Global Risk Regulator

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Evergrande: a watershed moment for China's regulators

China's regulators have turned sour on the nation's most high-profile — and the world's most indebted — property developer, Evergrande. Experts predict its demise is unlikely to batter the banking sector, but are sceptical as to whether China can steer an orderly deflation of its property bubble. *By Farah Khalique*

When it emerged that Chinese property developer Evergrande was buckling under the strain of its $300bn debt, not everyone was surprised. Just 10 years earlier, short-seller Andrew Left accused the developer of accounting fraud and dismissed it as insolvent; five years later, GMT Research investigated and came to the same conclusion. Yet Evergrande had the continued support of Chinese authorities and Mr Left was banned from trading in Hong Kong.

Iris Pang

Regulatory U-turn

But when Chinese regulators initiated steps to cool down China's overheated property market in the summer of 2020, it spelled the end of that undying support and the demise of one of China's success stories. Beijing introduced its "three red lines" guidance to curb how much property *to page 3*

Singapore doubles down on digitisation to future-proof financial centre

Singapore is attempting to boost its appeal to asset managers with the digitisation of a recently launched fund structure, which some in the industry believe will be a game-changer for the city state. *By Justin Pugsley*

In January last year, the variable capital company (VCC) structure was unveiled by the Monetary Authority of Singapore (MAS) and the Accounting and Corporate Regulatory Authority (Acra). VCCs are not particularly revolutionary: they are well established in the Cayman Islands and Luxembourg, for example, and used extensively by international investors. However, their relative simplicity, privacy, flexibility and low cost structure has attracted asset managers' interest. The previous legal options for setting up funds in Singapore were cumbersome and expensive and involved levels of

Irfan Ahmad

transparency that made some investors uncomfortable. And the proof of the pudding is that VCCs have taken off, with more than 300 launched in the first year. The authorities have since stopped publishing figures related to the number of VCCs being created.

"For Singapore this is an important industrial strategy," says Hugo van Kattendijke, head of financial intermediaries Asia-Pacific at UBS Wealth Management. "They *to page 5*

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EU finalisation of Basel III leaves banks concerned

The European Commission's proposals to better insulate EU banks from shocks have been met by the industry with concerns that they gold-plate Basel III rules. *By Justin Pugsley*

On October 27, the European Commission released a legislative package to inscribe Basel III rules into the capital requirements directive (CRD) 6 and capital requirements regulation (CRR) 3 along with amendments to its resolution procedures. The Commission said in a statement that the package faithfully implements Basel III while acknowledging specific characteristics of the bloc's banks. It added that the proposals ensure that bank internal models do not underestimate risk, foster better capitalisation and make it easier to compare risk ratios across banks without significantly bumping up capital requirements.

"The Commission's proposals differ quite widely from the global Basel standards, both in terms of their timing and their content. This will create more regulatory divergence and an increasingly complex regulatory landscape, in particular for international banks," warns David Strachan, head of Deloitte's EMEA centre for regulatory strategy.

The Commission estimates the package will see an increase in average minimum capital requirements of between 6.4% and 8.4%. "These figures are considerably lower than the previous impact assessment done by the European Banking Authority, which estimated an 18.5% average increase in minimum capital requirements if the Basel 3.1 framework was implemented in full. This gap in estimates shows the likely effect of the modifications that the CRD6/CRR3 proposal contains," says Mr Strachan.

The European Banking Federation (EBF) has reflected on the €27bn in extra capital needed for banks to meet the proposed minimum capital requirements. It warned that they do not reflect the capital amounts most banks will have to raise to maintain the current capital ratio of 15%. Given the role of capital buffers in supporting the EU economy during the Covid-19 shock, the EBF is calling for the authorities to disclose the amount of capital needed to restore the current 15% capital ratio after implementing Basel III.

The federation expressed concern over 'double counting' in the package. It said national buffers are an additional layer of gold-plated rules, multiplying the buffer requirements and the complexity of the EU regulatory framework. "The output floor should be applied only to the international buffers, as in other jurisdictions," it said.

The Association for Financial Markets in Europe (AFME) noted that European banks hold record capital levels and called on legislators not to go beyond Basel standards. "Unfortunately, several impact studies suggest that this is unlikely to be the case with the largest European banks facing material increases to their capital requirements, especially once all required capital buffers, such as banks' management buffers, are included. This could have negative consequences for lending," said AFME head of prudential regulation Michael Lever. Nonetheless, he welcomed the Commission extending the implementation date to January 1, 2025.

The Commission wants to ensure banks can cope with environmental, social and governance (ESG) risks. Banks would be required to identify, disclose and manage ESG risks as part of their risk management. The measures include regular climate stress testing and supervisory reviews.

The package envisages supervisors having better tools to assess whether senior staff are up to running a bank and for overseeing fintechs. It also delves into supervising third-country bank branches in the EU: a national supervisor competence. The EU wants to harmonise those rules.

"Today's proposal puts more pressure on the alignment between the EU and other countries' regulatory frameworks for bank capital," says Mr Strachan. "For an international bank operating in Europe, particularly if it operates in the EU through a third country branch, this means an increasingly different regulatory environment, as well as having potential competitiveness implications."

AFME supports the proposals with the caveat they should retain a high degree of reliance on national supervisory regimes and avoid any unnecessary local subsidiarisation. *GRR* will publish a follow-up article on the Commission's proposals in December. **GRR**

Evergrande: a watershed moment for China's regulators

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developers could borrow, in line with three balance sheet ratios: liabilities to assets, net debt to equity, and cash to short-term borrowings.

By the end of 2020, Evergrande had breached all three lines and its main underwriter, Credit Suisse, dumped its entire stock holdings in the business. By the first half of this year, around one in 10 of the top 60 developers had broken all three red lines and banks had reined in lending to property developers. Evergrande sounded the alarm bell on September 14 and called in the financial advisers.

Evergrande had cash and cash equivalents of $13.6bn as of the end of June and total liabilities of more than $300bn. It has $36bn of borrowings and $91bn of trade payables due in the next year, prompting regulators to command Evergrande to find the cash to meet its liabilities. Chinese authorities reportedly instructed billionaire founder Hui Ka Yan to dip into his personal wealth.

The China Banking and Insurance Regulatory Commission (CBIRC) said in a press release on August 19 that it and the People's Bank of China (PBoC) summoned Evergrande's executives and instructed them to "strive to maintain stable operations, actively resolve debt risks, and maintain the real estate market and financial stability."

On September 29, the central bank and the CBIRC stated after a meeting with 24 banks that financial institutions should work with relevant authorities and local governments to ensure the stable development of the property market and the legal rights of homebuyers.

Evergrande's attempts to conjure up cash have had mixed success. On September 29, the developer raised around Rmb10bn ($1.5bn) from selling its 19.93% stake in Shengjin Bank. It missed an interest payment on a dollar bond, but narrowly avoided a formal default after scrambling to pay it within the 30-day grace period. Analysts believe Evergrande has bought itself some time, but predict a drawn-out recovery.

Plans to offload its swanky Hong Kong headquarters fell by the wayside when Chinese state-owned Yuexiu Property got cold feet, and a reported $2.6bn deal to sell a controlling stake in its property management unit to rival developer Hopson hit the buffers.

Drawn-out restructuring

Despite the intervention of central government, a restructuring of Evergrande will not be easy because it is far from a simple business. Over the years, the property developer diversified into banking, pharmaceuticals and even an expressway company. Evergrande's total assets as of June 2021 were around 2.2% of China's nominal gross domestic product.

The spin-off of non-core businesses, such as Evergrande's stake in Shengjin Bank, is the first step that must be taken. The next is to sell stakes in its core property business to generate enough money to finish building existing residential property projects that can be sold to pay off Evergrande's debts. However, as recent failed attempts have demonstrated, this is proving to be tricky.

Iris Pang, chief economist for Greater China at Dutch bank ING, says: "The only comment we feel we can make with some degree of certainty is that the process of restructuring will likely be drawn out. We don't anticipate a full and complete answer to the current market anxiety any time soon."

The mess at Evergrande is spilling over into the wider property sector, which has been under pressure since the introduction of the government's 'three red lines' policy. At the end of October, Fitch Ratings placed 29 Chinese property developers on a watchlist, citing weaker funding prospects and industry conditions since early August.

Luxury developer Fantasia Holdings defaulted on its $206m bond in early October, despite assuring investors that it had no liquidity issues; international investors' fear has driven Chinese developers' bond sales to a screeching halt. In mid-October, Hong-Kong-listed Sinic failed to repay the principal on its $244m outstanding bond and Xinyuan Real Estate announced that a majority of the holders of its $300m bonds have agreed to the company's proposed exchange offer. Modern Land is also planning to conduct a consent solicitation process to extend the maturity on one of its dollar bonds.

Credit analysts are bearish on China's property sector. Property defaults across the country have intensified and credit concerns across the sector remain elevated, according to Goldman Sachs. Its analysts Kenneth Ho and Chakki Ting say that recovery prospects on recent defaults have worsened and the default resolution process appears to have slowed, with the bulk of the defaults since 2018 remaining unresolved. They point to higher leverage across the sector, more complicated capital structures, less certain outlook across the property market, and tighter credit conditions.

A Lehman moment?

Evergrande reportedly owes money to around 171 domestic banks and 121 other financial firms. There is a bright spot, however, on the gloomy horizon. Banking analysts broadly agree that China's overall banking sector is relatively protected from Evergrande and the deteriorating property sector. According to rating agency Moody's Investors Service, financial institutions have already curtailed their direct exposures to Evergrande over the past two years. Evergrande's borrowings from these institutions — mainly banks and trust companies — dropped from Rmb604.7bn at the end of 2019 to Rmb393.9bn at the end of June 2021.

This pales in comparison with China's financial system's total banking assets of Rmb336tn and trust companies' assets-under-management of Rmb20.6tn at the end of June 2021. The majorities of these borrowings are also secured with collateral. Moody's considers Chinese banks' off-balance-sheet exposure to Evergrande through bankers' acceptances to be small.

Shujin Chen, financial research analyst at investment bank Jefferies, says that the potential impact from Evergrande's worsening financial difficulties will not significantly affect major banks, given their lower exposure. Ms Chen says: "Some banks have already set aside provisions on the Evergrande exposure. Major Chinese banks have been using a 'white list' only including the top 30–50 developers since 2015, preferring state-owned entities, given their lower leverage and better solvency."

Evergrande only has around 4% market share in property sales, despite being a top-three property developer in China, and has limited direct linkages to the ▶

financial system. Jian Chang, chief China economist at Barclays Capital Asia, says: "We think Evergrande poses limited stability risks to the banking system, given outstanding bank loans of Rmb227bn, which only accounted for around 0.1% of total bank loans."

Banks have also slowed property development loan growth. The non-performing loan (NPL) ratio of property development of national banks increased in the past two years to 1.85% at the end of the first half of 2021 and is expected to further increase in 2022. In the worst-case scenario, Jefferies predicts that the NPL ratio of the property sector could hit around 20%, like the peak for the coal mining sector amid deleveraging in 2012–2016. The construction sector would also be affected, but can be partly offset by the benefit from potential future infrastructure projects.

Ms Chen says: "We don't expect much increase in the NPL ratio for mortgages, which accounts for 20% of Chinese banks' loans, unless there is a major property price collapse, as China requires a minimum 30% down payment."

Barclays's macro-strategists stress that, despite spillover effects from Evergrande on China's property sector, this is not a Lehman Brothers moment. In their September 20 report, '*Why Evergrande is not China's Lehman moment*', they note that: "One would need to see a lenders' strike across large parts of the financial system, a sharp increase in credit distress away from the real-estate sector, and banks being unwilling to face each other in the interbank funding market. And with all that, we would also need to see massive policy mistakes on the part of Chinese authorities. In our view, the conditions are simply not in place for even a large default to be China's Lehman moment."

Still, some analysts remain cautious. Citigroup analysts, led by Judy Zhang, estimate that around 41% of China's banking system assets were either directly or indirectly exposed to the property sector by the end of last year, and any plummet in property prices could have a knock-on effect on banks' asset quality due to higher default rates in related sectors and lower collateral value.

Green economy pivot

Chinese regulators' response to Evergrande contrasts with how Western regulators reacted in 2008 when the global financial crisis hit, in that China has yet to issue an explicit bailout.

Fund manager Patrick Boyle, founder of Palomar Capital, is following the situation closely. He says: "The Chinese government has so far given no indication that it will offer any financial support to the Chinese property sector."

Indeed, a PBoC official blamed Evergrande for its issues and said they were being resolved through "market and rule of law principles", adding that any spillover to the financial system was "controllable".

Mr Boyle says: "What is happening right now with Evergrande and the broader Chinese property sector is of great interest globally, as it could signal a huge change in the way that the Chinese economy works going forward. This matters both for China and for the rest of the world, as China has been the major engine of global growth in recent years."

Jian Chang
"We think Evergrande poses limited stability risks to the banking system"

China's options include accepting a much lower growth rate, relaxing the 'three red lines' to ease up on property developers, or increasing local government infrastructure spending to make up for the shrinking property sector.

