FSB FINANCIAL STABILITY BOARD

Market Fragmentation

Updates on ongoing work

14 October 2020

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Executive summary

The June 2019 FSB Report on Market Fragmentation identified four areas in which market fragmentation should be addressed by the Financial Stability Board (FSB), in collaboration with the standard setting bodies (SSBs). This report provides an update on progress made:

1. *Deference.* The International Organization of Securities Commissions (IOSCO) has published a Report on Good Practices on Processes for Deference in June 2020 that should help authorities to mitigate the risk of unintended, regulatory-driven, fragmentation in wholesale securities and derivatives markets.

2. *Pre-positioning of capital and liquidity.* FSB members are continuing work related to the distribution of resources within global systemically important banks (G-SIB) having regard to the need to achieve a balance between certainty for host jurisdictions and flexibility to deploy resources where needed within a group in times of stress. Drawing on a survey of cooperation and coordination among home and host authorities within crisis management groups (CMGs) and lessons from the COVID-19 pandemic, the FSB is working on identifying ways to further promote effective cooperation and coordination in crisis times.

3. *Regulatory and supervisory coordination and information-sharing.* Regulatory and supervisory coordination and information sharing has focused on policy measures taken in response to COVID-19. The FSB has established a repository of regulatory and supervisory policy measures taken in its member jurisdictions in response to the COVID-19 pandemic. The FSB continues to work on identifying whether differences in policy responses to COVID-19 may have fragmentary effects or give rise to cross-border and cross-sectoral spillovers that may warrant enhanced international coordination. The FSB is also exploring potential ways to facilitate convergence in reporting of data to authorities.

4. *"Too-big-to-fail" (TBTF) evaluation.* The FSB has publicly consulted on the evaluation on the effects of TBTF reforms for systemically important banks. The evaluation also examines potential fragmentary effects on cross-border bank lending and on the pre-positioning of financial resources within G-SIBs. The report finds no evidence that the implementation of reforms has reduced cross-border lending. The report also notes that internal total loss absorbing capacity (iTLAC) supports orderly resolution of a cross-border group and incentivises coordination between home and host authorities, thereby helping diminish incentives to ring-fence assets in resolution. Empirical evidence on the effects of iTLAC on the mobility of resources within the banking group is not yet available as implementation is still ongoing.

Looking beyond these specific areas, the policy response to COVID-19 has underlined the policymakers' awareness of harmful effects of market fragmentation. The official sector community has provided a rapid and coordinated response to support the real economy, maintain financial stability and minimise the risk of market fragmentation.

Introduction

This report updates G20 Finance Ministers and Central Bank Governors meeting on the progress the FSB, in collaboration with the SSBs, has been making in the work to address harmful market fragmentation. It follows up on the first update delivered to the G20 in October 2019.[1]

The report describes progress in the four areas identified in the June 2019 FSB Report on Market Fragmentation:[2] (i) deference;[3] (ii) pre-positioning of capital and liquidity; (iii) regulatory and supervisory coordination and information-sharing; and (iv) market fragmentation as part of the evaluation of reforms, starting with the TBTF evaluation.

COVID-19 has also affected work in some of these areas. For instance, regulatory and supervisory coordination and information sharing has focused on policy measures taken in response to COVID-19.

Looking beyond these specific areas, the policy response to COVID-19 has underlined the policymakers' awareness of harmful effects of market fragmentation. The official sector community has provided a rapid and coordinated response to support the real economy, maintain financial stability and minimise the risk of market fragmentation.

In this regard, the FSB agreed a set of principles to underpin policy measures taken in response to COVID-19, and to reiterate FSB members' commitment to maintaining common international standards.[4] The principles stated that FSB member authorities will make use of the flexibility built into existing financial standards, and their actions will not roll back regulatory reforms or compromise the underlying objectives of existing international standards. Authorities will coordinate on the future timely unwinding of the temporary measures taken.

1. Deference

International Organization of Securities Commissions (IOSCO) published a report on Good Practices on Processes for Deference in June 2020, setting out eleven good practices that should assist authorities in mitigating the risk of unintended, regulatory-driven, fragmentation in wholesale securities and derivatives markets.[5]

The eleven good practices are underpinned by the philosophy that deference processes should be outcomes-based, risk-sensitive, transparent, sufficiently flexible and supported by strong cooperation. They cover all phases of the deference process and focus on several key issues, such as: (i) arrangements for ensuring transparency of deference processes, including the scope, steps and criteria; (ii) the criteria for making an outcomes-based assessment of the

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1 FSB (2019c) *Updates on the Work on Market Fragmentation*, 14 October

2 FSB (2019a) *FSB Report on Market Fragmentation*, 4 June

3 The term "deference" is used in the context of market fragmentation "as an overarching concept to describe the reliance that authorities place on one another when carrying out regulation or supervision of participants operating cross-border. The term is used here in a generic manner and is not intended to refer to the legal framework of any single jurisdiction or regulatory mechanism that may be employed to achieve such deference". See IOSCO (2020) *Good Practices on Processes for Deference*, June.

