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LETTER FROM THE PRESIDENT

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London perspective: A survey of the key issues at play in global financial markets

HIGHLIGHTS:

For the coming year, IOSCO is focused on global risks, including corporate bond liquidity in stressed markets, ETF holdings at asset managers, cybersecurity, outsourcing and cryptocurrencies.

The continued disintegration of the multilateral trading order impairs the efficient functioning of global markets and risks market fragmentation. Brexit is the most serious concern.

With the impending March 2019 deadline, negotiations will lead to either a hard deal, temporary customs union in traded goods, or no-deal, with the eventual outcome turning on a House of Commons vote. The EU and UK will likely reach agreement on a regulatory equivalence regime to avoid cliff edge risks and provide needed transition in a no-deal Brexit scenario.

This President's Letter provides a perspective on risks in global capital markets, the priorities for further reform, and a focus on the key challenges at play, notably the impact of Brexit, disruptions in the multilateral trading system, and uncertainty regarding existing and proposed trade arrangements—all of which have rattled financial markets. This perspective was drawn from the International Council of Securities Associations (ICSA) Interim Meeting held November 7, and meetings with the Chair of the Fixed Income Currencies and Commodities Markets Standards Board (FMSB), Mark Yallop, and individual financial executives in London on November 8-9.

The International Organization of Securities Commissions (IOSCO) has identified core risks in global markets over the coming year. These include:

- Risks associated with evolving developments in the crypto-asset marketplace. IOSCO noted that many members have observed a notable increase in firms offering retail OTC leveraged products with a cryptocurrency underlying. Also, the distribution of cryptocurrencies across jurisdictions via online platforms poses a significant risk to investor protection;
- Concerns about secondary bond market liquidity in stressed market conditions;
- The concentration of ETF assets in institutional portfolios and systemic implications from significant financial shocks;
- The unintended impacts from recent regulatory reforms; and
- Lack of cross-border resolution in several areas, including information sharing, coordination and planning on how cross-border resolution for global systemically important banks (G-SIBs) would be conducted, and crisis management for systemic non-bank intermediaries, such as insurers and central counterparties (CCPs).

IOSCO PRIORITIES AND CONCERNS

IOSCO has structured several workstreams to address these perceived risks. A high priority for IOSCO, in conjunction with the Financial Stability Board (FSB), is the monitoring and assessment of concentrated ETF holdings with asset managers, the stability of bond market liquidity in response to stressed conditions, and leveraged balance sheets at non-bank intermediaries.

IOSCO is reviewing technology applications, such as digital ledger technology for trading and clearing, and artificial intelligence and machine learning (algorithms), to better understand the benefits and risks of their applications in regulatory compliance and the need to balance innovation with preserving a competitive playing field for market participants.

The management and sharing of financial data is a key concern, given strict new privacy laws in the EU (i.e. the General Data Protection Regulation or GDPR). This law is of particular concern to IOSCO given the successful information sharing arrangement under the Memorandum of Understanding regime. This regime has proven important to facilitate cross-border enforcement. IOSCO is working with the EU authorities to find an acceptable arrangement compatible with the prevailing GDPR.

Other IOSCO work includes monitoring developments in sustainable finance and green bonds to better understand emerging regulatory implications, notably in the adequacy of climate-related financial disclosures that are consistent, comparable, reliable, clear and efficient, and provide decision-useful information to lenders, insurers and investors.

The reliance on outsourcing, particularly technological expertise, has increased considerably in recent years, both front and middle-office, as well as back-office operations, and may act as a point of vulnerability in the financial services industry as firms' standard of financial integrity and cyber security fail to extend to third party vendors. IOSCO work is focused on monitoring and assessing the IOSCO Principles on Outsourcing to ensure regulated firms have the tools to carry out proper due diligence and oversight of outsourcing services to manage risk.

IOSCO's broad-based monitoring approach is designed to identify developing market trends in finance and ensure there are no regulatory gaps exposing markets to shocks with systemic dimensions.

A rising concern in global markets is the continued disintegration of the multilateral trading order and implications for the efficient functioning of global markets and global growth. These concerns emanate from several sources: i) the rhetoric and aggressive trade actions of the Trump Administration, including withdrawal from the Paris Agreement on Climate Change and the Trans-Pacific Partnership, and implementation of a series of broadly-based tariffs on traded goods; ii) the unfair and predatory trade practices of China; and iii) the impact from the Brexit negotiations and potential severing of European markets. It is not surprising that Japan, as the host country for the next G20 meeting, has designated cross-border regulation as the theme for the discussions.

BREXIT: NO DEAL OR HARD DEAL?

The elephant in the room is the impact of Brexit on the Eurozone economic outlook and stability of financial markets. A disorderly outcome could pose a significant downside risk to the euro-area economy and dislocation in financial markets. It could result in a downward revision of forecasts and possibly slow the process of normalizing monetary policy, blunting the projected increase in interest rates. European policymakers, notably the European Central Bank (ECB), will strongly encourage securities regulators to impose an accommodative regulatory regime, particularly with the prospect of a hard Brexit, to preserve cross-border transactional capital flows and limit potential market instability.