Mr Boyle says: "I think they are unlikely to decide to accept a lower growth rate — this wouldn't be politically acceptable in the short term. Increasing local government spending might also be tough, especially because a lot of local government revenues come from leasing land to property developers. Thus the most likely outcome is that Beijing relaxes the 'three red lines' a bit, so that they can better manage the decline of the property sector."

While Evergrande burns, Beijing is fiddling with the levers to attempt to deflate China's property bubble and shift economic growth to other, more sophisticated sectors such as green energy. By 2060, $46.6tn will need to be spent to meet China's carbon-neutrality goals — the equivalent of $1.2tn dollars per year being invested for the next 38 years.

Mr Boyle says: "That leads to the question of whether this new industry can step in and be big enough to make up for the shrinking real estate sector?"

China's president Xi Jinping made his thoughts on the property bubble quite clear when he said: "Houses are for people to live in, not for people to speculate on." Former Australian prime minister and fluent Mandarin speaker, Kevin Rudd, gave some insights into Mr Jinping's vision for resetting China's economy in a recent 15-minute speech to the Asia Society.

Mr Rudd said: "Xi Jinping has emphasised what he calls the paramount importance of what he calls the 'real economy' as opposed to what he describes as the 'fictitious economy'. The real economy, in his definition, is all about advanced manufacturing, infrastructure, technology, and deep economic transformation — what he describes as building a modern economic system ... By contrast, the fictitious economy is about the asset bubbles, property bubbles and financial bubbles which are built on that. This has become a parallel ideological debate within the Chinese system."

Regardless of China's lofty economic ambitions to diversify away from the property sector and regulators' insistence that a bailout is not on the cards, the sheer size of Evergrande's debts may well mean that a bailout by another name is inevitable. Karl Clowry, a London-based partner in the restructuring group at law firm Addleshaw Goddard, which is informally representing some Evergrande bondholders, says that the Chinese government may well intervene and incentivise banks to write off debt.

"It's been the understanding in a variety of debt or equity swaps where the authority — whether it's the local authority or it's a ministry — says to the financial institutions involved, 'We would expect you to do this, but you will be taken care of'. It's very opaque. Nobody can say, hand on heart, this bank wrote off this much and had their account with the PBoC credited with Y amount," Mr Clowry notes.

"Why would these institutions take such large hits and not necessarily provision for those? It's a way that the Chinese authorities have of containing the problem and defusing the problem for onshore creditors by lessening the ripples." GRR

Singapore doubles down on digitisation to future-proof financial centre

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identified that the corporate structures for funds were not really competitive, when you compare them to international fund centres such as Luxembourg. They identified what was needed and then they built it."

Irfan Ahmad, Asia-Pacific product lead at State Street Digital, says VCCs helped create a specialised corporate structure providing fund managers with flexibility in terms of operations so they can achieve economies of scale and generate savings. He explains that VCCs can accommodate traditional and alternative asset classes and can include retail and non-retail strategies.

He adds that the initiative also aims to bring tokenised assets into legislative frameworks that borrow from the treatment of traditional assets, from an operational, tax and legal perspective.

Mr van Kattendijke explains that the main issue pre-VCC was around privacy, where it was possible in Singapore to uncover the ownership of funds. Many investors prefer to keep that information private. The vehicle can also take advantage of Singapore's tax treaties with other jurisdictions, which outnumber those of many offshore financial centres.

Other important features are operational where numerous funds can sit under an umbrella structure, which handles many of the governance requirements and therefore saves costs. There are also considerations around tax efficiency and structural flexibility: VCCs can be applied to open and closed ended funds.

Singapore studied the best practices of other VCC regimes and honed them to suit its local environment. The authorities are hoping that Singapore, with its good reputation for stability and integrity, can position itself as a more 'respectable' alternative to the many offshore financial centres. Also, until January 15, 2023, MAS will cofund up to 70% of eligible expenses up to a maximum amount of S$450,000 ($334,00) paid to Singapore-based service providers to establish a VCC. Singapore hopes these measures will transform it into a major Asian centre for funds, much like Luxembourg is for Europe.

The digital twist

However, the VCC structure could be about to get another boost thanks to digitisation, which is likely to further enhance Singapore's attraction as an asset management centre.

The initiative is born out of Singapore's Financial Services Technology Innovation programme, which supports fintechs. The firm behind this latest twist on a VCC is digital securities offerings platform, InvestaX. In September 2020, MAS awarded the firm a grant to carry out a proof of concept (PoC) to digitise VCC securities. On September 30, it announced that the participants in the PoC, which included UBS, State Street, PwC and law firm CMS, were able to determine the lifecycle and workflow process behind the tokeniszation of the VCC structure.

It is envisaged that securities digitisation will mainly apply to funds holding illiquid assets, be they real estate or private equity type investments.

"This is a perfect vehicle for us to try to tokenise because at the sub-fund level there is no requirement for that to be held with a public registrar like Acra," says Alice Chen, general counsel and co-founder at Investax. "Using DLT [distributed ledger technology] removes a lot of the intermediaries and everyone can have access to the same ledger, and it really provides the promise of what DLT is meant to be used for."

She explains that the process was further helped by an amendment to the Electronic Transfers Act, which recognised instruments in digital form and is technology-neutral.

"With that amendment we effectively could use blockchain to represent those shares at a sub-fund level, that is, only issuing shares on blockchain," she says. This is a step beyond simply tokenising paper-based securities, and instead sees them issued in digital form directly on a blockchain. This introduces greater simplicity and lower costs.

"If you go directly to native blockchain issuance you only have one ledger," says Ms Chen. With tokenised securities there are typically two ledgers, one for the original paper-based securities and one for the digitised version, and both need to be updated and reconciled if one is changed. Ms Chen continues:

"It removes the intermediary, the backend processes, the manual reconciliation that's required and also provides visibility for investors and allows investors to hold their assets directly, rather than through a nominee structure."

Matthew Nortcliff, a partner at law firm CMS, says there is a big advantage when issuing shares directly on a blockchain because the whole process starts in a decentralised fashion and disintermediation begins immediately. He explains that it also cuts out the rigmarole of tokenising paper-based securities.

He believes there is a noticeably big cost and time benefit when it comes to secondary trading. He explains that it takes weeks to sell stakes in private equity and real estate funds set up under traditional legal structures and those shares are typically only available to institutional -type investors. "Whereas with a blockchain native security it should be as easy as buying and selling Facebook shares," says Mr Nortcliff.

He adds that apart from all the efficiencies derived from using blockchain technology, these funds remain properly regulated. "The groups involved in the PoC have to have governance and goldstar compliance by their nature," he says. "I think the PoC shows that the risks are no different to any other approach, and actually the reality of doing things on the DLT is that it should actually be more secure."

New secondary markets

According to Mr van Kattendijke, the consequences of digitising illiquid funds could be profound. "Access to these private market opportunities is typically relatively restricted," he says. This is due to a variety of factors from high distribution costs through to regulatory investor protections such as suitability requirements. These prevent fund managers and intermediaries from offering highly illiquid, volatile or complex products to investors who do not have the required investment experience and/or significant wealth.

Digitisation effectively democratises these otherwise exclusive markets. "If you are able to attract a good population of market participants into trading that security token… the secondary market is going to be much more liquid than the underlying asset itself," he says. He explains that digitisation allows the slicing and dicing of the fund's shares into smaller parts, potentially allowing lower-net-worth ▶

investors to become involved. The minimum ticket size to participate in some traditional private equity funds can range anywhere from $250,000 to tens of millions of dollars.

Mr van Kattendijke wonders if this democratisation of the investment landscape will prompt regulators to rethink some of their suitability rules for currently excluded investors. "Do we want to exclude that person from making good investments?" he asks. "The power of tokenisation for private assets is to potentially create liquidity where there is none today and to substantially reduce the minimum price of access." If financial inclusion is to be given greater priority, tokenisation may enable retail investors to invest a small proportion of their savings in such assets – so they can benefit from their performance – without the danger of losing all their wealth if they go wrong.

There is a debate within the industry over using permissioned/private or permissionless/public blockchains. The latter certainly offers the best potential in terms of driving secondary market liquidity because it is open to anyone to participate. But it has the disadvantage that it is difficult to control or to make amendments due to its decentralised nature.

Many in the industry therefore lean more towards private blockchains, where participants can be vetted, making it easier to establish common rules and to make amendments where necessary to fix glitches, for example. The use of private blockchains may be necessary as some types of investors might need to be excluded for 'suitability' reasons.

In the case of the eVCC PoC, the Tezos Foundation and Hashstacs provided support as public and private blockchain protocol providers, respectively. Tezos is a decentralised, open-source blockchain network able to execute peer-to-peer transactions and serve as a platform for deploying smart contracts.

Meanwhile, MAS is looking into granting recognised market operator (RMO) licences for platforms trading private digital securities. An RMO is one level below a recognised stock exchange such as the Singapore Exchange.

"What MAS does really well is to be open to the concept, but also is very stringent on the requirements so the only groups that are going to be operating these platforms will have been stress tested by them in terms of compliance and protocols," says Mr Nortcliff. "The biggest advantage Singapore has is that there will be security and comfort, and MAS is engaged with that."

The future

Indeed, the industry is full of optimism over the potential for eVCCs and their importance to Singapore as a financial centre. "Singapore is a regional hub for innovation in fintech, and has a rich history of fostering an environment that enables progressive change in the industry," says State Street Digital's Mr Ahmad.

"We believe that the work we've undertaken in this project, to be foundational as the industry, considers the benefits of utilising digital securities and the transparent and immutable nature of the underlying blockchain technology."

Alice Chen
"If you go directly to native blockchain issuance you only have one ledger"

Ms Chen believes that eVCCs help future-proof Singapore as they align perfectly with the global digitisation trend. "The eVCC project has demonstrated, among other things, a willingness among ecosystem participants to think expansively and leverage new technologies to create favourable conditions for fund creation and investment," says Mr Ahmad. He anticipates that the regulatory changes around digitisation could foster a new breed of fund managers and fintech start-ups looking to take advantage of Singapore's new digital financial market infrastructures.

"There is a huge pool in Asia-Pacific of high-net-worth individuals, and they are increasingly younger. So, they are either entrepreneurs themselves, or they are second-, third-, fourth-generation wealth and they see themselves as digital natives," says Mr Nortcliff. He adds that they are already very active in cryptocurrencies and digital assets such as non-fungible tokens and should therefore naturally take to eVCCs.

"I think you completely open up how much capital your funds can raise and how dynamic they can be. So from our clients' perspective, that's why they're looking at it, and why it is important for Singapore," he says.

Ms Chen explains that the first phase of the InvestaX project involved accepting fiat currencies. This nonetheless meant having separate cash and digital asset custodians, meaning that reconciliation between the two is still necessary.

For phase two, InvestaX would like to include the use of cryptocurrencies or stablecoins to facilitate the actual settlement transaction, which would see more automation. "I think that would really answer a lot of the unknown questions that we didn't get to explore [in phase one], in terms of delivery versus payment and the interaction between cryptocurrencies and digital securities," says Ms Chen.

She explains that InvestaX hopes to launch a live micro-portal for eVCCs sometime in the first quarter of 2022. There is not yet a set date for phase two, with InvestaX due to submit a proposal to MAS.

According to figures published by think tank Z/Yen earlier this year, Singapore ranks fifth among the world's top financial centres. In a 2021 report, Deloitte placed Singapore in second place as an international wealth management centre, and praised its competitiveness, business neutrality and fintech innovation. However, it flagged weaknesses around domestic capital markets and tax policies that are not as competitive as they could be for high-net-worth individuals. VCC vehicles, boosted by digitisation, are clearly an effort to address some of those shortcomings.

But rival financial centres are every bit as alive to the possibilities promised by digitisation and in some areas are ahead of Singapore. Though not necessarily specifically related to VCC-type vehicles, Luxembourg recognised in January the use of DLTs for issuing and settling dematerialised securities. The Cayman Islands, meanwhile, are not just a leading centre for funds, but also for those involved in digital assets. Jersey, a centre for alternative funds, is also a keen promoter of digitising finance.

Singapore is certainly upping the ante for rival financial centres and will no doubt force others to accelerate their own digital initiatives or risk losing business. If nothing else, the city state should be able to cash in on its good reputation, its innovative bias and, possibly just as importantly, its location. GRR

Some stablecoins could be labelled as systemically important

Global standard-setters are taking their first steps towards herding stablecoins into the regulatory ambit as their importance continues to grow worldwide, raising concerns about financial stability. *By Justin Pugsley*

Recent years have seen strong growth in stablecoins backed by fiat currencies. They are typically used by speculators as a temporary vehicle to park funds after selling out of cryptocurrencies. However, an entire alternative financial ecosystem has sprung up involving payment systems and financial products using stablecoins, which could disrupt traditional financial services, such as payments. Their explosive growth has unnerved regulators, with fiat-currency stablecoins already worth more than $130bn.

Hence on October 6, the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) put out a consultation, which closes on December 1, saying that stablecoins should observe international standards for payment, clearing and settlement systems. This is a clear message that stablecoin operators face more regulation. Compliance will be demanding for them, but not doing so could see them pushed out of the financial system, with regulated crypto exchanges having to shun them, for instance.