4 FSB (2020a) *COVID-19 pandemic: Financial stability implications and policy measures taken*, 15 April.

5 IOSCO (2020).

assessed authority and/or firm, including the nature of the supervisory and enforcement practices in the assessed jurisdiction; (iii) important factors such as the nature and degree of risks that entities from another jurisdiction may pose in their markets; (iv) the level of engagement, cooperation and communication between the assessing authority and the assessed authority and/or firm throughout the process and once deference has been granted; and (v) revocation of a deference determination.

IOSCO will now turn its attention more specifically to another cornerstone of deference, namely supervisory cooperation. The June 2019 IOSCO Report on Market Fragmentation and Cross-Border Regulation suggested that strengthening supervisory cooperation could also play a key role in mitigating instances of market fragmentation by increasing trust between regulatory authorities.[6] IOSCO will therefore explore how the use of Memoranda of Understanding (MoUs) has evolved in recent years and what further developments could be undertaken to improve the quality, scope and timeliness of the information a regulator is likely to receive from other jurisdictions. In addition, taking account of any existing and relevant work undertaken by other SSBs and supervisory authorities, IOSCO will explore whether and how existing supervisory colleges currently achieve their stated goals and, if appropriate, identify ways to increase their use in other areas of securities and derivatives markets.

2. Pre-positioning of capital and liquidity

In the first half of 2020, the FSB conducted a follow-up stock-take to the review of the Technical Implementation of the Total Loss Absorbing Capacity (TLAC) Standard of July 2019 with particular focus on approaches in home and host jurisdictions towards pre-positioning of capital and TLAC resources.[7] A certain level of pre-positioned resources is a core component of a credible resolution strategy. It moreover hard-wires cooperation in stress, serving as a coordination device to help diminish host authorities' incentive to ring-fence assets in resolution. However, the appropriate calibration of requirements for pre-positioned resources needs to strike a balance between certainty for host jurisdictions and flexibility to deploy unallocated resources where needed within a group in times of stress.

Follow-up work to the stock-take identified that, in some cases, the total allocation of iTLAC to subsidiaries may exceed minimum external TLAC requirements. Reasons for this situation may include: consolidation effects; binding local regulations exceeding the TLAC term sheet assumption; difference in legal structures; or voluntary funding structures determined by banking groups to increase their efficiency. Moreover, in some cases the amount of pre-positioned resources may exceed the amount of external TLAC issued. The home authorities of G-SIBs may have to assess the level of required external TLAC compared to the allocation of internal TLAC resources and any TLAC needed to cover material risks on the resolution entity's own balance sheet, taking into consideration any consolidation effects. The work also identified some obstacles to the flexible deployment of unallocated TLAC resources. These include legal constraints, location and form of unallocated TLAC resources, and operational challenges.

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6 IOSCO (2019) *Market Fragmentation and Cross-Border Regulation*, June

7 FSB (2019) *Review of the Technical Implementation of the Total Loss-Absorbing Capacity (TLAC) Standard*, 2 July.

The FSB is continuing technical work on the sufficiency and availability of unallocated TLAC resources and developed technical guidelines to assist the Crisis Management Groups (CMGs) for each G-SIB to have a common basis for assessing and understanding firms' unallocated TLAC resources and to enhance cooperation between home and host authorities. This work includes evaluating the availability of unallocated TLAC.[8]

The FSB carried out a survey on the functioning of CMGs. CMGs constitute important mechanisms for cooperation and communication. They should not only fulfil this role in a crisis but also support resolution planning in normal times and support ongoing coordination among home and key host authorities to, among other things, identify and address risks of fragmentation arising from authorities' actions. The survey not only confirmed the important role of CMGs in resolution planning but also as mechanisms for sharing timely and granular information which has proved essential during the COVID-19 pandemic. The survey also identified areas where existing arrangements could be further enhanced. The FSB is continuing work to identify practices for the operation of CMGs.

