The Financial Regulatory Outlook in the New Political Equilibrium

Angelo Federico Arcelli and Samantha St. Amand
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About CIGI

We are the Centre for International Governance Innovation: an independent, non-partisan think tank with an objective and uniquely global perspective. Our research, opinions and public voice make a difference in today’s world by bringing clarity and innovative thinking to global policy making. By working across disciplines and in partnership with the best peers and experts, we are the benchmark for influential research and trusted analysis.

Our research programs focus on governance of the global economy, global security and politics, and international law in collaboration with a range of strategic partners and support from the Government of Canada, the Government of Ontario, as well as founder Jim Balsillie.

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Addressing limitations in the ways nations tackle shared economic challenges, the Global Economy Program at CIGI strives to inform and guide policy debates through world-leading research and sustained stakeholder engagement.

With experts from academia, national agencies, international institutions and the private sector, the Global Economy Program supports research in the following areas: management of severe sovereign debt crises; central banking and international financial regulation; China’s role in the global economy; governance and policies of the Bretton Woods institutions; the Group of Twenty; global, plurilateral and regional trade agreements; and financing sustainable development. Each year, the Global Economy Program hosts, co-hosts and participates in many events worldwide, working with trusted international partners, which allows the program to disseminate policy recommendations to an international audience of policy makers.

Through its research, collaboration and publications, the Global Economy Program informs decision makers, fosters dialogue and debate on policy-relevant ideas and strengthens multilateral responses to the most pressing international governance issues.
About the Authors

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Executive Summary

As support for populist movements increases, policymakers may feel pressured to reduce international cooperation in finance and economics. Against this backdrop, the theme of CIGI and Oliver Wyman’s fourth annual Financial Regulatory Outlook Conference was the implications for financial regulation of the recent shift in political sentiment from multilateralism to nationalism. The policy discussions centred around four main themes: full and consistent implementation of the international financial regulatory reform efforts that began in the midst of the 2007–2009 financial crisis; developing international standards in areas where regulatory reforms have been less robust; international cooperation on creating standards for fintech; and improving policymakers’ communication of international policy initiatives to national constituencies. While conference participants did not forecast any dire consequences of the political landscape for the financial system, several conference participants held the view that a new regulatory equilibrium would not be reached any time soon.

Introduction

Globalization is increasingly seen by many commentators and voters as the main culprit behind unemployment and income inequality, rather than as a source of prosperity. In this context, policymakers may feel pressured to reduce international cooperation in finance and economics. For example, there is a risk that implementation of the strengthened international financial regulatory standards agreed upon in the aftermath of the 2007–2009 international financial crisis could be halted or even clawed back. Against this backdrop, policymakers, financial market participants and academics gathered at CIGI and Oliver Wyman’s fourth annual Financial Regulatory Outlook Conference in Rome on November 9, 2017, to discuss the implications for financial regulation of the recent shift in political sentiment from multilateralism to nationalism. This conference report summarizes the discussions at the conference as they relate to international financial policy cooperation.

Context: Populism and the Financial System

Participants’ views that there is a fundamental conflict between international cooperation and an evolving political culture that is increasingly focused on short-term goals set the tone of the conference. Adding to this difficulty is the perception that there is a growing imbalance between the complexity of socio-economic problems and the narrowness of the context in which policy decisions are made and people’s judgments are sought. In an age where public engagement in political debates often relies on one-minute video clips and 280-character tweets, it was argued that a clear and thorough discussion of complex and interconnected issues can scarcely be achieved.

Conference participants expressed concern that inward-focused political players are not necessarily implementing policies in the interest of enhancing their country’s social welfare — that is, policies that would foster sustainable long-term growth of output and employment, and reduce inequality. With respect to financial regulatory policy, this may take the form of withdrawing from commitments to implement the strengthened and more internationally consistent financial regulatory standards that have been agreed as essential to mitigate the vulnerabilities that caused the international financial crisis. Such an erosion of cooperation in financial regulation would risk undermining the strength and resilience of the international financial system, making it more vulnerable to crises. It could also entail competition among jurisdictions on such issues as capital taxation, thereby shifting the national tax burden from capital to income or consumption. Populist sentiments may also pressure policymakers to restructure key economic institutions — such as central banks and financial regulatory authorities — that have been blamed for some of the harm caused by globalization and the financial crisis;
for example, through imposing political direction on central bank and financial regulatory policies.

Weaknesses and vulnerabilities in the financial system have doubtless played a role in people’s disenchantment with the current political and institutional establishments. While it was previously held that the growth in the financial sector had a monotonic relationship with economic growth, recent events and subsequent scholarly works have demonstrated that the relationship is non-linear (see Constâncio 2017, and references therein). It is now widely accepted that without appropriate prudential regulation, financial sector growth and financial globalization can be detrimental to social welfare, through such channels as increasing inequality and the impact of financial crises on output and employment. What is good for the financial industry is not necessarily good for social welfare.

