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Study Group on International Financial Regulation

Opinion Paper by the Study Group on International Financial Regulation "Recommendations for the G20 Summit"

I. Background

The Study Group was established for the purpose of monitoring developments in recent international financial regulatory reforms, enabling relevant parties in Japan to appropriately express their opinion in the process of introducing various regulations, and supporting Japanese financial institutions in responding smoothly to the new regulatory environment.

This year Japan hosts its first ever G20 Summit, to be held in Osaka on June 28 and 29. Three key issues have been set as priority themes for discussion at the G20 Osaka Summit: risks and challenges to the global economy, concrete actions to strengthen medium-term growth potential, and policy responses to economic and social changes stemming from both technological innovation and globalization.

The Study Group hopes that the first G20 Summit hosted in Japan will provide an opportunity for productive discussion and enable agreements from previous G20 Summits to be further improved. Accordingly, this paper expresses the Study Group's opinion on the G20 Osaka Summit's individual themes for discussion that relate to the finance sector: (i) international coordination and cooperation to avoid financial market fragmentation, (ii) aging-population issues and policy responses, and (iii) investment in high quality infrastructure.

II. Avoiding Financial Market Fragmentation

In December 2017 the Basel Committee on Banking Supervision agreed on the finalization of the Basel III framework. This concluded the process of designing

international financial regulatory reforms that had been conducted over the decade following the global financial crisis in line with the earlier G20 commitments. At this point international financial regulatory reforms moved fully into its implementation phase. Against this backdrop, concerns about financial market fragmentation have started to arise in many countries. Such fragmentation results from inconsistencies among regulatory frameworks in different jurisdictions, impeding the progress and spread of beneficial innovations in financial services and compromising the efficacy of measures to promote financial stability. The following have been identified as sources of financial market fragmentation:

- Discrepancies: A single financial institution is subject to incompatible regulations imposed by multiple regulators
- Overlaps: As a result of regulatory extraterritoriality, a single market or transaction is subject to different regulations imposed by multiple regulators
- Desynchronization: The timing for implementing an internationally agreed standard varies among regulators in different countries
- Competition: Jurisdictions introduce policies aimed at securing resources and activities within home markets, such as location policies, ringfencing, or internal TLAC (total loss absorbing capacity) requirements

International coordination and cooperation to avoid financial market fragmentation has been identified as one of the main topics for discussion at the G20 Osaka Summit. The Study Group welcomes international consideration of measures to avoid financial market fragmentation, and hopes that measures such as those listed below will be implemented.

1. Increase trust and coordination among regulators
   - Increase trust among regulators to avoid conflicts between national interests and global interests.

- Avoid extraterritoriality, but if it is unavoidable, thoroughly discuss details including the scope and timeline with the regulator(s) in the other jurisdiction(s) prior to implementation.
- Put a standardized resolution process in place to prepare for situations in which regulatory discrepancies between different jurisdictions arise. The process should stipulate the procedure for raising issues, the framework for negotiations between regulators, and the estimated timescale for resolution, among other matters.
- Revise systems unique to individual jurisdictions that could potentially harm relationships of trust among regulators, ensuring that they do not harm trust.

2. Use recognition and equivalence assessment extensively and efficiently

- Recognition or assessment of equivalence for regulations in different jurisdictions should be based on efficient, effective assessment of outcomes or risks, rather than focusing on the detailed differences between regulations in different jurisdictions.
- International standard-setters should develop frameworks to enable regulators in individual jurisdictions to apply recognition or assessment of equivalence according to a predictable, consistent, appropriate timescale.
- Provision should be made so that recognition or assessment of equivalence is accepted automatically if the relevant regulators agree as part of a supervisory college or crisis management group, or if a process such as a Financial Stability Board peer review has deemed a newly introduced domestic regulation to be in line with international agreements.

3. Ensure compliance with international agreements

- Having accepted the reality that it is impossible to impose exactly the same level of regulation within every jurisdiction, greater consistency between regulations in different jurisdictions should be ensured by reducing the disparities between internationally agreed regulations and

the regulations actually implemented domestically within individual jurisdictions.

