Ensuring stable capital markets

The new reality publication series

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New publication series

The EMA FS Risk & Regulatory Insight Centre (RRIC) is pleased to publish the fourth paper in its new thought leadership series ***Financial Services: regulating the new reality***.

As the focus of government and businesses moves from initial response to the COVID-19 pandemic, through resilience concerns, to recovery and the new reality, financial services regulators are also expected to move into a new phase of adjustment and support.

This paper looks at how regulators are reviewing the financial market disruption caused by the pandemic, the immediate steps they took to mitigate the impacts and their areas of focus going forward. Over the coming months, look out for further articles and papers in which we will continue to build on the themes identified in the first overview paper.

Financial services: regulating the new reality

Remote governance and controls paper

Delivering sustainable finance

Other relevant publications

Evolving LIBOR

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Introduction

Central banks and regulators are reviewing the impact of COVID-19 on financial markets. They are considering the appropriate balance between private sector resilience and reliance on extraordinary central bank liquidity support, and whether interventions and temporary measures to mitigate the immediate impact on liquidity in the financial markets have set precedents – appropriate or otherwise. They also have ongoing concerns about the potential impacts of the rate of economic recovery and heightened credit risk, especially in the fixed income markets.

Against this backdrop, securities regulators are undertaking further analyses and are contemplating additional requirements, such as measures to address the pro-cyclicality in margin calls in the derivatives market. The pandemic has also renewed their determination to pursue issues that were already on regulatory agendas, including the transition to risk-free rates (RFRs), certain trading strategies and liquidity management in open-ended investment funds. Firms should factor these debates into the reviews of their operations and risk assessments.

There is consensus among policymakers that reforms put in place after the 2008 global financial crisis helped to increase the resilience of the banking system and enabled it initially to absorb, rather than magnify, the shock caused by the pandemic. Financial markets and infrastructure, particularly central counterparties (CCPs), have also continued to function.

However, in the capital markets or market-based (non-bank) finance system, volatility was greater than during the 2008 crisis and there were pinch points in the system which are likely to have to contributed to a sudden demand for liquidity. This sudden demand has been referred to by some commentators as an abrupt and extreme "dash for cash".

Central banks intervened with monetary easing to alleviate conditions. This was achieved through a variety of measures including asset purchases, liquidity insurance and enhanced US dollar liquidity arrangements. "Swift and forceful reaction" was the characterisation by the Bank of International Settlements (BIS) of central banks' responses in advanced economies, observing that they deployed "the full range of crisis tools within weeks".

Regulators are now reviewing what happened in March 2020. They recognise that the economic shock was caused by the pandemic, not by the financial services industry (unlike the 2008 crisis), and that its magnitude was such that it is not that surprising that central banks needed to intervene.

However, there are concerns about the precedents and incentives that the interventions may have set for the risk management of market participants. They are considering the appropriate balance between the use of public money to keep the economy functioning when there are shocks and for market participants adequately to insure themselves against these shocks and manage risks effectively, which may result in higher costs and less profitable financial transactions.

There are also concerns that the wider economic impacts of COVID-19 could lead to further market volatility and potential knock-on effects on the stability of capital markets. Specifically, there are concerns about significant pricing disconnects between the market and economic fundamentals,

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which could result in sudden and sharp repricing. The European Systemic Risk Board (ESRB) has noted that economic disruption caused by the pandemic could trigger a wave of credit rating downgrades in the corporate bonds sector due to the systemic increase in credit risk. These downgrades could be problematic, particularly for issuers losing their investment grade status, because of the "cliff-edge" effects they might create. BBB-rated corporate bonds represent roughly 60% of the investment grade universe.

Moreover, a significant section of the buy-side – the US$ 6 trillion sovereign wealth fund sector – is being called upon by governments to help repair damage caused by the pandemic on national economies. This could lead to a series of outflows and a shift in focus away from global investment strategies towards more leveraged, domestic investments. Coupled with lower levels of retirement and long-term savings or increased drawdowns, due to income loss or uncertainty, the investor universe could be reduced for some considerable time.

All these concerns are compounded by uncertainty. The Financial Stability Board (FSB) has noted that the depth of the downturn due to COVID-19, and the timing and shape of the recovery, remain uncertain and Christine Lagarde, President of the European Central Bank (ECB) has said, "There is no doubt that the economic situation we face today is characterised by profound uncertainty. Looking into the future has rarely been harder."