Two recent cases illustrate the damage that financial crises can wreak on social welfare. In the United States, since the subprime mortgage crisis began in 2007, there have been a total of 7.8 million foreclosures to residential mortgage loans (Sorohan 2017), income inequality has increased by around 8.6 percent and the rate of long-term unemployment remains 35 percent higher. The second case is the 2009–2013 European sovereign debt crisis, which revealed significant economic vulnerabilities and socio-political divides in the euro area. Conference participants pointed out that deep and growing mistrust among euro-area member states, which visibly follows a north-south divide, is the biggest barrier to effective policy cooperation in the euro area. Since 2007, the gap in the average unemployment rate in the north and south has increased from 1.8 to 7.9 percent, and the standard of living (measured by GDP per capita at EU purchasing power standards) has widened by almost 50 percent.

These facts only touch on the impact recent financial crises have had on the regions that were at the epicentre of the financial turmoil. Given the size of the US and euro-area economies, these crises and their associated policy responses have had significant global implications (see, for example, Chen, Mancini-Griffoli and Sahay 2014; Chen et al. 2015; International Monetary Fund [IMF] 2016 on spillovers from unconventional monetary policies).

Conference participants acknowledged that populist movements are not uniquely driven by economic inequalities. Still, in Europe, increases in unemployment as a result of the crisis have been found to be associated with rise of support for populism (Algan et al. 2017), while the regions of the United Kingdom that have been most affected by globalization were identified as having systematically higher support for leaving the European Union in the Brexit vote (Colantone and Stanig 2016; also see Rodrick 2017).

It was against this backdrop that the following key question was considered at this year’s conference: if developments in the financial system are part of the problem, how can international cooperation in financial policy reduce the harm from and enhance the benefits of finance for social welfare?

Leveraging Finance for Better Economic Outcomes

Over the past 30 years, the global economic and financial systems have become highly interconnected. The international network that has been established to facilitate the allocation of finance for investment and the production of goods through global value chains could not be undone without causing significant harm to social welfare. Indeed, despite some of the negative consequences outlined above, the financial system and global capital flows are pivotal for helping facilitate long-term economic growth by improving the allocation of savings and investment to productive activities. If policy makers were to erect significant barriers to these transactions at one extreme — through strict capital controls — or engage in competition in the relaxation of standards at the

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3 Northern countries include Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg and the Netherlands; southern countries include Greece, Italy, Portugal and Spain.

4 Cultural, social and demographic factors have been found to be a key driving force in recent events (Inglehart and Norris 2016).
other extreme — through changes in regulatory requirements or taxation policy — the benefits of global finance could deteriorate and systemic risks to the global financial system could increase.

Conference participants were enthusiastic about new areas of opportunity to improve the social welfare benefits of the financial system. The financial industry leaders were particularly interested in how new technologies can reduce the transaction costs of cross-border financial flows. For example, a number of major banks are working together to develop a platform that uses blockchain technology to improve the efficiency of interbank transactions (see Arnold 2017). There was also interest surrounding the inflow of new fintech firms that are opening access to financial services among the unbanked, thereby helping to unlock the economic potential of nearly two billion adults.5

The banking representatives in attendance were both eager and cautious about finding new ways to deliver client services in the banking industry and competing with new firms in this realm. The development of new methods to deliver client service has the potential to help increase financial literacy and provide tools to optimize individuals’ and businesses’ spending, saving and investment activities.

However, conference participants were quick to highlight that with new technologies and new business models, there will also be new risks. As the financial system moves further into the digital space, cyber security risks will grow. These threats are inherently borderless. Another concern is data privacy. Jurisdictions are taking different approaches to creating standards for data management; without a consistent set of standards, there may be significant gaps in the system. Participants noted that these concerns are intensified by the outsourcing of data collection and storage to third parties that may not be held to the same standards of accuracy and security. Finally, new business models could also sprout new issues of conduct risk.

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5 The most recent update to the World Bank’s Global Findex Database [see www.worldbank.org/en/programs/globalfindex] in 2014 found there were two billion adults who did not have a bank account.

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Synopsis of the Discussion on the Role of Policy Makers

The policy discussions at this year’s conference centred around four main themes: full and consistent implementation of the international financial regulatory reform efforts that began in the midst of the crisis; developing international standards in areas where regulatory reforms have been less robust; international cooperation on creating standards for fintech that balance the goals of maintaining stability, protecting depositors and investors and fostering competition; and improving policy makers’ communication of international policy initiatives to national constituencies.

