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Study Group on International Financial Regulation
Japan Securities Research institute

Opinion Paper by the Study Group on International Financial Regulation "Issues for International Financial Regulation and International Standards"

I. Purpose of the Study Group on International Financial Regulation

The Study Group was established for the purpose of monitoring developments in recent international financial regulatory developments, enabling relevant parties in Japan to appropriately express their opinion in the process of introducing various regulations, and supporting Japanese financial institutions to respond smoothly to the new regulatory environment.

Accordingly, the following result of discussions was compiled after conducting exchanges of views in seven meetings from November 2016 to July 2017, between experts in business categories with expertise across a broad range of financial regulation.

The Study Group plans to widely disseminate abroad this paper in English in order to make recommendations on the future course of global financial regulation to financial regulatory and supervisory authorities across countries.

Going forward, the Study Group intends to continue a follow-up of this Opinion Paper as necessary.

We would like to express our sincere appreciation to not only the Members of this Study Group but also researchers, etc. in many fields who have helped us greatly in preparing this report.

II. Reform of International Financial Regulation after the Financial Crisis: The Current Status and Assessment

After almost ten years from the outbreak of the Global Financial Crisis as symbolized by the so-called Lehman Shock, it is said that reform of international regulation has moved from the design stage to the implementation stage.

Nonetheless, the design stage is still partially continuing, as, for example, final agreement on Basel III -- scheduled for the end of last year has been postponed, and uncertainties remain in the details of national regulations. On the other hand, practical issues and requests for various revisions concerning the basic direction and the numerous international standards which have been agreed on at the G20 Summit since 2009, have been presented.

Accordingly, there are currently many problems in terms of transparency, comparability, fairness of competitive conditions, etc. in national regulation, which call for improvement.

It is also unclear what impact Brexit and the review of financial regulation started by the new U.S. administration will have; there is considerable uncertainty over what impact these developments could have on international financial regulation.

Moreover, in some jurisdictions, we are seeing moves to apply stricter (or looser) regulation than international standards by introducing jurisdiction-specific regulation not embodied in those standards, such as to ring-fence capital and liquidity within the respective jurisdictions.

Due to such developments, national regulations have become inconsistent, causing the fragmentation of regulation, which is in turn heightening the risk of fragmenting financial markets.

In the Study Group meetings, there were reports from participants in cross-border transactions, and financial institutions and market infrastructure operators active in cross-border businesses, that excessive cost increases and impediments to transactions are being caused by failing to sufficiently ensure consistency of cross-border regulation and supervision, or to avoid contradictions, duplications, and gaps between national regulations.

Moreover, more than one Study Group member who engages in financial businesses pointed out that a part of the highly diverse and cumulative layers of financial regulations that have been added are impairing or restricting the smooth functioning of financial and capital markets.

With the progress made in international financial regulatory reform, work has started at the FSB (Financial Stability Board) to assess the effects of regulatory reform, but it is still at the stage of developing methodologies and is also basically limited to an ex-post assessment.

However, if regulations is indeed having such negative effects, one should identify and correct the regulation causing them as soon as possible. Moreover, if any negative effects of regulations are expected, one should consider correcting them before their implementation as much as possible.

In previous reforms of international financial regulation, the priority was to prevent the recurrence of financial crises and secure financial stability. However, if the post-regulatory reform financial system cannot sufficiently fulfill its essential financial functions, the reform cannot be said to have achieved its original goal.

If markets shrink due to regulatory reform, or are fragmented by jurisdiction, risks in financial systems may decrease; however, the functions of financial markets to sustain corporate activities and support economic growth will be impaired, thereby rendering the financial regulatory reforms unable to achieve their original purposes.

In particular, upon entry into the implementation stage of international financial regulatory reform, members of the Study Group reported that the front lines of financial businesses have been experiencing many "unintended effects" not expected in advance. Among those reports, we cannot ignore the point that various costs borne by market participants are increasing rapidly, when considering the proper functioning of capital markets.

Moreover, since many regulations have been developed and established simultaneously in a relatively short period of time, there are, as mentioned above, some contradictions, duplications, and gaps. Having just started on assessing the cumulative and collective effects of the numerous regulations, such work has not yet led to actual revisions.

Furthermore, partly due to the hurried development of new regulations and the insufficient resources of the relevant international organizations such as the FSB and BCBS (Basel Committee on Banking Supervision,) there are criticisms that their discussions lack sufficient transparency, or that they are not fully accountable. It has been pointed out that there are many cases in which drafts are not fully presented in the development process, or that it is not clear how far the results of public comments have been reflected in revisions to the original draft. Such issues are also pointed out in the report of the U.S. Treasury Department to the President published in June of this year, showing that the transparency of the standard-setting process, its accountability, and the provision of sufficient opportunities for expressing stakeholder opinions are important issues not only for Japan but also for all countries concerned.

The current framework of international regulatory reform, which is led by the G20/FSB, and for which the development of specific international standards is

delegated to standard-setting bodies such as the BCBS, does not have a legal basis, such as international treaties. This could have been the cause of substantial differences in the content and implementation timing of international standards in relevant countries. Accordingly, it may be worthwhile to consider a mechanism for developing and implementing standards with a clearer legal basis in the future, as well as reconfirming the commitment of the G20 towards reform.

As stated above, it is true that efforts for international financial regulatory reform have shown substantial progress after nearly ten years from the outbreak of the global financial crisis. On the other hand, upon entry into the full implementation stage, it appears to be the appropriate timing to assess again the entirety of the achievements and the effects in order to make any necessary revisions.

Our attention is currently drawn to the fact that the new U.S. administration has announced a policy of relaxing financial regulation. We can support the overall direction of reviewing excessive regulations to avoid impairing financial intermediary functions to support economic growth, but, on the other hand, we will need to pay close attention as such regulatory reviews may generate new costs or harmful side-effects.

In addition to the developments above, we have recently been witnessing protectionist assertions to review free trade agreements on trade in goods and services including financial services, or to announce a reduction in current account deficits as a national policy in some countries. As a result of those movements, in the area of financial regulation, there are also concerns about possible damages being caused to the observance of such principles as market access, national treatment, and most-favored-nation treatment which have been recognized by free trade agreements and economic partnership agreements up to now.

