Guernsey Financial Services Commission

Industry Seminar – 22 November 2017

Financial stability, macro-prudential policy & mutual regulatory recognition

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This is a little bit different to last time I spoke after Sir Digby Jones after dinner speech delivered at nine am in the morning. My presentation was a bit dry in comparison then as for today, we will see.

I am going to walk through all the three of the topics in this title slide financial stability, macro-prudential policy and mutual recognition covering both of my formal areas of responsibility at the Commission – financial stability and international policy – and draw in today's themes, Brexit, innovation and international standards…

It is quite an eclectic mix of topics but I have hopefully structured it with a deliberate narrative and hopefully you will see the thread. My objectives for this session are threefold:

1) impart information that is useful in understanding the islands strategy in relation to Brexit, drawing on work that I have undertaken;
2) share some personal thoughts and insights in relation to the regulatory issues facing the UK and its negotiations with the EU27 and;
3) finally report on the results of local financial stability workstreams and thinking.

Slide: Bailiwick Risks 2017

In actual fact, I am starting with the third of those:

<u>Local financial stability workstreams</u>

FINSTAC was one of the recommendations of the IMF when they visited the Bailiwick back in 2010 undertaking their FSAP – that is financial stability assessment programme.

The list of recommendations back then were pretty benign, for example 'consider how best to implement the public disclosure standards established by the IAIS for insurance regulation.' and in the main, all recommendations have been reviewed and where actions determined, been completed.

One of the more material recommendations was and quote "consideration of establishing a forum devoted to monitoring financial stability and coordinating policy responses". This forum had been set up in 2016 and undertook its first assessment this year. Amongst other things, the objectives of FINSTAC are as follows: 'to identify, understand, monitor and assess threats, vulnerabilities and risks to financial stability in Guernsey'

The committee met several times this year, directed by its independent chair – and even occasionally discussed threats, vulnerabilities and risks to financial stability.

This slides summarises the main systemic risk issues then and now. I have a soft spot for pop cultural references and if I was not constrained by our house powerpoint template, I would have a watermark of Bill Murray and Andie McDowall as the actual risks have little changed in the intervening seven years.

Slide: Global Financial Stability Risks 2017

I'd probably use the same template for this slide.

… one which outlines what I believe are the greatest global risks to financial stability….

These are risks that could readily materialise and catalyse instability into asset classes and financial markets locally and over which we must remain vigilant.

I make no apologies for being a bore on the topic of debt and QE… those that read my Guernsey Press column in 2014 will vouch for my obsession with these particular risks. I feel a little like Tony Dye with my continually calling of these risks but for all our sakes it would be best if I am wrong… but as you see I have rather self-servingly compared these risks with those listed by the recently retired German Finance Minister.

40% of western sovereign debt is held by central banks, corporate debt is some 30% higher as a share of GDP than 2007.

But feeling sensitive to accusations of glass half-emptism, in a sop to cheerfulness writing for our annual report , I suggested at the beginning of the year that the likeliest outcome in 12 month times was that we would just be worrying about the same risks.

Just one more month not to be proven wrong! Which frankly feels like an eternity and hopefully I can better my predictions of last year as I was when in the recording I made for this event before I left for Hong Kong–had to be edited as I had suggested two weeks out from the US election that Trump was not likely to be elected!

Slide: Brexit Risks

I like to think I have had a better track record on appreciating Brexit risks than calling the US election. Ahead of the Brexit vote in 2016 before I went on holiday, I rather confidently wrote in my quarterly report to Commissioners that I considered there to be in actualite few financial stability risks associated with the vote itself, that the majority were economic, not of the catastrophic project fear variety but rather obviously predictable outcomes.

The Bank of England did rather grandstand with its policy response with, amongst other things, varying the countercyclical buffer but personally I rather viewed that as more traditional demand management as they were no monetary policy levers than could have been pulled in the face of the potential shock to consumer confidence.

Longer term, I do see Brexit as posing a significant financial shock to the EU27, one that personally I believe they are deliberately ignoring at the moment, I cannot see, given the dependence of EU27 corporates on London for financing, how it will be anything but painful for EU27 economy.

I am not getting into the long term economics of Brexit here – as they say before Stars in their eyes "today Mathew I am just compartmentalising and focussing on financial stability issues. And these risks are real. Elisabeth Corley, Vice-Chair of Allianz Global Investors, illustrated the scale of the problem at the ESMA inaugural annual conference last month when she reported that Allianz had 1m UK, 8 Million, EU27- contracts that require legal change.

Sam Woods, Deputy Governor of the Bank of England, made a telling contribution two weeks ago… one that I am personally minded to believe betrays the fact that contractual solutions can be achieved subject to the two sides talking to each other. I talked this through with one of the Barclays Brexit team the other day and we agreed, all seems pretty fixable through an exit agreements. Just need to keep our fingers crossed there is an exit agreement. For us… it is all a watching brief and trying to be plugged in

Slide: International Standards

I have hinted at my personal views here, which is that I consider global policy makers to be overly focussed on making the system more resilient against doing something about preventing problems in the first place. If I had a pound for each time I read that the recommended policy action in response to a build-up of systemic risk was close monitoring I would have retired by now.

One of my ongoing workstreams, to use a horrible public sector phrase, is assessment of our current macro-prudential policies and financial stability monitoring activities to ensure that they conform to current international standards.

In general, I am talking the relevant section of the relevant principle so of the relevant global standard setting bodies but the joint review by the IMF/FSB and BIS… elements of effective macro-prudential policies, also provides material for benchmarking our policy practice and importantly, it provides guidance on their thinking of future direction.

