Regulating ecosystem

Speech by HIMINO Ryozo, Vice Minister for International Affairs, Financial Services Agency, Japan, at 2019 ISDA Annual Japan Conference, Tokyo, October 25, 2019

Thank you, Scott (Mr. O'Malia), for the updates on ISDA's work on margin, capital and benchmarks. We share the goal of "safe, efficient markets," and I appreciate your focus on key issues relevant to the goal.

Good morning, everyone.

I was in Washington D.C. last week. There, the G20 finance ministers and central bank governors had their last meeting under the 2019 Japanese presidency. The Japanese Financial Services Agency (FSA), in collaboration with the Ministry of Finance and the Bank of Japan, has contributed to the G20 work with regard to financial sector issues. Now that this mission is largely completed and the torch is being handed over to Saudi Arabia, the 2020 presidency, we feel a bit relieved this week and take some pride in the work done over the year.

Market fragmentation work goes on

Last year, at this ISDA annual Tokyo conference, I shared with you some ideas about addressing the risks of market fragmentation.[1] One month later, the Japanese G20 presidency designated the issue as one of its priorities. ISDA and others contributed helpful analyses and proposals.

The Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) submitted reports on market fragmentation to the G20 ministers and governors in June.[2] The G20 Leaders declared in Osaka that they will address unintended, negative effects of market fragmentation including through regulatory and supervisory cooperation.[3]

[1] Ryozo Himino, Market Fragmentation, 2018
[2] Financial Stability Board, FSB Report on Market Fragmentation, 2019, and International Organization of Securities Commissioners, Market Fragmentation & Cross-border Regulation, 2019
[3] G20 Osaka Leaders' Declaration, June 2019

The work will continue.[4] We need to transform the program presented in the two reports into more specific actions. I look forward to your continued inputs and support.

The market and the states

The market fragmentation work has been an effort to alleviate the dissonance and tensions between the globally integrated market and nationally fragmented governmental power.

This *basso ostinato* resonates through many of the G20 discussions.

Last week in Washington D.C., ministers and governors issued two press releases, one on global stablecoins and the other on tax challenges arising from digitalization of the economy.

Governmental power is based on territory, but the nexus between territory and business is fading. You might not be able to determine the locus of your crypto-asset, as it is recorded in multitude of ledgers scattered across the globe and your key, which is just a series of numbers, can be stored anywhere in the world.

Also, while international principles base taxation on the existence of a permanent establishment in the territory, you can easily sell a movie or a music across the border without a permanent establishment such as a physical shop.

Fading nexus between territory and business is already a formidable challenge for national governments, but perhaps more formidable is a challenge arising from the changing nexus between legal entity and business.

Two regulatory approaches

There are two ways to regulate a financial system: the entity-based approach and the activity-based approach.

The entity-based approach confines its direct perimeter to entities licensed, authorized or registered to pursue certain financial activities. For example, you shall not take deposits unless you are licensed as a bank, and you are regulated as a bank only when you are licensed as a bank.

Activity-based approach, in its purest form, imposes regulations on anyone who conduct certain activities. For example, you shall not manipulate the stock market whether you are a broker-dealer or not.

---

[4] See FSB, Updates on the Work on Market Fragmentation, 2019

The latter is much more difficult to enforce than the former, as you need to watch everyone, not regulated entities alone.

The basis for effective entity-based approach is that the provision of certain financial activities is linked to particular types of financial institutions – deposit-taking, payment and lending to banks, writing of insurance contracts to insurers, and so on.

The concurrence of entities, activities and the associated risks allows entity-based regulation designed for each industry sector to address risks without unduly constraining market activity, innovation or economic growth.

Rapid technological innovation, however, may lead to a decoupling of financial activities from particular types of entities. Effectiveness of the entity-based, industry-by-industry regulation may be undermined.

Three types of activity-entity decoupling

Let me refer to three examples:

- First, <u>unbundling and re-bundling.</u>
  Functions and activities traditionally performed by a single entity in a certain financial industry sector are split up and re-packaged and performed by a range of entities. This may include entities which do not fit neatly to any of the traditional industry sector.
  For example, banking services can be unbundled into deposit-taking, payment services and lending. Each service can be provided by different entities – e.g., a money market fund, a platform for electronic payments, and a finance company --, but, combined with private scoring services, can be made accessible via a single application on smartphones.

- Second, <u>decentralization.</u>
  Decentralized financial technologies can allow financial services to be provided without the involvement of intermediaries or centralized processes that have traditionally been indispensable in the provision of financial services.
  For example, market participants transact peer-to-peer utilizing a platform designed and run by entities who contribute to the system without getting permissions from any controlling entities.

- Third, <u>ecosystem.</u>
  A multitude of actors within and beyond the traditional regulatory perimeter perform diverse activities and functions to form an ecosystem, which as a whole provides a set of financial (and non-financial) services.

For example, once an open distributed ledger network attains a large customer base, different entities may voluntarily start to access it, provide coins, wallets, deposits, lending, hedging, electronic commerce and other functions, and expand the economic zone.
The interaction within an ecosystem may give rise to risks beyond the simple sum of the impacts produced by the individual elements in the system.

Regulatory perimeter and activity-based regulation

Recognizing the relevance of these developments, reports by international organizations have pointed to the need of work on regulatory perimeter issues. They argue for complementing the entity-based approach with the activity-based approach to regulation, and advocate the "same activities, same risks, same rules" principle.

