Regulation remains local, finance remains global: Will this change? Keynote speech at ASIFMA Annual Conference 2015

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Thank you Mark for inviting me to speak at your conference this year.

Today I want to talk about problems which still affect the regulation of cross-border finance, especially our favourite subject of extraterritorial rulemaking.

I'll try to look at this from two viewpoints. First, a global one, mainly looking at the lessons learned from the International Organization of Securities Commissions' (IOSCO) Task Force on Cross-Border Regulation, which I chaired over the last two years, and which issued its public report in September. And I'll also speak about these issues more from an Asian perspective.

Now the base case is pretty much the same as when I spoke at the Asia Securities Industry & Financial Markets Association (ASIFMA) event last year: much of finance is still global, but on the whole regulation remains local. But after the global financial crisis, local rules now extend far beyond territorial borders. This simple fact of life gives rise to many issues on which I know ASIFMA and others have spent a lot of time.

And this is a really important issue for Asia. It's undeniable that we have been on the receiving end of a large volume of other countries' post-crisis rules and regulations. This is in part because firms headquartered in the West are very active in our part of the world. This in turn enables home regulation to extend its reach to where these firms operate, particularly local branches of foreign banks as well as to the Asian domestic firms they deal with.

But even within the region there are big challenges. And here I was struck by a statistic in an FT column this week. This was that the 10-member Asean group accounts for only 3% of global GDP despite having 9% of world population. The article concluded that "This underachievement derives in part from political and regulatory diversity that undermines regional competitiveness and inhibits inflows of investment into manufacturing and infrastructure".

From my experience this is absolutely correct. And this story isn't just about Asia – it has a parallel at the global level. This is because, despite the ambitions of the industry, it's still unrealistic to think we will have anything close to complete regulatory harmonisation anytime soon.

A world of extraterritoriality

Now, it's obvious that in recent years, US and EU policy goals have dominated the international reform agenda, both at a Group of Twenty (G20) and at a regional level.

The problems these policies are trying to address originated in their own economies, which account for over half of global markets. Their proposed solutions, however, have been exported to Asia. And this continues.

This obviously has been a major issue for Asian regulators. The upshot is that we have no option but to develop rules which at least take account of those in the US and in the EU. Basically this is to guard against the potential for a withdrawal of foreign firms from affected sectors in the region, and also the potential for restricted cross-border market access to western markets. And of course we need to ensure that solutions are consistent with our own distinctive markets and our legitimate policy goals, but still avoid regulatory arbitrage.

And I should make clear that all regulators know full well that the way in which cross-border laws and regulations are coordinated drives the business decisions of global firms. These decisions are mainly about the relative costs of regulation. An example at the simplest level is the potentially large capital charge if an EU bank operates in a place which hasn't been given a tick that its rules are sufficiently similar to EU rules. This in turn can impact capital market development and economic growth. So many in the industry are right to be concerned.

And from a different angle, I think it's interesting that worries about Know Your Client, anti-money laundering, sanctions and similar conduct violations under US or EU rules have now trigged a major concern about a withdrawal from correspondent banking around the world. The worry is that this is harming financial inclusion and broader financing in smaller markets. You can see the parallel with the more extreme implications of extraterritoriality, which can also incentivise firms to withdraw from some markets.

And of course all of this puts the onus on regulators to negotiate with their regional or international counterparts to achieve answers which do not load unnecessary costs on the industry, but which stick to the fundamentals of post-crisis reforms.

But the truth is that this is far easier said than done – it is really hard to make it work and is hugely time consuming.

But we fully recognise that this effort is worth it because it directly affects how firms operate in the real world.

Recent positive outcomes include the US Commodity Futures Trading Commission's (CFTC) decision to permit our firms to deal directly with US customers when trading futures or options. And a few months back, the EU recognised our over-the-counter (OTC) clearing house as well as those in Australia, Japan and Singapore. This meant that European banks can clear derivatives here without a penal capital charge.

But looking ahead, we can see more potential for extraterritoriality, including from Europe with new Benchmarks regulation hard on the heels of the Alternative Investment Fund Managers Directive (AIFMD), the European Market Infrastructure Regulation (EMIR) and the like.

The international reach of each of these has to be negotiated individually and also require memoranda of understanding (MOUs) to underpin agreed equivalence decisions. Just last month, we signed another MOU with the EU on the exchange of information about derivative contracts held in trade repositories. And this means that the MOUs for a range of recognition decisions will themselves multiply, implying even more time and resources to monitor compliance with MOU obligations. It's altogether a major project.

And I should say here that we have to be vigilant because extraterritoriality does not always operate in the way we would expect.

For example, late in 2014, the European Commission found that exchanges and investment firms amongst Australia, Hong Kong, India and Japan were not deemed equivalent for EU supervisory and regulatory purposes. This was about exposures under the EU's Capital Requirements Regulation, and again implied higher costs for firms connecting to Asian markets.

This was, to say the least, a surprise. First, there seems to have been no prior consultation with regulators in the affected markets. Second, it seems that the decision was based on the result of each jurisdiction's last International Monetary Fund Financial Sector Assessment. The problem with this was that most assessments were seriously out of date, which meant that progress made since then was ignored. Obviously, we were not all that happy with the process and also the fact that these assessments were made public.

Cross-border regulation

Now as I mentioned earlier, IOSCO has been considering how it can address these issues at a global level.

And here I would just like to take a few minutes to go through what I said at the last Financial Stability Board (FSB) Plenary meeting in September when reporting on the work of our IOSCO Task Force.

First, the basic problem is fairly straightforward. This is that the application of local rules to cross-border financial business which affects national interests can lead to conflicts where one internationally active firm is subject to different conflicting rules.