Precisely because of such circumstances, it is required for international organizations which are responsible for establishing standards for international financial regulation, as well as national regulatory and supervisory authorities, to listen carefully with humility to the views of a broad range of stakeholders including those in this report, and conduct future work carefully, revising existing regulations as necessary.

All regulatory and supervisory authorities should be highly conscious of sharing the responsibility for achieving the ultimate purpose of regulation; i.e.,

building financial systems and financial markets which contribute to sound economic growth and sustainable economic development.

III. The Ideal Design of International Financial Regulation

Regarding the ideal design of regulation, it is never easy to extract common principles thereof, as there are many elements and interests to consider, and it is greatly influenced by the actual political and economic situation of each country However, the following points should be considered as the criteria for ideal regulation in the design stage of international financial regulation.

These principles could first be compiled and enhanced as the "Ten Principles of International Financial Regulation", for example, and then agreed upon and adopted by fora leading the reform of international financial regulation such as the G20 and FSB.

i. **It should be repeatedly recognized that the ultimate goal of regulation is to contribute to sound economic growth and sustainable economic development, and confirmed that the stability of financial systems and the securing of the soundness of financial institutions are merely the means to achieve those goals. Regulatory reform should not place excessive emphasis on avoiding risks so as to hamper proper risk-taking which is necessary to provide finance for growth.**

ii. **In order to ensure consistency among different jurisdictions, national financial regulation should follow international standards to the extent possible. However, while international standards are regarded as minimum standards, the addition of nation-specific regulations and the introduction of exceptional treatment should be resisted, so as to prevent fragmentation of regulation among countries. On the other hand, if there are significant differences in the current situations of national financial systems, or in the historical background and business practices of national markets, we should be fully aware that application of uniform regulations (one-size-fits-all) will not be appropriate.**

iii. **Market access, national treatment, and most-favored-nation treatment, which have been recognized in free trade agreements or economic partnership agreements should not be impeded. (Not effectively complying with such obligations under the agreements in the name of the prudential carve-out should be avoided.)**

iv. Regulation should be proportionate to risks based on the principle of proportionality, while consistency between the purpose and the substance of regulation, and the necessity of the regulation (i.e. the inability to achieve the regulatory goal by other means) should be proven.

v. Any negative impact on market efficiency should be minimized, while the fairness and transparency of regulation should be ensured. While fair competitive conditions are important, they should be judged on the basis of substantial outcomes rather than formal requirements.

vi. One should not pursue the development of detailed rules only, but pursue an optimal combination of principles-based and rules-based approaches, making use of the advantages of the principles-based approach.

vii. One should aim at an optimal combination of entity-based regulation and activities-based regulation. (Identical regulation should be applied to identical business activities, regardless of the performing entities.

viii. Counter-cyclical macro-prudential regulation should be introduced and made use of, while pro-cyclicality of regulation should be eliminated as much as possible.

ix. Restrictions on free economic activity by ex-ante regulation should be kept to a minimum, and make use of rigorous ex-post regulation on violations as they occur; an optimal combination of the two approaches should be sought.

x. Always consider the enforceability of regulation; international coordination and cooperation between enforcing authorities should be strengthened. Furthermore, supervision of financial groups on a consolidated basis should be emphasized through strengthened cooperation among authorities.

In addition to the above principles concerning the purpose, substance and implementation of regulations, improvements are also deemed to be necessary for proceeding with international financial regulatory reform as mentioned above, including the strengthening of governance in the process of developing international standards, and the clarification of accountability.

Further, it is pointed out that the reforms so far may have overemphasized the strengthening of rules as a whole, possibly lacking the perspective of encouraging through more intensive supervision voluntary risk management of

financial institutions and improving incentives through enhancement of governance or review of corporate culture.

With the precondition of avoiding excessive intervention by government in daily activities of financial institutions, it is advisable for authorities to emphasize supervision with greater focus on substance rather than formal compliance with rules. Furthermore, appropriate supervision can also play a substantial role in facilitating forward-looking responses and reviews of management focused not on the parts but on the entirety of the business. While useful, stress tests should be treated with care in order to respect the autonomy of financial institutions to the greatest extent, and in a manner not to effectively introduce regulation based on supervisory authority.

IV. Recommendations on Individual Regulations

(Note) The following is a list of opinions expressed by members, etc. of the Study Group. Not all members necessarily agree with all of the opinions.

1. Basel Regulations

- **Consideration should be given to the conflict between the liquidity standards and the leverage ratio standard.**
- **Consideration should be given to a decline in market liquidity caused by the leverage ratio standard.**
- **In order to encourage risk-sensitivity of banks' business operations and further enhancement in risk management, it is important to retain risk sensitivity in risk asset measurement. Risk sensitivity in risk asset measurement should be allowed to the maximum extent so long as it is considered reasonable to use internal models.**
- **Even if the approach using internal models needs to be reviewed when risk asset calculation by using excessively complex models could cause substantial discrepancies between individual financial institutions, it should be noted that the standardized approach will not fundamentally resolve such discrepancies in risk assets and could introduce a new regulatory distortion.**
- **Regarding the review of the credit valuation adjustment (CVA) in the finalization process of Basel III, since there are many problems which require substantial time to be resolved associated with the introduction of the CVA based on market valuation in many jurisdictions except the US etc., including**

the fact that there is only a small number of traded issues and low liquidity in CDS markets, consideration must be given to providing sufficient transition periods upon implementation.

・In order to mitigate regulatory uncertainties, the finalization of Basel III should be agreed upon as soon as possible, after making necessary adjustments to earlier drafts. Since final agreement has been delayed by more than six months from the initial plan, the relevant authorities should endeavor to reduce uncertainties by ensuring transparency of the process as much as possible.

・In implementing new regulation, given that the levels of capital and liquidity at target financial institutions have already been substantially strengthened, sufficiently long transition periods should be provided so that preparatory moves by the covered institutions, in particular, will not have negative effects on lending for growth finance etc.

・Commitments should be reconfirmed at the Basel Committee, etc. to enhance the effectiveness and normative powers of the agreed-upon international standards, so that the substance and timing of implementation of the new Basel rules to be finalized will not differ substantially across major jurisdictions.

・A follow-up of the implementation status of the new regulations should be conducted early on, using a format which is more simple and which would will clarify differences among countries. Unimplemented rules should also be compared and assessed as soon as the substance is finalized.