- Fundamental principles should be established to curb excessive regulatory competition (a race to the bottom or a race to the top).
- Issues that come to light while legally enacting regulations in individual jurisdictions should be relayed as feedback to international standard-setters, which should develop frameworks for remedying the issues as necessary.
- In jurisdictions where financial activity is relatively inactive, consideration should be given to the methods and timings for application of international standards to ensure eventual convergence with the international agreement.

4. Affirm regulatory policy objectives

- When considering development of new regulations, jurisdictions should recognize the role that the global financial market plays in achieving sustainable economic growth.
- International standard-setters should be accountable for ensuring that regulations are efficient and effective in achieving policy objectives.
- If a series of reforms has resulted in regulations that are complex and multi-layered, the regulations should be retrospectively reviewed to ensure the overall efficacy of regulations.

III. Aging population issues and responses

Populations are aging in many countries worldwide, and especially in the developed countries. Japan in particular has the highest rate of aging when compared with other countries, making it the society with the world's oldest population. Consequently, Japan is under pressure to take the lead in responding to a range of policy issues such as the macroeconomic impact of population aging, the decrease in labor supply as a result of such aging, and the issue of old age and financial inclusion. At the same time, Japan must envisage

the type of economy and society it needs for the coming era of the 100-year lifespan.

Japan, host of the G20 Osaka Summit, is currently leading the way in terms of population aging, and the summit will include discussion of aging-related issues. Discussions will cover the financial services required for senior citizens whose physical and cognitive capacities are diminishing; the financial products, services, and wealth accumulation required to meet the demands of increased longevity; and the potential for digital technologies to facilitate or impede financial inclusion for senior citizens.

The Study Group therefore believes that participating countries should discuss the following at the G20 Osaka Summit: (i) policies to provide appropriate livelihood security (through self-help, mutual assistance, or public assistance) in the era of the 100-year lifespan; (ii) the importance of the roles played by private insurance and asset management firms in providing such livelihood security; and (iii) the regulations required to enable financial institutions such as private insurance providers to perform such roles. In addition, every country should share its insights on such issues as approaches to liquidation of assets in old age and public provision for dealing with declining mental capacity and ability to make decisions.

IV. Investment in high-quality infrastructure

Past G20 Summits have acknowledged that high-quality infrastructure is essential to growth in the global economy and have discussed various aspects of this issue, as a result of which certain outcomes have already been achieved. Delegates at the G7 Ise-Shima Summit held in 2016 agreed the G7 Ise-Shima Principles for Promoting Quality Infrastructure Investment, and the importance of those principles' key elements was reaffirmed at subsequent G20 Summits as well as at many other international meetings.

The Study Group believes that the G20 Osaka Summit should aim to promote greater investment in high-quality infrastructure by discussing how to establish conditions that will facilitate private-sector infrastructure investment (e.g., stable policies, and cooperation between the public and private sectors). Furthermore, a key element in quality infrastructure investment will be the need to not only reduce risk, but also to boost returns in order to increase return on risk. It should be possible to increase returns on investment as well as investment appeal by ensuring that returns reflect not only direct revenues from usage fees, but also the benefits that accompany infrastructure development in the form of increased tax revenue and prevention of decreased tax revenue.

V. Conclusion

The Study Group has made a unique attempt in Japan to analyze and assess international financial regulatory reforms across the various types of financial services businesses from the private-sector perspective. It is hoped that the opinions expressed by the Study Group will contribute to discussions during the G20 Osaka Summit under the Japanese leadership.

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(Affiliates and positions of replaced former Member and Observer are those at the time of the 10th meeting (March 8, 2019).)

EXAMPLES OF MARKET FRAGMENTATION

NOTE：The tables below based on documents submitted by Ms.Tomoko Morita（Senior Director and Head of Tokyo Office,ISDA）at the 10th meeting of the Study Group with some modification.

(1) Extraterritoriality

Regulation	Source of Fragmentation	Impact
Scope of Application of a Jurisdiction's Rules: Most jurisdictions require (1) transactions executed outside of their borders by entities they define to be within their regulatory purview, or (2) activities conducted inside their borders by third-country firms, to comply with their rules even when they would fall under the oversight of a third-country regulator.	Overlap	Counterparties, particularly derivatives end users, seek to mitigate inconsistencies and uncertainties in the scope of application of a jurisdiction's rules by transacting within, and with firms governed by, their home markets. This essentially leads to regionalized markets and creates inefficiencies in providing and using derivatives risk management products.
Equivalency/Substituted Compliance Determinations: The process by which regulators in one jurisdiction determine the regulations in another jurisdiction to be comparable is often conducted on a granular, rule-by-rule basis.	Competition	Rather than being forced to comply with the rule sets of two jurisdictions, putting market participants in the position of running duplicative and (in many cases) conflicting compliance programs, firms regionalize their activity to ensure their activities are not captured by other jurisdictions, decreasing competition and liquidity.

