

Tackling Fragmentation

Japanese officials have pledged to address market fragmentation during the country's presidency of the G-20 this year. Ryozo Himino, vice minister for international affairs at the Japanese Financial Services Agency, sets out his vision for reducing fragmentation.

IQ: When you spoke at ISDA's annual Japan conference in October 2018, you explained the need to address the risks of market fragmentation and to take action. Has there been any progress since then?

Ryozo Himino (RH): There has been significant progress at the Group-of-20 (G-20), the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO).

On December 1, 2018, G-20 leaders declared at the conclusion of the Buenos Aires summit that they would address fragmentation through regulatory and supervisory cooperation. On the same day, Japanese finance minister Taro Aso announced that addressing market fragmentation is a priority for the Japanese G-20 presidency in 2019. At their meeting in Tokyo in January, G-20 finance and central bank deputies supported Mr. Aso's plan. Addressing market fragmentation is back on the G-20 agenda.

In its 2019 work programme, the FSB states that it will "explore issues around market fragmentation, including what it is, under what conditions it can emerge, and its potential impact". It will also "identify tools that national authorities and standard setters can use to address the risk of market fragmentation arising from regulatory or other causes – in particular, when such fragmentation could adversely affect financial stability".

On January 28, the FSB hosted a workshop in Basel in collaboration with IOSCO. Many ISDA members were invited, along with leading academics, exchanges, central counterparties, asset managers, regulators, central bankers and senior officials of finance ministries. We had a very good discussion. ISDA chief executive Scott O'Malia participated actively in the workshop.

IOSCO is following up with its 2015 toolkit for cross-border regulation, which includes discussions on the processes and issues in assessing foreign regulatory regimes. The follow-up work is jointly chaired by Commodity Futures Trading Commission chairman J. Christopher Giancarlo and Japanese Financial Services Agency (JFSA) deputy commissioner Jun Mizuguchi.

I would say that the progress so far has exceeded my expectations last October.

IQ: Why do you think the G-20, the FSB and IOSCO have decided to address market fragmentation?

RH: Attaining an open and resilient global financial system has always been the common goal of the global regulatory community. Addressing market fragmentation is consistent with that objective.

Reforms to enhance resilience are now largely in place, and, as Randal Quarles, newly appointed chairman of the FSB, said in Hong Kong in February, we now need to ask ourselves three key questions. First, to what extent are those reforms having the intended effects in building a more resilient financial system? Second, have those reforms had any unintended, adverse effects that we can address? Third, can we achieve a strong level of financial resilience with reforms that are more efficient, simple, transparent and tailored?

Reforms implemented with cross-border discrepancies, overlaps, desynchronisation or competition can have unintended consequences for financial stability by fragmenting markets, reducing market liquidity and trapping pools of capital and liquidity resources. They could make problems worse, particularly during systemic stress.

They can also make reforms less efficient and more complicated. Excessive fragmentation can harm the G-20 objective of sustainable, balanced and inclusive growth by hindering the efficient allocation of capital globally, limiting services available to consumers and entrepreneurs, and unduly increasing compliance costs.

IQ: A recent ISDA paper lists 21 examples of derivatives market fragmentation caused by regulatory discrepancies, overlaps, desynchronisation and competition. Can we expect to see specific proposals to eliminate at least some of them?

RH: I do not intend to reopen already agreed standards or roll back regulatory reforms. Rather, I want to find ways to implement the agreed reforms without causing unintended market fragmentation.

I do not aim to eliminate jurisdictional differences or gold plating. Regulators and supervisors are accountable primarily to their own national depositors, investors and consumers. Their actions should reflect national policy priorities, cultural differences and their stage of development. After all, the last global crisis has shown that the buck still largely stops with national governments.

So what should we do? In trying to address fragmentation, one tends to focus on convergence in regulations. It is indeed encouraging that some authorities have recently indicated their willingness to review national regulations.

However, amending regulation that has already been set is not the only way to address fragmentation. Sometimes it is easier to do so by having discussions earlier in the process of setting regulation. This could help focus on preventing future inconsistencies.