2. Issue of the so-called "Too-big-to-fail" systemically important financial institutions (SIFIs)

・First, while the previous methods for identifying SIFIs have not depended solely on the indicators of size of the financial institutions, and a a method to assess systemic importance based on various indicators has been adopted, there is room for improvement in the methodology. In particular the methodologies for non-banks are not yet clear.

・It is argued, mainly in the U.S., that identification is not necessary for non-bank SIFIs in the first place; on the other hand, it cannot be ignored from the perspective of ensuring fair competitive conditions between banks and non-banks. Going forward, improvements should be made in the methodology for identifying systemic importance to adhere to "risk-proportionate regulation and supervision" (Principle of proportionality). For example, it is pointed out

that the methodology for identifying SIFIs does not duly reflect the reduction in systemic risk due to progress in derivative market reforms etc.

・Regulatory responses in the U.S. and Europe to this issue focus on primarily conducting orderly resolution without taxpayer bailout, mainly relying on regulation and supervision which place significant burden on financial institutions and financial markets, including the imposition of capital surcharges, etc., the development of recovery and resolution plans, business restructuring and liquidation, and the issuance of liabilities eligible for bail-in.

・While these measures may be necessary and appropriate for giant, globally active financial institutions in the U.S. and Europe, applying one-size-fits-all regulation and supervision is sometimes not appropriate when national financial systems and financial markets differ, and business models differ greatly even among major financial institutions. Especially in Japan, it should be noted that during the financial crisis from the end of 1990s to the start of the 21st century, the crisis was contained by recapitalizing financial institutions using public funds and conducting orderly resolution, in order to avoid systemic risk.

・Moreover, regarding the issue of imposing a temporary suspension (stay) of early termination rights for derivatives, it is still largely unknown whether effective orderly resolution can be carried out, while there exist substantial differences in national legal systems for resolution.

・Accordingly, in order to deal with this issue, and bearing in mind that global harmonization of legal systems for resolution is not achieved easily, it should first be made a precondition to develop safety nets, including a robust deposit insurance system in accordance with the actual situation in individual countries.

・In particular, given that in a financial crisis, a loss of confidence in the creditworthiness of some financial institutions lead to a loss of confidence in the entire financial system (i.e. contagion occurs), it should not be denied that decisive public intervention using public funds may be effective depending on the situation. Depending on the situation individual countries are in, it should therefore be confirmed that recapitalization of financial institutions and/or the full protection of liabilities including deposits using public funds are sometimes necessary, with the necessary precondition that strict measures to prevent moral hazard and cost sharing by the relevant industries, etc. are provided for.

・If loss is incurred by such temporary injection of public funds, a system should be developed ex ante for relevant industries to bear the loss in advance or ex post, by making use of frameworks such as deposit insurance fund contributions or special charges.

・A framework should be secured to smoothly provide liquidity necessary to enable an orderly resolution to the financial institution in question. In doing so, in the event a loss is incurred, the relevant industries should bear the loss under the system.

・The FSB's Key Attributes establishes to a significant extent an internationally standardized orderly resolution framework, their one-size-fits-all and rigid application should be avoided.

・In particular, the development of a bail-in framework should aim for a flexible framework since the potential market size for bail-in bonds differs greatly among jurisdictions, there is a risk that contagion can be exacerbated by such instruments depending on the situation, and it is difficult to gain full understanding of depositors and small creditors, while such a framework has the merit of preventing moral hazard and introducing governance by creditors.

・In the U.S. and Europe, there have been moves to require the establishment of intermediate parent entities for foreign banking groups. Such a framework would not only impede the optimal allocation of capital from the viewpoint of business, but also would make it a challenge in ensuring consistent design and implementation of the resolution plans that are formulated by the home resolution authorities for G-SIBs (global systemically important banking groups) in countries such as Japan that adopts the SPE (single-point-of-entry) resolution model. In order to realize regulation and supervision which enable an effective orderly resolution, coordination, understanding, and cooperation among national authorities are decisive elements, and they should be further promoted. Resolution plans have not been generally made public for G-SIBs up to now, but at least the main elements of the resolution process should be clarified and made more transparent to the extent possible.

(Insurance)

・The International Association of Insurance Supervisors (IAIS) has been developing international regulatory standards for insurers by classifying them into three categories: global systemically important insurers (G-SIIs), internationally active insurance groups (IAIGs) and other insurance groups. In this work to date, there appears to be a generally-held view that the systemic

risk of insurers are deemed to be lower than that of banks of equivalent size, but, in the work to develop a common supervisory framework for IAIGs (Comframe), there is a move to impose rules equivalent to those for G-SIIs on IAIGs. Such an approach could run the risk of imposing excessive regulation on IAIGs compared to the risks they pose.

・Regarding international regulatory standards on insurers, there is also a move to have common international standards for the corporate governance of insurers, and risk management systems, etc. Since insurance businesses have strong local characteristics compared to banking businesses, a certain degree of discretion should be allowed to the management of insurance companies, and therefore, excessively uniform regulation should not be imposed.

3. Regulation of Over-the-Counter (OTC) Derivatives

(Regulation of margin)

・Consideration should be made of possible negative side-effects and market fragmentation due to incentives created by margin regulation, as well as differences in the substance and the timing in implementing national rules. In particular, if there are differences in the scope of covered products or that of transactions, they should be aligned across jurisdictions as much as possible.

・It is regrettable that although the relevant authorities once agreed on the substance and timing of implementation of the new rules at the start of their development stage, in the end the substance and timing of implementation by national authorities diverged substantially in the subsequent implementation process.

・For such changes of regulation, which have major impacts on cross-border transactions, communication between authorities and market participants should be made much closer. While it was relatively smooth in Japan, concerns of market participants cannot be said to have fully dissipated, which calls for further effort going forward.

(Mandatory central clearing)

・In the application of the so-called FMI principles (PFMIs, Principles for Financial Market Infrastructures), consideration should be made of differences in the capability of market infrastructures such as national CCPs (Central Counterparties) and differences in the actual market conditions. Furthermore, consideration should be made so that regulation would enhance the capability of market infrastructures.

・It is pointed out that capital charges on collateralized assets related to OTC derivative transactions and applicable liquidity requirements in Basel III have become disincentives to central clearing of OTC derivatives at CCPs. As regards the leverage ratio requirement, there is still an ongoing argument as to whether initial margin for derivative transactions should have the effect of reducing exposures. While there has been discussion of practical solutions to such issues at the Basel Committee and International Organization of Securities Commissions (IOSCO), etc., it is reported that for banks etc. providing clearing services for clients (client clearing providers) the regulatory burden as whole is particularly onerous in practice. This issue should be examined further in light of actual evidence, and adjustments should be made if necessary.