Another imminent risk to capital markets stability is the demise of the widely-used London inter-bank offer rate (LIBOR) at the end of 2021 and the challenge of transitioning to risk-free rates (RFRs).

The effectiveness of the post-2008 reforms, which were adopted on a global basis, and of policy exchanges during the early stages of the pandemic, underline the importance to the stability of capital markets of collaboration and co-ordination by financial services regulators. These are of even greater importance when geo-political trends point to increased fragmentation.

Key messages

— Although financial markets have recovered to almost pre-crisis levels, there are ongoing concerns about the decoupling of financial market performance and underlying real economic activity.

— Central Counterparties and clearing members should expect to see more supervisory scrutiny around their measures to limit pro-cyclicality and their operational management of margin and liquidity, given the impact large margin calls had on the distribution of liquidity in the market.

— While regulators continue to analyse the systemic risk of liquidity mismatches in open-ended investment funds, fund managers should ensure existing liquidity management tools are used in a timely manner and should expect ongoing supervisory scrutiny in this area.

— Progress has been made by regulators and the industry on the mechanics of the transition to RFRs and IBOR reform. Firms need to continue to focus on active transition and risk management of their LIBOR-exposed portfolios before the end-2021 deadline.

— Global regulatory cooperation and international reforms of the financial system helped it to absorb the economic shock of the pandemic. Continued global regulatory collaboration and co-operation is key to help aid economic recovery.

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01. The "dash for cash": drivers and impacts

As the full extent of the pandemic became apparent and the possible economic impact of the containment measures recognised, prices of assets began to fall sharply. The Euro Stoxx 50 had its quickest fall on record, the FTSE All-Share fell over 10% on 12 March – the largest one-day fall since 1987 – and the Dow Jones had its biggest ever one-day point loss on 16 March. Investors started to sell more risky assets and buy "safer", more liquid assets. This led to significant market volatility, greater than that seen in the 2008 global financial crisis.

Falling asset prices led to large margin calls on derivatives positions held by institutional investors such as pension funds, insurers and investment funds, forcing them to sell outright or repo (i.e. exchange assets for cash with an agreement to repurchase) their liquid assets, such as bonds, to raise cash to meet the margin calls. This, in turn, put further downward pressure on bond prices, causing repo trades to become more difficult and expensive, so investors had to sell more bonds. At the same time, corporates whose cash flows were impacted by the containment measures needed to redeem investments (including in money market funds (MMFs) and other investment funds). The net effect was a vicious downward spiral.

The European Securities and Markets Authority (ESMA) reported that, in Europe, settlement fails in the second half of March reached their highest levels since reporting started in 2014, with fails around 14% for equities and nearly 6% for government and corporate bonds. However, ESMA concluded that most settlement fails were related to the operational challenges of high turnover from increased volatility at a time when many firms where having to adapt to remote working, rather than from a lack of cash.[1]

1 https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf

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There is also some evidence that during the period of high volatility in March 2020, dealers widened bid-offer spreads, making it more costly to trade. For example, gilt bid-offer spreads were around four times their normal levels and repo markets became so expensive that they almost closed. These markets are important in recycling liquidity. As dealers stopped offering repos, investors had to sell their assets or make redemptions from MMFs instead, causing a further pursuit of cash. It is likely that regulators will investigate what caused dealers' behaviour. There may be more focus on the regulatory capital of liquidity providers, dealers and high frequency trading firms going forward.

While the asset management and investment funds industry has remained broadly resilient despite the most extreme market conditions in living memory, a small number of open-ended funds had to suspend dealing temporarily in the face of heavy redemption activity. MMFs and real estate funds were especially hit in certain markets. Suspensions are of concern to both managers and regulators, given the impact on investors in those funds and potential risk of contagion effects. They also re-ignited long-standing debates about whether the activity of asset managers and investment funds gives rise to systemic risk.

Highly-leveraged funds, too, are a focus area for policymakers. For example, BIS and the Bank of England have signalled their interest in the role of particularly highly-leveraged hedge funds, which undertake arbitrage trades on the price differences between the value of derivatives and the value of the cash instrument upon which the derivative is based. In "normal" market conditions, these trades are generally viewed as stabilising market prices. However, a number of pressures – including the flight to safety driving up bond future prices making the position loss-making, increasing margin calls on derivatives positions and some funds unable to roll over their funding – meant that these funds had to undertake massive sales of government bonds (almost US$90bn during March 2020[2]), causing further falls in bond prices.

