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Study Group on International Financial Regulations
Japan Securities Research Institute

Summary

Opinion Paper by Study Group on International Financial Regulation

In the Study Group on International Financial Regulation, members from the banking, securities, insurance and asset management sectors; senior officers from trade associations and market operators, etc.; as well as researchers and experts gathered to discuss and share opinions and concerns about a wide range of issues related to international financial regulation, independent from their positions and the business categories they belong to.

On the basis of such discussions, this Opinion Paper not only compiles the progress to date and the issues regarding the international financial regulatory reforms but also presents the ideal design of international financial regulation and recommends measures to achieve it.

The following are the composition and main messages of this Opinion Paper:

I. Purpose of the Study Group on International Financial Regulations

Background, purpose, etc. for establishing the Study Group.

II. Reform of International Financial Regulation after the Financial Crisis:

Current Status and Evaluation

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.

At present, as the international financial regulatory reforms in the aftermath of the global financial crisis move from the design stage to the implementation stage, there is a concern that a large amount of unintended consequences would arise which had not been expected beforehand. This is because many regulations have been developed and established simultaneously in a relatively short period of time, causing some contradictions, duplication, gaps, and differences in the timing of

implementation, etc. among countries and regions, which have become noticeable in the implementation stage.

On the other hand, we are seeing moves to apply stricter (or looser) regulation than international standards by introducing jurisdiction-specific regulation not embodied in those standards. Such moves are resulting in inconsistent national regulations and the fragmentation of regulations, which is in turn heightening the risk of fragmenting global financial markets. As regulatory reforms are entering into the full implementation stage, it appears to be the appropriate timing to assess again the entirety of achievements and effects of regulatory reform, and make revisions where necessary. Under these circumstances, while the importance of international standards has further increased, the transparency of the standard-setting process, its accountability, and the provision of sufficient opportunities for expressing opinions are important issues for all countries concerned.

III. The Ideal Design of International Financial Regulation

Certain principles need to be established as guideposts for the ideal design of regulation in the design stage of international financial regulation. They include a requirement to follow international standards in order to ensure consistency of regulation among different jurisdictions, consistency between the objectives and the substance of regulation, and evidence of the need for regulation. This Opinion Paper has compiled such principles in the form of “Ten Principles of International Financial Regulation” (see below). Such principles should ideally be agreed upon and adopted by international fora leading the process of international financial regulatory reform such as the G20 and FSB.

IV. Recommendations concerning Individual Regulations

The Study Group has also examined various individual regulations which have global effects. They are compiled by the type of business concerned (Basel rules and regulations on insurance and asset management businesses); by country and region (U.S., Europe, and regulatory changes resulting from BREXIT); as well as by subjects such as over-the-counter derivatives and financial benchmarks, for which the issues are individually pointed out and recommendations made.

V. Recommendations for International Financial Regulations

Lastly, six proposals are presented in order to solve various issues of international financial regulations which have been discussed so far. They are summarized as follows:

1. Development and Management of International Standards

In the 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.

In the future, those international standards may be re-positioned as treaty-based standards with stronger normative powers. In such cases, it will be necessary to pursue an optimal combination of the principle-based approach and the rule-based approach by making use of the merits of the principle-based approach rather than putting all the details into the treaties.

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

While international standard-setting bodies, including FSB, BCBS, IOSCO and IAIS, have been endeavoring to enhance transparency and accountability, 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.

3. Towards a More Consistent Regulatory System

Some parts of the current system of international financial regulation lack an overall vision, consistency, and integrity. While the necessity of regulation is understandable for each individual item, when they are applied together, they may cause contradictions, duplications, gaps, and differences in the timing of implementation which cannot be said to have been fully taken into consideration.

Given such a situation, an assessment of the effects of regulation should not be just ex-post; an ex-ante assessment to confirm that the advantages of introducing regulation will sufficiently exceed the disadvantages should be made. Regarding such studies, it is hoped that an international examination system is developed, for example, by outsourcing the analysis to research institutes, etc. with specific mandates.

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

It is desirable for national regulations to 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 have retain the characteristics 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 or by making a determination of equivalence, thereby ensuring the efficiency and consistency of regulations and supervision through international cooperation. Moreover, regarding these processes, procedures could also be standardized and made impartial by international standards, and a standardized processing period can be established.

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 not allow political elements to affect the assessment process.

Furthermore, for the introduction of new regulation, it could be agreed among countries in the provisions of economic partnership agreements, etc. that a process of allowing such processes be established without exception and in advance, with the necessary procedures to be finished before the implementation of the new regulation.

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

In future regulatory reforms, better regulatory systems should be aimed for, taking time to discuss the overall vision. 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, the entire implementation process is left to individual countries and jurisdictions.

Accordingly, the current reform process should, in the future, have a legal basis which will further reduce differences in the substance and timing of implementation in individual countries and jurisdictions. Moreover, in order to avoid differences, there could be institutional flexibility for individual countries to postpone implementation even just before the implementation due date, or to adjust the substance. However, such flexibility in the implementation stage of regulation should be incorporated in the rules beforehand, in the design stage of the financial regulation.

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

Assessment and analysis of the impacts of individual regulations have been conducted by the Basel Committee and other bodies. However, comprehensive assessments and analyses have not been conducted on the cumulative or combined effects arising from these regulations. In conducting such comprehensive assessments, it is extremely difficult to quantitatively analyze the impacts on the economy and financial markets separately from the effects of other factors. However, it should at least always be attempted to identify a number of regulations which are expected to have major effects on financial activities and verify the impacts of their introduction.

Moreover, when the impact of regulation is assessed, a forward-looking perspective is also important. It is necessary to conduct simulations beforehand on the impact the introduction of regulation would have on the macro-economy and the financial and capital markets overall.

(Ten Principles for International Financial Regulation)

- 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.**