The work by the two bodies is an offshoot of initiatives promoted by the Financial Stability Board (FSB) to oversee stablecoins. On October 7, it brought out a progress report on the implementation of its high-level October 2020 regulatory recommendations for stablecoins by jurisdictions and global standard setting bodies, in which it noted that work is still in its infancy.

CPMI-IOSCO believe that stablecoins should be regulated as financial market infrastructures in the same way as clearing houses and payment systems. This would pave the way for stablecoins with large market capitalisations to be declared by national regulators as systemically important and subject to considerable regulatory scrutiny.

"Financial innovation offers the prospect of new payment services and greater competition in payments but also potential risks to the financial system," said Sir Jon Cunliffe, chair of the CPMI and deputy governor for financial stability at the Bank of England. He explained that the consultation is part of ensuring the principle of 'same risk, same regulation' is being applied, with financial stability maintained. The two organisations are not proposing a new regime for stablecoins, but instead the use of existing rules developed in 2012 for critical market infrastructures.

Being classified as systemically important would involve stablecoin operators having to make substantial disclosures, implement governance procedures and be much more transparent. The report even questions the current legal rights of stablecoin holders.

Properly backed?

Stablecoins should be backed one-to-one by an equivalent asset, such as US dollars. However, there is concern over a lack of transparency around the composition of their holdings – these could include relatively illiquid instruments – or the coins may not be fully backed. Fitch Ratings warned that large amounts of commercial paper held by stablecoin operators could become a source of financial contagion if credit markets went into meltdown.

Regulators fear a sudden exodus from stablecoins could unleash intense market volatility. This characteristic makes them similar to open ended money market funds. Also, some of them use offshore structures, making scrutiny of their operations and assets more difficult.

The FSB warned in its report that although stablecoins are not being significantly used for mainstream payments, they pose a steadily growing risk. In particular, it sees the increased participation by retail investors potentially creating financial stability issues through an erosion of trust in the financial system. It worries that a stablecoin could become widely adopted across jurisdictions and evolve into a global stablecoin (GSC), thereby posing a risk to financial stability internationally. The FSB is therefore calling for cross-border oversight of GSCs to prevent regulatory gaps and arbitrage. It said it will conclude its review by July 2023 to address any regulatory gaps, along with suggestions on how to plug them.

The lack of regulation, transparency and official oversight makes it relatively easy to sow confusion around stablecoins. On the same day the FSB report was launched, *Newsweek* published an article questioning whether the $69bn of Tether's stablecoins are properly backed.

The article described Tether Holdings, which administers the stablecoin and is controlled by Bitfinex, as a company riddled with "red flags". Bitfinex is a Hong Kong-based exchange owned by holding company iFinex. The article quoted a banker dismissing Tether as a high-risk offshore hedge fund, and that when he handled its funds it had more than 98% cash reserves, but wanted to use them to make investments.

Newsweek is not the first to raise concerns about Tether. In February 2021, Tether Holdings and Bitfinex were fined $18.5m by the New York attorney general and banned from the state.

The two companies were accused of making "false statements" about the backing of tether stablecoins and of covering up $850m in losses at Bitfinex

Following the publication of the *Newsweek* article, Tether retorted that its stablecoins are fully backed, citing an audit by global accounting firm Moore Cayman. On February 28, Moore Cayman published an opinion stating that Tether had more than enough reserves to redeem the digital assets it had issued on that date.

However, it added that it could not provide any assurances around activity before and after February 28. Such stories are making regulators increasingly wary of stablecoin operators, particularly as they grow in prominence in the financial system.

Alternatively, the role of fiat-currency backed stablecoins could be substantially marginalised by the introduction of central bank digital currencies (CBDCs), with which there would be no default risk. However, the US appears to be at least several years away from launching a dollar CBDC if it ever does, meaning that regulation will have to do the heavy lifting for making digital currencies safe. GRR

EBA warns that national supervisors are not grasping fintech risks

Digitisation of the EU's financial sector is accelerating – and the banking regulator is starting to pay attention. The EBA is advising supervisors to get up to speed with the potential risks, but its suspicions about digital platforms has left fintechs fuming. *By Farah Khalique*

Citizens of the EU are rapidly turning to digital platforms to take care of their banking and payments needs more quickly and to find the best deals, a trend partly accelerated by the Covid-19 crisis. Financial institutions like banks were forced to help their customers access financial products and services digitally, when governments across the bloc imposed lockdowns and people had to stay at home.

'Platformisation' picks up

The EU's banking regulator, the European Banking Authority (EBA), says it has identified a sharp acceleration in the digitalisation of both front- and back-office processes in the EU's banking and payment sector, with financial institutions increasingly developing or engaging third-party technologies to facilitate customer access to financial products and services through digital means. It published a paper in late September, *'Report on the use of digital platforms in the EU banking and payments sector'*, outlining its analysis and conclusions.

The pandemic merely sped up a movement that was already well underway. Digital platforms that bridge customers and financial institutions are a trend the EBA anticipates will accelerate in line with the wider trend of digitisation of the EU's financial sector. This 'platformisation' helps satisfy customers' search for convenience and can reduce user costs, offering a range of exciting opportunities for both EU customers and financial institutions.

The regulator identifies five buckets of different types of digital platforms that fall under its platformisation umbrella. These are comparators, financial institutions, banking or payments as a side service, ecosystems and enablers.

- Comparators are platforms that compare products offered by multiple financial institutions, such as price comparison websites for car insurance
- Some financial institutions like Dutch bank ING have platforms that sell products and services sold by third parties.
- Some platforms, such as supermarkets, mainly sell non-financial things like food but offer financial products and services on the side.
- Ecosystems are a single point of entry to multiple third party providers' financial and non-financial products.
- Enablers offer easy access to payments and other services, such as via a digital wallet like Apple Pay. The EBA does not consider these to be in scope of its definition of a digital platform.

Interdependencies risks

The pre-Covid digital infrastructure in the EU was not sufficiently and reliably developed to cater for an increase in demand, explains Claire Simm, managing director in the financial services compliance and regulation practice at consultancy firm Kroll.

"In essence, the EBA noticed the effects of what happens when natural developments are forced to expedite – you ultimately get results that are sub-optimal," she says.

Maria Staszkiewicz
"[The EBA] focuses only on unregulated actors, such as big tech, and looks at digital platforms through a bank's eye"

The EBA believes that platformisation creates new dependencies between financial and non-financial firms, and warns that supervisors are not on top of it. But the EBA itself does not know how many of these digital platforms operate in the EU, because this data is not reported. An EBA spokesperson clarified: "Platform use is not currently subject to an EU-wide reporting framework. But as per the EBA's September 2021 digital platforms report, we will be taking steps to improve reporting by financial institutions and monitoring by competent authorities, including on a co-ordinated EU-level basis."

In the meantime, the regulator wants to alert supervisors across the bloc – the national competent authorities – about new forms of financial, operational and reputational interdependencies that are emerging over which supervisors have limited visibility.

Its September report says: "Although the EBA does not identify the need for any specific legislative changes at this stage, the EBA observes that the platformisation of financial services is posing some challenges for competent authorities in monitoring market developments and any risks arising from these interdependencies."

Operational risk, notably information and communication technology risks, due to dependencies on third-party providers for key digital capabilities, was highlighted in the EBA's report. A recent, high-profile example of this was the Facebook, Whatsapp and Instagram social media outage in early October. Facebook owns all three social media platforms, which are used by around 3.5 billion people. The outage demonstrated that relying on a single centralised company can lead to a serious disruption in provision of services in many sectors.

The EBA also highlights concentration risk and potential network effects, should firms leverage access to customer data, distribution and provision of financial services. Some financial institutions have reported new forms of reputational and conduct of business risk when using third-party platforms, as doing so limits their control of things like cyber-security and customer data, how information is displayed about an institution's products and services, complaints handling and redress. Furthermore, if a third-party digital platform hits the buffers there is always the risk of that spilling over onto the financial institution itself.

Supervisors clueless

Most supervisors have a "limited understanding" about platform-based business models, particularly in the context of

interdependencies between financial institutions and technology companies beyond their direct supervision, concludes the EBA. It issues a stark warning to the bloc's supervisors in its report.

It says: "Over time, this imperfect understanding of business models could impair the effective monitoring of specific risks, including those arising from financial, operational and reputational interdependencies between financial institutions and technology companies."

Only seven out of 26 competent authorities that responded to a previous EBA survey from November 2020 reported that they have a good level of visibility over the use – for the marketing and conclusion with customers of contracts for financial products and services – of digital platforms and enablers by financial institutions established in their jurisdictions.

The EBA summarised some useful advice for supervisors, which includes: dialogue between line supervisors and financial institutions; ad hoc questionnaires to financial institutions; assessments like analysis of business models, examination, review and challenge of application wireframes showing the full end-to-end customer journey, particularly in cases where multiple regulated and/or unregulated services are offered; web-based monitoring; online mystery shopping to assess compliance with consumer protection requirements; and follow-up analysis and investigations in the event of customer complaints.

In 2022, the EBA also aims to help supervisors better their understanding of platform-based business models. It is developing common questionnaires for regulated financial institutions on digital platforms and enabler use, and will share information about financial institutions' reliance on digital platforms and enablers to co-ordinate EU-wide monitoring. The feedback from industry experts is mixed, however. Ms Simm at Kroll is not convinced.

"[Information sharing] is the same thing repeated over and over for the past 20 years: regulators should share information – we know that. Are common questionnaires really an effective medium to gather and share information, when the regulatory risks are now about understanding the regulatory perimeter and how to fit the digital platforms into that perimeter?" she asks.

Now that firms have grasped the cost benefits of digitalisation during the pandemic, there is no going back, says Ms Simm. Her advice for board members at financial institutions is to ask the following points about platformisation, before deciding how to capitalise on the digitisation trend.

- Do firms really understand the cybersecurity, data privacy and data integrity risks related to the use of interdependent platforms, application programming interfaces and and applications?
- What mistakes were made in the initial onset of digitalisation?

Jan Klesla
"National regulators are quite protective of their markets, so if you're not established in a country it's almost impossible to provide services"

- What is the exposure to the risks related to having multiple third parties as providers of technology?
- How much are we dependent on this technology, and is that dependency a key risk to our operations?

Fintech fights back

Digital platforms across the EU have viewed the paper with scepticism. Maria Staszkiewicz is the president of the European Digital Finance Association and the chief executive officer of the Czech Fintech Association; she believes the EBA correctly outlines the potential risks of platformisation but its focus is too narrow and its analysis somewhat limited.

"[The EBA] focuses only on unregulated actors, such as big tech, and looks at digital platforms through a bank's eye," she says. "What is even more important, the EBA [omits] to propose specific steps the agency and other EU institutions could take to finalise the digital single market in financial services."

A lack of a true digital single market in financial services, despite the EU's single market strategy, is a source of great frustration and disappointment to the European fintech world. This has hampered the degree of digitisation of the bloc's financial sector. Theoretically, a firm registered in one EU country can sell its products and services to other EU countries, but some regulators will impose extra burdens, explains Nikki Johnstone, partner in the banking regulatory and fintech practice at law firm Allen & Overy.

"So in some countries they will say that [extra] rules don't apply if you're passporting in from [another country], but then you would get a different response from certain EU countries where they impose their own conduct of business rules, maybe a complaints procedure or some additional protections," she says. "It's that kind of inconsistency which makes it very difficult for firms to provide a single, unified product to all customers in the EU."

Jan Klesla, chief strategy officer at Easychange, an online money transfer platform from the Czech Republic, experienced this problem when trying to expand Easychange as demand for its services increased. "National regulators are usually quite protective of their markets, so if you're not established in a country it's almost impossible to provide services in [that] market," he says. "In theory, it should be possible. In fact it is not, especially for the little players."

The EBA recommends supervisors get up to speed on the platformisation trend. Fanny Rodriguez, head of public affairs and open banking partnerships at fintechs Bankin' and Bridge, liaises with regulators regularly in countries including Germany and Spain, and believes this recommendation would pose challenges. "Sometimes the regulator doesn't understand everything which is maybe normal because it's quite complex and difficult to understand when you are not inside a fintech," she says.

The broad concern from Europe's digital finance players is that the EBA will introduce unnecessary red tape for fintechs. European businesses need more harmonised regulatory and technical standards and data pools, not more taxonomies, questionnaires and administrative burden, urges Ms Staszkiewicz.

She adds: "In order to support better services for consumers and businesses, the EBA and other european supervisory authorities should focus their efforts mainly on removing barriers from the financial market and work on harmonisation of standards and processes, so that we do not end up with one or more per member state as we have almost ended up in the course of PSD2 implementation." GRR

New board to bring 'welcome' consolidation of ESG standards

The creation of an International Sustainability Standards Board promises to replace a patchwork of ESG company disclosures standards with a single set of global rules, but will prove challenging to implement. *By Victor Smart*

The new International Sustainability Standards Board (ISSB) has all the right credentials to become a potent global financial standards-setter. Its birth has been fast-tracked by international regulatory players in an attempt to achieve in just 18 months what for financial accounting took four decades.