Ongoing concerns about credit tightening

As the economic shock evolves, regulators are also concerned about the systemic impact of "fallen angel" risk. Fallen angels are companies that are downgraded from investment grade (BBB and above) to sub-investment grade, also known as junk bond status. As the economic shock takes hold in the real economy, it is likely that there will be a growing number of downgrades. The systemic impact arises as many institutional investors' mandates prevent them from holding high-yield or sub-investment grade bonds. Even if asset owners are not forced to sell, holding assets not in the benchmark index may lower performance or rating, potentially leading to redemptions and forced sales.

Given around 50% of corporate bonds held in funds are BBB-rated, BIS research has found that if levels of downgrades were to reach 2009 levels, there would be forced portfolio rebalancing in excess of daily turnover in corporate bond markets.[3] The ESRB, the European Supervisory Authorities and the ECB are analysing the impact of a large-scale downgrade scenario across all parts of the financial sector to try to minimise the negative effects on the real economy. They are concerned that the impacts could be mark-to-market losses for investors and higher funding costs for corporates. The Bank of England is also concerned that large-scale portfolio rebalancing could further dampen market liquidity and restrict corporates from accessing funds.

Regulatory response

Regulators are reviewing, collectively and separately, the "pinch points" or vulnerabilities in market-based finance or non-bank financial intermediation (NBFI). By the G20 Summit, in November 2020, the FSB will carry out a holistic review of the market turmoil that occurred in March, as well as mapping the critical connections between traditional banking and non-bank sectors in a cross-border setting. These pieces of work are intended to help clarify the various points of vulnerabilities and risk amplification and transmission in the financial system.

In some areas, the reactions of the market to the economic shock of the pandemic have highlighted issues that were already concerning regulators, who are beginning to propose changes to existing regulation and possible new regulation, particularly related to:

- the pro-cyclicality of margin calls (see Chapter 2)
- vulnerabilities in MMFs (see Chapter 3)
- risks arising from liquidity mismatch in other open-ended funds and use of liquidity management tools (see Chapter 3)

In other areas, regulators are still at the first stage of articulating their concerns and analysis of:

- factors that might have limited dealer capacity
- the role of highly-leveraged non-bank investors
- amplified tightening of credit conditions in the event of a large wave of downgrades of corporate bonds or leveraged loans

An indication of the priority that regulators put on all these areas can be seen by the monitoring the FSB and International Organisation of Securities Commissions (IOSCO) have put in place. They will report regularly on what they see as the four critical areas in the global financial system's reaction to COVID-19 stresses, namely:

The ability of:

1. the financial system to finance the real economy
2. market participants to obtain US dollar funding, particularly in emerging markets
3. financial intermediaries to meet liquidity demands without forced asset sales
4. market participants to effectively manage counterparty risks

2 https://www.bis.org/publ/bisbull02.htm

3 https://www.bis.org/publ/qtrpdf/r_qt1903u.htm

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02. The pro-cyclicality of margin calls

Derivatives trades are effectively insurance against movements in asset prices. As the pandemic hit and asset prices began to fall, derivative margin calls (the collateral against potential counterparty credit failure) began to rise sharply. For example, in the case of cleared derivative transactions, initial margins at the four largest CCPs in the EU and the UK increased from around €300 billion to around €400 billion between January 2020 and end-March 2020.[4] Generally, it seems these margin calls were met and the system worked as it should have done, with no widespread panic around exposures to failing counterparties. In the bilateral market, the number of disputes between counterparties has increased, but total amounts have remained stable.

However, these margin calls put pressure on the overall liquidity of the system, causing knock-on impacts to the prices of government bonds and other instruments as market participants (such as investment funds, pension funds and insurers) sold assets to meet margin calls and redeemed their MMF holdings, causing further drops in prices and eventual interventions by central banks.

Major reforms in the derivatives markets were put in place after the 2008 financial crisis. An under-collateralised and complex web of over-the-counter derivatives trades had led to large exposures and amplified stress in the markets. The reforms, led by the FSB, set standards for margining and collateralisation of derivative trades, requiring that they be centrally cleared. Central clearing allows for some mutualisation of counterparty credit risk and, with the ability of central counterparties to net margin flows between market participants, has brought efficiency and reduced gross liquidity flows across the system. However, it has resulted in a concentration of risk in CCPs.

