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LETTER FROM THE PRESIDENT

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Charting a course for regulatory reform: Discussions with global regulators

HIGHLIGHTS:

Global regulators will strongly resist overtures for relief from the comprehensive G20 reforms put in place over the past eight years. However, deregulation plans in the United States, and industry concerns about eroding repo market liquidity, may result in selective and modest adjustment to margin rules and liquidity requirements.

Improving market conduct and culture in the FICC markets is a high priority for regulators. The efforts undertaken to date have moved in different directions. It is difficult to see a regulatory consensus emerging in the foreseeable future for a consistent approach to market conduct, important to avoid regulatory arbitrage and fragmentation in the global marketplace.

INTRODUCTION

Global regulatory reforms are important to all IIAC members. Last week, as Chairman of the International Council of Securities Associations (ICSA), I led a delegation to several meetings in London and Basel to better understand the priorities and direction of global regulatory reform, particularly focused on wholesale credit and derivatives markets.

Clearly the regulators, notably the Bank of International Settlements (BIS) and the Financial Stability Board (FSB), will hold firm on efforts to liberalize recent reforms. Over the nine years since the 2007-2008 financial crisis and its immediate aftermath, the full package of reforms defined in the G20 directives, including the Basel III regulatory framework for capital and liquidity, and the OTC derivative reforms, have been put in place across all major jurisdictions—a significant accomplishment. The regulators view this progress as providing a significant bulwark against reoccurring financial crises. The deregulation initiatives flowing from the new Trump Administration, and possibly the Brexit negotiations, will have some impact, but it is more likely that significant rollback in the G20 reforms will be resisted and limited. Any adjustments to the existing regulatory framework will be carefully scrutinized in terms of promoting capital formation and economic growth, and these changes will be minimal.

AN IMPASSE WITH REGULATORS: BOND MARKET LIQUIDITY

One of the global industry's key concerns is the erosion of liquidity in the repo markets and corporate bond markets, both in North America and Europe, and in regional markets around the globe. Discussions confirm that regulators are not convinced by the quantitative evidence and related analysis of a widespread liquidity problem in corporate bond markets. Certainly, they do not see sufficient evidence to justify broad-based countervailing adjustment to regulatory reforms. We seem to have reached an impasse with the regulators on the extent of deterioration in corporate bond liquidity. This difference in view between the regulatory community and the industry relate to interpretation of quantitative evidence, the impact of structural changes in the markets, such as electronic trading platforms, and the fact that most bonds are highly illiquid because bonds are highly idiosyncratic. The bonds issued by sovereigns and large corporations are less of a concern.

The global industry has argued that thinning liquidity in the repo and corporate bond markets could leave credit markets and institutions exposed to serious dislocations as external shocks trigger large adjustments in portfolio holdings and asset prices that can feed-back into destabilizing ever wider amplitudes of asset price swings.

It has been impressed upon regulators that market-making plays a critical role in secondary bond markets—the buy-side are simply "fair-weather" players generally going with the trading flow and not standing in to provide liquidity, particularly in difficult market conditions; and that the market making function requires a sufficient incentive or return to remain in place. The latter means sufficient trading spread and a competitive cost of capital. Fixed income operations have been scaled back and capital employed sparingly, given deterioration in returns in the fixed income business. Adequate liquidity now may prove inadequate in the event conditions deteriorate.

The BIS is engaged in ongoing analysis of the European repo markets, viewed as the critical market for funding of the European financial system. A well-functioning repo market is also essential to efficient market-making across the spectrum of corporate debt securities. The FSB, however, has refrained from embracing the detailed and extensive proposals of International Capital Market Association (ICMA)'s European Repo and Collateral

Council (ERCC), the industry consortium representing financial institutions in European capital markets. Some modification in terms of certain adjustments to the leverage and liquidity ratios, and better linkages across trading and clearing systems to access scarce collateral, are possibilities to address concerns in the repo markets.

THE DEBT MARKET: A NEED FOR REGULATORY CONSENSUS

The industry has also focused on the conduct and culture agenda in fixed income, currency and commodities (FICC) markets, led by the FICC Markets Standards Board (FMSB). The interesting finding from the on-going work on conduct and culture in debt and derivative markets is that the regulatory community is disjunctive in its approach to market conduct, and it is unclear whether consensus on market conduct in debt markets can be achieved. The FSB is focused on compensation as the mechanism to influence conduct, such as driving responsible risk-taking and good culture. On the other hand, IOSCO has engaged in an assessment of existing conduct regulations and enforcement practices across the major jurisdictions. The most interesting work on conduct is underway by the FMSB. The FMSB approach is to develop specific standards of conduct across all aspects of secondary trading and new issue offerings.

Four standards have been developed so far, but the intention is to move out with a wide number of specific standards. The exercise has strong buy-in from the industry because the standards provide important guidelines for traders and firms in carrying out specific functions. For example, how far can market conversations go between traders before these discussions are interpreted as buy or sell transactions? There is a lesson here for Canadian regulators. The proposed introduction of broad standards, such as the best interest standard in recent CSA proposals, should be accompanied by detailed guidelines and procedures to give participants the comfort of proper compliance with the principle. Without this detailed guidance, market activity will be scaled back to the disadvantage of investors.

CROSS-BORDER TRADE BARRIERS: BILATERAL PROGRESS, BUT LITTLE ACHIEVED MULTILATERALLY

The Cross-Border Regulation Forum (CBRF) is an international consortium of 50 financial service trade associations, investment banks, brokerage houses and market infrastructure operators that came together for the specific purpose of providing joint industry input to the IOSCO Cross-Border Task Force. IOSCO has been unable to achieve a multilateral solution to resolving cross-border regulatory trade barriers through mechanisms such as regulatory recognition or passporting, mainly because of regulatory reluctance to defer jurisdiction.

Despite this lack of progress, while there remain different rules and compliance duplication across jurisdictions, many major impediments in OTC derivatives markets have been resolved on a bilateral basis between jurisdictions. The major derivatives markets have achieved a rough equivalence in rule framework, despite differences. There is now the risk that incipient deregulation efforts, particularly in the United States, will upset this rough equilibrium, creating an uneven playing field, and disadvantage the competitiveness of non-U.S. OTC derivatives markets. The CBRF will need to monitor these deregulation efforts as they unfold and encourage non-U.S. regulators in move in sync.

CONCLUSION

It is evident from discussions with the key global regulators, notably the BIS, FSB and IOSCO, that recommendations for some easing in the regulatory reforms in the cash and OTC derivatives markets will be strongly resisted. The extended and comprehensive efforts over the past eight years to strengthen the resilience of the global banking system and capital markets have contributed significantly to a more stable global financial system. Pressure for easing will nonetheless persist reflecting government concerns that reforms have weighed down recovery of the global economy, especially weakened bank lending to business, and market participant concerns that eroding repo and bond market liquidity could unleash large unanticipated adjustments in portfolio holdings and asset price swings in response to external shocks.

The deregulation impetus in the United States, and the liquidity concerns in the repo markets in particular, will likely force a move for selective and modest relief from the reforms, such as margin adjustment in the OTC derivatives markets and some technical changes to the Basel III liquidity requirements. The regulatory objective will be to strengthen the resilience of capital markets by improving market liquidity (and boosting bank lending), without undermining the stability framework of the global financial system.

Yours sincerely,

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