On top of this, it has global backing: an offshoot of the International Financial Reporting Standards (IFRS) Foundation, it has unequivocal support from heavy-hitters like International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB). For good measure, some of the world's leading financial nations, including China, Germany, Switzerland and the UK, are vying to host its headquarters.

The body's formal launch is due at the high-profile two-week COP26 UN conference on climate change in Glasgow, UK, that started on October 31. As the months have gone by and concern about global warming has grown sharply, many now see robust, comparable disclosures to investors of the sort the ISSB should enable as central to the financial world's response to environmental threats.

In July the FSB published a report which backed the idea of the new global body to meet investors' need for "consistent, comparable and reliable" ESG data. G7 and G20 finance ministers have also thrown their weight behind the new body. Issuing a draft standard on climate-related financial disclosures will be a priority for the new board. However, it will be for individual jurisdictions to decide if and how they would like to adopt international sustainability reporting standards.

The new board will be sister to the London-based International Accounting Standards Board (IASB) which also sits under the aegis of the IFRS. To extend its scope from financials into sustainability standards, the IFRS was forced to amend its constitution. A consultation over the summer, however, showed overwhelming support for the move; investors declared they needed better and globally comparable information on sustainability matters and wanted the ISSB created to provide "a global baseline" that allows investors "to have common information around the world that jurisdictions can adopt and combine with their jurisdiction-specific requirements".

"It is one of the most significant moments on the journey to standardise disclosures", comments Marina Petroleka, head of ESG research at Fitch Ratings.

Strict remit

By the same token, strict boundaries have been imposed on the ISSB's remit. The new body has been instructed not to sweep away the useful, if piecemeal, work already done by other bodies, but rather to build on it. Furthermore, the focus is squarely on investors' information needs when assessing the impact of the changing environment on enterprise value, and not the broader impact of a firm on the environment.

Marina Petroleka
"It is one of the most significant moments on the journey to standardise disclosures"

After a slow start, the global financial community has in the past three or four years strenuously ratcheted up its response to environmental threats. The sheer number of frameworks and standards has led to confusion and inconsistent disclosures with an 'alphabet soup' of bodies crowding the regulatory landscape.

There is, for example, already the Global Sustainability Standards Board run by the Global Reporting Initiative (GRI) that exists separately from the ISSB. The GRI mainly focuses on the impact of firms on the environment, whereas the ISSB focuses on the impact of the environment on firms.

To ensure that the ISSB does indeed consolidate the regulatory landscape rather than cause further proliferation, a raft of major players have been co-opted from the outset.

Among these are the Climate Disclosure Standards Board (CDSB), the World Economic Forum and FSB's TCFD (Taskforce on Financial Disclosures). Also on board are the International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB), which are helping the decluttering by merging into a new organisation called the Value Reporting Foundation.

Felicity Hall, senior associate at Global Counsel, a strategic advisory business, explains: "The whole point of the ISSB is to act as a unifying body, bringing together best practice from the various ESG standard-setters and frameworks already in existence. In terms of driving consensus on what is currently an extremely fragmented issue, the work of the ISSB is likely to be crucial. With the right level of ambition, and appropriate consideration of the expertise we have already developed, the ISSB could finally answer a long overdue call from both corporates and investors for harmony in ESG reporting."

The IFRS has created a technical working group to prepare the ground. This emphasises that the ISSB's efforts will be congruent with the FSB's TCFD framework, thereby cementing the latter's pivotal position. As countries shift from encouraging disclosure against voluntary ESG frameworks to introducing mandatory requirements, many, including the UK, are insisting that firms report against the TCFD requirements. The technical working group set out the four pillars of the TCFD: governance, strategy, risk management, and metrics and targets.

Created by former Bank of England governor Mark Carney and billionaire Michael Bloomberg, the TCFD framework is now seen as the gold standard, underpinning many of the most important regulatory initiatives on sustainability in banking

and insurance. The combined market capitalisation of financial institutions supporting TCFD has recently climbed to $25tn.

Highly ambitious

Despite the strictures on the ISSB not to start with a blank sheet of paper, there is no mistaking the scale of ambitions for it. The IFRS has a bold timeline for developing the standards, suggesting that they could be ready as early as next June. One option is to adopt the climate-related financial disclosures prototype standard proposed by SASB, IIRC and others in 2020 as a basis for the new standards.

And although the new body is to focus initially on climate change, it will be expected to move into all other areas of environmental, social and governance (ESG) asset disclosure. On the environmental front that will draw on biodiversity and also social, or 'S', matters such as gender and race equality, and human rights which some see as thorny areas where it is tricky to devise hard metrics. IOSCO, for one, is not fazed by this. In fact it demands a "defined timeline" for ISSB to develop standards that address other ESG areas.

Given mounting fears about rampant 'greenwashing', this sense of urgency is perhaps not surprising as the scale of the boom in ESG investing becomes apparent. The value of ESG assets under management hit $103tn last year, according to an estimate by Boston Consulting Group.

John Boulton, director of policy at the accounting body the Institute of Chartered Accountants in England and Wales, comments: "The IFRS foundation has been scrupulous in ensuring global legitimacy for its work. It has been very careful to involve the EU, US, Chinese, South Koreans, Japanese and others."

But account will need to be taken of regional and national differences. During the original IFRS consultation there was pushback over the misalignment of the initial proposals with developments in individual jurisdictions, notably the EU's Corporate Sustainability Reporting Directive (CSRD) with its much broader stakeholder focus.

The CSRD envisages the adoption of EU sustainability reporting standards which would be developed by the European Financial Reporting Advisory Group. How closely aligned these will be the ISSB's remains to be seen, but there is already some clear divergence between the two proposals.

Jeffrey Hales, chair of SASB, comments: "I think everyone recognises a global solution is ideal, but global solutions are very hard to actually implement and maintain because of regional jurisdictions… So I think the second best [option] is that regional distinctions end up being part of a building blocks approach…where you might have the IFRS Foundation establish a set of standards that could be applied globally."

John Boulton
"The IFRS foundation has been scrupulous in ensuring global legitimacy for its work"

Meanwhile, some top European corporations with assets of more than €8tn felt it necessary to urge the European Commission to support the ISSB. A 'building block approach', with global standards upon which national and regional standard-setters may build supplementary standards, is necessary "to minimise the risk of divergence, inconsistency and lack of comparability", they maintain.

The rush by influential countries to entice the ISSB headquarters to their shores is a mark of the new board's probable prestige.

London, which already hosts the IFRS and the IASB headquarters, has most at stake: it should be the front-runner and is lobbying hard, backed by promises of financial aid from the UK government and early commitment to the ISSB standards.

Two weeks ahead of COP26, the UK government confirmed in its new *'Greening Finance: A Roadmap to Sustainable Investing'* report that its recently announced mandatory Sustainability Disclosure Requirements (SDR) will be aligned with the ISSB.

It stated: "The government expects that ISSB standards will form a core component of the SDR framework, and the backbone of its corporate reporting element. To deliver this, the government will create a mechanism to adopt and endorse ISSB-issued standards for use in the UK."

Even so, observers caution that China, the EU and the US each have their own reasons for reluctance to hand a diplomatic favour to the UK at the moment.

Perhaps predictably, US Republicans have not joined the chorus of support for the ISSB. Hester Peirce, a commissioner to the US Securities and Exchange Commission (SEC), told the IFRS: "We do not have perfectly converged global financial reporting standards. A single set of sustainability standards is an even more difficult task given… the difficulty in reducing sustainability matters to objective, easily comparable, broadly applicable metrics."

But another SEC commissioner, Allison Herren Lee, has more recently described the ISSB as an "important and promising international effort…The SEC, through [IOSCO] and other international work streams, is engaged in efforts to assist in this work."

Tough call?

Despite the head of steam behind the ISSB's creation, one irony is that, "in terms of content, it's not a massive breakthrough", according to Global Counsel's Ms Hall. The standards-setting is still on a theoretical level and pretty abstract.

Fitch Ratings' Ms Petroleka adds: "It remains to be seen how the dust settles because there are quite a lot of standards that the ISSB is expected to build on, build from, and learn from. For instance there are some really big regulatory moves happening in Europe with the CSRD, the SFDR [Sustainable Finance Disclosure Regulation], mandatory disclosure and so on. Within an ecosystem where such disclosures are mandatory on a regional and/or country basis, where does the ISSB stand? Likely in parallel – they'll have to sort of coexist."

She adds: "But outside the EU and other regions with strong standards, we anticipate that standards set out by the ISSB could actually be taken up by several different jurisdictions around the world quite rapidly."

There are questions too about the level of granularity, something that could shift over time. Ms Hall warns: "Ultimately, the ISSB will inevitably find itself in a tug of war between simplicity and granularity. The board will want to set ambitious standards which are aligned with existing voluntary and mandatory ESG reporting frameworks, and which can apply across jurisdictions. This is an extremely difficult balance to find." GRR

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Bundesbank president to step down potentially influencing ECB policy

Jens Weidman, president of the Bundesbank, Germany's influential central bank, is due to step down on December 31 – a move that could impact the balance of power within the European Central Bank (ECB) where he is a member of its governing council.

His departure is more likely to influence the ECB's monetary policies rather than its approach to banking regulation. He was often a lone hawkish voice within the ECB trying to hold back the central bank's bond buying and negative interest rates policies. He also lost the race to replace ECB president Mario Draghi in 2019 with Christine Lagarde gaining the position instead.

With Germany possibly about to establish a more left-leaning coalition government, there is some speculation that the next Bundesbank president will be more dovish on monetary policy. The economist Isabel Schnabel who has recently been appointed to the ECB's executive board is a potential replacement as Bundesbank president. Other names that have been floated include Jorg Kukies, a finance ministry official, Rolf Strauch, chief economist at the European Stability Mechanism and Marcel Fratzscher, head of Germany's Institute for Economic Research.

Mr Weidmann also chairs the board of the Bank for International Settlements and will automatically step down from that position, which he has held since 2015.

On October 20, the BIS's general manager Agustín Carstens expressed sadness over Mr Weidmann's resignation. He praised him for helping the BIS develop a culture of innovation and for promoting diversity and inclusion within central banks.

Mr Weidman's resignation letter, released on October 20, stated that he is leaving for personal reasons, but according to some media reports he has grown weary of battles with other ECB council members over monetary policy.

His letter makes reference to the ECB's emergency monetary policy measures being stabilising, but also associated with considerable side effects.

However, Mr Weidman wrote that a symmetrical, clearer inflation target had been agreed. "Side effects and, in particular, financial stability risks are to be given greater attention. A targeted overshooting of the inflation rate was rejected. And the Eurosystem will pay more attention to climate risks in the future. These are all points that were important to me," he wrote.

He called on the Bundesbank, which he headed since 2011, to preserve its "important stability policy legacy", which makes this institution so unique.

Banque de France completes Europe's largest CBDC trial

As part of a 10-month pilot scheme, the Banque de France completed Europe's largest trial involving central bank digital currencies (CBCDs), which saw the participation of private sector banks, the public debt office and generated around 500 transactions.

The transactions involved primary and secondary markets using a system developed by the French central bank and IBM. The US technology giant said the pilot went well beyond other trials as it tested most central securities depository and central bank processes while eliminating current interim steps, such as reconciliation between market intermediaries. The company also noted that the experiment represents a move towards fundamentally changing the post-trade market infrastructure.

"Such an important central bank successfully using digital currency to settle treasury bonds on blockchain will further vindicate the steps other countries – inside the EU and globally – have taken to implement a CBDC," said Todd McDonald, co-founder and chief product officer at R3, an enterprise blockchain technology company. "It also proved that it is possible for a well-designed blockchain platform to interoperate with a pre-existing market infrastructure."

He explained that developing interoperability between old and new market infrastructure is also critical to driving adoption of blockchain in the broader financial services space.

"Interoperability between the ledger and today's platforms holds the key to releasing financial intermediaries from the technological binds in which they find themselves after years of unstructured investment in multiple generations of expensive legacy technology," he added. The Banque de France has also conducted CBDC experiments with its counterparts in Singapore, Switzerland and the Bank for International Settlements.

UK to cut bank surcharge, partially offsets big tax increases

A special tax on banks introduced in the UK following the 2007-9 global financial crisis is to be dramatically reduced as the government seeks to safeguard the City of London's status as a leading financial centre following Brexit.

On October 27, UK chancellor (finance minister) Rishi Sunak announced that the bank surcharge will be cut to 3% from 8% in April 2023. Also the profit threshold at which the surcharge is paid will rise to £100m from £25m to help smaller challenger banks compete.

However, for banks this only partially offsets the upcoming big jump in corporation tax, which will rise to 25% in April 2023 from 19% now. Nonetheless, the cut was welcomed by banks.

The banks have long pushed back against the surcharge introduced in 2015 arguing that it reduces the attraction of London as a centre to base their operations. Mr Sunak said the move helps preserve the City's competitiveness while making sure banks pay their fair share of taxes.

"The banking sector will, however, see an increase in its total tax rate and will continue to be taxed at a higher rate than other sectors of the UK economy," said David Postings, chief executive at UK Finance, a bank lobby group.

