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Challenges in Global Regulatory Reform

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Introduction

It is my great pleasure and honor to be invited to speak at the Mid-Year Meeting of IOSCO's Affiliate Members Consultative Committee this year.

Today, I would like to briefly introduce the main pillars of global regulatory reform we have been undertaking at the Financial Stability Board, and the main financial standard-setters, including IOSCO which is taking up an increasingly important role.

The standard disclaimer is, of course, that any views I express today will be my own, and not necessarily identical to the official views of FSA, Japan or IOSCO.

Progress so far in global regulatory reform and remaining work

First, let me try to assess the overall progress we have been making. Views may differ whether we have achieved a lot in terms of preventing the recurrence of global financial crises by strengthening our financial systems and reforming our financial infrastructures, or not enough has been accomplished so far. While I would tend to subscribe with the former, as a regulator having spent most of my professional career in fighting financial crises during those years, there is probably a general consensus that a lot still needs to be done. The main pillars of reform have increasingly entered the implementation phase as opposed to the rule-making phase during the past 5 years or so, but even in rule-making, many of the reforms require further work in fleshing out the details, and providing transparency and accountability towards global stakeholders and market participants.

Next, let me run through the main pillars of reform, on which the G20 has decided to focus. The G20 places particular emphasis on four main pillars of reform, namely 1) Building resilient financial institutions, 2) Ending “too-big-to-fail”, 3) Shadow banking, and 4) OTC derivatives reforms.

While focusing on completion of those major four pillars of reform, the G20 Australian Presidency has stated that caution needs to be applied when considering the addition of more items on the agenda of global financial regulatory reform outside those four pillars. I fully subscribe to this view, because we need to avoid over-regulation, and focus more on how to foster sustainable economic growth and development.

The first pillar of reform, which is building resilient financial institutions, includes the completion of the so-called Basel III rules as its core element. This strand of work has made substantial progress. Capital rules for banks have been strengthened, and liquidity rules, i.e. the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are either completed or nearing completion. Agreement has been reached on the design of the leverage ratio as a supplementary measure. Implementation monitoring has started jurisdictions entered the phase of implementing the agreed rules. But even in this area, there is a long list of work that needs to be done further by the Basel Committee, and bank stress tests and asset quality reviews are undertaken in major jurisdictions to identify financial institutions still requiring strengthening and taking steps to improve.

The second pillar of reform is ending “too big to fail”. This covers i) the orderly resolution of global systemically important financial institutions, or G-SIFIs, ii) ensuring higher loss absorbency for those institutions, and iii) applying supervisory intensity and effectiveness. While the basic principles and direction of reforms have been agreed and have resulted in substantial reforms in the legal frameworks of jurisdictions, particularly resolution frameworks of jurisdictions, a lot more has to be done in actually developing the rules and arrangements to implement the reforms in the cross-border context.

The third pillar is shadow banking. This is a potentially vast area of reform covering all types of credit intermediation outside the regulated banking sector. Large efforts have been made to identify and monitor the extent of such activities and monitoring the scale of systemic risks that those activities could potentially pose by collecting data and sharing information. Examples of shadow banking placed under particular scrutiny and development of reform measures are money-market funds (MMFs), securitization, as well as repos and securities lending. The relationship between banks and shadow banking are also been addressed through such measures as large exposure rules and consolidation.

The fourth and final pillar of OTC derivatives reforms has been the focus of particular attention by market regulators in recent years. Jurisdictions have made substantial progress in honoring the G20 commitment of introducing central clearing requirements, trade reporting requirements, margin requirements for non-centrally cleared derivatives, and mandatory trading on electronic trading platforms, where appropriate. However, given the inherently cross-border nature of OTC derivatives transactions, further progress is needed in settling the cross-border issues arising from differences in the content and timing of implementing rules across jurisdictions, which give rise to potential inconsistencies and duplications of multiple rules. This is one of the most important challenges for regulators as we enter the implementation phase of the various reform measures, which I will turn to in minute.

Challenges for regulators in the implementation phase

There are, in my view, three particular issues for regulators in implementing the reform measures appropriately as agreed, while preventing actual or possible unintended consequences of the reforms. Those issues are particularly challenging, since they arise despite each of the reform measures are needed and properly conceived, but, when they are taken together, give rise to difficult issues. They may perhaps be called risks of either “silo mentality” or “fallacies of composition” in the implementation phase.

1. Resolving cross-border issues.

This is needed to resolve conflicts, inconsistencies and overlaps between rules of different jurisdictions, when they are implemented across jurisdictions in different ways, and the timing of implementation is not properly coordinated. Examples of most significant issues are the following:

- First, there is the question of how to reconcile differences in the rules as they apply to cross-border transactions and activities. Even if the rules of jurisdictions are essentially converged, they will never be identical, and regulatory approval could still be uncoordinated or lacking. Being compliant with the rules of one jurisdiction could entail a breach of the rules of another jurisdiction. Some forms of deference to regulation and supervision by foreign authorities using such tools as mutual recognition, substituted compliance, or other measures have become necessary, and are being arranged between authorities of different jurisdictions.

- Second, the question of how to prevent risks of market fragmentation, or, vice versa, how to prevent dominance by a small number of major financial institutions or markets is an important one. Concentrations of risks in a small number of financial market infrastructures (FMIs) are a particular challenge. Concentration becomes an issue where there are economies of scale/scope in the activities of market participants and operations of market infrastructures. Such issues may be dealt with by close coordination between authorities in avoiding taking measures that could stifle cross-border activities or create/raise barriers to entry.

