and associations representing venture capital funds, issuers and chambers of commerce. The associations emphasised the importance of fostering an ‘equity culture’ in Europe. Equity finance, especially for small and mid-sized enterprises (SMEs) can play a key role in reducing leverage in the EU at a time when public and private debt levels are high.

“There is a need to further develop and recognise the importance of private sources of funding, especially equity, and to promote an investment risk culture in order to fund SMEs, notably start-ups, scale-ups and emerging and high growth companies,” said the response. The associations also called on the CMU initiative to ensure “a transparent and fair market including proportionate access for issuers, lenders and investors.”

The Prospectus Directive review will be the key focus of questions about proportionate regulation. In a separate submission to the green paper, AFME called for the development of a “less costly and complex” process for issuing securities, and especially for initial public offerings.

“Formal passporting requirements for full prospectuses of issuers listed on regulated markets should be removed, provided that investors are given a translated summary. Secondary issuers listed on any exchange should be allowed to use a short form prospectus,” said the AFME paper.

Crucially, the commission’s approach on this topic also appears to have garnered support from those focused on consumer protection, including regulators themselves and end-user groups. The French securities regulator Autorité des marchés financiers published several dedicated response papers, including one on the Prospectus Directive.

“The review of the Prospectus Directive must be an opportunity to streamline the information provided by issuers when they are up-to-date with their permanent and periodic reporting obligations. For SMEs and intermediate-sized enterprises, the proportionality regime of the Prospectus Directive could also be made more relevant without raising the prospectus exemption thresholds,” the AMF said in its response.

Better Finance, the European federation of investors and financial services end-users, also gave its backing to the green paper’s approach to the Prospectus Directive. It noted that previous reviews of this directive had not addressed key concerns for retail investors, but the green paper does. In particular, Better Finance is advocating the development of shorter, clearer and more standardised prospectuses with risks clearly weighted, rather than documents “produced as an exemption from liability rather than for the information of the investor.”

This consensus is in sharp contrast to proposals in the CMU consultation on easing rules for securitisation, which are backed by investment banks but have evoked scepticism from pro-reform voices. Public interest advocacy group Finance Watch argued in its response that securitisation was too complex to boost SME finance.

On Solvency II, reopening the level 1 legislation agreed by the European Parliament, Commission and Council as recently as November 2013 might be unwelcome. But there is clearly strong support for ensuring the level 2 rules currently being finalised by the commission should take account of the need to foster infrastructure finance. Insurance Europe, the industry’s trade association, expressed its ‘strong support’ for a “tailored prudential treatment” of infrastructure in Solvency II.

“This should include a flexible definition of infrastructure, as well as changes to the standard formula for both infrastructure debt and infrastructure equity to better reflect the true risks,” Insurance Europe said in its response.

In his speech in Brussels, Mr Hill recognised that life insurance companies and pension funds are the natural long-term investors in infrastructure, but had been retrenching into more liquid debt in recent years.

“There is a concern on the part of some member states, the insurance industry and other observers that the regulatory framework may indeed be driving this tendency,” he said.

France appears to be one of the member states taking this view. As with the Prospectus Directive, the AMF expressed support for reassessing Solvency II.

“The prudential requirements applicable to certain institutional investors (notably insurers under Solvency II) need to be reviewed in light of the objective set by the commission for a capital markets union to improve access to financing for infrastructure projects,” said the AMF in its response.
Newsroom

Warren’s ire turns to Mary Jo White

MASSACHUSETTS Senator Elizabeth Warren has publicly castigated the Securities and Exchange Commission (SEC) chair Mary Jo White for multiple failings during her two-year leadership. In a public letter dated June 2, Ms Warren said: “You have now been SEC chair for over two years, and to date, your leadership of the commission has been extremely disappointing.”