4 https://www.esrb.europa.eu/pub/pdf/reports/esrb.report200608_on_Liquidity_risks_arising_from_margin_calls_3~08542993cf.en.pdf

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Regulators are concerned that, given the high concentration and interconnectedness of the derivatives markets among several large clearing members, if liquidity constraints (in terms of cash and available collateral) arise in one member, there could be a knock-on impact across the system. Regulators are also concerned that there may be further large margin calls due to likely future credit rating downgrades and possible further market volatility, as the impact of the COVID-19 stress fully works through the economic system.

Areas of further investigation and regulation

Regulators are particularly concerned about the pro-cyclicality of initial margin calls in times of stress. Specifically, are there ways that pressure from margin calls at times of market stress can be reduced without reducing the benefits that it brings to market stability? The European Market Infrastructure Regulation (EMIR) requires EU CCPs to take specific measures to mitigate pro-cyclicality. Questions are arising on whether higher initial margins in normal times could help to reduce the build-up of leverage and therefore the need for pro-cyclical increases in stress. But this would need to be balanced against the increase in the cost of hedging derivative transactions.

Regulators would like to see analysis of the interconnectedness of risk between CCPs, clearing members and their clients, which are typically in the non-bank sector. Clearing members retain some discretion over how and when margin is collected, i.e. their approach to the risk management of client exposures.

Although there are international standards and regulation around the transparency of margin-setting between CCPs and clearing members (e.g. in EMIR Refit), there are no standards or regulation in this area on the relationship between clearing members and their clients (i.e. minimum requirements for risk management when providing client clearing services – both centrally-cleared and non-centrally-cleared). This could be an area of emerging regulation.

- Could CCPs take more progressive and granular steps to implementing rating downgrades to limit cliff-edge effects?
- Could clearing members pass on these changes to their clients in a similar way?
- Could CCPs better model margin calls required, particularly the split of initial margin versus variation margin, to put less liquidity pressure on their members?
- Could clearing members help non-bank clients better anticipate margin calls?
- Would expanding central clearing to more markets and counterparties make the non-bank system more resilient to liquidity risks?

Another expected area of review is the operations of CCPs and whether they are trapping market liquidity by calling large amounts of intra-day margin to cover market movements, with the corresponding variation margin pay-out often occurring only the next morning. Similarly, the operational flows between clearing members and their clients when passing on margin may also be trapping liquidity. The ESRB is considering whether it should recommend the amending of EMIR in Level 1 or 2 regulation in order to require CCPs to implement an accelerated pass-through of intra-day variation margins.

There are concerns that the largest impact on the liquidity of CCPs could, in fact, come from an entity that is providing a service to the CCP – such as an investment or repo counterparty, payment agent, custodian or liquidity provider – rather than a clearing member. Under EMIR, stress tests currently only include the default of two clearing members. Regulators are therefore considering whether future stress tests of CCPs should include the default of any two entities with the largest liquidity impact on the CCP and not be restricted to just clearing members. However, when planning how to cover the shortfall of liquidity in this scenario, the CCPs would need to seek liquidity from alternative market sources, as relying on clearing members for funding would place an additional burden on them in times of stress and would increase pro-cyclicality.

It is also proposed that, given the large concentration in the provision of liquidity service providers as well as global interconnectedness between CCPs, regulators should conduct co-ordinated liquidity stress test exercises.

Regulators recognise that this analysis and development of policy needs to happen at a global level, given the international nature of the derivatives market.

It may be some time before regulations are changed or developed.However, **CCPs and clearing members should expect to see more supervisory scrutiny around their measures to limit pro-cyclicality and their operational management of margin and liquidity. There is also likely to be continuing pressure on CCPs to maintain adequate prefunded own resources or capital by limiting dividend payments, earning distributions to parent companies and variable renumeration.**

