"International/Transatlantic regulation of cross-border business"

Financial markets are global and deeply interconnected and modern-day finance is international by its very nature. Ensuring that regulation is designed in such a way as to reflect this reality is essential.

Inconsistencies in the implementation of the G-20 agenda are a real issue for cross-border businesses

The financial crisis triggered a complete overhaul of existing rules for financial services, which was put forward at the 2008 G20 summit in the world's major jurisdictions. While a number of recent regulatory reforms had the benefit of common objectives and a clear political will from successive G20 summits, practical rules and implementing regulations still show a number of differences and underline the lack of alignment and compatibility of implementing measures. These differences have emerged in the context of the specific (and diverse) nature of the financial markets within various jurisdictions, but overall they have a major impact on cross-border business.

Such deficiency in coordination in the implementation of G20-driven requirements leads to a number of negative consequences, including fragmentation, increased barriers to entry, reductions in incentives to innovate and distortions to competition, resulting in a reduction in products available to end-users and reduced market liquidity.

By the 2009 Pittsburgh Summit, G20 leaders had already recognized the importance of individual authorities implementing "global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage" Yet, in too many instances, international standards have been implemented in a way that does not allow regulatory systems and the relevant regulators and supervisors to work together.

This is particularly noticeable in the OTC derivatives market, where US central counterparties (CCPs) are still not recognised as equivalent within the framework of the European Market Infrastructure Regulation (EMIR) three years after its entry into force, whilst at the same time the CFTC insists that European counterparties need to comply with the US entity and transaction rules. This type of deadlock fuels the risk that EU banks are unable to apply qualifying CCP capital treatment to those CCPs which have not been recognized by the European Securities and Markets Authority (ESMA).

These regulatory divergences have very concrete impacts, as is illustrated by data indicating that liquidity has already been bifurcated between US and non-US pools in light of divergent implementation and lack of recognition of non-domestic trading venues: the average cross-border volume of euro Interest Rate Swaps (IRS) transacted between European and US dealers has reduced from 25% of global volumes to 9% in the period following the implementation of the Swap Execution Facility rule (SEF) (beginning 2014).

Diverging supervisory rules – reinforced by their often extraterritorial reach – are an additional challenge

The recognition of each other's regulatory regimes also proves to be problematic in the prudential area for firms which fall within European and American jurisdictions. In particular, one aspect of the so-called Tarullo rule obliges foreign banking organizations (FBOs), i.e. foreign banking groups with a significant US presence, to establish an intermediate holding company (IHC) over its US subsidiaries.

While this was set up with the goal of facilitating supervision of the US operations of foreign subsidiary banks, this requirement comes with capital and liquidity surcharges, depending exclusively on the amount of global and US assets of the institution, whilst disregarding whether the FBOs are subject or not to a consolidated supervision in their home country equivalent to that of the US. Such an approach compromises the level playing field and implies a lack of confidence in European supervision.

The upcoming requirements for Total Loss Absorbency Capital (TLAC) also raise concerns that European banks may be confronted with the threat of having to comply with duplicative standards if the European Minimum Requirements for own funds and Eligible Liabilities (MREL) do not give sufficient attention to the final TLAC calibration. While the details of TLAC remain to be determined, to avoid a potential issue in the future regarding consistency between regulations, it should be carefully calibrated to accommodate the different group structures and avoid once again the risk of compromising a level playing field.

Another example which remains unresolved is the situation in the US whereby foreign public funds and foreign non-covered private funds (i.e. foreign private funds that are offered and sold exclusively to non-US persons) would be subject to the Volcker Rule prohibitions on proprietary trading and covered fund, even though covered funds themselves are not. (This situation emerges merely because of definitional issues – a "covered fund" excludes public funds and foreign non-covered private funds.)

If applied, these prohibitions would make it impossible for these non-US funds to operate. However, the FAQs recently published by the five US Volcker agencies do provide a practical solution for most EU foreign public funds, but the issues related to foreign private funds remain unaddressed.

A further example which has been discussed on both sides of the Atlantic is the proposed benchmarks regulation[1] currently in trilogue. In the field of commodity benchmarks, the EU proposes to legislate significantly beyond existing IOSCO principles[2] whereas the US CFTC and Congress have stated that they have neither the mandate nor the intention to regulate/legislate in this area. Such global inconsistency may well result in the unintended consequence of reduced use of EU benchmarks globally and possible disruptions in these inherently global markets.

Diverging approaches to bank structural reform also raise significant issues. Given the divergences in the scope of activities to be separated and the extraterritorial footprint of both the US and EU proposals, it is currently unclear how the European bank structural reform (BSR) proposals could work in practice without creating significant competitive strains between firms from different jurisdictions. For example, an EU firm will be subject to the BSR globally, even in markets where such rules are not applied locally. This creates competitive disadvantages, as well as supervisory challenges when the local competent authority would prefer the activities to be carried out within one entity. The same bank – at least its US facing arm – will also be subject to the Volcker rule with its variations in scope and reporting requirements. In addition, it is also unclear how the potential separation of activities would work with bank-specific recovery and resolution plans if the final BSR rules impose a one-size-fits-all separation for large European banks that is not always aligned with the best resolvability options.