(Cross-border derivative transactions)

・Ideally, even when national rules are not the same, it would not be problematic if the outcome of the implementation of the rules were similar or equivalent, and authorities could rely on the rules of other countries. Nevertheless, at present, extra-territorial application has come to the forefront. If the rules of more than one jurisdiction are applicable to a single transaction, an authority should, as a matter of principle, rely on the other authority's regulation and supervision as much as possible, and a relationship enabling coordination and cooperation among regulatory and supervisory authorities should be developed. The need for developing a relationship for coordination and cooperation among regulatory and supervisory authorities is not limited to derivative transactions; it would apply to any other financial market transaction.

(Trade reporting obligation)

・At present, since the format and scope, etc. of the trade reporting requirements differ significantly from country to country, the burden on market participants is very heavy in terms of system costs etc. for compiling, and submitting data etc. On the other hand, there are concerns that the submitted data are not sufficiently made use of by CCPs and authorities, which requires further efforts for improvement.

4. Regulation applicable to Asset Management Businesses

・Appropriate regulation would need to be crafted for shadow banking entities and activities, especially for those in the asset management business, in accordance with not only their diverse nature, but also with the functions they perform and the degree of risks they pose to financial systems.

・While regulated funds such as investment trusts, etc. are discussed under “shadow banking” as part of the asset management business in the context of international financial regulatory reform, such funds -- excluding MMFs for which regulation has already been strengthened -- cannot be said to have caused the instability of financial systems in the first place, and their risks are small.

・Moreover, since, apart from a few exceptions, investors bear the risks in the asset management business, regulation should remain minimal to the extent that distributors and investment management companies, etc. are offering financial products in accordance with their fiduciary duties.

・Accordingly, negative side-effects could be caused if such businesses are classified as shadow banking entities performing the same functions as financial institutions such as banks and are applied the same rules as banks, etc. .

・In markets like Japan where further growth of the asset management business is anticipated going forward, attention should be paid so that new regulation will not impede such growth and undermine the efficiency of markets.

・While not being an internationally agreed-upon rule, regulation aimed primarily for investor protection such as those requirements to unbundle research fees, which could have a significant impact on the asset management business, would need to be developed carefully, taking into full account the effects of the rule on business activities outside the jurisdiction in which the rules are directly applicable.

5. Regulation of Insurance

・It is important for the development of international capital standards to be flexible, given that the business environment for insurers differ significantly from country to country. In particular, regarding the treatment of economic value assessment of liabilities for which the basic thinking of national authorities differ significantly even among major countries, the standards should provide for a range of options for the time being, rather than uniformly applying ruled-based international standards, and aim for gradual convergence of national regulations.

・As with the opinion of this Study Group on Basel III for banks, regarding the capital requirements of insurers, they should aim for risk-based regulatory systems, and tools such as restrictions on leverage, applied regardless of the magnitude of risks, should not be used as an expedient.

・Risk characteristics of private insurance products differ greatly by country and by region, depending on the social security systems and public healthcare and medical insurance systems in respective jurisdictions, or on differences in damages caused by natural disasters, etc. Accordingly, regarding the global Insurance Capital Standard (ICS) currently under consideration by the IAIS, aiming for completion in 2019, it should also be appropriately designed to take into account the diversity of risk characteristics when setting the standards for risk measurement, calibration, capital structure, etc.

・In Japan which is exposed to various natural disasters and are witnessing a rapidly aging society with fewer children, private insurance is playing an important role by providing long-term protection that supplements social security systems and public medical insurance systems, etc. In the development of the ICS, consideration should be given so as not to impair the insurers' ability to provide natural disaster damage relief and long-term protection. In particular, the ICS should substantively reflect the characteristics of insurers such as the long-term nature of insurance policies in the assessment of insurance risks and the mark-to-market valuation of ultra-long-term liabilities. For example, the introduction of the long-term forward rate (LTFR) in the valuation of liabilities under ICS can be considered an appropriate step.

・One should also note that international capital standards are being developed following the evolution of enterprise risk management (ERM). For example, there is also a view that the introduction of the LTFR above would seem to deviate from a pure economic-value-based assessment of liabilities. Therefore, due attention is needed so that the ICS does not impede progress in ERM of insurers.

・In the midst of developing ERM systems at insurance companies, a minimum capital standard on an economic-value-basis could become an additional constraint on business management of companies; in such a case, the stated minimum capital standard should not be the sole yardstick for authorities to judge the firm's soundness. In such a case, the soundness of insurers should not be assessed solely by economic-value-based indicators but should be

judged on a comprehensive basis by also considering qualitative elements including the respective companies' actual risk-taking behavior, the quality of risk management systems, and its medium- to long-term business outlook.

・These points are deemed extremely important, as economic value assessment tends to increase the volatility of net assets, especially for life insurance which provides long-term guarantees.

・Accordingly, when introducing economic-value-based indicators, it is worthwhile to consider such options as starting their application as soft standards such as monitoring indicators, and subsequently refine them through close communication between supervisory authorities and insurers. Moreover, regarding the disclosure of firm-specific figures of economic-value-based capital by companies, sufficient and careful thought should be given to their content and frequency.

・More discussion is needed on the ideal formulation of medium to longer-term economic-value-based capital standards, as to whether they should be constraints on the firm's internal risk management, or should be as aligned as possible with the economic-value-based ERM of firms. If one pursues the former approach, capital standards based on economic value could become constraints on the firm's risk management and capital allocation. If one takes the latter approach, there can be an issue as to whether it would be truly possible to construct comparable regulation across countries and firms, bearing in mind that insurance risk has strong local characteristics reflecting each country's risk profile and social security systems etc.

・In considering international capital standards for insurance businesses, close attention needs to be paid to unintended effects, as compared to banking and security businesses for which the standards have been further advanced, as there seems to be a larger unknown concerning the effects of regulation on financial markets and the real economy.