"While these actions will help shore up the UK's status as a world-leading international financial centre, we still need to make up ground on New York, and other centres who continue to gain market share from the UK. Even with the cut to

the surcharge, the effective tax rate on UK banks will remain significantly above rates in rival financial centres," said Miles Celic, chief executive officer at the lobby group TheCityUK.

"We urge HM Treasury to keep the banking and finance sector's total tax rate under active review – this will ensure the UK continues to be an attractive place to do business, and is globally competitive."

ESMA proposes streamlining certain MiFID reporting requirements

Certain 'burdensome' reporting requirements contained in the markets in financial instruments directive (MiFID) 2 look set to be streamlined under proposals from the European Securities and Markets Authority (ESMA) – a move welcomed by the industry.

Industry responses are starting to appear in response to ESMA's consultation published on September 24 with comments due by December 23. ESMA will report its findings to the European Commission during the second half of 2022.

Of particular interest are the regulatory technical standards (RTS) 27 and 28. The former deals with quarterly reports that venues and some brokers have to make and are part of best execution requirements while the latter requires investment firms executing client orders to summarise and publish the top five execution venues in terms of trading volumes, for each class of financial instrument.

Such are the industry's difficulties with meeting RTS 27 that its requirements are suspended for two years while the European Commission reviews the standard.

In its consultation, ESMA identifies several issues with RTS 27 that to some extent also apply to RTS 28, which include the production of overly lengthy reports that are of limited use and a lack of consistency due to confusion around reporting requirements.

"The large number of fields required under RTS 27 requirements has been a challenge for firms since MiFID II was introduced, exacerbated by a general lack of data consistency," said Alex Dorfmann, senior product manager, financial information at SIX, the Swiss exchange. "While the legislation review will be an ongoing process, reducing the overall number of reportable fields will in turn free up market participants to deliver more value through providing accurate data, given that the call for transparency is getting louder across jurisdictions."

ESMA aims to streamline the reporting requirements by making them less detailed and more user friendly while still capturing the most meaningful information for understanding execution quality of trades.

To achieve that objective, ESMA proposes a raft of measures. For RTS 27 these include reducing the overall number of reportable fields to 13, there are currently over 50, with only six being 'calculated' fields. Among the proposed RTS 28 changes are to distinguish between orders which a firm executes and orders a firm transmits for onward execution and to remove fields that distinguish between passive and aggressive order percentages.

FSB tells G20 that Covid demonstrated value of global co-operation

In a letter sent to G20 leaders ahead of their October summit in Rome, Financial Stability Board (FSB) chair Randall Quarles wrote that some of the lessons learned from the Covid-19 pandemic include the importance of global co-operation to help preserve financial stability.

The letter, dated October 28, stressed the need to assess the financial stability implications of financial, and particularly, technological innovation, and to ensure that supervisory and regulatory frameworks and approaches provide a solid foundation for harnessing the benefits of such innovation while containing their risks.

He explained that the FSB has been looking at more systemic ways of assessing vulnerabilities across the global financial system, through a new Financial Stability Surveillance Framework. It added that it is developing a workplan for 2022 in concert with the incoming G20 Indonesian Presidency to build a path forward.

On November 1, the FSB delivered a progress report on enhancing the resilience of non-bank financial intermediation (NBFI). It noted that NBFIs have grown considerably in the last decade and now account for half of global assets. It said the March 2020 turmoil caused by Covid-19 underscored the need to strengthen the sector's resilience. In the second part of its work on NBFIs, the FSB said it will enhance its approach towards understanding and monitoring these firms. It set out a number of dates for deliverables running up to 2026.

Transformed Bafin two-thirds of way through its reforms

Following the bruising Wirecard scandal, around two-thirds of the 40 measures to reform Germany's Federal Financial Supervisory Authority (BaFin) have been carried out with the remainder close to implementation. Around 100 employees have worked on the project for seven months.

On October 13, BaFin president Mark Branson and Dr Jörg Kukies, state secretary at the federal ministry of finance, gave a six-month update on the execution of the seven-point plan to reform the regulator *(see March 2021 GRR: A reformed BaFin to get 'teeth')*. The report suggests that substantial progress has been made with new divisions created, significant investment in technology and 150 new personnel have been recruited, with 80% of vacancies now filled.

The reforms were spurred by Wirecard, which was once Germany's leading fintech and filed for insolvency on June 25, 2020 following accounting irregularities *(Sept 2020 GRR: Wirecard: where did it all go wrong?)*. The scandal highlighted BaFin's inadequate supervision and it was even accused of hostility towards whistleblowers.

"BaFin is well on its way to performing effective financial reporting enforcement as a one-tier process for all companies listed in Germany, starting in 2022," Mr Kukies said, following legislators providing a clear modernisation mandate. Mr Branson added that there is a clear expectation for BaFin ▶

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to be ambitious, modern and digital. "It will take time before we reach our objectives in all areas. But we are heading in the right direction and motivation is high," he said.

In mid-August, a new division was launched to supervise complex and innovative financial firms and is already overseeing 17 companies. The regulator said it will evolve its approach to become more holistic to identify and counteract critical risks.

From next year, financial reporting enforcement will be BaFin's responsibility and it will conduct ad hoc and sample audits of listed companies. The unit will be reinforced at the start of 2022 with accounting experts from the Financial Reporting Enforcement Panel (FREP).

In August, BaFin reorganised its point of contact for whistleblowers, which already acts in accordance with the EU Whistleblower Directive. That same month, the Data Intelligence Unit began work on providing analytics and IT-based supervision. By year-end, the first version of a 'supervisor cockpit' should go live.

On July 1, BaFin's operational statute was changed to mean its president has more power over personnel allocations, budget, financial resources and organisational structure. Also from next year, BaFin will launch a mystery shopping unit to boost investor protection. It will make undercover purchases of financial products to verify that providers are acting in accordance with the law.

Global standard setters propose new measures on initial margins

Due to intense market volatility in March/April last year as the Covid-19 pandemic struck Western countries, global standard setters are consulting on a raft of measures such as increased transparency in centrally cleared markets through to enhancing liquidity preparedness.

In a joint statement on October 26, the standard setters also advocated for identifying data gaps in regulatory reporting, streamlining variation margin processes in centrally and non-centrally cleared markets and evaluating the responsiveness of centrally cleared initial margin models to market stresses, with a focus on impacts and implications for clearing house resources and the wider financial system. Other proposals involve evaluating the responsiveness of non-centrally cleared initial margin models to market stresses.

The consultative report noted that variation margin calls in centrally and non-centrally cleared markets in March were large, and significantly higher than in February 2020. The peak clearing house variation margin call was $140bn on March 9, 2020. Initial margin requirements for centrally cleared markets increased by roughly $300bn over March 2020, and varied substantially across, and within, asset classes. Also, initial margin requirements on non-centrally cleared derivatives remained relatively stable during the stress period.

The standard setters, which are supporting the Financial Stability Board's work on the topic are the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions. Respondents have until January 12, 2022, to give feedback.

France's regulators urge banks to strengthen their climate policies

France's regulators are prompting financial firms to strengthen their climate policies and take into account expected long-term weather patterns to help meet the objectives of the Paris Agreement to reduce carbon emissions.

The statement from the Autorité des Marchés Financiers (AMF) and the Autorité de Contrôle Prudentiel et de Résolution (ACPR) came with the release of their second report monitoring climate-related commitments by financial institutions. This one has a particular focus on reducing exposure to thermal coal and also looks at lending to other fossil fuel sectors. The two regulators sent out detailed questionnaires to the largest firms made up of nine banks, 17 insurers and 20 asset management companies, supplemented by interviews with representatives of these companies.

The survey found that exposure to coal accounted for less than 1% of assets though there were disparities between individual firms. Financial firms are also becoming stricter towards their exposures to coal with more of them setting similar exit dates. The full report on the monitoring and evaluation of climate change commitments will be published in December.

European Commission rejects idea of delayed consolidated tape

The EU needs a near real-time consolidated tape (CT) according to senior European Commission officials in rejection of having one with a 15 minute delay as proposed by a trade association representing exchanges.

A delayed tape would not help investors find the most liquid markets and though it does not need to deliver in nano-seconds, it must do so in seconds rather than minutes, said John Berrigan deputy director-general for financial stability, financial services and capital markets union at the European Commission. Also, the tape would not be for high frequency traders, but must still have enough value for other market participants, said Tilman Lueder, head of the Commission's securities market unit.

These were swift rebuttals to a study commissioned by the Federation of European Securities Exchanges (FESE) suggesting that a 15-minute delay post-trade tape would be the optimal starting position for equity, equity-like (including exchange-traded funds) and fixed income financial instruments and 'provides the best cost-benefit characteristics'. It would include data from systematic internalisers (SI) and over-the-counter (OTC) markets with each asset class ideally having its own CT. FESE commissioned the study on the CT from consultants Oliver Wyman.

"As the study shows, a CT is no panacea for market structure – only if market structure rules are redefined and enforced so as to foster transparent trading can significant benefits be realised," said FESE director general, Rainer Riess.

"For a CT to be useful, it must provide a complete overview of market activity to investors. The persistence of low quality market data – notably from SI and OTC

venues – is a barrier to that."

Other recommendations from Oliver Wyman include addressing data quality gaps before introducing a CT with a reduction of deferral rules for SIs and OTC. Once the CT is established, a shortening of the delay time towards post-trade close to real-time with a sensible 'speed limit' could be investigated, it said. Another is that it should be independently administered by a pan-European body such as the European Securities and Markets Authority.

However, the European Commission also found support from other parts of the industry for a real time CT. The Plato Partnership, a consortium of buy-side and sell-side firms, welcomes the idea of a real time CT across Europe including the UK and Switzerland.

In an open letter dated October 12, the Plato Partnership wrote that a CT would provide a consolidated view of prices and volumes that would level the playing field, would support best execution requirements and therefore lower transaction costs and would improve fund liquidity risk management. This would help funds mitigate systemic market risk by being able to gauge real executable liquidity. The Commission hopes to have a prototype CT ready in 2023.

New identifier launched to track cryptocurrencies

A new ISO standard identifier has been launched by the DTI (Digital Token Identifier) Foundation that enables the tracking of the top 100 cryptocurrencies by market capitalisation. The service will issue identifiers for digital assets based on the new International Organization for Standardization (ISO) standard, said the DTI Foundation, a not for profit division of Etrading Software, on October 7.

The identifier complements existing ISO standards for tracking counterparties trading via the Legal Entity Identifier (LEI). The committee involved in the new identifier also designed the Unique Product Identifier (UPI) for tracking all over-the-counter derivatives globally. The LEI and the UPI have been recommended by the Financial Stability Board for the regulatory reporting of trades across the G20 to enhance risk management and increase transparency in traditional capital markets.

The DTI will enable firms and regulators to more easily track and oversee trades in digital assets and can help with detecting money laundering.

"Registration eligibility for the DTI is based on objective and verifiable information provided by the applicant. This will help the market identify different tokens that may be exchanged, aggregated, listed, or tracked," said Dominique Tanner, chairman of the ISO/TC68/SC8 standards body.

"This is an important step for the industry in being able to identify digital assets, in a standardised way and reduce ambiguity, increasing transparency and consistency, enabling further global interoperability and lowers the bar for greater institutional investment in this burgeoning asset class."

FCA warns firms over 'work from home' risks

Financial firms with staff working from home in regulated functions need to ensure this does not lead to damage to clients, market integrity, reduced competition or foster criminal activity, the Financial Conduct Authority said in a guidance notice on October 11.

Due to measures taken in the first quarter of last year to stem the spread of Covid-19, entire workforces were sent to work from home. With the social restrictions lifted, many financial professionals have adopted hybrid arrangements by splitting their working week between the office and home.

And the FCA appears to have cause for concern. Chris Ross, a senior vice president at IT services firm Barracuda Networks, said its research revealed that 81% of IT leaders admitted that their organisation had suffered a security breach in the past 12 months. For those with a hybrid work model the breach rate was 85%, compared with 65% for those that only work in the office. Ransomware attacks were among the problems cited.

The FCA said it will evaluate hybrid arrangements on a case-by-case basis to ensure a firm's ability to meet its regulatory obligations is not being undermined.
The FCA recommends that firms have appropriate systems and controls and necessary IT functionality in place to support remote working. This should account for data, cyber and security risks. This could see the FCA making home visits.

"Far too many companies still lack the training and assessment of personnel and the IT infrastructure and systems to ensure complete compliance," said Sridhar Iyengar, managing director at software firm Zoho Europe.

"As well as ensuring the right security systems are in place, it's essential that staff are fully trained about the risks posed in terms of data security around incorrectly addressed email correspondence as well as external threats like phishing emails, ransomware attacks. Financial services organisations manage valuable and critical data, and it's so important that they do not allow flexible working practices to put them at risk of a breach," said Tim Sadler, CEO of IT security consultancy Tessian.

IOSCO updates outsourcing principles to reflect evolving trends

A set of outsourcing principles for regulated financial firms has been updated by the International Organization of Securities Commissions (IOSCO) reflecting new technological developments.