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[1] Proposal for a Regulation of the European Parliament and of the Council on indices used as benchmarks in financial instruments and financial contracts (http://ec.europa.eu/internal_market/securities/docs/benchmarks/130918_proposal_en.pdf)

[2] Principles for Oil Price Reporting Agencies (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD391.pdf)

Ongoing efforts to address shortcomings

The challenges and risks of regulatory fragmentation for cross-border business are thus well known. So far, a few initiatives to tackle this problem have been put forward. The first example is the role increasingly played by the IOSCO. In June 2013, it created a Task Force on Cross-Border Regulation, with a mandate to identify and consider cross-border regulatory tools and, if appropriate, develop guidance about how the tools could be developed and used by IOSCO members. In parallel, representatives of the financial services industry have made a concerted effort to provide constructive input to this process, e.g. through the formation of the Cross-Border Regulation Forum (CBRF), an international group of financial service trade associations, investment banks, brokerage houses and market infrastructure operators.

On EU-US regulatory discussions in particular, progress made within the Financial Markets Regulatory Dialogue (FMRD) is welcome but, as pointed out below, there is still a long way to go.

What more could be done?

Notwithstanding the continued progress in the FMRD on issues concerning regulatory convergence, this transatlantic dialogue would clearly benefit from the foundation of a more robust framework, which could be provided by the EU-US Transatlantic Trade and Investment Partnership (TTIP).

Another possibility would be the option put forward by the European Commission in March 2014 in a TTIP non paper, which would see the creation of a Joint EU/US Financial Regulatory Forum. Not only would high-level meetings be organized, but there would also be regular working groups and consultations aiming to reinforce cooperation between supervisors and efforts towards mutual recognition. Such mechanisms would be much more efficient than the current FMRD, which, despite its merits, only meets twice a year to take stock of existing issues without providing for binding mechanisms.

Other suggestions have been put forward by the ECON committee in a January 2014 report on enhancing the coherence of EU financial services legislation. Among its conclusions, the report suggested that, in the next Parliament, consideration should be given to formalising the scrutiny of the Commission's activities in relation to third countries. It also asked the EP administration to consider ways in which the monitoring of relevant policy developments in major third countries could be enhanced so as to inform ECON's work. These proposals could provide a way for MEPs to be alerted to possible inconsistencies with third countries in a timely fashion, and possibly amend EU legislations in discussion to address these issues.

David Wright, outgoing secretary general of the IOSCO, also recently stated that regulators should coordinate their actions as early as possible to limit inconsistencies. He also suggested that the texts elaborated by IOSCO should be more detailed, and considered the possibility of setting up a dispute resolution system, referring to the success in this regard of the World Trade Organization (WTO). In the absence of a system endowed with legal powers, there could be an informal system able to highlight shortcomings in some jurisdictions.

Discriminatory US collateral requirements apply to the cross-border business of European (re)insurers

(Re)insurance is an inherently international industry, dominated by European and US companies which together make up 61% of global insurance premiums and more than 90% of reinsurance premiums. A large part of these premiums are transacted on a cross-border basis.

Of significant concern to European reinsurers are the discriminatory collateral requirements that apply only to EU reinsurance companies operating on a cross-border basis in the US. These collateral requirements have actually been identified as a trade barrier in the recent research work by the Organisation for Economic Co-operation and Development (OECD) on the Services in Trade Restrictiveness Index.

One platform recently set up to address this concern is the US-EU "covered agreement". The Commission has received a negotiating mandate from the Council to enter a covered agreement and is ready to start the process. On the US side there are still a number of procedural issues to be clarified before the Federal Insurance Office (FIO) and the US Trade Representative (USTR) can start negotiations. While a covered agreement could be a very effective way to ensure EU reinsurers and local insurers have the same collateral treatment in the US, the political challenges around the project on the US side and the different timing ambitions expressed by both parties could in reality delay a successful conclusion.

The concern around collateral requirements was also one of the triggers of the establishment, in 2012, of the EU-US Insurance Project, which aims to "enhance the understanding and cooperation for the benefit of insurance consumers, business opportunity and effective supervision". Led by the European Commission, EIOPA, the US National Association of Insurance Commissioners (NAIC) and the US FIO, one of the key objectives of the project is to implement a consistent approach for collateral requirements in both jurisdictions. This would ideally include the examination of reduction and, potentially, complete removal of collateral requirements applied to EU reinsurers in the US. Despite the positive welcome by stakeholders, it is unfortunate that these ambitious goals have not been matched by equal political support or a clear outline of key deliverables and expected timeframe.

TTIP is another platform through which the removal of collateral requirements could be achieved. From this perspective, the insurance industry has strongly advocated for the inclusion of financial services in the scope of the TTIP.

It is of key importance that EU policymakers understand the concern and support removal of US collateral requirements in the ongoing EU-US engagement platforms, as mentioned above. This would free up significant levels of capital, which could be used by European reinsurers in a more efficient, investment-oriented way.

Conclusion

The aforementioned proposals – and others – show that there is a real need to tackle regulatory inconsistencies at the local and international level. Inconsistent rules fall short of internationally agreed objectives. Regulatory fragmentation weakens the resilience of financial markets and creates challenges for economic recovery. In addition, while the EU has now embarked on a project to establish a fully integrated capital markets union, which will have important implications for global markets, a reduction in inconsistencies between jurisdictions seems all the more necessary for such ambitions to be realised

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Secretariat or the Chair of the Financial Industry Committee.

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