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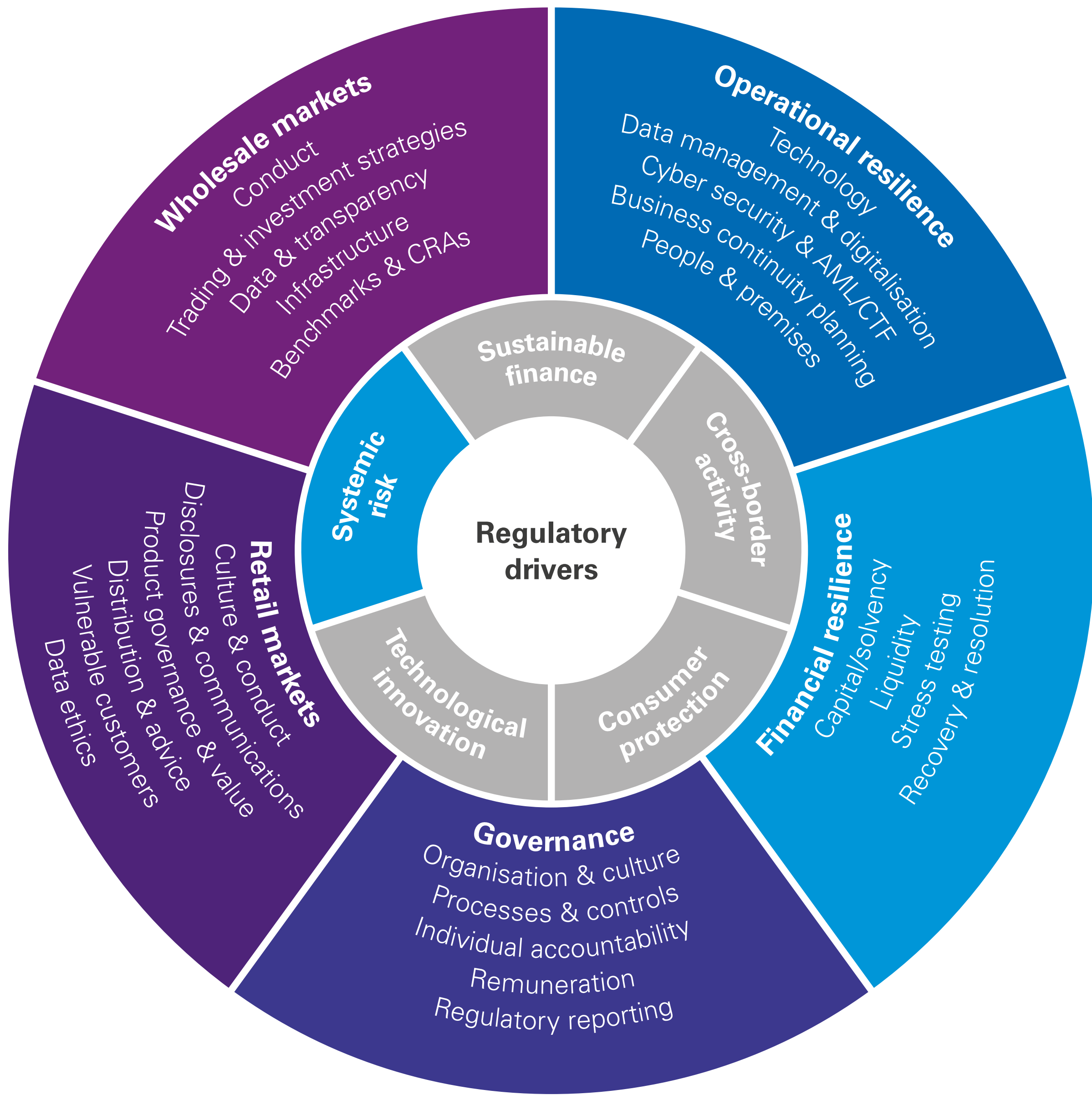
Systemic risk: a key driver influencing regulatory priorities



Five key drivers are influencing priorities in regulatory agendas. Consumer protection and financial stability are the bulwarks of much financial services regulation, but the impacts of the pandemic and lock-down measures have brought additional topics to the fore.

Volatility in capital markets has led to a renewed focus on systemic risk in relation to margin, computer-led trading strategies and certain types of funds. Also, the pandemic has accelerated trends in the use of technology and demands for sustainable finance, and there are new challenges to doing business across borders. These three trends are now equally prominent drivers of regulatory priorities.

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03. Potential systemic risks within investment funds

In times of market stress, widely held open-ended investment funds can encounter difficulties when redemptions suddenly increase, if underlying investments cannot easily be liquidated at prices close to valuations. Automated asset valuation processes can require manual intervention and sudden changes in asset valuations can lead to "passive" breaches to exposure limits. Regulators are concerned about potential systemic risks arising from liquidity mismatches in funds and whether their access to and use of liquidity management tools has been effective. There is a focus on funds investing in corporate debt and real estate, and on MMFs.

Some funds had to suspend dealing in spring 2020 in the face of high redemption requests and difficulties in selling assets in volatile and sharply falling markets. The number of such funds represented a small percentage of the total market – ESMA put the figure among European funds at about EUR 100 billion in March 2020. Since then flows into investment funds are reported to have returned. Nevertheless, any fund suspensions can have a significant impact on investors, which concerns managers and regulators from an investor protection perspective.