In a statement on October 27, IOSCO said the update has expanded the principles to cover trading venues, intermediaries, market participants acting on a proprietary basis and credit rating agencies. The body laid out seven principles for regulated entities to consider when outsourcing. These include due diligence, contracts with service providers, confidentiality issues and concentration of outsourcing arrangements.

And while financial market infrastructures (FMIs) are outside the scope of the principles, IOSCO said they may consider applying them. However, IOSCO said it will be engaging with the Committee on Payments and Market Infrastructures (CPMI) to draw up a set of principles for FMIs. GRR

Bid to shift euro clearing into EU remains frustrated by financial stability risks

The eurozone authorities retain an undimmed desire to shift the bulk of euro clearing into the bloc, fearing financial instability risks if it is left in third countries, but they face the dilemma that if they push too hard they could trigger the very circumstances they wish to avoid. *By Justin Pugsley*

"Third-country regulators have publicly said that they only want one hand on the steering wheel during a crisis, and that hand of course, should be their own, which is not surprising," Fiona van Echelpoel, deputy director general at the European Central Bank (ECB) told the 14th Annual European Post Trade Virtual Conference hosted by the Association for Financial Markets in Europe (AFME) on October 18.

Ms van Echelpoel said she respected that stance, but said it raised the question as to how dependent the EU should be on third countries for clearing services.

She also reflected on the long running debate within the EU over relocating clearing services into the eurozone, which intensified after the UK voted to leave the union in June 2016.

"What is clear, however, is that the EU should build up its own clearing services in market segments which are currently cleared mostly outside of the EU. And these include critical derivatives markets such as interest rates, and credit derivatives," she said.

She acknowledged efforts by UK-based LCH, which according to data firm Osttra clears 90% of euro derivatives, to develop clearing services in the bloc for repos and certificates of deposit, and that progress is being made by Eurex in building up interest rate swaps.

Pressure is on

However, often strident language from EU authorities over their determination to shift euro clearing out of London in particular has worried financial institutions that rely on the country's sophisticated infrastructure and deep markets.

For example, on January 19 the European Commission published a 'strategic autonomy' paper about fostering openness, strength and resilience, in which it presented euro-clearing outside the EU as a financial stability concern. It also said there is a clear expectation for EU banks to reduce their exposure to UK clearing houses.

A typical reflection of thinking by financial firms was aired during the AFME event: "There's so much pressure to end the equivalence period in mid-next year," said Koen Holdtgrefe, co-head of government and regulatory affairs at Deutsche Bank. "And that's why we think we need more time because there is progress in shifting clients across [to the EU]." He reflected that Eurex has been picking up greater euro clearing business, meaning that the shift to the bloc is happening naturally and should be given more time. Ultimately, however, it is down to clients to decide where they want to do their clearing, he said.

On October 18, European Commissioner for financial services Mairead McGuinness soothed nerves over any forced relocations by stating that there would be "no cliff edge" situation over EU banks accessing UK clearing houses. In an interview with the *Financial Times* (owner of *Global Risk Regulator*) she said there cannot be instability in the short term, but the EU's long-term interests must be addressed. "[Banks] should read my lips and hear what I am saying. We do view this as a strategic issue for us in the medium, long term," she said.

The EU granted temporary equivalence to the UK on clearing but this runs out in June next year and banks have been pressuring the European Commission to extend the deadline. Most expect this will happen.

Currently, there are around €80tn of open contracts in the UK, which are no longer subject to direct oversight from the EU authorities. Ms McGuinness hinted that there will be some announcements on the matter shortly.

The attraction of London and New York is the deep pools of liquidity, allowing users to optimally net off their positions, which saves them considerable capital and reduces risk. The eurozone currently does not have those attributes.

At the AFME conference, Ms van Echelpoel suggested that there is "a massive reliance" on UK and US regulators in terms of overseeing euro clearing and in managing any associated systemic risks. "[Relying on] third-country CCPs [central counterparty clearing houses] during normal times works fine. I would say we have good co-operation with the third-country CCPs with the US and the supervisory committee chaired by Klaus [the European Securities and Markets Authority, or ESMA], with the Bank of England as the supervisory authority," she said.

Political risks

She explained that the real concerns arise during a financial crisis, with the risk that the situation becomes politicised. UK-EU relations are very poor following Brexit and Ms van Echelpoel cited the spat between the two over fisheries as an example of a topic that has become politically charged. Indeed, a memorandum of understanding drafted by the EU and UK on financial services in March, which detailed certain areas of supervisory cooperation remains unsigned.

She explained that repatriating euro clearing is seen as a key building block to the capital markets union, whereby market participants can rely on EU-based infrastructure, supervised by EU authorities who can manage financial stability risks themselves. Ms van Echelpoel nonetheless believes there can be liquidity pools in the EU, US and UK for euro clearing.

"For me as chair of the CCP supervisory committee, I need to know whether a CCP that is established in the EU or is accessing the EU is causing risks, potentially even causing systemic implications, and whether we have an appropriate toolkit to address it," said Klaus Löber, chair of the CCP supervisory committee at ESMA. The authority oversees around 40 CCPs.

He explained that the European Markets Infrastructure Regulation (Emir) 2.2 has provided some new tools, such as

peer reviews, that are intended to enhance faster supervisory conversations, but that cross-border implications nonetheless continue to grow. But he fears that the existing Emir rules may not be sufficient to contain potential risks and the issue could be gaining in urgency.

Julien Jardelot, head of Europe, government relations and regulatory strategy at the London Stock Exchange Group, which owns LCH, noted that there has been a growing interest in clearing, not always for regulatory reasons, but for economic ones. He said volumes for clearing foreign exchange had soared 79% in the year to September 2021 and that there is growing interest from pension funds.

"We see more and more asset classes moving into the centrally cleared world and I think that's a key trend," confirmed Philip Simons, global head of sales, fixed-income derivatives funding and financing at Eurex.

Mr Jardelot sees the EU's next-generation bond programme, which will run into hundreds of billions of euros and is designed to spur a green economic recovery from the pandemic, as a future big driver for euro clearing in the bloc as well.

To offset any gaps in supervision, Mr Löber explained that ESMA is tiering CCPs to help decide the appropriate regime for them, which could have implications beyond how UK-located CCPs are treated by the EU.

As part of evaluating UK CCPs, he said ESMA is looking at whether the existing tools available to supervisors are sufficient to protect against risks in the business, particularly in a crisis situation.

Aside from third-country CCPs, Mr Löber cited operational risk generally as among the top preoccupations for ESMA at the moment. This is particularly true in the context of remote working due to the Covid-19 pandemic.

Also, "there is an increased reliance on third-party providers. We are going to look at our current stress test exercise which is covering not only EU CCPs but also tier two CCPs which looks at reliance on third-party providers as part of operational risk," he said. The second greatest concern is the issue of procyclicality, particularly as major markets simultaneously fell sharply in response to the pandemic spreading across the West in March last year.

This has triggered a review of whether or not ESMA has sufficient tools to manage such fallouts.These are all factors that a supervisor will argue are easier to oversee when such systemically important firms are based on their turf.

The ECB has questioned how reliant the EU should be on third countries for clearing services

Why so slow?

What has frustrated EU authorities is the glacial pace at which euro clearing is shifting from the UK to the bloc. Though some business has moved to the EU, London still dominates, while some has migrated to New York. Data from Osttra showed that the relocation out of London may have stalled recently given that 70% of new single-currency euro swaps traded in the EU are still being cleared in London.

The risk for the EU authorities is that if they manage to drive euro clearing out of London, it could simply migrate to New York. The US and EU have established mutual recognition of each other's clearing services. Any attempt to undermine that to move clearing into the EU could be met with swift and damaging retaliation from the US, meaning it could slip even further from the bloc's grasp as the bloc has even less influence over the US than it does over the UK.

Ms van Echelpoel attributed the slow drift of euro clearing to the continent as being down to participants awaiting reviews from ESMA and the European Commission on clearing. She also dismissed any risks around fragmentation believing that there can be separate liquidity pools.

However, Mr Simons said Eurex is seeing evidence of euro clearing moving to the bloc.

"We are growing our market share, particularly in the long-dated interest rate swaps, which is predominantly coming from EU real money accounts such as pension funds, asset managers, insurance companies, mortgage banks, and savings banks, etc," he said, adding that they now have a market share of around 20% in terms of open interest, but 10% in terms of traded volumes. The latter reflects that Eurex is attracting more 'real money' firms rather than hedge funds and broker dealers, which tend to trade more.

"What we've also seen as part of Brexit is that most of the UK dealer banks and UK client clearers have now established an entity within the EU," said Mr Simons. He believes this could increase as firms carry out less back-to-back business with their UK operations.

Mr Jardelot somewhat tempered that enthusiasm by pointing out the increasingly international nature of the euro, which is the world's second largest reserve currency.

He explained that overseas participants dominate many euro-cleared products, with some 75% of euro interest rate swaps activity originating outside the EU, for example. He therefore warned policy-makers not to turn the 'capital' markets union into a 'captive' markets union.

Even though the tone over the EU authorities' desire to move most euro clearing into the bloc has been softened recently, the overall aim clearly remains intact. They will therefore continue to find ways to try and coax euro clearing out of London, with the industry hoping they do not try to rush it. GRR

Bad insolvency regimes keep Europe's zombie firms alive

Propping up zombie firms beyond the point of viability is often blamed on the banks that continue to support them. However, inefficient resolution regimes might be the real cause. *By Justin Pugsley*

The topic of 'zombie firms' has been the subject of plenty of literature, particularly following Japan's lost decades. Economic stagnation in parts of the eurozone has also caught the interest of academics and policy-makers.

Economists view zombie firms as bad for the economy because they produce sub-optimal returns on capital, are effectively being subsidised and hog resources that could otherwise be redeployed more productively. The traditional view is that these firms are able to limp on thanks to misaligned incentives from the banks that support them.

Weaker banks may not want to pull the plug on unsustainable businesses for fear of having to record a loss on their balance sheets, leading to further capital constraints and potentially regulatory actions. Under those circumstances, it is easier to 'extend and pretend'.

This is a headache for regulators with regards to estimating the true number of bad loans, and means the banking system remains too weak and therefore unable to sustain new lending to more dynamic businesses.

"The traditional view of zombie lending puts the problem firmly with the banks," Victoria Ivashina, a professor at Harvard Business School, told a forum on corporate insolvency and zombie lending hosted by the European Central Bank (ECB) on September 29.

She was primarily discussing firms that are operationally still viable, but have experienced a negative shock and are saddled with an unsuitable capital structure. This likely involves over-indebtedness with very low or even negative interest rate cover. Such firms can often be restructured through cost-cutting, partial loan write-offs, debt-for-equity swaps or capital injections. This involves going through significant legal and regulatory procedures. These firms are potentially still viable following a restructuring and differ from those that have ceased to be operationally viable.

Ms Ivashina explained that policy-makers' typical solution to the issue is for banks to be well capitalised or in extreme cases by removing the ailing assets from a bank's balance sheet to help restart the flow of capital. She acknowledged that for many other reasons – such as having a healthy banking system – such actions can be desirable.

However, in some jurisdictions simply blaming banks for zombie lending is to view the problem too narrowly.

"We argue that the insolvency system is actually an intrinsic part of how we think about zombie lending, and to be clear this is not an alternative explanation, this is an intrinsic part of the problem," said Ms Ivashina. She argued in response to an audience question about the prudential implications that in the absence of reforms to insolvency regimes, efforts around recapitalising weak banks can even go too far.

Ms Ivashina authored a paper with Bo Becker, a professor at Stockholm School of Economics, on this topic entitled *'Corporate Insolvency Rules and Zombie Lending'*, which was the basis of her presentation at the ECB event.

"This is interesting because it's the first time that I've seen this in the research field. It attempts to answer a micro question and a macro question. The micro question on the mind of many policy-makers, as well as academics, is should we worry about lending to zombie firms?" said Simeon Djankov, director, financial markets group at the London School of Economics. The former deputy prime minister and minister of finance of Bulgaria and World Bank economist thought the macro question addressed in the research, around the extent that insolvency regimes can be part of a macroeconomic recovery solution, was groundbreaking.

Effective resolution laws

In their paper, Ms Ivashina and Mr Becker seek to demonstrate that substantial variation in the efficiency of resolution regimes across Europe is a key explanation of the cyclical use, and high development of private debt markets which rely heavily on those regimes. In other words, the more efficient a country's resolution regime, the more likely that zombie firms will be tackled by their creditors, including banks.

Indeed, the paper goes so far as to argue that the substantial cost of restructuring insolvent firms – due to ineffective insolvency regimes – not only narrows a banks' choices, but can even in extreme cases see them engage in "sham loan restructurings".

Importantly, they believe that lending to zombie firms cannot be curtailed through bank-targeted policies. They argue, therefore, that reforming ineffective insolvency laws should be a key complement to bank capital requirements and supervision.

At the event, Ms Ivashina explained that weak insolvency regimes make it harder for creditors to restructure poorly performing firms and, in the case of banks, such hurdles incentivise them to carry on supporting them financially instead. "The insolvency system amplifies zombie lending," she added.

