Changing Dynamics - How should regulators respond to new challenges

Speech by Shigeru Ariizumi, Vice Minister for International Affairs, Financial Services Agency, Japan, at the "Eurofi High Level Seminar 2024" on February 21, 2024

[Introduction]

Hello everyone, I am very pleased to be here today and first would like to thank David Wright and the team at Eurofi for inviting me to this High Level Seminar in the historic and beautiful city of Ghent.

As all of us here are aware, our world is becoming more integrated, not only in terms of finance but more broadly. For example, in the area of goods, the increasing volume of global trade and the importance of global supply chains are well-known evidence. In the area of finance, we have witnessed a complete transformation during the recent decades, particularly before and after the Global Financial Crisis, underpinned by rapid financial innovation and the need to tackle climate change. However, it is ironic that the more we are becoming integrated, the world seems to be more fragmented.

The recent global developments have amplified such fragmentation. Not to mention the COVID-19 pandemic, structural shifts such as intensifying geopolitical tensions, elevated energy prices, and mounting pressure on global supply chains have all exacerbated this trend.

This has become one of the pressing policy agenda at hand. The recent report by the International Monetary Fund (IMF) has sounded the alarm on the risk of geo-economic fragmentation. The G7 and G20 Presidencies are both eagerly looking into this. But fragmentation is not confined to the economy as-a-whole but it is everywhere including in the financial sector.

Today, I would like to talk about the changing dynamics we are seeing in the world of finance and how regulators should respond to it.

As you know, market fragmentation has long been recognized as a challenge in the area of financial regulation, and financial regulators have striven to make the global financial system more resilient and to maintain an open and integrated structure. When introducing new regulations to this end, there have been efforts to minimize market fragmentation, through continuous jurisdictional coordination and cooperation.

[Market Fragmentation]

Robust international standards and international coordination and cooperation are important to avoid fragmentation. At the heart of this role is the Financial Stability Board (FSB) and the standard-setting bodies (SSBs). Japan, during its presidency of the G20 in 2019, identified 'addressing market fragmentation' as one of its top priorities, and has continued to lead discussions at the FSB and elsewhere. Since then, the FSB, the International

Organization of Securities Commissions (IOSCO) and other organizations have been working on this issue, and to this day, IOSCO is following up on the issue on a regular basis. I would like to thank everyone involved for their efforts.

Unfortunately, we may be witnessing a new surge in fragmentation due to emerging technologies, and challenges that all of us on this planet face. The changing dynamics are making it necessary to revisit the issues that we discussed intensively in 2019 to 2020. Let me touch upon two notable developments, crypto assets and stablecoins as well as sustainability issues such as climate change. Then I will briefly mention Basel III implementation.

[Crypto-assets and Stablecoins]

First I will talk about crypto-assets and stable coins. We all know about the benefits and the risks associated with financial innovation, given its remarkably rapid progress and its borderless nature. It is always important to remind ourselves of the importance to achieve policy objectives such as financial stability and investor protection, in a way that does not hinder innovation or growth, but rather promotes them.

The world of crypto assets can easily be fragmented. This could be attributed to; firstly, differences in regulators' emphasis on regulation and innovation; secondly, rapid innovation and lastly borderless characteristics. These aspects have prompted regulators to urgently come up with an appropriate global response.

The FSB and IOSCO swiftly discussed and issued high level recommendations last year on the regulatory and supervisory framework on crypto assets and stablecoins, which was a welcome development. Furthermore, responding to call from the G20 India Presidency last year, the FSB and IMF produced a Synthesis Paper covering a wide range of policy issues including implications for financial stability, regulation, and macroeconomic policies including monetary policy, capital flows and taxation, as well as for other risks such as anti-money laundering (AML) and countering the financing of terrorism (CFT).

However, this is not the end to our endeavor to address fragmentation, but rather only the beginning. FSB members need to lead by example in implementing the recommendations. Japan has one of the most comprehensive regulatory and supervisory frameworks in place and these are already in full implementation. Our framework is not exactly a result of our foresight, but rather of the hard lessons that we learned from various incidents, including the collapse of Mt. Gox in 2014 and hacking at Coincheck in 2018. We are delighted to see the Markets in Crypto-Assets (MiCA) Regulation taking up many of the features of our regulations and working beyond them.

In addition, given the cross-border nature of crypto-assets, we need to engage with non-FSB jurisdictions to avoid fragmentation and regulatory arbitrage in the crypto space. In other words, it is extremely important for us to work with non-FSB and non-G20 jurisdictions.

There are two additional points that I would like to emphasize. The first is the importance of leveraging the work of various international organizations in our path forward. One would think of the collaboration between the FSB and SSBs. For example, cooperation between the FSB and IOSCO at the regional level could also help build a comprehensive approach. Another point that, I would like to emphasize is that the work underway at the Financial Action Task Force (FATF) that aims to identify regulatory gaps of jurisdictions where investor and market activities are concentrated, also as highly relevant. Leveraging this FATF work may be a useful way to find an effective path to engage with non-FSB jurisdictions. Given the borderless nature and rapid innovation, supervisors should have regular exchanges of views on recent activities and developments. Coupled with such information sharing, outreach to various stakeholders will be critical moving forward.