The 13-page letter outlines four key deficiencies in Ms White’s leadership: failure to finalise Dodd-Frank rules on CEO pay disclosure; failure to curb the use of waivers for companies found to be in violation of securities law; settling the “vast majority” of cases without requiring that companies admit guilt; and being unable to participate in “numerous” cases because of recusals related to Ms White’s prior employment at a Wall Street law firm and her husband’s ongoing employment at a Wall Street law firm.

Ms Warren also accused Ms White of failing to address undisclosed corporate campaign contributions and presiding over new SEC rule-making that have created large loopholes in Dodd-Frank disclosure rules.

Picking up on SEC commissioner Kara Stein’s recent dissent over waivers granted to companies that have violated securities laws enabling them to bypass certain SEC rules before raising capital, Ms Warren said a total of 20 waivers had been granted since Ms White became SEC chair “with virtually all going to large financial institutions”.

In her May 21 dissent, Ms Stein said that SEC’s granting of waivers to firms that had violated securities laws had “rendered criminal convictions of financial institutions largely symbolic”.

After its Libor guilty plea, Ms Stein said UBS had been granted a waiver on the explicit condition of compliance with the Libor judgment.

“That explicit condition has now been violated. Yet, the commission has just issued UBS a new WKSI (Well-Known Seasoned Issuer) waiver. It is troubling enough to consistently grant waivers for criminal misconduct. It is an order of magnitude more troubling to refuse to enforce our own explicit requirements for such waivers. This type of recidivism and repeated criminal misconduct should lead to revocations of prior waivers, not the granting of a whole new set of waivers.”

“Allowing these institutions to continue business as usual, after multiple and serious regulatory and criminal violations, poses risks to investors and the American public that are being ignored,” said Ms Stein.

Recent waivers include those granted to UBS, Royal Bank of Scotland and Deutsche Bank. “For more than six years, Deutsche Bank engaged in criminal conduct to rig interest rates in a manner that was ‘systemic and pervasive’ and sought profits at the expense of its customers. This waiver was granted by a 3-2 vote of the commissioners, and once again, you voted for the waiver,” wrote Ms Warren.

“And last week – one day before our meeting – five banks (UBS, Barclays, Citigroup, JPMorgan Chase & Co, and the Royal Bank of Scotland Group) pled guilty to ‘conspiring to manipulate the price of US dollars and euros exchanged in the foreign currency exchange’ and paid fines of more than $2.5bn. Despite the widespread criminal conduct to which these large banks admitted, the SEC granted WKSI waivers to each of them.”

Ms Warren ended the letter saying she was “disappointed that you have not been the strong leader that many hoped for – and that you promised to be. I hope that you will step up to the job for which you have been confirmed.” She also requested detailed updates on the issues raised in the letter.

Bermuda seeks full Solvency II equivalence

THE European Commission has announced its first package of equivalence decisions under the Solvency II insurance regulation. Full equivalence would allow insurers from the covered jurisdictions to insure or reinsure EU clients based on compliance with regulations in their home jurisdiction, rather than having to demonstrate compliance separately with Solvency II itself.

Switzerland was granted full, permanent equivalence in all three areas covered: solvency calculations, group supervision and reinsurance. Australia, Bermuda, Brazil, Canada, Mexico and the US were granted provisional equivalence for 10 years, covering the solvency calculation only.

The US had not applied for equivalence and some US state regulators have been critical of the EU’s rules. Chris Finney, insurance partner at law firm Cooley in London, says the decision is more of benefit to EU insurers than their US counterparts.

Jeremy Cox

“The authority has been working aggressively on addressing those caveats and we are well on target”

“Group capital equivalence only matters if a European (re)insurance group has a third-country subsidiary. If the third-country is not equivalent, the subsidiary’s assets and liabilities, and its contribution towards the group’s capital position must be calculated using Solvency II instead. And, in most cases, when that happens, the European group needs more capital than it would need if local rules could be used instead,” says Mr Finney.