(2) Capital

Regulation	Source of Fragmentation	Impact
Market Risk Capital Rules (Fundamental Review of the Trading Book, FRTB): Significant uncertainties exist about the timing and extent of implementation of these rules in key jurisdictions.	Desynchronization	Inconsistencies in the substance and timing of implementation of the market risk capital rules in key jurisdictions will have significant impact on the relative abilities of firms to offer, price and risk manage derivatives to their counterparties and to support strong, liquid markets.

Regulation	Source of Fragmentation	Impact
Net Stable Funding Ratio (NSFR): The global standard developed by the BCBS as part of its review of the net stable funding ratio gives national jurisdictions the ability to impose a gross derivatives liability add-on (GDLA) for derivatives that ranges from 5% to 20%.	Competition	Inconsistent application of the GDLA by individual jurisdictions would have the potential to adversely affect the ability of banks to provide market services that facilitate client financing, investing and hedging.
Credit Valuation Adjustment (CVA): Jurisdictions differ in their implementation of the BCBS CVA risk framework.	Competition	CVA risk can affect the cost of capital of derivatives trades under the Basel standards and therefore in determining the price of those trades. The differing treatment of CVA risk could consequently affect the cost and availability of derivatives for end users in certain jurisdictions.
Leverage Ratio: Jurisdictions differ in whether they require segregated margin posted by clients with their bank counterparties for cleared swaps transactions to be counted in calculating banks' capital requirements under the leverage ratio.	Competition	Cash collateral posted by clients, which reduces credit exposure, would count as on-balance-sheet assets and therefore increase the capital requirement in the leverage ratio for banks in such jurisdictions. This could consequently increase the cost of clearing and limit access to it in these jurisdictions.

(3) Non-Cleared Margin

Regulation	Source of Fragmentation	Impact
Timeframe for Posting Margin: Jurisdictions differ in the time frame they impose for the calculation and settlement of both initial margin (IM) and variation margin, with some requiring it in T+1, and others requiring T+2 or later, depending on the standard settlement cycle of the relevant collateral.	Overlap	Inhibits timely settlement when two counterparties are not located in the same time zone. In particular, counterparties in Asian time zones find it difficult to transact with US counterparties for which T+1 settlement is required.

Regulation	Source of Fragmentation	Impact
Collateral Eligibility Requirements: Collateral eligibility requirements vary considerably across jurisdictions.	Competition	Firms may be disincentivized to trade with entities subject to different collateral eligibility requirements because doing so requires both parties to the transaction to follow the strictest requirements applicable, potentially limiting the sources of collateral for the relevant portfolio.
Posting of Initial Margin for Inter-Affiliate transactions: Some jurisdictions (eg, US prudential regulators) require swap dealers that are banks to post and collect IM for their inter-affiliate transactions. The US Commodity Futures Trading Commission (CFTC) provides an exemption, as does the JFSA and many other jurisdictions.	Discrepancies	Banks subject to inter-affiliate IM rules are incurring substantial funding costs for trades that pose no systemic risk.
Standard Initial Margin Model (ISDA SIMM) Backtesting: Some jurisdictions (eg, EU and Japan) may require all counterparties, including non-dealers, to monitor and back- test industry standard models used to calculate IM for their trades.	Discrepancies	End users generally do not have the resources or expertise to perform this type of testing and, as such, may be disadvantaged and forced to use the standard grid, which could potentially lead to higher prices.
Documentation for Phase 5 Counterparties: Some jurisdictions (eg, US) require counterparties to have in place regulatory IM documentation (including collateral support agreements) if they are above the $8 billion notional threshold that's effective September 2020, even if they would not exchange IM under the rules because their IM calculation is less than the allowed IM threshold (up to $50 million).	Discrepancies	Counterparties that are not required to post IM would be subject to time-consuming and expensive documentation negotiations and dormant custodial accounts in jurisdictions with this requirement.