This can balkanise markets and lead to a broader drag on cost-effective financing for growth.

And of course the most discussed example is derivatives, where talks are still eating up a large amount of time in the EU, the US and elsewhere.

Now the G20 in its 2013 Moscow and St Petersburg communiques introduced a new idea called "deference". This was meant to solve cross-border conflicts in the derivatives world. This formula was repeated in April of this year in another G20 communique from Washington.

The idea looks good in principle. It's basically a reference to substituted compliance or EU-style recognition.

But in reality the G20 formula begs a lot of tricky questions. It provides that jurisdictions can defer to another "when justified by the quality of respective regulations and enforcement regimes", but only if these lead to "essentially identical outcomes" and so long as the rules are "non-discriminatory". It also says that we all must also have "due respect to home country regulation".

This is asking a lot. And these questions are largely the same as those which IOSCO's Task Force on Cross-Border Regulation wrestled with for over two years.

Now the end result of our Task Force's work is that we have a very detailed toolkit for regulators to refer to when looking at cross-border financial activity and the specific factors to take into account when using it. And we also decided to hardwire cross-border considerations such as timing mismatches into all of IOSCO's standard-setting work.

But the Task Force also concluded that "IOSCO should engage more with the G20 and FSB to raise greater awareness of the key issues and challenges faced by IOSCO members on cross-border regulation, including the need for more refined thinking on the concept of deference".

Now what are these issues and challenges?

First, we need to understand that national securities regulators are firmly bound by their domestic laws, national interests and national policy objectives when acting on a cross-border basis.

Second, the real authority of international standard setters such as IOSCO is inevitably weak because it isn't based on binding treaty obligations, and as a result, global standards do not trump local law. In fact, global standards are rarely even referred to directly in securities legislation. And if they aren't, it's hard for national regulators to take them into account if local law already deals with an issue.

Third, peer pressure to apply international standards on a uniform basis can be effective, but this is far harder in securities markets compared to the Basel world for banks as there is far more diversity and complexity of firms, investors, products, infrastructure and exchange platforms.

Fourth, on top of this, regulators sometimes act protectively if they think that recognition of a foreign regime could cause domestic business to move overseas. In other words, even if differences in rules don't increase systemic risk or compromise investor protection, if they still imply a difference in the cost of doing business, regulators will react in their national interests. This seems to be a factor in the current US and EU standoff about the recognition of clearing houses. And the current debate about margins for uncleared derivatives is also worth watching here.

Fifth, recognition or deference becomes harder when the countries involved are at different stages of development, as is the case in Asia.

And finally, there is often a basic reluctance to outsource regulation when a failure could end up with blame heaped at the door of the domestic regulator.

So we are a long way from the ambition expressed by global firms that any proposed markets regulation that could have a significant cross-border effect must first be decided on as an international standard, before being transplanted uniformly into local law.

However, I think there is light at the end of the tunnel. Our IOSCO report recognises that in reality, regulators have put in an enormous effort trying to overcome hurdles where it matters, normally through bilateral negotiations of different types of recognition or deference agreements supported by the MOUs I mentioned earlier.

You will have seen how the CFTC and the Securities and Exchange Commission have both progressed their approach to recognition through substituted compliance – a big change when compared to the hard line taken a while ago. And it seems that international standards are referred to as a measure of equivalence in new EU legislation about benchmarks. And occasionally, discussions have been multilateral, a good example being an ad hoc group of regulators from major markets that meet to discuss derivatives – called the OTC Derivatives Regulators Group (ODRG).

Our IOSCO Task Force therefore concluded that the general direction of travel is fairly clear. "The emphasis is towards more engagement via recognition to solve cross-border overlaps, gaps and inconsistencies through a combination of more granular international standards

implemented at a jurisdictional level, and an increasing emphasis on determining when it may be appropriate to recognise foreign laws and regulations as a sufficient substitute or equivalent for domestic laws and regulations”.

View from Asia

I’d like to finish by going back to an Asian perspective. The globalisation of securities regulation presents challenges to regulators all over the world, but as I mentioned at the start, this is felt strongly in Asia, a complex region made up of markets with varying degrees of regulatory oversight.

An extreme view is that we face being reduced to becoming mere importers of US and EU rules, or alternatively isolating local markets from the rest of the world if we resist.

But the reality is a lot different to this depressing view. There has been a real willingness on the part of Asian regulators to work together to resolve a few important extraterritorial issues relating to the region. This has mainly been done through the Asian arm of IOSCO, which the SFC chairs until next May. And in my view it’s been significant because in many respects these are competitor jurisdictions.

The first major success of this coordinated approach was when we were able to agree with the EU last year on the recognition of Asia-Pacific central counterparty clearing houses.

And this year, we Asian regulators agreed to promote a new way to handle extraterritorial rulemaking, again acting together.

As part of this, we proposed a single, permanent channel of communication with the EU to discuss, at an early stage, any new rules which could have a cross-border impact on the region. And I’m pleased to say that this idea has already been informally welcomed by the European Commission. Basically this process would replace what has been a fairly ad hoc, reactive approach to rules as they emerge.

So all in all, the tone is changing as both the EU and US have shown themselves to be far more willing to take account of Asian realities when acting across borders.

Conclusion

So to conclude, we are still dealing with the fact that participants in global markets are regulated by national regulators, and perfect harmonisation and total convergence of regulatory standards are unlikely. And a global rulebook is an unattainable ideal. But I think that the outlook is far brighter than a few months ago, and I am hopeful that further progress will be made as we start to deal with Europe on the international reach of its benchmark legislation.

Thank you.