Regulators are also concerned about potential systemic risk implications – that fund suspensions could cause a knock-on impact on other funds and the wider market. While markets remain volatile, and given ongoing concerns about the fixed income markets, regulators have been requesting more frequent information from managers about the liquidity position of funds. Many regulators had already reviewed their liquidity management requirements against IOSCO's 2018 recommendations or were in the process of doing so. Stress testing scenarios have joined the priority list and will be more rigorous going forward.

The ESRB called in May 2020[5] for ESMA to co-ordinate a supervisory exercise with national regulators, and to report by end-October 2020, on **funds with significant exposures to corporate debt and real estate assets**, to assess their preparedness for potential future adverse shocks, including any potential resumption of significant redemptions and/or an increase in valuation uncertainty.

Vulnerabilities in MMFs

A wide variety of investors – from non-financial corporations, public authorities and financial entities to individuals – use MMFs as alternatives or complements to bank deposits. In some markets (e.g. Europe), MMFs tend to be institutional vehicles with large minimum subscriptions. In others, such as the US, MMFs are commonly held by retail savers.

In the early stages of the pandemic, some MMFs experienced inflows as investors moved to safer, more cash-like products. But as market conditions worsened and investors needed more cash, some MMFs experienced large outflows. Some fund assets (such as commercial paper) could not be sold under strained market conditions, resulting in a liquidity mismatch. Once liquidity buffers fall below a certain threshold, regulations allow fund managers to suspend or limit redemptions or to apply liquidity fees. The prospect of suspensions may have created incentives for investors to redeem early, creating further liquidity pressure.

Given the importance of MMFs to the real economy and therefore to financial stability, policymakers support a review of vulnerabilities posed by MMFs as part of the FSB review of market-based finance in the pandemic. Policy reviews are likely to evaluate the effectiveness of post-financial crisis reforms in this area and whether some aspects of those reforms may have created undesirable incentives. For example, breaking the link between liquidity thresholds and the ability of fund managers to apply liquidity tools, including suspensions, may help MMFs manage large redemptions in stress. Central banks are also questioning the liquidity profile of some MMF investments given investors' expectations that MMF units are cash-like and generally redeemable on demand.

Such analyses will need to consider the differences between apparently similar funds in different jurisdictions, the different rules to which managers are subject, the tools at their disposal, investor types and regulatory influences on investor behaviour.

Recent events also demonstrate the importance of rigorous stress testing. ESMA has confirmed that **the 2019 Guidelines on stress test scenarios under the MMF Regulation will be updated in 2020** to include a modification of the risk parameters to reflect recent market developments related to the COVID-19 crisis.

5 https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation200514_ESRB_on_liquidity_risks_in_investment_funds~4a3972a25d.en.pdf

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04. Transition to risk-free rates

One of the most significant issues to face capital markets in the next 18 months is the ceasing of LIBOR in its current form. Since the global financial crisis, in response to both cases of attempted manipulation of key IBORs and the decline in liquidity in the related unsecured funding markets, the FSB has coordinated global efforts to strengthen the robustness and reliability of existing benchmarks and promote the development and adoption of RFR benchmarks based on transactional data.

The July 2017 announcement by the UK Financial Conduct Authority (FCA), that it would no longer compel banks to submit data for LIBOR after 2021, set a deadline for regulators and the industry to develop and implement plans to transition to RFRs. Around US$400 trillion worth of financial contracts reference LIBOR across several currencies.

Moving to RFRs: where to start?

Initial impact assessment
Modelling and systems analysis by all business units of: operational, legal and conduct risks; functional, economic and client impacts; and regional timings.

Strategic Planning
Based on economic impacts to existing portfolios and the potential business opportunities: establish client communication and negotiation workflows; review contract structure; and evaluate profitability, cash-flows and hedging risk.

Governance & client outreach
Develop internal governance processes to approve changes to policies, systems, processes and controls; educate client-facing staff to guide clients transparently and fairly through the process.

Contract identification
Leveraging technology if possible, identify all products and business lines, including expected fall-backs, and the bilateral negotiations likely to be in scope.

IBOR exposures & risk management
Measure exposure by maturities beyond 2021, grouped by fund, portfolio and counterparty.