6. Regulatory Reform in the U.S.

・In the U.S., there were analyses finding that the DF Act (Dodd-Frank Wall Street Reform and Consumer Protection Act), especially the Volker Rule, etc., constituted excessive regulation, or had unintended negative effects, and in accordance with the Presidential Order of February this year, the U.S Treasury Department has been making recommendations from June in successive order.

・Such developments are welcome as an initiative to reconfirm the original purpose of financial regulatory reform.

・When regulation is reviewed as a result of an exercise, thorough in-depth discussion should be conducted for making necessary adjustments so that the achievements of the previous reforms will not be lost, and, in particular, that financial systems will not be unintentionally destabilized or weakened.

・In the process, moreover, sufficient opportunities for expressing opinions should be provided to foreign financial institutions and authorities.

・Not only the U.S. but also other countries should not apply their national rules as they are on an extra-territorial basis, and should proceed with mutual deference to each other's regulation and supervision. For that purpose, authorities should expeditiously promote the granting of substituted compliance to reduce regulatory uncertainty as much as possible.

・Furthermore, in the currently ongoing review for relaxing U.S. financial regulation, discriminatory treatment of foreign financial institutions and markets should not be made, and fair competitive conditions should be firmly maintained and national treatment guaranteed.

・On the other hand, regarding the regulation of Foreign Banking Organizations (FBOs) in the U.S., the current regulation requiring FBOs to establish an intermediate holding company on the grounds of smooth resolution and equal competition conditions with domestic banks should be replaced with regulations relying on home country authorities, giving more confidence to supervision by home country authorities.

・In reviewing regulation which could affect foreign financial institutions and markets, maximum effort should be made to ensure that the views of foreign stakeholders are fully heard of, and to bring about win-win results in relation to other countries.

7. European Regulation

・Equivalence assessments should be promptly conducted under MIFIDII (the Second Markets in Financial Instruments Directive) and MIFIR (Markets in Financial Instruments Regulation) to minimize legal uncertainty and opacity. Moreover, sufficient consideration should be given to negative side effects which could be caused by the new rules such as the research unbundling requirement.

・ The current complex and excessively time-consuming equivalence

assessment process should be reviewed expeditiously to reduce, as much as possible, regulatory uncertainty.

・The draft set of revisions to EU banking regulation issued by the European Commission contains many proposals which are relaxed versions of international agreements on capital and liquidity of banks. On the other hand, it contains proposals not incorporated in any international agreement such as the requirement to establish Intermediate Parent Undertakings (IPU). Such proposals could encourage regulatory fragmentation by inducing similar initiatives in other jurisdictions, and, as a result, damage confidence in and effectiveness of the agreed international standards.

・When introducing regulation which might affect foreign financial institutions and markets, maximum consideration should be made to ensure that the opinions of foreign stakeholders are fully heard, and win-win results are achieved in relation to other countries.

・Regarding trade issues with the U.K. related to Brexit and equivalence assessment negotiations with other countries, The EU authorities should deal with trade issues with the U.K. and equivalence assessments of other countries as separate issues, and deal with the latter as quickly as possible. In particular, it should be noted that postponing the equivalence assessments of third countries until the conclusion of the Brexit negotiations will not only hamper the activities in the EU of financial institutions from these countries but also negatively affect the activities of EU financial institutions.

8. BREXIT

・Regrettably, it has become difficult to foresee how the results of the Brexit negotiations will affect financial institutions and markets of third countries including Japan, due to the unclear political situation in the U.K.

・In the area of financial services, regulatory arbitrage can occur relatively easily with globalization. Under such circumstances, if an unclear situation is prolonged or an agreement cannot be reached in negotiations, it may cause unexpected turmoil in financial markets or even instability of the global financial system.

・The European and U.K. authorities should make utmost effort in the Brexit negotiation process in order not to damage the functions of the financial system in supporting sustainable economic growth, and not to prolong the uncertainty for a long period of time. As stated above, moreover, regarding

trade issues with the U.K. related to Brexit and equivalence assessment negotiations with other countries, they should be dealt with as separate issues and as quickly as possible.

9. Financial Benchmark Regulation

・Financial benchmark regulation is required to be both consistent globally and flexible according to the actual situation of individual countries.

・While financial benchmarks should be calculated by eliminating fraudulent operations and arbitrary use of data, etc., it should be recognized that they cannot exist independently from the history or market practices of individual financial markets, such as those for the currency on which the benchmark is based, and that they should be designed and operationalized by incorporating practical solutions for avoiding negative impact on the functioning of the markets.

・Attention should be paid to the risk that a system which increases regulatory burden such as excessive costs on reference financial institutions providing data for the calculation of financial benchmarks, could bring about market dislocations.

・Especially in EU where new regulations are to be introduced on the cross-border use of financial benchmarks, their restrictive effects on competition should be watched carefully, and a designing of systems which develops competitive markets is desired.

10. Response to New Risks

・Regulation and supervision should be constantly reviewed in order to respond promptly and flexibly to new risks for financial stability that constantly emerge, including threats of cybercrimes and terrorism, emergence of new financial businesses and services due to the development of Fintech, and financial sector responses to environmental issues.

・In doing so, approaches to facilitate risk-based measures should be adopted, taking into account the differences in national laws and regulations as well as market practices related to financial systems. Moreover, regarding initiatives such as the regulatory sandbox which many authorities are beginning to adopt, it seems worthwhile to consider global guidelines to maintain a level playing field and prevent *de facto* competition towards excessive deregulation.

V. Recommendations for International Financial Regulation

1. Development and Management of International Standards

Standards agreed upon at international standard-setting bodies such as the Basel Committee are not based on international treaties, and are therefore not legally binding. Nevertheless, international standards have exerted *de facto* enforcement power. That is because, for the implementation of international standards, national governments and central banks have expressed strong commitments and implemented them, with close cooperation and collaboration. On the other hand, although rules were formulated and agreed for the financial service sector under the WTO's GATS (General Agreement on Trade in Services) in 1997, they cannot be said to be fully functioning as the standards for financial regulation because regulation, etc. for maintaining the integrity and stability of the financial system were carved-out from their application (the so-called prudential carve-out).

As already stated, in major global financial markets today, we are witnessing a successive flow of introductions of or proposals for new regulations that diverge from international standards, which can be characterized as 'regulatory fragmentation'; if the unifying power of international standards is not strengthened, such developments may only be accelerated. (See the Attached "Examples of Fragmentation of Financial Regulations" for reference.)

