Remedies for conflicting regulatory demands

Interview with Ryozo Himino, Vice Minister for International Affairs, Financial Services Agency, Japan, published in the EUROFI Magazine on September 5, 2018

What are the main issues and related impacts regarding the consistency of the implementation of global banking and financial standards across the different parts of the world?

The global regulatory community has pursued two objectives: making the financial system more resilient and avoiding market fragmentation. Your question relates to the second objective. On this front, we have both good and bad news.

The good news is that, after ten years of intensive work and overcoming several critical impasses at Basel meetings, we now have a new set of globally agreed regulatory standards. It is also good news that, contrary to some earlier speculations, the US financial regulators have continued to emphasize the important roles that multilateral regulatory cooperation plays.

The bad news is that the trust between authorities has not been lifted to the level needed to smoothly implement cross-border resolution of systemically important financial institutions. It is not uncommon that an authority, which adopts a single-point-of-entry strategy when acting as a home authority, flexes its muscle for ring-fencing when acting as a host authority. In addition, Brexit may inadvertently lead to a regulatory framework less tolerant of the cross-border provision of financial services by third-country firms.

What should be the priorities to address this situation?

Internationally agreed standards are minimum standards and would not prevent national authorities from doing more. What one can do is, when assessing the equivalence of other authorities' national regulation with one's own, to benchmark with internationally agreed standards, not with one's own gold plating or unique approaches, and to focus on the outcome of the regulation, not on specific articles or languages.

In addition, I wonder if countries could install a process to address conflicting national regulations and supervisory actions. We cannot eliminate differences between national regulations. Neither can we eliminate the extraterritorial effects of national regulations. But we should at least try to address outright conflicts.

There are many cases of conflicting requirements. Authority A may request a bank never to tell anyone about the forthcoming sanctions, but Authority B might impose another sanction on the bank for not having reported to Authority B about Authority A's action in advance. A host authority's demand to establish a single local holding company for all operations may conflict with the home authority's demand to separate corporate chains for different activities. A home authority might demand that the global KYC control has to be audited by the headquarters, while a host authority might not allow personal data to leave its territory.

What if countries agree on a simple process to address conflicts between national regulations? First, a financial institution operating in two countries and facing conflicting requests from two regulators submits a letter describing the conflict to the two regulators. Second, the bank and the two regulators will have a two-hour conference call within three weeks of the submission of the letter. Third, within six weeks, each regulator will write a short response and publish an outcome document, which comprises the bank's initial letter and the two responses, on their websites. Each of the initial letter and the two responses shall be no longer than three pages.

Is that all? Can this eliminate cross-border inconsistencies?

No, it cannot. But the proposed process will at least make policy makers aware of the pain they create. The process can be agreed bilaterally or can be incorporated in a multilateral memorandum of understanding. We can also choose to task, say, the secretariat of the Financial Stability Board to act as a repository of bilateral and multilateral MOUs and of outcome documents on individual cases. It might also be useful if one of the FSB's Standing Committees could review the outcome periodically. A stronger process involving arbitrators can also be designed, but my preference is avoiding a burdensome, legalistic or binding process. I hope to use the Vienna Eurofi to try out this idea with my European and other colleagues.

What are the key new areas where global coordination is necessary (cyber risks, digitalization/fintech, sustainable/green finance, macro prudential

frameworks…)?

Many key new areas do not fit well with the structure of the existing fora for global coordination. Let’s take the example of crypto assets. The financial stability aspects of crypto assets are addressed by the FSB, the customer protection and market integrity aspects by IOSCO, banks’ exposure to crypto asset businesses by the BCBS, the use of crypto assets for payments by CPMI, and the money laundering and terrorist financing issues by FATF. A process to integrate the various pieces of this mosaic into a package of coherent policies is needed.

The regulatory authorities have only four options to deal with crypto-asset businesses: i) prohibit, as China and India do, ii) regulate, as Japan does, iii) monitor, as the FSB has started to do, or iv) ignore. In practice, the various aspects mentioned above cannot be considered in isolation when a regulatory authority chooses one among the four options. There is a mismatch between the structure of the existing fora and the cross-sectoral and cross-border nature of the issue.

More widely, in a slower moving world, a three step approach to design regulation has worked reasonably well: i) regulators talk with the industry to find the status quo ii) they design regulations, and iii) the industry starts to think about how to implement them. In a faster moving world, however, this approach may make regulators lag behind and allow the damage to grow. On the other hand, if regulators aim to prevent every possible future problem, they may unduly stifle innovation. A more synchronized process may be needed, where regulators and the industry identify emerging issues and solutions together. There is a mismatch between the existing regulator-industry relationship and the speed and potential of innovation.

What do you think can be a remedy for such mismatches?

There may be several useful things we can do. Compiling a crypto-regulators’ directory which describes, for each jurisdiction, which regulator (central bank, capital market regulator, banking regulator, AML/CFT authority…) do what (prohibit, explicitly regulate, interpret and apply existing general framework, monitor…) for which policy objectives (financial stability, customer protection, market integrity, AML/CFT…) may lay the groundwork for cross-border knowledge sharing and cooperation.

A roundtable of representatives from the financial and information technology industries, academia and regulators may also be useful in mitigating the two mismatches. The Japan FSA plans to host a crypto asset roundtable inviting regulators, innovators and academia in September and I hope it may work as a testing of a prototype.

A more ambitious endeavor could be to come up with a to-do list a common list of issues to be addressed and key considerations and trade-offs in designing solutions. If regulators can produce a common set of principles for addressing crypto-asset businesses, such would also be valuable.

10 years after the 2008 financial crisis, the leverage of the economies has considerably increased: what are the consequences and threats for the financial systems? Taking into account the G20 regulatory reforms, is the financial system up to the vulnerabilities created by such a level of public and private leverage?

This question is about the first of the two objectives I mentioned at the beginning; making the financial system more resilient. Banks now have much stronger capital and liquidity buffers. The derivatives markets are reformed and are now less likely to be a major channel of contagion. We have come a long way indeed, but, if we are to attain lasting financial stability, we should aim to build an economy which can attain full employment and avoid deflation without relying on the continuous build-up of leverage. Banking regulators alone cannot achieve this, but they may be able to make their own contributions.

After the banking crisis in the late 1990s and early 2000s, Japan attained financial stability but until recently the economy continued to stagnate. Learning from this experience, the JFSA has been trying to design a supervisory approach which rigorously pursues financial stability but at the same time is least constraining to growth and innovation. Our current thinking is summarized in JFSA’s supervisory approaches – Replacing checklists with engagement, published in June. It is not easy, but we will keep trying.