By contrast, the main benefits for US insurers and reinsurers will only come if they are granted equivalence on group supervision and reinsurance rules. Mr Finney expects that, in practice, EU insurers and reinsurers will only come if they are granted equivalence on group supervision and reinsurance rules.
regulators will rely on US oversight for the purposes of group supervision on the European subsidiaries of US insurers, even if no equivalence decision is reached.

“The thorn in the flesh is therefore really a reinsurance thorn in the side of North American reinsurers. [This] is only likely to be salved, or removed, if the US/EU Solvency II equivalence negotiations get off the ground and a settlement can be found,” says Mr Finney.

Meanwhile, in the case of Bermuda, solvency calculation equivalence has only been granted for commercial insurers, not captive insurance. Mr Finney says this is surprising, as there had been indications that Bermuda would receive a full equivalence decision across all three categories.

Following the commission’s announcement, the Bermuda Monetary Authority (BMA) indicated that it would continue to seek full equivalence. BMA chief executive Jeremy Cox said that the European Insurance and Occupational Pensions Authority had recommended full equivalence, but with “certain caveats”.

“The authority has been working aggressively on addressing those caveats and we are well on target. Our submission for full equivalence is being reviewed as we speak and we anticipate a decision sometime between the third quarter of 2015 and the first quarter of 2016,” said Mr Cox.

Gaps remain in systemic bank supervision

THE quality of supervision for systemically important banks (SIBs) has improved significantly since the financial crisis, but gaps remain according to the Financial Stability Board (FSB). Its thematic review of SIB supervisory approaches found that progress varied between jurisdictions, with the UK, US and Switzerland making the most sweeping changes. In addition, the introduction of the single supervisory mechanism holds the potential for a major overhaul in the eurozone (see pp14-15).

“A common focus across all jurisdictions, particularly those that are home to a global SIB, has been the development of recovery and resolution plans. Corporate governance is another area of focus for many national authorities, with supervisors in Germany and the UK regularly attending banks’ board meetings and having a more intensive approach to assessing applicants in key management positions for those firms,” the FSB noted in its review.

The FSB also praised the use of stress-testing and business model analysis to establish a more forward-looking approach to SIB supervision. However, the review identified a number of outstanding challenges that need addressing. These include identifying the goals against which the supervisors’ own effectiveness can be assessed, maintaining constructive dialogue with banking institutions and ensuring that data requests are relevant to a deeper understanding of SIBs’ strategic choices and related risks. The FSB also called for a reassessment of the functioning of cross-border supervisory colleges that are used to oversee global SIBs and of the resources needed for supervision.

“[The authorities need to] effectively manage the volume of regulatory and supervisory change, including by having sufficient budgetary resources and building and maintaining a skilled, capable and experienced workforce,” the FSB warned.

Clearing reprieve for EU pension funds

THE European Commission has given pension funds an extra two years to comply with the clearing requirements under the European Market Infrastructure Regulation. Mandatory clearing of derivatives by pension schemes, which would have come into force at the same time as for other financial institutions, will not now commence in the EU until August 2017. European commissioner for financial services Jonathan Hill has indicated that he expects clearing obligations for interest rate swaps to begin in April 2016 (see pp8-9).

This decision follows a baseline study by the commission examining whether clearing houses had developed “appropriate technical solutions” that would allow pension funds to post non-cash collateral such as government bonds. The study also analysed the impact of removing the exemption for pension funds without such a solution being in place, in terms of the reduction in retirement income for pensioners.

“Based on the study, the commission concludes that the necessary effort to develop appropriate technical solutions has not been made at this point in time,” the commission announced in a new delegated act extending the exemption.

France calls for progress on money market funds

THE French securities regulator, Autorité des Marchés Financiers (AMF), has called for the EU to implement proposed regulation of money market funds as soon as possible. The European Parliament approved draft legislation in April 2015, but the European Council of member state governments has yet to agree a negotiating position. The AMF was responding to the commission’s consultation on capital markets union (see p17), which did not specifically mention money market fund reform. The regulator said that this reform was a vital part of reconciling investors with the markets, which is the underlying aim of capital markets union.