International standards such as those in the area of financial regulation prevent the distortion of markets due to regulatory arbitrage or evasive market behavior, and perform excellent functions in securing transparency, comparability and fairness in competitive conditions, all of which are beneficial to all participating countries (i.e. a win-win).

In the future, those international standards may be re-positioned as treaty-based standards with a stronger normative powers, although it will be necessary to devise a framework in which, rather than putting all the details into the treaties, basic standards pursuant to the principle-based approach are given a legal foundation, while the relevant authorities retain their ability to flexibly revise the detailed rules upon agreement at the respective standard-setting bodies.

In any case, emphasizing fairness in competitive conditions, transparency and comparability of international standards should not result in the flooding of detailed rules-based standards. Rather, it will be required to pursue an optimal combination of principles-based and rules-based approaches, taking advantage of the merits of a principles-based approach.

One possible suggestion is that there could be a framework in which international standards are given a certain legal basis, including an international treaty and qualitative standards are developed pursuant to a principles-based approach; then, building on this legal foundation, the respective standard-setting bodies can develop detailed rules upon agreement, if necessary; and finally the substance of the agreement can be flexibly applied by countries according to their actual market and other situations. As stated below, it seems that the rules on financial cooperation currently stipulated in bilateral economic partnership agreements can be referred to in considering such a framework.

In any case, in the rapidly changing landscape of global financial systems and markets, such international standards will require constant review, necessitating a framework which can enable expeditious review of regulation, if there is any regulation that does not correspond to the changing realties.

2. Enhancement of the Functions, and Reinforcement of Transparency and Accountability of International Standard Setting Bodies.

International standard-setting bodies, including the FSB, BCBS, IOSCO, and IAIS, have been endeavoring to enhance transparency and accountability by frequent use of public comments, strengthened dialogues with stakeholders, etc. However, there is still substantial room for improvement.

In order to develop international financial regulation with long-term perspectives, more appropriate systems are required which are commensurate with the roles of global organizations, such as improving the functions of the relevant international organizations, having a more balanced staff composition, and strengthening their financial statuses.

Needless to say, while providing for an international legal basis for those international organizations will not solve all such problems, measures should be considered going forward to improve the situation.

3. Towards a More Consistent Regulatory System

Members of the Study Group, especially those engaged in financial businesses, pointed out that the current system of international financial regulation consists of a patchwork of regulations crafted for the respective sectors and sub-sectors, and lack an overall vision, consistency, and integrity.

For example, with regard to Basel regulation, in addition to the capital adequacy standards , it is undergoing further tightening of existing standards and introduction of new ones in a number of areas including the leverage ratio and liquidity requirements, while sufficient analysis has not been made of the cumulative effects and interactions of such rules. It was reported that these rules have various effects on liquidity in the markets, etc. in which banks are participating, and affect transactions in tandem with market regulations on OTC derivatives, etc.

Furthermore, regarding the disclosure requirement and the trade reporting requirement to authorities, it was also pointed out that each requirement or each authority requires disclosure and reporting of similar information with inconsistencies in the content and in duplication, resulting in significant costs to financial institutions.

While the necessity of regulation is understandable for each individual item, if they are applied without mutually considering their effects, not only duplication of regulation would occur, but also conflicts and contradictions may result. Such combined effects of regulation on the functioning of financial institutions and markets cannot be said to have been fully taken into consideration.

In particular, it was pointed out at the Study Group that the simultaneous introduction of too many regulations may have increased the costs for financial institutions, so much so as to cause problems in their ability to conduct their normal operations. As a consequence, the effectiveness of individual rules could have been undermined, or incentives could have mutually canceled out.

Furthermore, concerns were reported for cases in which the original purpose of the regulation has been detached with reality, and seemingly unnecessary regulations are introduced through inertia or executing authorities face difficulties in implementation because regulations had not been sufficiently examined in the design phase. Given such situations, an assessment of the effects of regulation (as stated below) should be not only be conducted ex post (i.e. after implementation), as planned by the FSB, but also an ex-ante assessment to confirm that the advantages of introducing the regulation will sufficiently exceed the disadvantages.

Even if the purpose and the means of an individual regulations is legitimate, the cumulative outcomes and impacts in combination with the effects of other regulations may become excessive, resulting in the inconsistencies among regulations distorting markets, or generating the wrong incentives. Regulatory arbitrage by relevant parties sometimes makes the originally appropriate regulation ineffective, making it inappropriate. In pursuing an ideal set of regulations, such aspects should be fully considered.

Regarding the above issues, since they are beyond what regulatory authorities have the time to analyze while dealing with their day-to-day work, it is hoped that an international examination system is developed which is capable of studying such issues by gathering global expertise, and outsourcing the analysis to research institutes, etc. for example, with specific mandates.

4. Allowing Substituted Compliance and Mutual Deference on Each Other's Regulation by Equivalence Assessment.

At present, the regulations of the home and host countries are applied simultaneously and affecting each other in complex ways, thereby increasing regulatory costs for financial institutions and markets, with fragmentation occurring in some markets.

As for the future, it is desirable if national regulations converge globally, with international common standards consistently applied in individual countries and regions. On the other hand, it is not appropriate to apply one-size-fits-all rules globally, given that financial systems and market activities retain the idiosyncratic features of individual countries and regions.

Accordingly, regarding overseas activities and cross-border transactions of financial institutions, rather than applying national regulations on an extra-territorial basis, application of other countries' regulation and supervision should be mutually allowed through granting substituted compliance status or by making a determination of equivalence, thereby ensuring the efficiency and consistency of regulation and supervision through international cooperation.

The process for allowing substituted compliance and determining equivalence has been unsatisfactory in that they were slow to progress despite requiring substantial input in terms of time and effort, and often resulted in conditional equivalence determinations. Further efforts are required to improve the efficiency of such processes in order to remove uncertainty.

Moreover, as long as such assessments aim to compare how effective prudential regulation on financial institutions and market regulation are in individual jurisdictions, the criteria for assessment should be how much the objectives of regulation has been effectively achieved in terms of outcome, and should not focus on the formal aspects of the rules nor allow political elements to affect the assessment process.

To deal with the above issues, for the processes of allowing substituted compliance and determining equivalence, for example, procedures could also be standardized and made impartial by international standards, and a standard processing period can be established. Moreover, for the introduction of new regulation, it could be agreed among countries in the provisions of the “Financial Cooperation” chapters of economic partnership agreements, etc. that a process of allowing substituted compliance or making equivalence assessments be established without exception, with the necessary procedures to be finished before the implementation of the new regulation.