For example, the FSB report on decentralized financial technologies, published in June, argued that "a more decentralized financial system may reinforce the importance of an activity-based approach to regulation, particularly where it delivers financial services that are difficult to link to specific entities and/or jurisdictions."[5]

This year's BIS annual report maintained that "new rules may be warranted in those cases where big techs have brought structural changes that take them outside the scope of existing financial regulation," and that "[t]he basic principle is 'same activity, same regulation.'"[6]

Some national authorities have also started to explore the issue.

For example, last year, the U.S. Treasury, in its report to President Trump, stated that "[r]egulators must be more agile than in the past in order to successfully uphold their missions without creating unnecessary barriers to innovation. This requires principles- and performance-based regulation that enables the private sector to adopt innovative, technology-based compliance solutions."[7]

Also last year, the Financial System Council of Japan pointed that "it is critical to incorporate function based, cross-sectoral elements more to the regulatory

---

[5] Financial Stability Board, Decentralised financial technologies: Report on financial stability, regulatory and governance implications, 2019
[6] Bank for International Settlements, "III. Big tech in finance: opportunities and risks," in *Annual Economic Report*, 2019
[7] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities - Nonbank Financials, Fintech, and Innovation, Report to President Donald J. Trump, 2018

framework and to apply the same rules to activities with the same functions and risks."[8]

I understand that these reports do not necessarily advocate discarding the entity-based approach or jumping to the pure form of activity-based approach, but propose modifying the traditional industry-by-industry definition of regulated entities to accommodate the decoupling of activities and entities.

Enter Libra

The recent discussions around global "stablecoins" are just another example of the potential momentum that such developments may unfold.

Let me quote from the Libra white paper: "Imagine an open, interoperable ecosystem of financial services that developers and organizations will build to help people and businesses hold and transfer Libra for everyday use."[9]

It is an attractive proposition. Perhaps John Lennon might have unconditionally agreed, as he could imagine the world with no countries, possessions, or greed. But we still have to deal with them.

The report by the G7 working group on stablecoins issued last week stated that "stablecoin arrangements may. . . pose risks that fall outside existing legal or regulatory frameworks," and that "[p]ublic authorities should apply a technology-neutral, function-based regulatory approach."[10]

Also talking about stablecoins, the FSB chair, in his letter to G20 ministers and governors, maintained that "it is essential to apply the principle of 'same activity – same rules', independent of the underlying technology."[11]

Same activities, same risks, same rules?

These propositions all sound reasonable. Operationalizing the "same activities, same risks, same rules" principle, however, would pose a formidable challenge.

Firstly, same activities do not necessarily entail same risks. Risks will differ depending on the combination of activities within an entity. The same lending activities could pose totally different risks to the financial system, depending on how they are funded, by deposits, by interbank borrowing, by issuing long term bonds, or by equity issuance.

---

[8] Financial System Council of Japan, Interim Note -Toward function-based, crosssectoral financial regulations, 2018
[9] Libra Association Members, Introduction to Libra, 2019
[10] G7 Working Group on Stablecoins, Investigating the impact of global stablecoins, 2019
[11] FSB Chair's letter to G20 Finance Ministers and Central Bank Governors: October 2019

Also, the role of activities in the entire ecosystem could affect the risks they pose. The same wallet providers could pose different money laundering risks depending on whether they deal with Bitcoin or Libra.

Secondly, the “same risks, same rules” principle itself is not straightforward either. The risks posed by a global systemically important bank (G-SIB) and a community bank are totally different quantitatively, and significantly different even qualitatively, but they are regulated pretty much the same way except for very limited aspects. Does the principle demand complete overhaul of this current arrangement?

Complementing the entity-based approach with the activity-based approach is pretty difficult. We have seen some new frameworks which provide regulatory categories coined expressly for certain unbundled or re-bundled activities related to payment or distribution, but modifying traditional entity definitions may be particularly difficult for activities which utilize players’ balance sheets.

An alternative?

The task is formidable, but I still believe we need to start thinking about how regulators could cope with unbundling/re-bundling, decentralization and emergence of major ecosystem.

If we fail to adapt the entity-based regulations to the new reality by complementing them by the activity-based approach, the only remaining choice while maintaining regulatory effectiveness is the pure form of activity-based approach, or regulating everybody on a broad range of financial activities.

The Libra white paper argues that “the Libra Blockchain will be open to everyone: any consumer, developer, or business can use the Libra network, build products on top of it, and add value through their services.”[12] This sounds to me like an invitation to regulate everyone.

And it will be doable utilizing technologies. Regulators will monitor if rules are embedded in protocols, police all transactions using big data and AI, and technologically block problematic activities.

Such omnipresent regulation has already been imposed on internet communications in many jurisdictions in the world, though with varying degrees. Technology-wise, it can surely be expanded to financial transactions, and even today many capital market regulators detect insider trading, pump and dump schemes and other frauds by monitoring both capital market transactions and internet communications. But we should think carefully before expanding this approach to broader areas of financial regulation.

[12] Libra Association members, *op.cit.*

A trilemma

Speaking in Beijing last year, I argued that national authorities may need to face the choice between three options.

The first option is accepting inefficiency which would disadvantage the country in international competition. For example, continued use of cash.

The second option is a dystopia resembling George Orwell's *Nineteen Eighty-Four*, where the government knows everything. For example, the central bank gathering data on each and every transaction through the use of central bank digital currencies.

The third option is an anarchy extending beyond the government reach.[13] For example, private stablecoins and anonymized peer-to-peer network opening the gate for money laundering and terrorists financing.

It seems that the time for this choice is drawing nearer than I anticipated then. We need to start exploring how we can expand the tradeoff frontier between economic efficiency, privacy and freedom, and effective regulation. Better regulatory design, together with private sector initiatives, will help us find ways.

Thank you.

[13] Ryozo Himino, "FinTech, the future of society and regulation," 2018