[Sustainability]

Another area at the risk of fragmentation is that of sustainability, and particularly climate change. Given that climate change impacts all of us on this planet, we have a broad consensus on the urgent need to address this issue. However, there is an undeniable difference as to the extent, the speed and the approaches that respective jurisdictions take, which could lead to fragmentation.

One area in which we are grappling with such differences is disclosure. The International Sustainability Standards Board (ISSB) finalized International Financial Reporting Standards (IFRS) S1 and S2 for the disclosure of sustainability-related financial information last year, which represents the emergence of a global framework for consistent, comparable and reliable sustainability reporting that can effectively and efficiently influence capital investment decisions. Of course, there are some jurisdictions that take different approaches and have even stronger ambitions, and we welcome the efforts of the ISSB and other jurisdictions to provide for interoperability. However, the future challenges will be very difficult, as we need to consider our approaches and engagement, particularly with small and medium-sized enterprises (SMEs) and developing and emerging economies. I do not have any clear or concrete answer right now, but only an inclusive approach would be workable to avoid market fragmentation in the implementation of standards.

[Basel III reforms]

Now let me turn to Basel III implementation. As all of you know, Basel III was finalized seven years ago, in 2017 with a subsequent amendment in 2019 on minimum capital requirements for market risks.

However, as we all know, implementation timelines differ among jurisdictions. From a European perspective, you may think that Basel III implementation is something to happen in the future, say in 2028. However, for Japanese banks it is happening right now. There are already Japanese banks that opted for early implementation from fiscal year 2022, and the majority of major banks will have been complying with our Basel III regulation from fiscal year 2023, meaning that they will come up with fiscal statements perhaps in June or July this year. That is how quickly we are moving on that issue.

Needless to say, differences in implementation timelines may lead to similar exposures being treated differently across jurisdictions, also resulting in market fragmentation affecting the liquidity profiles of financial instruments. In addition, internationally active banks will have to implement different versions of the standards in different countries in which they operate, creating significant operational challenges. Moreover, and perhaps more importantly, it will raise the level playing field issues.

An important lesson from the banking turmoil last March is that regulatory reforms in the aftermath of the global financial crisis have played a significant part in ensuring the resilience of our banking system. That is why member jurisdictions should implement all aspects of the Basel III framework in full, consistently and as soon as possible. The Group of Central Bank Governors and Heads of Supervision (GHOS) has made this point clear, and we need to live up to our commitment to avoid fragmentation and to ensure our credibility in what we have agreed.

[How to avoid market fragmentation]

So, how can we avoid market fragmentation? As I mentioned, robust international standards and international coordination and cooperation are the answers, but they require ingenuity in both the process of introducing new regulations and their implementation. For example, in the process of rule-making, we tend to be ambitious in our approach to fully pursue our respective mandates. While being ambitious is completely understandable and needed, we should also consider whether such regulations could be effectively implemented in respective jurisdictions.

The FSB and SSBs have been mindful of these aspects, introducing impact assessments and conducting public consultations. During these multilateral efforts, if certain standards are agreed, each jurisdiction should consider, whether they can really put such regulations in place. In such consideration, it would be helpful to thoroughly discuss these standards with various domestic stakeholders, making a strong case for credible standards. While this process could be resource-consuming, this approach may yield better results in the end – namely, prompt and full implementation globally, avoiding market fragmentation.

Japan may sometimes seem overly cautious in the discussions on international standard setting, but once we agree to a standard, we have generally been successful in full domestic implementation. This could be attributed to close communication with various stakeholders in the course of impact assessments and public consultations. It is not an easy path and may not be applicable to all jurisdictions, but it would be useful to explore ways to ensure the full implementation of any agreed standards.

It is also true that domestic regulations and supervisory frameworks need not be identical across jurisdictions, but could be tailored to the uniqueness of respective jurisdictions and domestic considerations. These differences could be acceptable, but even in such cases, we need to continuously assess whether such differences are aligned with international standards. Peer reviews and the implementation assessment frameworks conducted by the FSB and SSBs will help assist with such alignment.

As highlighted by the FSB report in 2019, we also need to leverage our supervisory cooperation frameworks and mutual recognition among jurisdictions that aim at ensuring consistency at the outcome level in the application of regulations.

[Conclusion]

As I mentioned at the outset, there are immense benefits in avoiding fragmentation, including in finance. This may sound somewhat extreme, but avoiding market fragmentation is as important as setting international standards. In the end, what counts is whether we can deliver what we have agreed and promised in each jurisdiction. Of course, this is not always easy, but we should at least make our best efforts to implement the agreed standards. If there are substantial discrepancies, we should strengthen our supervisory cooperation to mitigate the fragmentation. The changing dynamics will remind us of the challenges ahead. Thank you very much for your attention.