As can be discerned from the above, in order to avoid a reduction of liquidity and fragmentation of markets, it is extremely important to remove uncertainty in the markets and to secure enough time for financial institutions and market participants to make sufficient preparations.

It may be useful in some cases to determine equivalence on a temporary basis before making a final determination in order to allow businesses and transactions to maintain the current status for a certain period of time. However, even when such temporary equivalence is determined, it cannot be denied that uncertainties remain, due to the temporary nature of the determination. Preferably, a system should be constructed in such a way that all procedures for the equivalence determination should be completed before the implementation of new regulation.

If a decision on equivalence is not made before the implementation of the new regulation, the counterparties of derivative transactions, for example, need to conclude collateral agreements to cover the highest common standard of regulations in individual jurisdictions and develop infrastructures for exchanging collateral on that basis. As a result, not only must they bear extra costs, but they will no longer be able to fully benefit from an equivalence determination even if a favorable decision is reached later.

5. Toward Further Strengthening of Cooperation among National Regulation and Supervision

Going forward, with some hindsight on how the previous regulatory reforms have been carried out, rather than trying to hastily agree upon and implement individual parts of regulatory reforms in a piecemeal fashion, better regulatory systems should be aimed for, taking time to discuss the overall vision. Especially in the rapidly changing financial world, financial regulations themselves, if not constantly reviewed, could become the cause of the next financial crisis.

Moreover, it must be pointed out that there are weak points in the current reform process in which, once the substance and the timing of implementation of regulations have been agreed upon (without any legal basis,) the entire implementation process is left to individual countries and jurisdictions, and verification of implementation is conducted afterwards by peer review, with the results of the peer review published much later.

In economic partnership agreements (EPAs) between countries, there already exist provisions pertaining to regulatory cooperation in finance or to financial dialogue, such as in the bilateral agreements between Japan and Singapore as well as between Japan and Switzerland. Regarding the Japan-EU agreement, negotiations are currently being accelerated.

Along with individual countries participating in discussions at international fora, such international treaties could be a useful method for jurisdictions mutually having significant impact on each other to strengthen commitments towards cooperation in this manner.

Recently, we have been witnessing increasing trends in which individual jurisdictions introduce stricter or looser regulations than international standards, or impose requirements to ring fence capital and liquidity within the jurisdiction. Such trends could fragment regulatory frameworks and markets among jurisdictions, reduce competition, and increase costs for the users of financial services. Going forward, rather than allowing individual jurisdictions to introduce their own regulations to secure financial stability, measures for financial stability should be taken through closer cooperation of authorities of individual jurisdictions based on international standards.

Accordingly, the current reform process should be replaced in the future by a more robust process with a legal basis, which will further reduce differences in the substance and timing of implementation in individual countries and jurisdictions. On the other hand, it also needs to be a flexible process in which individual standard-setting bodies are given clear mandates for details of regulations and are able to develop standards expeditiously.

Moreover, until the transition to such a system, for the time being, commitments at the G20 should be reconfirmed for compliance with the substance and timing of implementing international standards as much as possible.

In order to avoid differences in substance among national regulations and divergence of timing in the implementation process of regulations, there could be institutional flexibility introduced for individual countries to postpone implementation even just before the implementation due date, or to adjust the substance. It is desirable to incorporate such flexibility in the implementation stage of regulation beforehand, during the design stage of the financial regulation.

6. Promotion of Impact Analysis and Assessment of the Effects of Regulation

In the face of fundamental questions being raised over the system of international financial regulation, the Study Group has re-acknowledged the importance of assessing and analyzing the impact of various regulations on financial businesses and market functions, in pursuing the ideal set of regulations. Regarding the assessment and analysis on the impact of regulations, the FSB has started work to establish a framework for assessing the effects of regulatory reform under the direction of G20, and the Study Group exchanged views on how such work should be carried forward.

In doing so, the Study Group was especially concerned about the following: (i) while assessment and analysis of impacts of individual regulations have frequently been conducted by the Basel Committee and other bodies in the form of QISs (Quantitative Impact Studies), etc., comprehensive analysis has not been conducted to see what impacts these regulations as a whole have on the economy and finance; and (ii) whereas the focus of the FSB and other work is mainly ex-post analysis conducted after the introduction of new regulation, ex-ante verification before the introduction of the regulation may be more important as financial institutions and markets react in anticipation of the introduction of the new regulation.

(Necessity of comprehensive analysis)

In the reform up to now of international financial regulations led by the G20 and FSB, given the urgency of preventing a recurrence of financial crises, numerous regulations were developed and implemented successively to deal with individual risks which could cause financial crisis in a relatively short period of time. As a result, although QISs were frequently conducted by the Basel Committee and other bodies in regard to individual regulations, comprehensive assessment and analysis have not been conducted to assess the cumulative or combined effects from the almost simultaneous implementation of these various regulations.

Comprehensive assessment of the cumulative and combined effects of such regulations is not easy to conduct in the process of successive implementation of numerous regulations, and it is almost impossible to quantitatively analyze their effects on the economies and financial markets separately from the effects of other factors. However, even if that is the case, it is not appropriate to abandon such a perspective, and attempts to identify a number of regulations which are expected to have major effects on financial activities and verify the impacts of their introduction should always be made.

(Necessity of ex-ante verification)

In the Study Group, it was pointed out that when the impact of regulation is assessed, forward-looking perspectives should be emphasized. For example, as pointed out by the Federal Reserve Bank of New York Staff Report in December 2016, even if regulations are not a problem when markets are calm, they could cause problems when markets are under stress. In order to foresee these issues and link them to regulatory reviews, it is necessary to conduct simulations beforehand on the impact the introduction of regulation would have on the macro-economy and on the financial and capital markets over all using some techniques.

Of course, it is not easy to analyze the impact of regulations beforehand in this manner. In the Study Group, it was also reported that extracting only the impact of regulation from the dynamic developments in finance and the economy entails difficulties even for regulations already implemented, and there is only limited data which can be used for such analyses. For ex-ante assessment, quantitative analysis is even more difficult.

