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Introduction

It is my great pleasure and honor to be invited to speak at the Asia Pacific Chief Risk Officers Forum hosted by the Institute of International Finance (IIF).

Today, I would like to briefly introduce the main pillars of global financial regulatory reform at the Financial Stability Board (FSB) and the main financial standard-setting bodies (SSBs). Then, I would like to present some important challenges for regulators in this reform effort, and to describe some of our viewpoints as an integrated financial regulator.

The standard disclaimer is that any views I express today will be my own, and not necessarily identical to the official views of the FSA or any other institution I am associated with.

Progress in global financial regulatory reform and remaining work

First, let me try to provide an overview of the overall progress we have been making so far. Views may differ as to 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 whether not enough has been accomplished so far. As a regulator having spent most of my professional career in dealing with financial crises during the past quarter of a century, I am tempted to associate myself with the former view, i.e. a lot has been achieved, but there is probably a broad

consensus among global regulators themselves that a lot still needs to be done. The main pillars of reform work have increasingly entered the implementation phase, as opposed to the rule-making phase during the past five or so years. However, even in rule-making, many of the reform measures require further work in fleshing out the details, and providing transparency and accountability towards global stakeholders and market participants.

Next, I would like to 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.

In focusing on the completion of those four major pillars of financial regulatory reform, the G20 Australian Presidency has expressed caution in adding any more items on the agenda for global financial regulatory reform besides those four pillars. I fully subscribe to this view, because we would need to avoid over-regulation, and be better off focusing on how to foster sustainable economic growth and development through implementation of the agreed reforms than anything else.

The first pillar of reform is about building resilient financial institutions, including the completion of the so-called Basel III rules as its core element. It is fair to say that this strand of work has made substantial progress. Capital rules for banks have been strengthened, and liquidity rules are now being finalized, i.e. the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) by the end of 2014. Agreement has been reached on the design of the leverage ratio as a supplementary measure to the risk-based capital ratio. Implementation monitoring has started for jurisdictions having entered the phase of implementation of the so-called Basel III.

But even in this area, there is a long list of work that needs to be

done further by the Basel Committee. This includes further work on the Net Stable Funding ratio (NSFR) and on the Interest Rate Risk in the Banking Book (IRRBB) which I will refer to later.

One should also take note that, in parallel with the rule-making and implementation work I just mentioned, bank stress tests and asset quality reviews are now being undertaken in major jurisdictions to identify the financial institutions still requiring a strengthening of their capital and liquidity positions, and to take steps to improve the quality of their assets/liabilities and risk management practices.

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 of the resolution frameworks of jurisdictions, a lot more must be done in actually developing the rules and arrangements to implement the required reforms in the cross-border context. The FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions (the Key Attributes)" provides useful guidance for jurisdictions in designing and implementing those reforms, but further work is needed.

The third pillar is shadow banking. This is a potentially vast area of reform covering all forms of credit intermediation outside the regulated banking sector. Large efforts have been made to identify and monitor the extent of such activities and assess 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 is also being addressed through such measures as large exposure rules and consolidation.

The fourth and final pillar of reform, i.e. 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 a minute.

Challenges for regulators in the implementation phase

There are, in my view, three particular challenges for regulators in implementing the reform measures appropriately as agreed, while preventing actual or possible unintended consequences of those reforms. The issues are particularly challenging, since they arise despite each of the reform measures are needed and properly conceived, but, when they are taken together, they give rise to difficult issues. They may perhaps be called the 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 where the timing of implementation is not properly coordinated. Examples of the 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 directly entail a breach of the rules of another jurisdiction. Therefore, 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. This is particularly the case with OTC derivatives reforms, as cross-border activities are prevalent in this area, but similar issues arise in other areas, as well.

- 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, i.e. how to prevent the risks of over-concentration, is an important one. Concentration becomes an issue where there are economies of scale/scope in the activities of market participants and operations of market infrastructures. Concentration of risks in a small number of financial market infrastructures (FMIs), particularly central counterparties (CCPs), is a major challenge. 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. Assessing the cumulative impacts of reform measures and addressing 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 could be taken to prevent, or, quickly address any 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 might 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 be relevant in this context.

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

In the present organizational structure of financial standard-setting, which is divided between bodies responsible for 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 needs to make sure that adjustments are made when and where 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 bank 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 appropriate manners 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 across entities and borders.

Some specific reform measures under development

i) Net Stable Funding Ratio (NSFR)

Now, I would like to touch upon a couple of topics that concern regulatory reform measures currently under development. Again, I should state the disclaimer that any views I express today are my own, and, for these areas, preliminary at best. However, since I believe transparency is required in the course of developing those regulatory measures that have the potential to impact industries and market participants quite significantly, I would give it a try.

The first subject is the Net Stable Funding Ratio (NSFR), being developed as a part of the Basel III rules. As you are probably aware, the NSFR is conceived as a measure to properly manage the maturity mismatch between a bank’s funding and its assets. When properly calibrated, it should contribute to stabilizing the supply of and demand for liquidity of banks. The Basel Committee issued in January of this year a consultation document containing revisions to the NSFR rules proposed in December of 2010.

While I do not have time to go into the details of the document, a large number of comments were submitted from stakeholders in the consultation, and they are now being analyzed in preparing a revised

set of rules for final approval by the Basel Committee.