Disruptions in existing trade arrangements can feed through to capital markets in several ways: First, the direct dislocation of markets from disruption in trade flows and, second, market fragmentation as the existing regulatory regime to facilitate cross-border transactions may need modification given the new relationship. These disruptions manifest specifically in the potential dislocations from the Brexit negotiations, with regulators needing to adapt mechanisms of mutual recognition and regulatory equivalence standards, or jurisdictional deference, to preserve unfettered capital flows between the EU and UK. Disruptions in trade arrangements elsewhere could require similar adjustments to the regulatory regime. It is ironic that in the midst of this trade and regulatory dissonance, and despite the U.S. Administration as the instigator behind much of this uncertainty, new leadership at the U.S. Commodity and Futures Trading Commission (CFTC) and the U.S. Securities and Exchange Commission (SEC) has demonstrated greater outreach and global vision and accommodation with international standards than their predecessors. Recent comments by CFTC Chair Christopher Giancarlo suggest potential non-access of European banks to U.S. clearinghouses, if the EU resorts to mandating home jurisdiction for clearing. This approach to integrated markets explains the reason IOSCO has resurrected its much-lauded work on cross-border regulation, namely, the 2015 IOSCO Task Force on Cross-Border Regulation.

The Global capital markets will be on edge over the next several months as Brexit negotiations reach a climax in the lead-up to the March 2019 deadline for a formal agreement. The deadline shifts even closer with needed approval of the negotiated agreement by the British Parliament, and formal ratification by each of the remaining 27 EU member states.

While most London-based financial institutions have been preparing for the worst case— i.e. a "no-deal" scenario—for at least a year, if not longer, the rapidly encroaching March 2019 deadline has increased the likelihood of the worst-case outcome. The efforts of UK-based banks to establish the required presence in continental Europe has been complicated by differing national banking standards among EU member states. For example, the European Banking Union, with uniform regulations, is still not entirely complete. Further, assessing the Brexit impact of job losses in the London market through needed restructuring is complicated by ongoing employee attrition through increased technology/systems applications. For example, Credit Suisse has slashed London operations from 10,000 to 6,000 employees in the lead-up to Brexit to achieve efficiency and earnings gains.

There remains a lack of clarity on the regulatory arrangements in the event of a "no-deal" scenario, specifically the regulatory arrangement once the UK withdraws from the EU framework. Two areas of uncertainty are the continued access of European financial institutions to UK-based CCPs (notably LCH), and the continuity of existing contracts in uncleared derivatives. There is now a better understanding among European regulators of the magnitude of these cliff edge risks and potential for market dislocation. The general view is that the Commission will permit access to UK CCPs through a temporary equivalence regime, although there is no certainty and clarity of the terms, and no clear timelines. To facilitate the enhanced equivalence regime, there has been an "on-shoring" of EU law into UK legislation. The Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA) have produced a joint paper on the need for a solution to CCP access, and the continuity in contract renewals for uncleared derivative contracts. A group of EU member states have similarly been mobilized to work to an acceptable solution.

The consensus is that the UK and EU will pull a deal on Brexit out of the fire at the eleventh hour. The temporary withdrawal agreement will take the form of a temporary customs union for traded goods and would be accompanied by similar temporary equivalence regime for financial regulation. The complications of this deal are:

i. It is a temporary regime with the related uncertainty of what comes next;
ii. The customs union may provide zero tariffs and open access for UK goods, but not unfettered access to the EU single market, and does not include financial services;
iii. The arrangement will come with conditions, such as taxation and environmental measures;
iv. Withdrawal from the temporary customs union will not be a UK decision, but determined jointly by the UK and EU, potentially stranding the UK in this temporary deal indefinitely; and
v. The EU may demand additional compensation above the agreed £39 billion.

Finally, the proposed temporary customs union has sovereignty implications for the UK. If a permanent agreement is not reached by July 2020, the temporary custom union and related conditions may continue indefinitely. In this event, the so-called Northern Ireland backstop would fall into place with Northern Ireland permitted to follow the single market rules to keep the Irish border open, while the rest of the EU stays in the customs union. This outcome is politically unacceptable.

If some version of the temporary customs union is accepted as an interim Brexit deal, it is likely government policy will continue to be preoccupied with Brexit negotiations as the UK attempts to improve access to the EU internal market and move to a "mid-Atlantic" trade strategy seeking to build trade relationships outside the EU.

While the UK can be accused of failure to define a clear negotiating strategy and objectives at the outset of the negotiations, the EU has similarly failed to recognize the UK, unique among European countries, as a large diversified economy with deep capital markets of global dimension, has not thought-through the important strategic issues of a Brexit outcome, leaving the negotiating strategy largely in the hands of the EU bureaucracy.

Yours sincerely,

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