One way of gauging an insolvency regime's efficacy is to track a country's bankruptcy rates against the twists and turns of the economic cycle. But Ms Ivashina added the caveat that comparing bankruptcies across jurisdictions is challenging due to different definitions and processes for winding down failing firms.

But it is still possible nonetheless to draw some conclusions. "You're looking at the gross spikes in bankruptcies, and our hypothesis is that if an insolvency system is good it will be used as we face negative shocks," she said.

The price of credit also reveals something about the effectiveness of a country's insolvency regime.

"It is not the fact that better insolvency is associated with cheaper credit," said Ms Ivashina. "It's actually the opposite when tough economic conditions strike, the cost of credit rises, particularly for poor-quality firms. This is often visually manifested in the corporate bond markets when yields on low-rated credits soar.

She has extensively investigated the phenomenon of zombie firms managing to maintain cheap credit from their banks during times of economic stress. "This cannot be a mere flight to quality, because here we include controls for the type of firms," she said.

She explained that insolvency lies at the heart of the zombie problem, "because this is an important mechanism for translating negative shocks into long term effects". Observed through that prism, insolvency regimes are no longer just a problem for banks, but for all kinds of creditors.

Private funds

The paper notes the important role of funds and private equity groups that specialise in restructuring struggling businesses. Europe has seen the rapid growth of specialist private debt markets since the 2007-09 global financial crisis. According to data firm Preqin, global private debt funds had assets under management estimated at $848bn last year and are projected to grow at 11.4% annually for the next five years.

The paper explains that these funds have the expertise, low co-ordination costs and flexibility to restructure the debts of a struggling firm – often more effectively than banks. As such, they will often finance riskier debts.

However, without effective insolvency procedures, these specialists tend not to turn up even if creditors are willing to be flexible and do not have high co-ordination costs.

"Our hypothesis, therefore, is that the development of private debt investments is dependent on the strength of the insolvency framework. This is exactly what we find," the paper's authors write.

So countries with effective insolvency regimes tend to have larger specialist private debt markets and greater participation by the global funds that dominate this segment, such as Blackstone and CVC.

In her speech, Ms Ivashina drilled a little deeper into resolution processes and their importance. "Formal resolution systems are very important. But equally important are private resolutions. Formal resolutions set the floor for the efficiency of restructuring. Private resolutions improve upon their interdependence," she said.

Good resolution systems also foster an expertise base and markets around restructuring or liquidating struggling firms, which in the long term benefits the wider economy.

"Similarly in the ways that we think about banking regulation, there is a benefit to thinking of converting to a set of standardised procedures, because this will facilitate the flow of capital into, say, clever, private solutions or restructurings," said Ms Ivashina.

Weaker banks may not want to pull the plug on unsustainable businesses for fear of having to record a loss on their balance sheets

Often banks will offload non-performing loans (NPLs) to specialist firms, but these will only buy if they believe they can carry out the necessary restructuring.

One topic that also got an airing at the event was whether the massive public support measures given to firms during lockdowns to limit the spread of Covid-19 were actually creating a new hoard of zombie firms.

Mr Djankov noted that there are currently about a third fewer bankruptcy filings in the EU than before the Covid crisis. But reflecting on Ms Ivashina's arguments, he added that these programmes were a success given that the aim was temporarily sustaining businesses through an unusually difficult time. He explained that in countries where firms are reorganising their operations, there is less concern about zombification.

Harmonising regimes

There has long been a debate in the EU about insolvency regimes, particularly following the 2007-09 global financial crisis, and around cleaning up NPLs.

However, the authorities are well aware of the plethora of insolvency and resolution regimes across the bloc, each with their own particular national characteristics. They have actively attempted to harmonise these rules to support the functioning of the single market and the nascent capital markets union. But so far they have only had limited success.

Reforming insolvency regimes, even at a national level, has proved challenging, despite progress in some jurisdictions. The chair of the forum, ECB vice-president Luis de Guindos, remarked that ministries of justice are often responsible for insolvency regimes and he wondered if this might be a hindrance to reforming them. This is pertinent given that banks come under finance ministries and central banks.

Ms Ivashina responded that the challenge of reforming insolvency rules is that it has often been reduced to a local issue separate from macroeconomic policy. "So my view is that there ought to be some integration of the macroeconomic priorities with the functioning of the insolvency system," she said. "Insolvency is an extremely specialised process. And in that sense I don't think that central bankers can quite take over, designing a perfect insolvency system."

Mr Djankov said finance ministers need to be a lot more cognisant of the benefits of reorganising the system. This would see justice and finance ministries work closer together.

Meanwhile, the EU authorities are trying to roll out a harmonised insolvency regime across the bloc. However, their implementation has not been a priority for member states and enthusiasm for a harmonised system around insolvency has been further blunted by the fallout from the Covid-19 pandemic.

As noted by the ECB's Mr de Guindos, Ms Ivashina and Mr Becker make a strong case for the reform and even harmonisation of insolvency regimes across the EU. It would incentivise better capital allocation by banks, the rehabilitation of struggling firms and potentially faster economic recoveries and growth. The hard part is convincing finance ministers and justice ministers to jointly take up the cause. GRR

FCA takes 'use it or lose it' approach to regulatory permissions

Under proposed new powers, the Financial Conduct Authority could quickly revoke or alter certain regulated firms' permissions, potentially making it harder to launch new products. *By Justion Pugsley*

Superficially, the proposals from the the UK's Financial Conduct Authority (FCA) on regulatory permissions look like a tidy-up exercise primarily to weed out scams. However, some industry sources are concerned it could hinder competition, particularly from new entrants.

In a consultation on September 9 called *'New cancellation and variation power: Changes to the Handbook and Enforcement Guide'*, the Financial Conduct Authority (FCA) will be able to cancel or vary a firms' permissions where they are not being used. The consultation closes on October 29.

Currently, the FCA has to wait a year before revoking an unused licence. Under its new powers, the FCA will be able at any time to issue a notice warning that a firm faces a cancellation or variation of its permissions. If there is no response, a second notice is issued with a deadline and details of what will happen to a firm's permissions. The notice will contain details over how a firm can avoid having its permissions cancelled or amended.

The FCA is already warming up the industry for the change by reminding firms of their obligations to review their regulatory permissions so that they are still up to date.

An embarrassment?

Regulatory consultant Effecta explained in a note that under the new system, when a firm fails to respond, the FCA will publish a public notice stating that it is not using the permission and failure to provide satisfactory evidence to the contrary could see the regulator varying or removing the permission after one month. Airing this publicly could prove embarrassing for some firms.

Also, the holder of the permission will have no general right to challenge the FCA's ruling, nor will the regulator have to provide any evidence backing its decision.

"The regulators always had the power to take away people's regulatory permissions, so no fundamental change there," says Max Savoie, a partner at law firm Sidley Austin. However, the proposals represent a significant increase in the FCA's powers, he says. Currently, firms have an opportunity to demonstrate that they are using the permissions they have been granted or intend to do so soon.

Under the new approach: "[The FCA] can request a response within a very short period of time, and then it can send a second notice 14 days later, and then within 14 days after that it can cancel the permission," says Mr Savoie. He explains that under the current approach there is more scope for a discussion with the FCA, but the new one will firmly place the onus on the permission holder to demonstrate that they are using it.

According to a blog post by compliance specialist Thistle, an FCA review of a firm's permissions could be triggered by a failure to pay periodic fees or to provide information required by the handbook. However, the new powers do not apply to payment service providers nor to firms supervised by the Prudential Regulation Authority.

Mr Savoie says the new approach could put extra pressure on fintechs and other new market entrants over the timing of rolling out new products as they will have to go live soon after a permission is granted. He fears this could stifle innovation because product launches do not always go to schedule or as planned and therefore a firm could lose its permissions in the process. This could be a problem because the FCA currently has a backlog of applications and is therefore taking time over issuing permissions. "This could significantly extend your timeframe for going to market," says Mr Savoie.

Weeding out fraud

So why is the FCA taking these measures? According to Thistle's blog, the FCA associates incorrect and outdated permissions with firms potentially misleading customers over the level of protection they receive and could lend credibility to its unregulated activities.

"The changes are intended to help to prevent scams and to ensure that [the FCA] register presents a clearer picture of the permissions firms hold. Firms are required to confirm annually that the information on the register is accurate," according to Thistle's blog.

Effecta's note explains that the FCA was recently accused of negligence after a complaint was partly upheld that it listed a firm on its register as active when it had ceased to trade about three years ago. This enabled fraudsters to set up a clone firm mimicking the one still on the register and were able to fleece investors. The FCA was forced to apologise after the Complaints Commission partially upheld the investors' complaint. Effecta believes this incident could have contributed towards the FCA cleaning up its register.

Streamlined processes

"We want to use this power to take quicker action to prevent consumers being misled. It is part of our transformation and drive to be more assertive, drawing on an innovative approach and using new streamlined processes to make important regulatory interventions," said Mark Steward, executive director of enforcement and market oversight at the FCA in a statement coinciding with the consultation.

"Firms can and should apply to have their permissions cancelled if they no longer plan to use them, but many fail to do so. We understand that business models may evolve over time and there may be valid reasons why regulatory permissions are not being used, but unless firms notify us and keep their permissions up to date, they will risk losing market access." GRR

Concerns linger over US dollar Libor transition

A recent survey found that most financial institutions should have negligible US dollar London interbank offered rate (Libor) exposures by the end of this year. Nevertheless, pockets of concern remain despite continued warnings from regulators. *By Justin Pugsley*

On October 6, Moody's Investors Service published a survey of 54 banks and non-bank financial institutions, revealing that for 89% of them their transition plans to alternative rates are on track. This compares with 77% in 2020 and 52% in 2019, proving that most financial institutions are taking regulators' warnings seriously over the sunsetting Libor.

"For the rest of the year, surveyed institutions expect to focus on increased client outreach, in particular to less responsive clients and for contracts linked to benchmarks being retired at year-end," says Olivier Panis, a senior vice president at Moody's.

Typically, most institutions are moving to the Federal Reserve-approved Secured Overnight Financing Rate (SOFR). Fed vice chair for supervision Randal Quarles recently reminded an audience of bankers of the growing urgency to ditch Libor. After this year, Libor will no longer be available for new contracts, and though some US dollar tenors will continue for legacy contracts, they too will cease after June 30, 2023.

"A handful of firms have said that they may want more time to evaluate potential alternative rates. There is no more time, and banks will not find Libor available to use after year-end no matter how unhappy they may be with their options to replace it," Mr Quarles warned the Structured Finance Association Conference in Las Vegas on October 5.

However, shifting financial products to new benchmarks is a mammoth task involving repapering millions of contracts. Currently, there are around $200tn in financial products referencing Libor, including $1tn in US residential mortgages. Fortunately, many Libor-referencing products, such as derivatives, are short-lived and are expiring ahead of the deadlines.

In recent months, several lawyers have told *Global Risk Regulator* that there are a small number of banks still hoping for further extensions to Libor cessation deadlines, despite increasingly strident warnings from regulators that there will be no more delays.

Mr Quarles explained that based on data for the second quarter 2021, the Fed estimates that large firms used alternative rates for fewer than 1% of floating rate corporate loans and 8% of derivatives. "To be ready for year-end, lenders will have to pick up the pace, and our examiners expect to see supervised institutions accelerate their use of alternative rates," he said.

The Moody's survey found one of the main stumbling blocks for coming off Libor from next year onwards is client unresponsiveness with a particular problem around 'tough' legacy contracts. These are often bespoke long-dated products. An ongoing complaint is that SOFR is a risk-free rate and therefore does not replicate Libor's credit sensitivity, a particular issue for loan markets.

Randall Quarles
"Banks will not find Libor available to use after year-end no matter how unhappy they may be with their options to replace it"

The rating agency raised other transition snags such as insufficient liquidity in the new benchmarks. It said liquidity concerns mainly centre around cash products, since term markets have yet to show liquidity on a par with overnight markets. But there does appear to be movement. "The key to increasing alternative reference rate liquidity, say respondents, is investor and borrower demand, which is growing with wider availability of forward-looking term rates and as interdealer brokers switch trading of interest rate swaps from Libor to alternative reference rates," the authors of the Moody's report wrote.

Addressing the concerns around SOFR for some users, Mr Quarles said: "A bank may use SOFR for its loans, but it may also use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs." For example, small and medium-sized US banks tend to prefer the American Interbank Offered Rate (Ameribor) as it does reflect credit risks. There is even an Ameribor futures contract hosted by the Cboe Global Markets exchange.

However, regulators and trade associations have bent over backwards to provide legal solutions, such as fallback language to ease the transition to alternative rates, including extending the life of key dollar Libor tenors into 2023. For example on October 6, the Alternative Reference Rates Committee (ARRC) published a summary of its recommendations for spread-adjusted fallbacks for contracts referencing US dollar Libor. The ARRC is composed of market participants and the New York Fed and aims to facilitate the transition to SOFR.

"Today's summary provides market participants with a central document that captures each of the ARRC's recommendations regarding spread-adjusted fallbacks," says Tom Wipf, ARRC chair and vice chairman of institutional securities at Morgan Stanley, explaining that market participants now have all the needed tools to transition to SOFR.

And the regulatory agencies have been working in concert to wean the financial system off Libor.