2. Assess the cumulative impacts of reform measures and address any problems of possibly overburdening the system, or vice versa, of not taking sufficiently effective measures.

While no regulator can have perfect foresight or conduct a prefect assessment of the cumulative impacts of various reform measures, some steps can be taken to prevent, or, quickly address problems. Examples of such steps may be to calibrate individual measures taking into account the results of extensive and comprehensive quantitative impact studies (QISs). An informed judgment must be made when deciding on the proper calibration of each of the measures. If multiple measures, when taken together, produce, or are likely to produce unintended consequences, adjustments may need to be made.

One of the issues in the minds of regulators is the cumulative impact of reform measures as they affect liquidity in the financial markets, as shortages of high quality liquid assets may occur as a result of tightened bank liquidity requirements as well as capital and margin requirements imposed on market participants. Minimum haircut rules on repo and other securities financing transactions may also relevant in this context.

3. Identify inconsistencies of incentives created by different reform measures, and address them if and when necessary.

In the present organizational structure of financial standard-setting, which is divided between different sectors (i.e. Basel Committee for banking, IOSCO for securities, and IAIS for insurance), conflicting or inconsistent incentives may be created. Cross-check and close coordination between international bodies are needed, and one should make sure adjustments are made when necessary. Although each measure may be justifiable and necessary for strengthening the resilience of the global financial system, in some cases, the measures taken by different authorities may create opposite incentives for certain types of activities. As an example, measures to incentivize central clearing of OTC derivatives transactions, e.g. market regulators imposing higher margin requirements on non-centrally-cleared transactions, may contradict incentives created by banking regulators imposing higher capital charges on exposures to CCPs. In order to deal with such issues, analyses of incentives created by multiple measures need to be conducted by regulators coordinating across sectors, and constantly updated as implementation progresses.

I must also add that such challenges for regulators have been amplified by the impact of technological change and financial innovation. The increasing ease for market participants to conduct cross-border transactions at high speed has had various effects and implications for market regulation, in particular. The development of new means of electronic payment has prompted regulators to study the appropriate manner of dealing with them, as measures to strengthen the financial system may be undermined by the facilitation by new technology of shifts in activities and regulatory arbitrage.

<u>Implications for Asia</u>

One question we have often been asking recently is whether and how those global regulatory reform measures are relevant for Asia, and what are the particular challenges for Asian regulators.

There is no doubt that each of the pillars of reform is relevant for Asia, despite the fact that the most recent global financial crisis did not find its primary causes in the region per se. Taking measures to build a more resilient and stable financial system globally is certainly in the interest of Asian markets and jurisdictions, and are being taken forward. However, the relative emphasis of the measures, or the capacity-building aspect of financial reform may be more relevant in Asia, as compared to Europe or the United States, for example. In Japan, it is very much part of our growth strategy that we need an efficient and stable financial system that supports sustainable growth of the entire economy.

To be sure, in implementing global regulatory reform, we need to be mindful of the specific circumstances and features of the financial systems in each region. In emerging Asia, in particular, an appropriate balance needs to be struck between strengthening the financial system which has traditionally been bank-centered, and developing efficient and vibrant capital markets providing an alternative means of finance to SMEs and start-up firms.

Financial inclusion is also an important policy objective in emerging Asia, and shadow banking may be a promising means to promote financial inclusion. Therefore, a regulatory model for shadow banking that is appropriate for other regions may not be applicable in emerging Asia. Regulation of each type of shadow banking needs to be proportionate to the systemic risk posed by the activity, and not hinder useful development of the various activities that fall under “shadow banking”. The development of liquid and efficient derivatives markets may take preponderance over the need to apply tighter regulation in emerging Asia. At least, regulatory measures may need to be designed and implemented in tandem with efforts to build the required infrastructures.

In fact, those arguments are, more or less, relevant for Japan as well. In Japan, the current and ongoing growth strategy includes the increased use of market-based finance, and the use of alternative means of finance such as crowd funding. Such measures need to be carried forward in parallel with the G20 regulatory reform measures I described earlier, in a balanced manner.

Conclusion

In concluding my speech, I would like to again come back to a fundamental principle of financial regulation that a well-regulated financial system must support sustainable economic growth and development. An appropriate balance needs to be struck between introducing tougher regulation to make the financial system more resilient and avoiding excessive or overly burdensome regulation that prevents the financial system from functioning efficiently and stifles useful innovation. In some cases re-regulation is needed, and in other cases deregulation may be appropriate for promoting efficient markets.

Another observation may be that internationally agreed standards and principles should form the basis for global financial regulatory reform. Country specific independent measures should be avoided as much as possible to the extent that they have the potential to cause cross-border conflicts, inconsistencies and overlaps. The international standards themselves need to avoid an overly prescriptive approach, since the rules will never be identical across jurisdictions. Some flexibility is warranted to accommodate national measures catered for different circumstances and specificities of each financial systems/markets in different jurisdictions.

From this point of view, when we monitor the implementation of internationally-agreed reform measures in jurisdictions, the assessment process needs to take a deep-dive into the different circumstances and specificities in each region/country before drawing conclusions.

Regulation is not an end in itself; it is only a means of securing sound and efficient financial systems that provide vital services to the entire economy. While this may sound too obvious, I sometimes feel our discussions over the numerous details of financial regulatory reform risk losing sight of this overarching objective. I would like to conclude by stating that if there is any piece of regulation that would appear out of place in light of this fundamental objective, we should have the courage to revisit it. In a changing world, businesses must change, for sure, but regulation must also change accordingly.

Thank you very much for your kind attention.