“To restore investor confidence in markets, reforms underway and planned reforms aimed at mitigating systemic risk must be completed. Finalising the reform of money market funds is a major piece in the regulation and supervision of shadow banking,” the AMF said.

In particular, the AMF urged EU legislators to go further than current proposals and mandate the transformation of all constant net asset value (CNAV) money market funds into the variable net asset value (VNAV) format. VNAV funds account for about 40% of the total EU money market funds industry, and almost 80% of them are domiciled in France. The text voted on by the European Parliament suggests retaining CNAV funds for retail investors and funds invested in government bonds.

“Although we see positively the fact →
that the debate is moving forward, we still consider that requiring CNAV funds to float their NAV ultimately – like any other investment product – is the only way to fully address the financial stability concern associated with the CNAV model and put an end to the confusion with bank deposits,” the AMF warned.

### CFTC objects to reauthorisation terms

COMMODITY Futures Trading Commission (CFTC) chairman Timothy Massad has written to House Agriculture Committee chairman Mike Conaway criticising proposed legislation that would reauthorise the CFTC for five years. Mr Massad described provisions outlining the CFTC’s regulatory powers as unnecessary and unduly restrictive, making “it harder to fulfil our mission”.

**Timothy Massad**

“Many of the provisions are either unnecessary or impose requirements that would make it harder to fulfil our mission”

“Many of the provisions in the bill before the committee are either unnecessary or impose requirements on the commission that would make it harder to fulfil our mission,” Mr Massad said in his May 13 letter explaining that the bill would limit the CFTC’s ability to respond quickly to market events. “It will make it more difficult for us to make adjustments to rules and achieve greater global harmonisation of swaps rules,” he added.

“Title II of the CFTC reauthorisation act 2015 also imposes procedural requirements on the [CFTC] that to my knowledge are not followed by any other independent agency. These changes would make it difficult to manage the [CFTC] and ensure accountability, and could weaken the commission for administrations to come.”

By seeking to codify CFTC actions into law, Mr Massad said the legislation could create new and unintended loopholes and uncertainties. Furthermore, a provision addressing the cross-border application of swaps rules “would make the challenge of harmonising rules harder, rather than easier”.

### EU benchmarks reform moves to next stage

A plenary session of the European Parliament endorsed the proposed regulation of financial benchmarks that had earlier been approved by the parliamentary economic and monetary affairs committee.

The regulation, a response to the rigging of key interest rate benchmarks such as Libor, will now proceed to tria- role negotiations with the European Commission and Council of member states, starting in June.

“We need safeguards in place for such benchmarks as Libor, we also need a large number of indices to avoid the market concentration, and we need a balanced approach towards smaller and bigger benchmarks,” said Cora van Nieuwenhuizen, the parliamentary rapporteur on the legislation.

The threshold for benchmarks to be deemed “critical” and face higher levels of supervision was set by the parliament at €500bn. By contrast, the council’s negotiating position, agreed in February 2015, proposed a lower threshold of €400bn. The inclusion of commodity benchmarks and the right of national authorities to deem a benchmark “critical” in their jurisdiction are likely to be the other key points of contention in the trialogue discussion.

“Our proposal will put in place rules for safer benchmarks across the EU. I am confident that we can now move swiftly to find an agreement on a final text,” said Jonathan Hill, the European commissioner for financial services, welcoming the parliamentary vote.

### European Parliament rejects bank structural reform

THE European Parliament’s economic and monetary affairs committee (ECON) voted down proposals that would require the largest universal banks to structurally separate their trading desks if they could not demonstrate their resolvability. The draft legislation was defeated by a combination of centre-left parties and right-wing eurosceptics.