Implementing the Basel III Regulatory Reforms for Banks

At the height of the international financial crisis, Group of Twenty (G20) leaders, finance ministers and regulatory agencies worked together to create a comprehensive reform program for global financial regulatory architecture. The aim was to enhance the stability and soundness of the international financial system by making it more resilient and less prone to contagion. As the final phase of these reform efforts is being reached — the initial phase of the Basel III regulatory framework for banks is scheduled to be implemented by 2019 — there are concerns that it will not be put into place in the full, internationally consistent manner that the original G20 financial regulatory reform program foresaw.6 Currently, while most G20 jurisdictions have implemented important elements of the broader G20 program, only three of the 20 participating jurisdictions are fully on schedule in putting the reforms in place (Basel Committee on Banking Supervision [BCBS] 2017). A key concern is whether the implementation of these regulatory rules will be consistent across jurisdictions. The Bank for International Settlement’s (BIS’) assessment suggests that not all members are fully compliant with the standards.7 Furthermore,

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6 Additional reforms were agreed to in December 2017, primarily focused on creating consistent standards for calculating risk-weighted assets, with most reforms scheduled to be implemented by 2022, and full implementation set for 2027.

7 See www.bis.org/bcbs/implementation/rcap_jurisdictional.htm.
recent regulatory initiatives in the United States and shifts in its regulatory institutions might be harbingers of a decline in the strength of US financial regulatory oversight (Elliott 2017).

Policy makers, practitioners and academic participants alike were all in agreement that it is crucial that the regulatory standards in the initial phase of the Basel III framework are implemented in full and consistently across jurisdictions. Without these efforts, there is a risk that international financial regulation will become more fragmented, and the global financial system will become more vulnerable to systemic risk, increasing the probability of financial crises.

Filling Gaps in International Regulatory Standards

The G20’s international financial regulatory reforms are comprehensive in improving the solvency, liquidity and risk management of internationally active banks. But the scope of regulation has not been extended as vigorously to other institutions, such as shadow banks, capital markets and asset management (Knight 2015). Conference participants expressed concern that without more comprehensive regulation, risky activity could be shifted from banks to these segments of the markets, which are competitors in a number of the banks’ business lines. These areas of the global financial system could pose systemic risk and, in the event of failure or impairment, fiscal support could still be required to prevent contagion and major economic losses. Participants supported efforts to renew international cooperation to create regulatory standards for non-bank financial institutions. This is viewed as crucial for securing the safety and stability of the global financial system.

International Cooperation on Fintech

On fintech, conference participants agreed that a balance needs to be struck between encouraging innovative activity on the one hand, and ensuring that start-ups follow appropriate procedures to safeguard the deposits and investments of their clients on the other. Reaching agreements on minimum standards in areas where new technologies create new challenges — for example, securities regulation, liquidity requirement, consumer protection standards, data and privacy security, and standards of conduct — could help create a level playing field for international fintech activities. Several regulatory agreements have already been signed among jurisdictions (Global FinTech Hubs Federation 2017). However, regulatory approaches remain highly fragmented. On this front, international agencies play an important role: the IMF, the BIS and the Financial Stability Board have indeed been actively engaged in facilitating open discussion and monitoring international activity in the fintech industry.

Communicating International Policy Initiatives

Several conference participants argued that, in order to gain support for international financial policy cooperation, policy makers need to identify better ways to communicate the benefits of international policy initiatives. More transparency is required in international policy discussions and better explanations must be provided as to how the international system can support national agendas. The conversation with the public can change by identifying new communications strategies with the media that emphasize complexity over platitudes. In legislatures, efforts can be made to improve the quality of cross-party dialogue, for example, by changing parliamentary procedures or highlighting areas of cross-party cooperation. There was a general view that finding ways to improve policy dialogue is necessary to re-engage citizens in the broader conversation.

Conclusion

Conference participants did not forecast any dire consequences of the political landscape for the financial system, but a certain unease remained. There were concerns about the impetus for committing to the full implementation of the initial phase of the Basel III regulatory reform package. Despite progress within the BCBS to further strengthen the safety and stability of the global financial system, several conference participants held the view that a new regulatory equilibrium would not be reached any time soon, especially since it remains unclear whether some elected politicians are willing to compromise in finding mutually beneficial solutions to global problems.
Works Cited


Agenda

November 9, 2017

11:30–11:50 a.m. Registrations and appetizers
11:50 a.m. –12:00 p.m. Welcome
12:00–12:30 p.m. Opening address
   → Mario Monti, Senator-for-life, EU Commissioner (1994–2004) and Prime Minister of Italy (2011–2013)
12:30–13:45 p.m. PANEL I: The new political equilibrium: what are the implications of this shift for banks and multinationals?
   → CHAIR: Douglas Elliott, Partner, Oliver Wyman
   → PANELLISTS:
     • Carlo Cottarelli, Executive Director, International Monetary Fund
     • Gerd Häusler, Chairman of the Supervisory Board, Bayerische Landesbank and Member of the G30
     • Sandie O’Connor, Chief Regulatory Affairs Officer, JP Morgan Chase
13:45–14:45 p.m. Networking lunch
14:45–15:15 p.m. Keynote address
   → Vítor Constâncio, Vice President, European Central Bank
15:15–16:45 p.m. PANEL II: Bank strategy in an era of increasing nationalism
16:45–17:15 p.m. Coffee break
17:15–18:15 p.m. PANEL III: What will the new regulatory equilibrium look like?
18:15–18:30 p.m. Closing remarks
18:45–22:00 p.m. Evening event at Galleria Borghese