Following the financial crisis of 2007-2008, bank regulators were universally focused on reducing systemic risk and ensuring that government funding was not required to bail-out a failing bank in the future. In line with Financial Stability Board recommendations, regulators began establishing credible and operationally effective global recovery and resolution plans for the largest financial institutions, and agreed timetables for the implementation of Basel III.

While the regulatory components required to increase the safety and soundness of financial institutions and reduce systemic risk were largely agreed internationally, individual countries prioritized implementation of the components differently. The EU and the US focused on increasing transparency and regulation in derivatives markets while Switzerland set out to implement enhanced capital and liquidity requirements for its largest financial institutions. Different priorities and implementation time frames have lead individual regulators to issue rules that appear to extend the reach of regulation well outside of the countries’ borders. This article shows the implications of this course of action for a globally operating bank with two concrete examples.

Recent Developments in the US Regulatory Environment

Recent US proposals are causing concern among the international regulatory community and financial institutions with a global presence as they indicate a lack of confidence in the ability of global regulators continuing to work together cooperatively.

Dodd-Frank, the US response to the financial crisis, was signed into law in July 2010. It was meant to comprehensively address US financial stability issues, increase accountability and transparency in the financial system, protect consumers from unethical practices by financial institutions, prevent future taxpayer bailouts of banks, and end the “too big to fail” problem. Many parts of Dodd-Frank require US regulators to make rules to implement the general concepts, often within defined time frames. This article focuses on the proposed and final implementing regulations required by two parts of Dodd-Frank – Title VII (derivatives market reforms) and Sections 165 & 166 (enhanced regulatory supervision and early remediation requirements for financial institutions identified as weak or struggling).

Extraterritorial Effects of US Derivatives Market Reforms

Derivatives markets were largely blamed for the 2007-2008 financial crisis. Increasing their transparency and integrity is a top priority of individual regulators and regulatory consortiums. In the US, responsibility for regulating derivatives (or swaps) is split between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), based on the type of swap.

The CFTC has already required financial entities that engage in derivatives transactions with “US persons” to register as swap dealers. While the definition of a “US person” is not finalized, an interim definition for purposes of registration includes entities incorporated or domiciled in the USA. Registered swap dealers are subject to substantial new requirements for clearing, trade execution, transaction reporting, record keeping, risk management and business conduct. The CFTC has initially limited the scope of new requirements to transactions with US persons, but certain of the CFTC’s regulations, including those relating to swap data reporting, record keeping, compliance and supervision, are expected to apply to registered swap dealers globally in July of this year. This means, that financial institutions that conduct swaps business through their parent bank and registered that entity as a swap dealer will potentially have US requirements imposed on transactions with non-US persons that occur entirely outside of the US (i.e. transactions between a non-US person and a foreign branch). US requirements include the reporting of each and every transaction to a swap data repository, including client identifying data that is visible to US regulators and potentially the public.

Application of these requirements to a non-US bank’s swaps business with non-US persons presents a substantial implementation burden, duplicates or conflicts with legal requirements in other jurisdictions and places registered swap dealers incorporated outside of the US at a competitive disadvantage to other firms that are not CFTC registered swap dealers. The SEC has recently proposed rules for the extraterritorial application of its regulation of securities-based swaps, and will require registration of securities-based swap dealers in the US following adoption of such rules. Under the current structure the two agencies can define the extraterritorial effects of the rules differently. Having to manage two separate sets of cross-border rules for similar transactions would present major implementation burdens for every registered swap dealer.

There is concern about the effect of extraterritorial application of US requirements even within the US government. The House of Representatives Agriculture Committee is considering a number of bills seeking to amend Title VII of Dodd-Frank. One of these bills, the Swaps Jurisdiction Certainty Act, would require the CFTC and SEC to issue joint cross-border rules for swaps. The bill would also provide a general exemption from US requirements for transactions with non-US persons in G-20 countries with equivalent regulation. Equivalency determinations are made jointly by the SEC and CFTC under the current draft of the bill. It is far from certain that this bill, or equivalent legislation, will gain any traction in Congress but it will hopefully send a clear message to the CFTC and SEC.

Extraterritorial Effects of Additional Rules for Foreign Banking Organizations

In mid-December, the Federal Reserve Board (Fed) issued a proposed rule to implement enhanced regulatory supervision and early remediation requirements required by Dodd-Frank for foreign banking organizations. Traditionally, the Fed has relied on home country regulation rather than subject foreign banks operating in the US to multiple sets of standards. However, the proposed rule as currently drafted would look to impose US regulatory requirements on all US operations conducted by a foreign bank outside of its branches. There are
tiered requirements based on the overall size of the foreign banking organization and the size of its US based assets. As currently drafted, the proposal would provide the Fed with its own ring-fenced capital and liquidity pools in the event that they were concerned about either the condition of the parent bank or the US operations of a foreign banking organization. They could choose to limit the US activities of a foreign bank without even consulting the home country regulator. In the most extreme case, they could place US operations conducted outside of a foreign bank’s US branches into receivership, which may accelerate the issues a problem bank is facing enough to destroy its global operations. Once again, this would be possible without even consulting the home country regulator.

In addition to the concerns above, many of the US-specific reporting requirements and risk measures overlap significantly with what is already required by home country regulators for large international banks, and impose costly and time consuming implementation burdens. Building and maintaining slightly different requirements by country presents infrastructure overhead and risks that are not justified, given the slight benefit from an exact comparison of the largest institutions. A coherent and consistent implementation of current initiatives would provide materially higher marginal returns from a stability perspective than yet another set of regulatory requirements.

Conclusion

There are signs that the earlier commitment for international coordination among regulatory authorities is fading. If individual regulators create regimes where they have global jurisdiction over an international bank’s swap business or give themselves the authority to make unilateral decisions about a foreign bank’s local operations, we will end up with a fragmented and weaker banking system at a time when economic recovery is still fragile.

In light of the fierce competition amongst the largest international banks, differences in the implementation of new regulation can have a significant impact on the competitive position of individual banks. This fragmented, locally oriented approach has several consequences which may work against the stated regulatory aims. It may create additional barriers to entry to new market players. A possible unintended consequence could be the favoring of domestic large banks at the expense of foreign competitors, counteracting the political desire to tackle the too-big-to-fail problem. The US extraterritorial proposals demonstrate a lack of confidence by US regulators in the ability of global regulators to continue working together cooperatively to supervise internationally active banks. This is a concerning development in international financial regulation and undermines the progress that has been made towards an efficient global framework for regulation of the large international financial firms. The major global economies will benefit if the US continues its leadership on international financial regulatory cooperation and reciprocity, rather than taking a stance that is simultaneously extraterritorial and territorial.

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