Left-wing members of the European Parliament believe rapporteur on bank structural reform, Gunnar Hökmark, has diluted the European Commission’s original proposal too far, by making mandatory separation unlikely and excluding market-making activities. Mr Hökmark, who is from the largest centre-right grouping the European People’s Party (EPP), tried to build a majority with the right-wing European Conservatives and Reformists and the liberal grouping, excluding the largest centre-left grouping, the Social Democrats, who introduced amendments to force mandatory separation. In a confusing outcome that will prevent attempts to open trialogue discussions with the European Commission and Council of member states, neither the Social Democrat amendments nor Mr Hökmark’s proposals could muster a majority.

**Jakob von Weizsäcker**

“We are calling for a reversal in the burden of proof for the largest banks with the most extreme business models”
“ECON voted against mandatory separation in support of the rapporteur, but the report was voted down by an alliance of the left and the extremes,” Mr Hökmark said after the vote.

Gunnar Hökmark “ECON voted against mandatory separation in support of the rapporteur, but the report was voted down”

Public interest advocacy group Finance Watch suggested that the failure was an opportunity to introduce more meaningful reform of too-big-to-fail banks. The group’s secretary-general, former investment banker Christophe Nijdam, said Mr Hökmark’s claim that the largest universal banks produce stable long-term investment was contradicted by the evidence.

“Structural reform of the EU’s too-big-to-fail banks is essential if we are to restore trust in the banking sector and a level playing field among banks. ECON rejected the Hökmark report, which would have added layers of administrative burden without benefiting the public interest,” said Mr Nijdam.

Jakob von Weizsäcker, the Social Democrat shadow rapporteur on bank structural reform, emphasised that his grouping was ready to resume negotiations with Mr Hökmark. But this could only happen if the EPP rolled back its attempts to “water down” the commission’s original proposal, he indicated.

“Since too-big-to-fail banks continue to pose a serious risk to taxpayers, we are calling for a reversal in the burden of proof for the largest banks with the most extreme business models. In the future, they should be obliged to demonstrate to bank supervisors beyond any reasonable doubt that they do not present any systemic risks. If a bank fails to pass this test, it would then either be split up or, alternatively, the capital requirements would be increased very substantially,” said Mr von Weizsäcker.

In the context of this effort to toughen up Mr Hökmark’s failed draft, the European Banking Federation (EBF) said that it remained “deeply concerned” about the bank structural reform proposals.

“The outcome of the ECON vote shows that there is no clear consensus on what is right for big universal banks in Europe. The EBF urges policy-makers to rethink their priorities as the bank structural reform proposal could lead to a loss in European investment capacity equal to 5%, representing a decline of almost €100bn in capital expenditure in the long term,” the EBF said in a press release.

Asset manager backlash against SIFI designation

THE Financial Stability Board/International Organisation of Securities Commissions (FSB/Iosco) second consultation on a methodology to designate non-bank, non-insurer systemically important financial institutions (SIFIs) has triggered a wave of highly critical responses from the financial industry. The largest US asset management firms believe the criteria will most likely result in their designation as SIFIs, with few other institutions affected. The FSB will upload all public responses to the March 2015 consultation to its website on June 15, 2015.

Many industry participants, however, have already published their views directly. The Investment Company Institute (ICI) filed a 216-page response which emphasised that the FSB has not addressed the criticisms it had already received following the first consultation in January 2014.

“The second consultation continues to place undue emphasis on the size of a fund, thus continuing to single out large, highly regulated US funds as candidates for potential designation. The second consultation also adds criteria to sweep large asset managers into the designation net, again appearing to target large US firms,” the ICI said in its response.

According to the ICI, the consultation has acknowledged “the vastly different risk profile of investment funds and asset managers, as compared to those of banks,” but failed to act on this recognition. In particular, the ICI criticised proposed materiality thresholds ($100bn for individual funds, $30bn and three times leverage for alternative investment funds and $1000bn for asset management companies) as having “no data or analysis” to support them. The ICI noted that long-only mutual funds are usually unleveraged, making them entirely different from banks. This “undermines the FSB’s goal of “broad consistency” with the global systemically important bank methodology,” the ICI argued.