Even if regulatory gaps remain, we can try to enhance supervisory cooperation and improve the interface between different frameworks. We can look at various phases in regulation and supervision: the development of international standards, national rule-making, processes to recognise foreign regulatory regimes, and daily supervisory activities. We may want to design processes and approaches fitted to each of the phases.

Sometimes, small, practical steps can make a difference. A lighter, simpler process tends to work better than one that is bigger and more cumbersome. National authorities may not be able to promise to solve problems, but they may be able to commit to listening.

Addressing market fragmentation is not an easy task, as it involves bridging between globalised financial markets and national regulatory and supervisory governance. But if we are flexible and innovative, we can make a difference. And starting to take specific steps in the right direction is particularly meaningful in today's world.

IQ: What do you expect to see?

RH: All the elements listed in the FSB work programme are important, but I would particularly like to see improvements in processes and approaches for regulators, supervisors and international standard-setting bodies, which can help prevent future proliferation of market fragmentation.

IQ: Can you be more specific about processes and approaches?

RH: At this brainstorming stage, we should try to explore as many potential ideas as possible. Let me try to set out some ideas, just as illustrations.

For example, the Fundamental Review of the Trading Book was recently finalized by the Basel Committee on Banking Supervision. I suppose national authorities will produce domestic regulations for their banks and develop data reporting requirements to monitor their implementation. Global banks will then start to fill in multiple reporting templates that are almost the same but not exactly, and submit them to authorities in the jurisdictions in which they operate. Meanwhile, the Basel Committee uses quantitative impact study templates to collect data from member authorities during the standard development phase, and supervisory reporting system templates during the post-implementation phase.

I wonder if interested Basel Committee members could work together to develop a non-binding model of a supervisory reporting template that could be used by multiple national authorities. These national authorities should be free to modify the model template, but we might be able to reduce unnecessary unintended differences.

Improvements could also be made to increase the efficiency and efficacy of cross-border interaction during the domestic rule-making process. Let me take the case of Japan. When introducing a new regulatory framework, the JFSA typically first sets up an advisory group composed of various stakeholders and experts. After many rounds of discussion, the group gives recommendations to the JFSA. The JFSA drafts a bill and the cabinet submits it to the parliament. If the law is passed by the parliament, then the JFSA drafts the implementing regulation, publishes the draft for public comments and finalises it, reflecting comments received.

It would be best if concerns on the cross-border consequences of these regulations are put on the table at the point at which the advisory group is formed. But typically, we are made aware of concerns after the implementing regulations are finalised. I suppose similar things are happening across the world – for instance, people start submitting letters after the European Commission has submitted its proposal to the European Parliament and the Council of the European Union.

I wonder if standard-setting bodies could operate as fora through which national authorities could share stylised domestic rule-making processes so that efforts to coordinate can be made more efficient. If information could be shared on projects and plans in the pipeline that might have cross-border implications, then that would be even better.

Maybe the recognition process could also be streamlined and made more efficient. The JFSA has been responding to many questionnaires to have our regulatory framework recognised by overseas authorities. Usually, the questionnaires are based on the overseas authorities' own domestic regulations. Then the International Monetary Fund's financial sector assessment programme team or the standard-setting bodies' peer review team give us long questionnaires based on the international standards.

There has been a case where the regulators of Australia, Hong Kong, Japan and Singapore developed a common questionnaire based on the relevant international standards to help each national authority's decision on bilateral recognition. I wonder if we can go one step further. After a new international

standard is agreed, the standard- setting body in charge could produce a basic questionnaire that national and international reviewers could use as a basis for their own questionnaires, subject to necessary additions or modifications. It would be desirable if the questionnaire could be designed to focus more on the outcome of regulation, rather than as a paragraph-by-paragraph checklist.

IQ: So you hope to see ideas like these agreed by the G-20, the FSB or IOSCO?

RH: I would prefer to see many other good ideas put on the table by my regulatory colleagues and other stakeholders. I particularly look forward to ISDA's further contributions.