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Building blocks towards transition

Over the last year, several building blocks have been put in place that should allow the smooth transition to RFRs. In the US and the UK, the working groups of regulators and market participants have now set intermediate deadlines for each different type of financial product. Intermediate deadlines are also emerging in Asian jurisdictions, such as Hong Kong. Supervisors will be monitoring firms' progress against these deadlines.

Market infrastructure providers are updating their software to be able to process the new RFRs and there is beginning to be an increased availability of products referencing the new rates.

Many derivatives trades are executed under ISDA master agreements, so there has been intensive work over the last few years to gain consensus on language for an ISDA IBOR Fallback Protocol. This will enable millions of derivatives trades to be safely and consistently transitioned away from the IBOR benchmarks. The protocol is expected to be published shortly, but regulated entities and market participants with significant derivatives exposures are being encouraged to sign up and adhere to the Protocol "in escrow" in order to encourage timely adoption throughout financial markets.

However, especially in non-derivatives markets, there is still a lot of work to do to meet the transition deadline of end-2021. With the onset of the pandemic, there was an expectation from some market participants that regulators would extend the deadline for the end of the transition as they did for other regulatory changes. Instead, regulators around the globe emphasised that the risk from continuing to use LIBOR was too high to extend the deadline, although intermediate deadlines were revised. During the pandemic's onset, RFRs fell with central bank rates; LIBOR did not. Firms need to consider the impacts of using a rate that does not embed a credit element.

Tough legacy products

Regulators have recognised that some products, often referred to as "tough legacy" products, will be almost impossible to transition from IBORs. In the main LIBOR jurisdictions, proposals to help manage the risk posed by such products are now emerging.

In June, the UK Government announced its plans to amend the UK version of the EU Benchmarks Regulation.[6] This will give the FCA enhanced supervisory powers to be able to direct the administrator of LIBOR to change the methodology used to calculate the benchmark, if doing so would protect consumers and market integrity. This may provide a mechanism for publishing a "LIBOR rate" if the panel banks fall away. This concept of a synthetic LIBOR calculation could be applied post-2021 to avoid existing LIBOR contracts becoming frustrated.

> "firms should continue to focus on active transition of their LIBOR contracts"

However, in their announcements, both HM Treasury and the FCA make it clear that regulatory action to change the LIBOR methodology may not be feasible in all circumstances – for example, where the inputs necessary for an alternative methodology are not available in the relevant currency. Further, even if regulatory action to change the methodology enabled by the legislation is feasible, the economic terms of the action may not be the most beneficial to the parties involved. Therefore, firms should continue to focus on active transition of their LIBOR contracts.

The legislation will be amended, later this year, as part of the Financial Services Bill. The FCA will publish statements of policy on how it might use its new powers and consult on the possible new methodology.

The European Commission is also proposing to amend the EU version of the Benchmarks Regulation (BMR).[7] In a slightly different methodology to the UK, the amendments to the EU BMR would empower the Commission to designate a replacement benchmark to cover all references to a critical benchmark, such as LIBOR, when such a benchmark ceased to be published and could result in significant disruption to EU financial markets. The statutory replacement rate would be available only for financial contracts that referenced the critical benchmark at the time it ceased to be published.

In the US, the Alternative Rates Reference Committee (ARRC) has proposed New York State legislation to address the tough legacy issues, as a substantial number of US-Dollar LIBOR contracts are governed by New York law.[8] The proposed legislation would apply to certain LIBOR-based financial contracts executed prior to the discontinuation of LIBOR and would amend them, by operation of law, to include ARRC's recommended fallback rate plus a spread adjustment.

It is not yet clear, for any of these solutions, exactly how they will apply or the economic impact they will have on individual contracts. All these solutions also require legislative approvals at a time when legislators are likely to be very occupied with measures to combat the pandemic or national developments. Therefore, **it is crucial that the industry maintains momentum on finding solutions to help with transitions and that individual firms focus on transitioning as many of their IBOR-referencing exposures as possible. Firms should expect increasing scrutiny from supervisors as the end of 2021 draws near.**

6 https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS307/

7 https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1376

8 https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Proposed_Legislative_Solution.pdf

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05. The importance of global co-operation

Whether capital markets work best – most efficiently, effectively and safely – if they are open or closed is a long-standing policy debate. The high volatility seen in the early stages of the spread of COVID-19 has re-opened that debate yet again. As economies struggle to recover, there may be a temptation to close markets to international trade to help protect national businesses from competition. We suggest that this should be avoided in relation to the capital markets: the pandemic has highlighted the importance of global regulatory co-operation.