Meanwhile, the asset management group of the Securities Industry and Financial Markets Association (Sifma) urged the FSB/Iosco working group to “drop efforts” to develop a SIFI designator altogether. Sifma suggested the FSB should focus instead on its recently convened working group on asset management products and activities.

“This second consultation does not reflect the avalanche of empirical studies and substantive comments that highlight how asset managers and investment funds do not present systemic risk, making global SIFI designation at the entity level ineffective at best. Sifma is concerned that the second consultation could lead to increased costs and other negative consequences for investors and capital markets without actually addressing any systemic risk concern,” said Timothy Cameron, head of Sifma’s asset management group.

A common thread in the responses is the effort to paint the SIFI identification methodology as primarily the work of FSB prudential regulators, rather than the Iosco securities regulators. This may reflect divisions within the workstream itself. Members of the US Securities and Exchange Commission (SEC) have repeatedly criticised the proposals. Most recently, in May 2015 SEC commissioner Michael Piwowar expressed the view
that “banking regulators do not understand the asset management industry or that asset managers and investment companies are already subject to comprehensive regulation by the commission.”

“It is the commission, not the banking regulators, that has the requisite expertise and experience with capital markets,” said Mr Piwowar.

For the first time, securities regulators in other countries have begun to hint at sympathy with this view. In an interview with the Financial Times newspaper in June, Martin Wheatley, the head of the UK Financial Conduct Authority, questioned the exclusion of private investors and sovereign wealth funds from any examination of systemic risk. The ICI’s response also pointed out that many sovereign wealth and state pension funds would exceed the FSB/Iosco thresholds, but were not considered in the SIFI consultation.

“I’d find it perverse if we ended up putting handcuffs on a set of players in markets – the asset managers – just because they’re regulated and we know them, and yet allow people on the lakeside in Switzerland and sovereign wealth funds in the Far East and central banks to play with free rein in those markets,” said Mr Wheatley.

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**Basel consults on interest rate risk**

THE Basel Committee on Banking Supervision (BCBS) has published a first consultation on how to capitalise interest rate risk on the banking book (IRRBB). The BCBS task force on IRRBB has been meeting since the first half of 2013 and had previously intended to submit a first consultation during 2014.

“The committee’s review is motivated by two objectives. First, to help ensure that banks have appropriate capital to cover potential losses from exposures to changes in interest rates. This is particularly important in the light of the current exceptionally low interest rate environment in many jurisdictions. Second, to limit capital arbitrage between the trading book and the banking book, as well as between banking book portfolios that are subject to different accounting treatments,” the BCBS said in a statement announcing the consultation.

The delay is partly because the topic has proved contentious among regulators. At the core of the debate is whether IRRBB should be capitalised under Pillar 1 or Pillar 2 of the Basel framework – the public capital ratio of the bank or its confidential supervisory add-ons.

In a sign that this divide has not been reconciled yet, the BCBS proposed a choice between Pillar 1 and Pillar 2 approaches in its consultation. Pillar 1 would “have the benefit of promoting greater consistency, transparency and comparability, thereby promoting market confidence in banks’ capital adequacy and a level playing field internationally,” the BCBS said. By contrast, the proposed Pillar 2 approach would include quantitative disclosure of what the Pillar 1 IRRBB capital requirement would be, but would “better accommodate differing market conditions and risk management practices across jurisdictions.”

A number of jurisdictions, including Australia and Germany, have already moved toward Pillar 1 capital requirements for IRRBB. But most continue to treat this risk as part of the Pillar 2 process. Just two weeks before the BCBS announcement, the European Banking Authority updated its guidance on how supervisors should monitor IRRBB under the Capital Requirements Directive.

These guidelines specify how supervisors can add a Pillar 2 capital charge if a simulated 200 basis point interest rate shock had a significant impact on a bank’s capital adequacy. The Pillar 2 choice in the new BCBS consultation emphasises that supervisory responses should have “a strong presumption for capital consequences for banks with high levels of IRRBB.” The consultation closes on September 11, 2015.