I have heavily abridged their key recommendations of the elements here… and italicised what I think is a material point 'addressing systemic risk from across the financial system' for which read shadow banking….that is lending done outside of the regulated banking sector. The FSB/IOSCO report in January sets out a series of recommendations in part because they were rebuffed trying to designate globally significant Asset managers…one of DGs of one of these regulatory bodies told me at a conference in March that they felt the FSB was having an existential crisis – the report proposes actions which on the face of it seem straightforward, such as leverage limits but the working party has not yet been able to find single definition of leverage. This report suggests that pension funds are next… something that I spoke against on a panel at the IOPS global forum in February.

Slide: Financial Stability, prudential carveout and protectionism: a Brexit Battleground

This is the part of my presentation where the segway to talking Brexit is as subtle as a chord change by Status Quo.

It's a difficult topic to cover, pitching the level of information correctly is a bit difficult because it is such a followed topic everyone has become bar-room experts.

The options available to the UK have not changed in the last 18 months. EEA, Swiss, Canadian or WTO.

I was at a conference in Amsterdam in May 2016 when President of the Euro group (I cannot pronounce his name) said on June 23, that British voters should bear in mind that the EU had never negotiated an FTA with a large FS element.

In terms of precedent, the Canadian model provides most guidance and, in my view, provides the basic template because it does allow for cross-border provision of financial services… it is there the principle is set… it is just that the scope gets completely salami sliced out in the appendices…

My previous slide might have implied that I feel, at times, that policy makers have a bit of a fetish for introducing MP tools into market based financing supervision…speaking at the ECB financial stability conference in May, Vitor Constancio, Vice-President of the ECB complained that the European Commission had not proposed new MP tools.

A key point to make here is that in terms of the FTA model, there is an allowable prudential carve out… that it is considered perfectly allowable to carve stuff out of an FTA on FS grounds. And the EU are already following this route….And let's give credit where credits due they are being pretty innovative with the tricks they are pulling.

EMIR2 proposing the extraterritorial supervision of third country clearers and giving itself the power to instate of relocation of activities of third country CCPs if they are deemed to pose systemic risk.

Barnier just this week said that the EU could not agree to a free trade agreement in financial services because of financial stability risks.

Slide: Preferred UK financial services approach

Assuming that Barnier's public statements are effectively just public positioning and negotiating ploys moving to some arrangement for free trade in financial services which require some arrangement for regulatory recognition. The EU quite rationally prefer to default to their equivalence provisions but frankly they have privately and publicly stated that the current third country regimes weren't designed for a market the UK's size.

The EU equivalence process has major downside but it took a little time for City lobbyists to get fully up to speed with the issue and what it was they were lobbing for. But now they are effectively on all the same page and their efforts are now well coordinated.

Appreciating that regulation is potentially the largest non-tariff barrier to free trade in financial services – the City lobby groups generally favour an agreement which mutually recognises the two sides regulatory regimes… in principle not necessarily a difficult task one might presume as they'd supposedly be identical day one...but the devils is in the detail.

The key issue is agreeing a framework for governance, process and measurement arrangements of the architectural and institutional arrangements to manage and oversee the process going forward, including creating a generic template to be frank… agreeing some kind of joint supervisory arrangements for clearing.

Slide: Mutual recognition narrative

It might be a little harsh but possibly true some UK policy makers were a little behind the curve on these issues – particularly the problems with reliance on existing EU equivalence process for market access post Brexit and as such a 'narrative' was catalysed and kicked off by Mark Carney, Governor of the Bank of England and Andrew Bailey, Chief Executive of the FCA, at the beginning of 2017… one that suggested looking to international standards was a better route for creating consistent and coherent global regulation… no self-interest obviously!

This key issues to this narrative are outlined on this slide.

The fundamental problem is that principles and standards are set high level and the tendency in EU equivalence assessments tend to follow a granular rule book approach.

In a nutshell for a deep and meaningful relationship for free trade in financial services agreement of a framework to facilitate regulatory recognition is the whole ball game.

Slide: Guernsey and mutual regulatory recognition

So, to bring this back to Guernsey and turn to the relevance to ourselves of all this…

As communicated by Deputy Trott earlier… we have been pursuing a strategy of engagement on these issues. This slide talks to some of the specific activities of that strategy. It is something that I have personally gotten deeply involved in.

As a regulatory body we have had several technical discussion with other competent authorities on the topic during the year, flying a few kites on processes and pilots that might help on the road to developing a recognition framework. Through the Guernsey Finance membership of CityUK I was on the IRSG working party that produced FTA report fronted by Mark Hoban.

Where the Mutual regulatory recognition discussion will lead is impossible to say, there is every possibility that we may end up with a new international framework or template for bilateral agreements to follow… we could well see harmonisation of supervisory standards through the growth a networks of multilateral agreements..

However the here and now position vis-à-vis the UK, where it could be entirely possible for us to be under the UK wing in ROW trade agreements and it is important for us to be technically understanding of how such arrangements might work. Important for us however is to use this narrative to position ourselves as supporting the UK regime and position ourselves as a natural partner…important messaging in normal, let alone these extraordinary times.

Slide: Pointers for 2018

So finally…. not quite in the order above.

MRR is a potential major focus going into 2018… to be frank. We are not getting a seat at the table for any UK/EU agreement but it is important that we win the debate that a framework for MRR could form the core for other future free trade agreements and networks and thus to continue to work to be part of that conversation

We will see the EU continue to use financial stability to keep activities out of scope of the free trade arrangements, importantly not necessarily immediately but with a continuing eye on the future.

Finally, the big ticket FS risks remain unchanged but added to the necessity to unwind the policy measures of recent years and to be frank that is a whole presentation all on its own.

To conclude, hopefully I have taken you on a little journey, drawing on the various themes and topics highlighted on my title slide and I have succeeded in providing a little light on how the various strands fit together and their potential relevance to us.