The full economic impacts of the pandemic are not yet fully understood, but it is certain that businesses of all sorts will need to tackle debt burdens not seen on such a scale before. The crisis has highlighted that all business sectors are deeply interconnected across borders and that economies of all types and sizes are vulnerable. Financing channels – in particular, the capital markets – need to reflect this reality in order to help support recovery. Achieving sustainability goals, both environmental and social, will require additional and large levels of private funding.

In the face of such extraordinary circumstances, it is understandable that some temporary measures were introduced to protect capital markets and sovereign debt. They should be temporary. The building of more permanent protective walls around economies, including limiting access to national financial markets, must be avoided. Historic examples show closed capital markets can damage the very economies that officials are trying to protect. The debate should move away from open or closed, to what helps markets to operate most safely and efficiently, whether access should be limited in anyway and the optimal degree of regulation.

In the retail markets, a greater degree of regulatory protection is understandable and necessary. In the wholesale capital markets, while consumer protection should not be forgotten **the focus should be on financial stability, market integrity, fair competition and the prevention of regulatory arbitrage**. To achieve this, there needs to be an ongoing commitment to continue to develop deep constructive relationships between regulators, including dialogue on enhancing supervision and co-ordination.

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Initial indications are positive, with authorities agreeing, under the auspices of the FSB and after the initial economic shocks in April, that their "actions will be consistent with maintaining common international standards, given that these provide the resilience needed to sustain lending to the real economy, and preserve an international level playing field. Such actions will not roll back regulatory reforms or compromise the underlying objectives of existing international standards."[9]

As outlined in Chapter 2, central clearing and corresponding margining, for example, is a global issue and is key to financial stability in the capital markets. Regulation around the recovery and resolution of clearing houses is developing. The intention is that all market participants can plan for, and will know how to act, if a clearing house becomes distressed or starts to fail. Regulators are encouraged to work closely together in their supervision of clearing houses through regulatory colleges and crisis management groups, sharing information and helping to ensure a smooth system. Strong regulatory co-operation is essential. To be truly effective, it requires trust on both sides.

Access to EU markets largely falls under equivalence provisions. Given the UK has onshored most EU financial legislation as part of the process of leaving the EU, access to UK markets, at least in the near future, will also fall under equivalence provisions. The equivalence process is meant to be outcomes-based: assessments should be determined not only by reference to the content of law and regulation, but also considering approaches to supervision and enforcement. Line-by-line analyses of a third country's rules can miss the point and, potentially, limit market access, adversely impacting economies, businesses and citizens.

Barriers to capital markets will result in corporates having less access to liquidity and choice, and potentially higher cost of financing, which will be a cost to the overall finance system.

In its June 2020 report on "deference",[10] IOSCO identified the following good practices:

— **Outcomes-based**: assessing whether another country's regime aims to achieve outcomes that are generally like those achieved by the domestic regulator in terms of investor protection, market integrity and the reduction of systemic risk.

— **Risk-sensitive**: for example, the scope of assessment may be adjusted depending upon the level of risks that domestic participants may be exposed to, or access may be allowed to other countries' firms if the activity of a firm does not exceed a pre-determined threshold.

— **Transparent**: both in the process and in the criteria for granting deference and withdrawing it.

— **Co-operative**: underpinned by strong, ongoing regulatory, supervisory and enforcement co-operation between authorities.

— **Sufficiently flexible**: allowing jurisdictions to make changes to regulations, without deference being withdrawn, provided the regulation still aims to achieve similar outcomes.

In the US, there are indications of a greater acceptance of other regulators' frameworks and supervision. For example, the Commodity Futures Trading Commission (CFTC) recently announced[11] a change in approach from its 2013 cross-border guidance, with new cross-border rules that introduce a broader, more holistic approach to determining the comparability of another countries' rules based on overall outcomes rather than whether each individual requirement is identical.

The above underlines the importance of regulatory dialogue and co-ordination. Specifically, it requires a framework for strengthening the processes for granting and withdrawing access to, and rights within, EU markets. It should ensure greater legal and regulatory certainty, while protecting regulatory autonomy. It is also paramount that central banks and banking regulators co-ordinate actions to ensure they do not inadvertently jeopardise systemically-important, global financial market infrastructures.

Look out for further articles and papers in this thought leadership series that will consider other "new reality" issues.

9 https://www.fsb.org/wp-content/uploads/P150420.pdf#page=4
10 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD659.pdf
11 https://www.cftc.gov/PressRoom/PressReleases/8211-20

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