A major concern expressed in the comments from industry was the impact of the rules on the cost of secured lending to non-bank financial institutions. Under the treatment as proposed in the January 2014 document, there is a sizable difference in the required stable funding for secured lending to banks as opposed to that to non-bank financial institutions. According to those comments, the liquidity of the government bond market, for example, would be adversely affected, due to the presumably higher cost of borrowing for non-bank financial institutions active in this market.

This topic is still under discussion within the Basel Committee, so I should refrain from making definitive statements on the topic as of today. The unavailability of adequate data also makes it difficult to make proper assessments of the likely impact on the markets.

However, there is certainly a need to carefully consider the impact of this measure, which could also incentivize non-bank financial institutions to turn to other sources of funding which could be even more unstable than bank lending. I would favor a careful consideration of this issue within the Committee in finalizing the rules text for the NSFR.

ii) Interest Rate Risk in the Banking Book (IRRBB)

The other subject I would like to touch upon is the question of interest rate risk in the banking book (IRRBB). Currently, IRRBB is covered under Pillar 2 of the Basel framework, and in Japan, it is incorporated in the so-called Early Warning System. The primary reason for this treatment is for ensuring that the banks themselves individually manage this risk properly in accordance with their risk profiles, and supervisors will ensure that the risk management is appropriately administered on a continuous basis.

Last year, the Basel Committee set up a sub-group called the

Task Force on Interest Rate Risk (TFIR) to examine options for capturing IRRBB within the capital framework. The work has been given impetus by the fundamental review of the trading book already undertaken by the Basel Committee as a result of serious issues perceived to have arisen from arbitrage opportunities between the trading and banking books. It was pointed out that a major contributor to the creation of such arbitrage opportunities was the differentiated capital treatments applied to essentially identical risks arising in either side of the boundary between the two books. The other motivation was the recognition that the global environment of historically low interest rates could change quickly and unexpectedly, with the potential of severely adverse consequences on financial institutions holding large fixed-income portfolios.

At this stage, the TFIR is focused on the question of how to capture IRRBB, i.e. the measurement of risks arising from sudden changes in interest rates. The issue of whether to require capital treatment under the so-called Pillar 1 rules, as opposed to continue with the current Pillar 2 approach albeit with some more normative guidance is something put on hold for the moment. Once the measurement issue is dealt with, the Basel Committee will move to deciding the capital treatment.

Before anything may become part of the framework, it would have to be put out for consultation. In my current understanding, the consultation paper would go out towards the end of this year, at the earliest.

We believe that in measuring IRRBB, it is important to:

i. Reflect the local interest rate environment – the level and volatility of interest rates differ quite substantially across jurisdictions and currencies;
ii. Consider both the asset side and the liability side – in particular, the existence of core deposits should be taken into account appropriately; and,

iii. Take into account net interest income, in addition to measuring the economic value of balance-sheet assets and liabilities.

In other words, any new treatment of the banking book should not be a simple extension of the tighter treatment of the trading book.

It should be beneficial for both regulators and industry to improve the measurement of IRRBB, as it enables them to be better prepared for sudden hikes in interest rates, and to take pre-emptive measures, promptly if necessary. Any additional capital charges that a new requirement would entail must be reasonable and proportionate to the risks involved. In this sense, there is still some doubt as to whether a globally applicable numerical minimum capital charge could be devised and implemented for IRRBB.

In any case, the impact of any change to regulatory treatment would need to be carefully assessed through a QIS exercise. As in past revisions to the Basel capital accord, sufficient transition periods and/or phased-in implementation would need to be considered if the market impact is expected to be material.

The Asian Financial Partnership Center (AFPAC)

Before closing my remarks, I would like to mention a few words about an initiative we recently started at the Financial Services Agency of Japan (JFSA). With the objective of supporting further development of Asia’s financial markets by promoting stronger ties between market participants and authorities of the region, we established the Asian Financial Partnership Center (AFPAC) on April 30 of this year.

The AFPAC is conceived as JFSA’s nerve center for our technical cooperation projects in supporting the development in Asia of the necessary legal frameworks, financial market infrastructures including payment and settlement systems, as well as technical expertise in financial regulation and supervision. More specifically,

the AFPAC invites government officials from Asian financial authorities to work at the FSA as Fellows, and to engage in day-to-day regulatory/supervisory work, as well as to conduct research work on subjects related to financial regulation and supervision in Asia. The focus will be on enhancing closer ties between Asian markets and authorities to facilitate financial market development, and to ensure the integrity and stability of Asia's financial systems and markets.

It is our hope that the AFPAC will, in the years to come, contribute significantly to capacity building and financial inclusion within Asia, and help the internationalization and re-activation of the Japanese financial markets, as well. Through its multiple functions, the AFPAC could support foreign financial institutions and market infrastructure operators wishing to enter the Japanese market by providing cross-jurisdiction information on regulatory frameworks and entry requirements. Developing and expressing a stronger "Asian voice" at international meetings could also be an objective of AFPAC's work.

Conclusion

In concluding my speech, I would like to come back to the 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 and competitive markets.

Another observation I would like to make is 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, since 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 would never be identical across jurisdictions given the significant differences in the structure of financial systems and in market conditions across jurisdictions. Some flexibility is warranted to accommodate national measures catered for different circumstances and specificities of each financial system/market in different jurisdictions.

Thank you very much for your kind attention.