(4) Clearing

Regulation	Source of Fragmentation	Impact
Clearing Location Policy: Some jurisdictions require certain trades executed within their borders to be cleared at central counterparties (CCPs) within their borders that are subject to local supervision. Clearing mandates in jurisdictions with closed currency markets also create de facto CCP location policies.	Competition	Clearing location policies adversely impact liquidity, as evidenced by the basis risk that arises from time to time at different CCPs clearing the same product. In addition, clearing location policies force firms to split their netting sets, which can significantly increase capital and margin requirements and related costs. Competition is therefore stifled and global systemic risk is increased.
Client clearing: Some jurisdictions require persons/clients that are not members of CCPs to only clear swaps with CCPs that are registered locally (eg, registered with the CFTC as a derivatives clearing organization).	Competition	This requirement prevents firms from providing liquidity and hedging for certain customers at offshore CCPs. In the US, this is the result even where local CCPs have obtained an order of exemption from the CFTC.
MPOR for IM Requirements: Jurisdictions differ in the minimum margin period of risk (MPOR) they require CCPs to use in setting IM they require for cleared transactions.	Competition/ Discrepancies	Differences between jurisdictions in the minimum MPOR required for cleared IM could result in customers having to post different amounts of IM for the same transaction, depending on the jurisdiction of the CCP in which their trade is cleared.

(5) Trade Execution

Regulation	Source of Fragmentation	Impact
Trading Location Policy: Requirements that certain trades must be executed on designated platforms within a particular jurisdiction.	Competition	Location-based trading regulations have fragmented liquidity across platform and cross-border lines, resulting in separate liquidity pools and prices for similar transactions. While the 2018 US-EU trading venue equivalence determination has alleviated some market fragmentation concerns, the lack of trading venue recognition across other jurisdictions continues to fragment global markets.

Trading Personnel Location Policy: US rules require trades between non-US entities that are arranged, negotiated or executed by US personnel (ANE transactions) to be cleared, executed and reported pursuant to US rules.	Competition/ Overlap	This discourages non-US entities from using US personnel for fear of being captured by US rules and subject to duplicative (potentially conflicting) requirements. Non-US entities that seek to engage in these transactions must build duplicative compliance systems to ensure they are compliant with CFTC rules and local clearing and trading rules, which may not be consistent.

(6) Data and Reporting

Regulation	Source of Fragmentation	Impact
Trade reporting: Jurisdictions differ in whether they require one or both counterparties to a trade to report the transaction to a trade repository.	Discrepancies	Buy-side market participants and end users in a jurisdiction that requires them to report their derivatives transactions are disadvantaged, being burdened with onerous obligations that duplicate the data reported by their counterparty.
Required data fields: Different jurisdictions have different definitions, formats and allowable values for the trade data required to be reported	Discrepancies	Lack of consistency in the type and format of data required across jurisdictions creates inefficiencies that not only inflate the requisite cost and resources, but also impede the ability of regulators to aggregate and reconcile data.

(7) Netting

Regulation	Source of Fragmentation	Impact
Scope of Eligible Counterparties: Jurisdictions differ in the scope of eligible counterparties covered by netting legislation. Some differentiate based on type of bank (state-owned vs. privately owned) and others by type of firm (bank vs. securities vs. insurance).	Competition/ Overlap	Differences in the scope of eligible counterparties restricts the benefits of netting (which includes, among other things, a reduction in counterparty credit exposure) to a minimum or limited number of counterparties.
Scope of Eligible Transactions: Jurisdictions differ in the scope of eligible transactions covered by netting legislation. For example, some jurisdictions do not recognize physically settled commodity transactions as eligible transactions, but do recognize financially settled commodity transactions.	Competition/ Overlap	Differences in the scope of eligible transactions restricts the benefits of netting, which is an important tool for reducing counterparty credit exposure.

(8) Benchmarks

Regulation	Source of Fragmentation	Impact
Certain jurisdictions require that only approved benchmarks or indices can be used within their borders in order to ensure their accuracy and integrity. Benchmark administrators and data contributors are subject to new rules and processes. Providers and users of unapproved benchmarks may be fined.	Competition	If benchmark administrators and contributors find the rules too onerous or do not receive approval, the number of available benchmarks will decrease, fragmenting liquidity and reducing investment choices