Changing dynamics – How should regulators respond to new challenges

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1. Is regulatory fragmentation increasing at the global level? Are on-going initiatives at the international level sufficient to address market fragmentation issues?

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 Financial Stability Board (FSB) and elsewhere. Since the global financial crisis, financial regulators as well as the FSB and the standard-setting bodies (SSBs) 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, including through continuous jurisdictional coordination and cooperation.

However, we may be witnessing a new surge of fragmentation against the background of emerging technologies and challenges in the financial sector. For example, for crypto-assets and stablecoins, there are significant differences in regulatory and supervisory responses among jurisdictions. To address such issues, the FSB and the International Organization of Securities Commissions (IOSCO) have issued high-level recommendations. To avoid market fragmentation, however, we need to engage non-FSB jurisdictions, given the cross-border nature and rapid innovation of digital assets. Turning to sustainability, we welcome the International Sustainability Standards Board (ISSB) and others' efforts to provide for a global framework with interoperability, but the journey has just begun. We must be mindful to avoid market fragmentation in the implementation of the standards while recognizing jurisdictional differences. Another example is in insurance, with the finalization of the Insurance Capital Standard (ICS) for Internationally Active Insurance Groups (IAIGs) planned by the end of 2024. The adoption and consistent implementation of the ICS will greatly contribute to minimizing market fragmentation in the sector. The IAIS is now in the process of assessing whether the Aggregation Method (AM) being developed by the United States as group capital calculation provides comparable outcomes to the ICS. If so, it will be considered an outcome-equivalent implementation of the ICS. Finalizing the ICS and the assessment of the comparability of the AM to the ICS will be among my initial priorities as Chair of the IAIS Executive Committee.

2. How can regulatory fragmentation issues be effectively tackled and can they be prevented?

Robust international standards and international coordination and cooperation are important to prevent fragmentation. This requires ingenuity in both the process of introducing new regulations and its 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, each jurisdiction should consider, if certain standards are agreed, whether they can 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, it can help avoid market fragmentation, such as delay in implementation or partial implementation. Japan may sometimes seem overly cautious in the discussions on international standard setting, but once we agree to one, 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. We fully understand that this 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, due 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, which aim at ensuring consistency at the outcome level in the application of regulations.

3. Is enough being done to address Non-Bank Financial Intermediation (NBFI) risks and potential interactions between the NBFI and banking sectors?

With NBFI accounting for approximately half of global financial assets, there is an increasing concern about the risks that NBFI may pose to financial stability. Some players in NBFI are highly leveraged and interconnected with banks. One example is the case of Archegos, which exposed the vulnerabilities in the NBFI sector, with negative spillovers to the banking sector. Recent episodes have fortified the notion that the NBFI sector may lack regulatory and supervisory oversight compared to the banking sector.

Against this background, FSB, in collaboration with SSBs, has been accelerating its effort to address risks associated with NBFI. MMFs policy proposals and OEFs recommendations have demonstrated the determination to strengthen the resilience of the NBFI sector. Work is still ongoing at the FSB, particularly focusing on leverage in NBFI. In our discussions, it has become clear that comprehensive data collection is critical to fully assess the vulnerabilities in NBFI. Given the diverse entities and activities in the NBFI sector, this is a significant challenge, as regulators currently have access to limited data, including from public data, national statistics, and supervisory data. In addition to a data gap, differences in the extent and granularity of the available data among jurisdictions pose challenges in exploring the optimal regulatory response in the NBFI sector.

While there is no easy answer, FSB and SSBs will continue to work in strengthening data collections and metric building on stocktakes of existing regulations, while assessing the costs of data collection and the resources constraints of authorities.

Having said that, we must remain mindful of the risks and vulnerabilities in the banking sector as seen in the turmoil last March, with some negative spillovers in the NBFI space. Japan's experience in the 1990's was highlighted by a vicious negative feedback loop between banks' NPL problem and equity market downturn. Fiscal and monetary policy management can also present challenges as seen in the consequences of Liability Driven Investment (LDI) strategies. Prudent banking regulation and supervision and sound macroeconomic policies remains at the core of financial stability. As an integrated regulator, the FSA is committed to contributing to global stability efforts, including through providing a holistic perspective across the financial sector.

4. <u>How important is addressing climate-related risks in the banking and insurance sectors and what are the related policy priorities?</u>

Given the inevitable transformation that climate change brings to the wider economy and financial system, addressing climate-related risks in the banking and insurance sectors remains our key focus. Climate-related risks are unique in that they are not adequately captured by conventional metrics owing to their high degree of uncertainty and longer time horizons. Due to limited data availability, methodologies for calculating emissions are still in the process of development. Therefore, we do not believe that requiring immediate capital strengthening is an appropriate response to climate-related risks. It is important for banks and insurance companies to assess how climate-related risks affect risks in each category such as credit risk, market risk, liquidity risk and operational risk over the medium to long term and to respond to such risks.

The road to net-zero is a transition encompassing the whole of the economy and requiring long-term efforts. Taking an inclusive approach, engaging with and encouraging all sectors towards our common goal is needed. Japan has been a longtime advocate of 'transition finance,' now a widely recognized concept. In providing transition finance, if banks, for example, can support their clients in proactively managing their climate risk and leveraging new business opportunities, this will be favorable for their risk management through better earnings for their clients. It can also help reduce their Scope 3 emissions.

Operationalizing the concept of transition finance, including through a credible transition plan, is an urgent priority. The FSA's Chief Sustainable Finance Officer, Satoshi Ikeda, is chairing the Transition Plan Working Group at the FSB, and we are firmly committed to advancing this important work.