A case in point is the US Commodity Futures Trading Commission (CFTC) with its 'SOFR First' initiative adopted on July 13, 2021. This is a set of recommendations for interdealer brokers to switch from trading Libor swaps towards trading SOFR alternatives before year-end and is supported by industry groups and regulators worldwide.

"Reviewing banks' cessation of Libor use after year-end will be one of the highest priorities of the Fed's bank supervisors in the coming months," Mr Quarles said. "The year of magical thinking is over."

Financial institutions have been consistently warned by regulators about the demise of Libor. Those that nonetheless find themselves in difficulty once Libor ceases are unlikely to earn much sympathy from regulators. GRR

US regulatory round-up

SEC gives green light to bitcoin futures ETFs

Bitcoin-backed exchange-traded funds (ETF) have finally been given the green light by the US Securities and Exchange Commission (SEC) with the first one launched on the New York Stock Exchange (NYSE) on October 19 to much fanfare among cryptocurrency enthusiasts.

The new fund from ProShares buys bitcoin futures rather than the actual coins and rapidly accumulated $1bn in assets barely a week after its IPO. It was soon followed by other bitcoin futures ETFs from rival funds firms, Vaneck and Valkyrie. Crypto enthusiasts see the launch of the funds as a key milestone, which helped propel bitcoin to record highs.

"We believe a multitude of investors have been eagerly awaiting the launch of a bitcoin-linked ETF after years of efforts to launch one," said ProShares CEO Michael Sapir, explaining that it will open up the investor base for cryptocurrencies, particularly for those wanting to invest in a regulated market while avoiding the difficulties of setting up crypto wallets or dealing with unregulated operators.

"It enables investors to participate in the digital asset markets through a regulated, transparent product that trades on a trusted, reliable exchange and can be bought and sold as easily as any other investment currently available," said Leah Wald, Valkyrie's CEO.

"The approval of ETFs based on CME Bitcoin futures is a positive development for the broader bitcoin ecosystem, and a reflection of the strong growth and client demand for exposure to bitcoin via our transparent, deeply liquid and regulated futures contracts," said Tim McCourt, CME Group global head of equity index and alternative investment products.

Though the SEC, under chairman Gary Gensler, has been aggressively suing many crypto firms, he has nonetheless been supportive of the idea of cryptocurrency futures backed ETFs. Industry sources say Mr Gensler supports cryptocurrency futures because they trade on highly regulated exchanges and there are no issues with futures contracts being lost or stolen as can sometimes happen with cryptocurrencies. He therefore believes they provide higher levels of investor protection.

There are media reports that the SEC has blocked the launch of leveraged bitcoin futures ETFs and those based on the actual coins. Some industry sources don't think the SEC will approve a bitcoin ETF until it sees satisfactory custodial arrangements for storing the coins and that approval for such funds probably will not happen until the summer of next year.

FFIEC warns banks over Libor risks

US financial institutions have had another shot fired across their bows to unwind their dependence on the London Interbank Offered Rate (Libor) by the Federal Financial Institutions Examination Council (FFIEC), which warned that this will become a bigger supervisory focus.

In a statement dated October 20, FFIEC wrote that during scheduled examinations, supervisory staff will query banks about their Libor transition plans, including asking detailed questions about their exposures, contractual fall backs, operational preparedness, and consumer protection considerations.

"Supervisory focus will be tailored to the size and complexity of each institution's Libor exposures. Large or complex institutions and those with material Libor exposures should have a robust, well-developed transition process in place," the statement read.

The Council noted institutions can have a variety of on- and off-balance sheet assets and contracts that reference Libor including derivatives, commercial and retail loans, investment securities, and securitisations. On the liability side, Federal Home Loan Bank advances, other borrowings, derivatives and capital instruments, including subordinated notes and trust preferred securities, can reference Libor.

Moreover, many market participants rely on Libor for discounting and other purposes. Though the statement did not offer any new guidance it is a sign of the growing urgency among regulators to force financial institutions to move away from Libor towards alternative interest rate benchmarks. They are concerned that a minority of laggards could threaten financial stability. Libor will no longer be available for new contracts after this year and though some US dollar tenors will continue for legacy contracts, they are to cease after June 30, 2023.

Climate change poses risk to financial stability

Climate change threatens US financial stability, says the Financial Stability Oversight Council (FSOC), which is pushing for more reporting requirements.

"It's a critical first step forward to the threat of addressing climate change but will by no means be the end of this work," said Treasury secretary Janet Yellen, who chairs the FSOC. The Federal Reserve Board said the report addresses climate-related risks in an analytically rigorous, transparent, and collaborative way.

"A disclosure framework that is interoperable with other jurisdictions' regimes will serve to fill data gaps and ensure a level playing field across countries," said Lauren Anderson, associate general counsel of advocacy group the Bank Policy Institute.

Regulators ask for stablecoins to be regulated like banks

Stablecoins should be regulated like banks, said US regulators urging Congress to pass laws to make this happen.

On November 1, the US Treasury released the President's Working Group on Financial Markets (PWG) report, supported by the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

The report said that stablecoins are mainly used to facilitate trading in other digital assets, but could go mainstream. "Stablecoins that are well-designed and subject to appropriate oversight have the potential to support beneficial payments options. But the absence of appropriate oversight presents risks to users and the broader system," said US treasury secretary Janet Yellen, warning that current oversight is inconsistent and fragmented. GRR

Speakers' Corner
Banks can teach big tech a thing or two about regulation

Big tech's move into financial services has been keenly observed by financial institutions and regulators alike in recent years. Yet latest communications from the Bank for International Settlements indicate a decisive change in tone – financial regulators need to "get a grip on big tech and be prepared to act quickly". *By Kuangyi Wei, director of regulatory strategy at Accenture*

Big tech's presence in financial services alone should not warrant significant apprehension. Financial services represent just over 10% of big tech's revenue globally. The scope for greater innovation, efficiency and consumer choice remains ample. And in most cases, big tech's forays into finance – be that payments, consumer credit or wealth management – have been delivered in partnership with regulated incumbents.

Big tech's ability to redefine the contours of the regulatory framework is another story. Harnessing what the BIS describes as a D-N-A model, big techs are seasoned operators in capitalising on extensive customer Data and the associated Network effect to launch new, value-adding Activities. This, combined with enviable balance sheets and fully-fledged customer bases, gives big techs a formidable speed to scale, beyond the pace at which regulatory frameworks can adapt. Their business models also naturally straddle the remits of data, communication, financial and competition authorities, making the trade-offs between regulatory objectives more visible and the co-ordination more challenging.

Close to financial regulators' hearts is big tech's impact on financial stability. This can arise from many factors: big techs' potential in disintermediating the financial value chain and 'decoupling' origination from funding; mobile payments' growing importance for consumers; and more pressingly, big techs' role in powering digital transformation across financial services.

To date, big techs' provision of cloud and other technology services have been managed 'at arm's length' by financial regulators – by setting expectations for financial institutions, in their capacity as big techs' clients, on areas of material outsourcing, security, resilience and data governance. Yet a digital uptick propelled by the pandemic brings this approach into question. Cloud adoption has accelerated across financial services and moved beyond back-office functions. Core banking and payment processing are now seen as prime targets for cloud migration, according to research firm Gartner.

This development has made the resilience of big techs integral to both financial stability and consumer protection. In response, the financial regulators are now exploring direct oversight – or, in BIS language "entity-specific rules" for big techs – something traditionally preserved for global banks.

Across key jurisdictions, the policy dial is already shifting. The US House of Representatives fired the opening salvo in August 2019 with a letter to the Financial Stability Oversight Council regarding designating US cloud service providers as "systemically important financial market utilities" under the Dodd-Frank Act.

The EU has since drafted the Digital Operational Resilience Act (Dora), which would empower the three European supervisory authorities to supervise technology providers serving the financial industry directly. More recently, the Bank of England/Prudential Regulation Authority called for "additional policy measures, some requiring legislative change" to address the concentration of third-party services to UK firms. In practice, this could mean designating cloud service providers (as well as other providers) as "critical" with the associated governance process, resilience standards and testing.

While these developments are geared towards enhancing resilience, China went a step further in giving big techs the prudential treatment. Technology firms that operate two or more financial businesses are asked to set up regulated financial holding companies with capital and resolvability requirements.

In most markets, there is little reason to treat big techs as big banks: few have shown appetite for deposit-taking or maturity transformation. But singling out big techs' cloud services provision for more direct oversight now seem unavoidable. If the approach explored by Dora paves the path for a global template, firms – big banks and big techs alike – will want to be on the front foot.

For financial institutions, regulatory caution should not deter digital transformation. However, firms need to give more balanced consideration to both technological and regulatory developments during their journey to the cloud. This requires a clear enterprise-wide articulation of the business objectives and a holistic cost-benefit analysis of financial, operational, and control factors. For incumbents, managing change risk is as key as mitigating cloud risks. Treating the journey to the cloud as a multi-year 'regulatory business plan' may help to capture broader stakeholder considerations.

For big techs, growing regulatory scrutiny may come as a culture shock to their disruption-centric heritage. Governance, risk management and control frameworks may lag technology firms' innovation prowess. Notable areas to watch out for may include product development that misaligns with regulatory expectations, an increased conflict of interest from diversified businesses within the group, and unfamiliar operational and compliance challenges from new entity-based, cross-border requirements.

Agustín Carstens, head of the BIS, aptly captured financial regulators' changing perspective on big techs as "from 'too small to care', to 'too big to ignore' to 'too big to fail'." Perhaps, just as banks look to big tech for innovation, there are a few leaves big techs can take from banks' books when it comes to regulatory excellence in a fast-evolving landscape.

A Speakers' Corner is an area where open-air public speaking, debate and discussion are allowed. The original and most noted is in the north-east of Hyde Park in London (Wikipedia definition)

Diary: conferences, meetings and deadlines

November 2021

Nov 3 Consultation closes proposed amendments to the prohibition on order incentives as part of market integrity rules, Australian Securities & Investments Commission

Nov 8 Expected compliance date for SEC Security-Based Swap Reporting, Securities & Exchange Commission

Nov 8-16 The 46th IOSCO annual meeting to be held virtually

Nov 15 Consultation closes on second consultation paper on proposed revisions to guidelines on business continuity management, Monetary Authority of Singapore

Nov 15 Consultation closes on proposed amendments to appeals regulations, Monetary Authority of Singapore

Nov 19 Consultation closes on the review of certain aspects of the Short Selling Regulation, European Securities & Markets Authority

Nov 25 Consultation closes on the amendment to technical standards on strong customer authentication and secure communication in relation to the 90-day exemption for account access, European Banking Authority

December 2021

Dec 1 Consultation closes on stablecoin arrangements covering international standards for payment, clearing and settlement systems, International Organization of Securities Commissions & The Committee on Payments and Market Infrastructures

Dec 23 Consultation closes on Review of the MiFID II framework on best execution reports, European Securities & Markets Authority

Dec 30 The European Supervisory Authorities to submit a RTS specifying website disclosures of adverse social sustainability impacts at entity level under the sustainability-related disclosures in the financial sector regulation, ESAs

Dec 31 UK ceases compelling publication of Libor, Financial Conduct Authority

Dec 31 Benchmark administrators in scope of the European Benchmarks Regulation with the exception of currency and interest rate benchmarks, to explain how their methodology aligns with carbon emission reductions.

Dec 31 Deadline for authorised institutions to cease issuing new Libor-linked products maturing after 2021, Hong Kong Monetary Authority

Dec 31 Deadline for The European Commission to publish a report describing the provisions that would be required to extend the scope of the EU Taxonomy Regulation beyond environmentally sustainable economic activities, The European Commission

Dec 31 Deadline for The European Commission to review the application requirements for the resolution authority to write down and convert any instruments of ownership and debt instruments or other unsecured liabilities immediately before or together the use of a government stabilization tools for CCPs, The European Commission

Dec 31 Expiry date of transitional provisions for 'critical benchmarks: Euribor, Eonia, Nibor, Stibor and Wibor under the EU's Benchmarks Regulation

January 2022

Jan 1 Start date for parts of the UK version of the Capital Requirements Regulation 2 to apply, which will include the net stable funding ratio, leverage ratio and the standardized approach for counterparty credit risk, Prudential Regulation Authority

Jan 1 Start date for administrators of significant benchmarks to try and market at least one EU climate-transition benchmark under the EU Benchmarks Regulation, European Securities & Markets Authority

Jan 1 Start date for disclosure requirements related to the establishment of a framework to facilitate sustainable investment under the EU Taxonomy, with respect to the environmental objectives 'climate change mitigation' and 'climate change adaptation', European Commission

Jan 1 Deadline for advanced approaches banking organisations of standardised approach for counterparty credit risk for calculating the exposure amount of derivative contracts under US prudential regulators' regulatory capital rule, US federal prudential regulators

Jan 1 Deadline for call for evidence on aspects of retail investor protection, European Securities and Markets Authority

Insight into the latest regulatory developments

Global Risk Regulator offers insight into the latest thinking of regulators and involves in-depth coverage of key policies, including:

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- Dodd-Frank
- IOSCO
- IFRS 9
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