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**FSOC report lists current risks**

THE Financial Stability Oversight Council’s (FSOCs) annual report has highlighted that potential credit and liquidity risks associated with central counterparties during periods of market stress are minimised. Also among the risks being monitored by the FSOC in its annual report released in May are those arising from market structure, liquidity, interest rates, cyber security and data collection.

FSOC’s annual report specifically cites a lack of transparency in sectors of the financial system, including asset management, securities lending and bilateral repo markets.
Shelby aims to bring clarity to insurance SIFI designations

While the Republican bill may not immediately overturn the status of insurance firms as systemically important financial institutions, it could lead to a gradual decline.

By Philip Alexander with additional reporting by Charles Piggott

Senator Richard Shelby’s financial regulatory improvement bill is mainly focused on the banking sector (see cover story), but it also steps up his scrutiny of the Financial Stability Oversight Council (FSOC). In particular, Mr Shelby has repeatedly criticised FSOC’s process for designating insurers as systemically important financial institutions (SIFIs). Titles 3 and 4 of his bill are the most relevant to the insurance sector. Title 3 is designed to encourage SIFIs to take steps that might lead to their removal from the designated SIFI list. Title 4 specifically focuses on insurance regulation.

“Title 4 contains three provisions intended to improve accountability and transparency in the regulation of the insurance market. Two of the three provisions are based on bipartisan bills co-sponsored by members of this committee,” Mr Shelby said in his opening statement to the hearing on the bill in May 2015.

Questions over FSOC designation of insurance SIFIs, and how the Federal Reserve will regulate them, are certainly coming from beyond the Republican Party. Evidence of this came from two non-partisan officials working in insurance regulation, during earlier hearings at the Senate Banking Committee in late April 2015. Roy Woodall, the former Kentucky insurance commissioner appointed by President Barack Obama to be the independent insurance expert on the FSOC, has long criticised the designation process. Mr Woodall told the Senate hearing that he thinks the FSOC should focus on specific activities within insurance companies, where they heighten the systemic risks or interconnectedness of insurers with the rest of the financial system.

“In my opinion, the better approach would be for the council to designate the activities themselves as presenting systemic risk,” said Mr Woodall.

Kevin McCarty, the insurance commissioner for the state of Florida who represented the National Association of Insurance Commissioners (NAIC) at the Senate hearings, steered clear of the designation process itself. But he emphasised the need for the Fed to adopt insurance capital standards that are appropriate to insurers’ business models.

“These standards are in addition to, and not in lieu of, state risk-based capital standards applicable to the insurers within those groups, so we would encourage the Federal Reserve to work closely with us to ensure their standards complement our existing regulatory authority,” said Mr McCarty.

Despite the broad-based desire to ensure that insurance regulation does not mimic the rules imposed on very different bank business models, the initial indications are that the insurance debate will still split along party lines. This would prevent an immediate roll-back of SIFI status. Sherrod Brown, the ranking Democrat member of the Senate Banking Committee, told the April hearings that FSOC members needed to be alert to emerging risks in the insurance industry.

“While I believe that traditional insurance is a distinct business from banking, and should be treated as such, it is important to remember that institutions often combine regulated activities and so-called shadow banking. We know that insurers can engage in a wide range of activities, from derivatives to securities lending,” said Mr Brown.

Jeffery Harte, principal at asset management firm Sandler O’Neill, says the role of insurers may change precisely because of the tougher regulations facing banks.

“As riskier activities get pushed out of regulated banks into the shadow banks, some insurance companies have balance sheets large enough to take on the role historically played by banks. Whether non-banks are more likely to escape enhanced regulation under Senator Shelby’s proposals may have a bearing on the extent to which they compete with banks in traditional lending businesses,” says Mr Harte.

Daniel Schwarcz, associate professor at the University of Minnesota law school and a longstanding advocate of federal insurance regulation, told the April Senate hearings that the changing nature of the insurance industry was a strong reason to maintain a flexible FSOC designation process.