Drawing on the survey findings and preliminary lessons from the COVID-19 pandemic, the FSB will hold a virtual meeting on 30 November 2020 for supervisory and resolution authorities to discuss: crisis preparedness under specific crisis scenarios; actions that could be taken to prevent detrimental ring-fencing and fragmentation of capital and liquidity, as well as to facilitate cross-border cooperation and communication; and other actions to promote confidence in times of crisis.

3. Regulatory and supervisory coordination and information-sharing

Since March 2020, regulatory and supervisory coordination and information sharing in the FSB has focused on policy measures taken in response to COVID-19. The FSB has promoted an intensive, high-frequency information exchange of financial policy responses taken by FSB members to address COVID-19. Since mid-March, FSB members have reported an unprecedented number of over 1,800 discrete actions to address the financial and economic fallout related to COVID-19, including actions to support lending, funding, and market functioning.

Updates on these policy actions are also being shared with the 70 jurisdictions in the FSB's Regional Consultative Groups, as well as with SSBs and other international organisations. Between March and August, this information was shared on a daily basis, and more recently on a twice a week basis. This sharing of information across a broad group has helped jurisdictions to respond quickly and consistently to the effects of COVID-19, while minimising the risk of market fragmentation.

The policy measures reported in the repository show common approaches in several areas. Authorities in many jurisdictions have taken actions to sustain the supply of financing to the real economy; provide economic assistance; and support market functioning. However, as the timing

[8] See FSB 2020 Resolution Report, November (forthcoming).

and severity of the pandemic vary across jurisdictions, the specific design of such measures differs across jurisdictions. The FSB continues to work on identifying whether such differences may have fragmentary effects or give rise to cross-border and cross-sectoral spillovers that may warrant enhanced international coordination. In accordance with the FSB Principles that underpin the official sector response to the pandemic,[9] FSB members are also discussing the future timely unwinding of the temporary measures taken and factors that could be considered when unwinding such measures, with a view to mitigate any unintended effects across sectors and jurisdictions.

The FSB is also exploring other approaches that could be undertaken to address fragmentation, including in relation to potential ways to facilitate convergence in reporting of data to authorities.

4. Market fragmentation as part of the evaluation of reforms

The FSB has publicly consulted on the evaluation on the effects of TBTF reforms for systemically important banks.[10] These reforms, which were endorsed by the G20 in the aftermath of the 2007-08 global financial crisis and have been implemented in FSB jurisdictions over the past decade,[11] include: (i) standards for additional loss absorbency through capital surcharges and TLAC requirements; (ii) recommendations for enhanced supervision and heightened supervisory expectations; and (iii) policies to put in place effective resolution regimes and resolution planning to improve the resolvability of banks. Overall, the evaluation has found that TBTF reforms have made banks more resilient and resolvable; that the benefits of the reforms significantly outweigh the costs; and that there are still some gaps that need to be addressed.

Two aspects of potential fragmentation are examined in the evaluation. The first is cross-border bank lending. The report finds no evidence that the implementation of TBTF reforms has reduced cross-border lending. While G-SIBs lend to foreign borrowers more than other banks, the proportion of foreign lending is relatively stable for both groups (fluctuating between 55%-65% for G-SIBs and 30%-40% for other banks). There is some evidence that G-SIBs shifted lending towards less risky borrowers after the reforms when compared with other banks. G-SIBs have also become more conservative in their pricing behaviour, though this reduced the pricing gap relative to other banks and is consistent with a reduction in their implicit funding subsidies.

The second aspect concerns the pre-positioning of financial resources within G-SIBs as a result of resolution reforms. The report notes that iTLAC supports orderly resolution of a cross-border group and incentivises coordination between home and host authorities, thereby helping diminish incentives to ring-fence assets in resolution. Empirical evidence on the effects of iTLAC on the mobility of resources within banking groups is not yet available as implementation is still ongoing. That said, the report also notes that it is unrealistic to assume – as the 2007-08 global financial crisis has shown – that absent iTLAC capital would be fully mobile.

The final evaluation report will be published in early 2021.

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9 See Principle 5 in FSB (2020) *COVID-19 pandemic: Financial stability implications and policy measures taken*, 15 April, pp2.

10 See FSB (2020) *Evaluation of the effects of too-big-to-fail reforms: consultation report*, 28 June.

11 In FSB (2019) *Implementation and Effects of the G20 Financial Regulatory Reforms: Fifth Annual Report*, October, the FSB concluded that implementation of TBTF reforms for systemically important banks continues to advance but remains uneven.