However, it was reported in the Study Group that even unimplemented regulations are beginning to have effects as financial institutions change their behaviors in preparation for their introduction. If such effects are expected, standard-setting bodies should minimize the possibility of the authorities failures in regulation by having sufficient dialogue with various stakeholders, including financial institutions and market participants, to fully discuss whether there is any alternative measure in the process of developing new regulatory standards.

VI. Conclusion

The Study Group has made a unique endeavor to try to analyze and assess international financial regulations across the various types of financial services businesses from the perspective of the private sector. Going forward, it is hoped

that such discussions will take place further in all countries to widely disseminate the contents of discussions to authorities and to various stakeholders, leading to constructive recommendations on future regulation and supervision.

(Reference) Examples of Fragmentation of Financial Regulation

[Example 1] Current European Capital Requirements Regulation/Directive (CRR/CRD IV)

- **The Capital Requirements Regulation/Directive (CRR/CRD IV) currently applied in the EU have some contents which are more relaxed than international agreement (Basel Accord) such as lighter risk weights for exposures to SMEs, and exempting the recording of CVA risk assets in transactions with business corporations.**

[Example 2] Draft Revised European Capital Requirements Regulation/Directive (CRR II/CRD V)

- **For the revision of CRR/CRD IV currently proposed by EC, more relaxed contents than the international agreement (Basel Accord) are proposed, including further preferential treatments of exposures to SMEs, and the exclusion of the initial margin for derivatives to be settled through CCP from the denominator exposure of the leverage ratio. Moreover, there are some items for which a different implementation schedule from the international agreement is assumed, including the interest rate risk of bank accounts.**

[Example 3] Draft Revised European Capital Requirements Regulation/Directive (CRR II/CRD V) (Requirement to establish "Intermediate Parent Undertaking (IPU)")

- **The draft revision (Article 21(b) of CRD) makes a unique EU proposal to require the establishment of an Intermediate Parent Undertaking (IPU) in EU in the case of G-SIBs or if assets in the EU exceed 30 billion euros with two or more subsidiaries in the EU. This raises concerns that it could encourage the ring-fencing of capital and liquidity, and the division of regulatory frameworks and markets in individual jurisdictions.**

[Example 4] Prudential Regulation in the U.S.

- **In the U.S., a layered approach is adopted, imposing different regulations according to the size of the financial institution. In particular, for large-scale financial institutions, considerably stricter regulations than the international agreement (Basel Accord) are imposed, including G-SIB surcharges and leverage ratios, making them classic examples of so-called Gold Plating.**

[Example 5] Prudential Regulation for Foreign Banks in the U.S.

- **Large-scale Foreign Banking Organizations (FBOs) are required to establish an Intermediate Holding Company (IHC). As with [Example 3], this also raises concerns that it could encourage the ring-fencing of capital and liquidity, and division of regulatory frameworks and markets in individual jurisdictions.**

[Example 6] Internal Total Loss-Absorbing Capacity (TLAC) Regulation

- **The FSB is in the process of formulating international agreement on the details of regulatory requirements of internal TLAC, currently conducting consultations to clarify the regulatory requirements of internal TLAC. Moreover, the FSB's "The Key Attributes of Effective Resolution Regimes for Financial Institutions" (the "Key Attributes") also stipulates the importance of cooperation among home and host authorities in G-SIB resolutions. Nevertheless, some host countries including the U.S. are unilaterally establishing and proposing strict methods for identifying major subsidiaries or required levels of internal TLAC.**

[Example 7] Regulation on Clearing Margin

- **There are differences in the substance of regulations and the timing of introducing them. For example, regarding the variation margin, only four jurisdictions -- Japan, the U.S., Canada, and Europe -- started application on the internationally agreed date of March 1, 2017. There are substantial differences in the status of introduction; some countries such as Singapore, Hong Kong, and Australia have established a six-month transition period, while China and many emerging countries have yet to formulate draft regulations.**

[Example 8] Speech by Mr. Rudin, Superintendent of the Canadian Office of the Superintendent of Financial Institutions (OSFI) (April 7, 2017)

http://www.osfi-bsif.gc.ca/Eng/Docs/jr20170406.pdf

- **Superintendent Rudin of the Canadian Office of the Superintendent of Financial Institutions (OSFI) suggested withdrawal from the international agreement (Basel Accord), saying that "Negotiations for the Basel III review have stalled, and if discussions at the Basel Committee on Banking Supervision (BCBS) do not restart in the near future, OSFI will put forward a Canada-specific plan for improving our capital regime."**

(Reference) Remarks by Key Persons Expressing Concerns about Fragmentation

(1) Speech by Mr. Carney, Chair of FSB (April 20, 2017)

http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech976.pdf

- **There are nascent risks that, if unchecked, could threaten the**

progress of G20 regulatory reforms. These risks include the outcome of Brexit negotiations, the need to complete Basel III revision, and the importance of finishing the job of ending "too big to fail (TBTF)." The global financial system is now at a crossroads.

- **If the fragmentation of regulations hardens, domestic authorities could impose local requirements on domestic entities of foreign banks. If that happens, in a world where many banks are highly interconnected, inefficiencies would be generated.**
- **However, there is another path. This builds on the completion of introducing regulations and cooperation among national authorities. The combination of international agreements and trust among national authorities can create a new global financial system.**

(2) Speech by Mr. Coen, Secretary General of the Basel Committee (May 25, 2017)

http://www.bis.org/speeches/sp170525.pdf

- **Global minimum standards are important. If minimum standards are not agreed upon and implemented, there is a risk that (i) jurisdictions will engage in a race to the bottom in terms of regulatory standards, and (ii) there will be less reliance on the global rules, leading to fragmentation. Both create inefficiencies, complexity, and risks and are therefore undesirable for both banks and regulators. That is why it is so important to agree upon and implement harmonized global standards for global business.**
- **Jurisdictions are free to adopt a standard that exceeds the Basel minimum standards. The practice is often referred to as "gold plating." On the other hand, a deviation below the minimum standard may be unsafe or unsound as it dilutes the global standard to which internationally active banks are held. Over the long term, a departure from the minimum Basel standards can damage the bank's viability, reduce confidence in the banking system and have adverse effects on economic development and growth.**

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(Affiliates and positions of replaced former Members are those at the time of their appointment)

*For discussion topics and summary minutes of the Study Group's each meeting, please see our website (Japanese): http://www.jsri.or.jp/society/society_15.html.