“Although this design choice inevitably reduces transparency, FSOC has done a reasonably good job of addressing this concern; for instance, FSOC’s development of a quantitative screen in the first stage of its designation process. At the same time, FSOC’s refusal to rely exclusively on quantitative metrics in its designation process or to define a simple, formulaic ‘off-ramp’ for designated firms preserves its ability to effectively evaluate and monitor the potential systemic importance of individual firms,” said Mr Schwarcz.

Mr Shelby’s bill seeks to clarify an off-ramp process. An insurance SIFI’s representatives would have the chance to meet with FSOC members and present materials including a remedial plan during the annual FSOC re-evaluation of the firm’s SIFI status. FSOC would then have to hold a vote and provide the insurer with a justification if it voted to maintain the SIFI designation.

At present, the focus is inevitably on MetLife, which has launched a legal appeal against its 2014 SIFI designation; the designation was opposed by Mr Woodall. But even AIG, which was at the epicentre of the financial crisis and whose designation was supported by Mr Woodall, could be on a path away from SIFI status. Isaac Boltansky, policy analyst at Compass Point Research & Trading, thinks the FSOC will consider de-designating non-bank SIFIs regardless of the fate of Mr Shelby’s legislation.

“The reality is AIG has three separate units that could be carved up pretty neatly between property and casualty, life, and mortgage insurance, at which point each one of those can be a stand-alone entity, at which point the FSOC can declare victory against perhaps the best-known too-big-to-fail firm in the world,” says Mr Boltansky.
Diary: conferences, meetings and deadlines

June
Jun 14 G20 workshop on the international monetary and financial system, ‘Short term challenges, long-term solutions’, Bodrum, Turkey www.g20.org
Jun 14-17 American Bankers Association regulatory compliance conference, Washington, DC www.aba.com
Jun 15 European Securities and Markets Authority consultation on complex debt instruments and structured deposits in Markets in Financial Instruments Directive II closes www.esma.europa.eu
Jun 15-19 32nd Financial Stability Institute international banking supervision seminar, Beatenberg, Switzerland
Jun 19 Comment deadline for European Banking Authority consultation on EU firms’ exposures to shadow banking and appropriateness, and impact of imposing exposure limits under the Capital Requirements Regulation www.eba.europa.eu
Jun 22-24 Futures Industry Association’s annual law and compliance division conference on derivatives regulation. Event has been moved to Washington DC www.fia.org
Jun 24 British Bankers’ Association annual liquidity conference focusing on new liquidity coverage ratio templates, net stable funding ratio, capital treatments of liquidity and managing interest rate risk, London www.bba.org.uk
Jun 25-26 Institute of International Finance Europe summit, Frankfurt www.iif.com

July
Jul 6 Comments due on Securities and Exchange Commission’s additional analysis on proposed pay ratio disclosure rules www.sec.gov
Jul 24 Comment deadline on Federal Reserve board proposal to add certain state and municipal bonds to the range of assets banks can use as high-quality liquid assets under the liquidity coverage ratio requirement www.federalreserve.gov

August
Aug 4 International Association of Insurance Supervisors capital standards development stakeholder meeting, Basel

September
Sep 10 Institute of International Finance China Economic and Financial Forum, Beijing
Sep 8-10 International Association of Deposit Insurers/Financial Stability Institute policy meeting on bank resolution, crisis management, total loss absorbency capacity and deposit insurance, Basel www.iadi.org
Sep 11 Basel Committee on Banking Supervision comments due on consultative document on interest rate risk in the banking book www.bis.org
Sep 14-18 Financial Stability Institute applied risk management seminar for bank supervisors on credit risk and asset securitisation, Beatenberg, Switzerland
Sep 14 Prudential Regulation Authority consultation closes on its draft supervisory statement on good board governance www.bankofengland.co.uk/pra
Sep 29-Oct 1 FSI seminar for bank supervisors on international accounting and auditing for banks, Basel, Switzerland www.bis.org

October

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