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Financial Services Sector

Striking the Right Balance Between Regulation and Economic Growth

■ **Critical Role of Financial Institutions:** Financial institutions are critical to the functioning of the economy and financial systems around the globe. The sector serves society by providing credit to drive economic activity, liquidity to facilitate the need for cash, and risk management to shield households and businesses. In a rapidly-changing world, financial institutions continue to evolve and innovate to benefit consumers and society. Further, the financial industry is an important component of trade in services around the globe and, in particular, between Japan and the U.S.. Investments by U.S. financial firms in Japan, and by Japanese financial firms in the U.S., provide extensive employment and promote economic growth in both countries.

Since the financial crisis of 2008, countries have sought to coordinate at an international level to develop a global regulatory framework to strengthen financial stability and lower the likelihood and severity of a future financial crisis. At the same time, the United States and Japan have pursued far-reaching reforms to prevent another crisis and sustain their economies over the long term. The Councils fully support reasonable reforms designed to strengthen the global financial system, and ultimately promote sustainable economic growth.

In this new global regulatory environment, the Councils believe that any regulatory and supervisory measures undertaken by the regulators should be appropriate and proportionate to attain clear supervisory objectives for the benefit of the wider public interest, and not go beyond those objectives, to avoid unintended consequences on the real economy and distortion in market competition. As work continues to develop and implement a new regime of international financial standards, the Councils see key opportunities for the United States and Japan, as the largest and third-largest economies in the world, respectively, to cooperate and speak with one voice on areas of common interest. The Councils strongly urge U.S. and Japanese financial regulators to continue working in close collaboration with each other and the industry to complete the reform process, while striking an appropriate balance between financial stability and economic growth. The Councils believe a coherent regulatory framework and level playing field can be achieved through continued commitment to international cooperation and coordination. At the same time, the Councils request that both the US and Japan pursue a leadership role in formulating international financial standards.

In this context, the Councils urge both governments to adopt the following measures and principles, which will contribute to the sound regulation of financial services in both countries and help ensure robust and effective outcomes in the development of international financial standards.

The Councils believe transparency contributes to policy effectiveness by reducing uncertainty in the decision-making of market participants, and promotes financial and systemic stability by enabling better understanding of government policies. Transparency is critical for commercial entities to confidently make management and investment decisions and, as a result, improve the quality of financial services for customers. In this regard, the Councils urge regulators in both countries to continue to expand dialogue with the financial industry and consider views of market participants when crafting and implementing new regulations.

In responding to the imperatives of aging societies globally, for example, the implications for financial markets, macroeconomic growth, and financial stability are significant. With financial institutions playing an increasingly important role in the management of shifting demographics, the Councils encourage governments to provide a policy environment that supports financial markets and institutions in addressing these challenges.

As the demands for infrastructure investment expand in Asia and around the globe[1], financial institutions will continue to play a vital role in financing the economy and supporting growth. Given their scale, global reach and strong fundamentals, financial institutions in the U.S. and Japan are especially well prepared and eager to support these agendas.

Finally, as cybercrime has now become the second-most reported economic crime, financial institutions are a prime target. The Councils affirm their obligation to protect consumers from cyber threats and to seek continued collaboration with relevant policy-making institutions to prevent them.

■ **Cross-sectoral guiding principles:** Efforts toward international financial regulatory reform have delivered substantial progress nearly ten years after the global financial crisis. With implementation of the immediate post-crisis reform agenda now largely complete, the timing is appropriate for a thorough assessment of the output and effects of the new rules and consideration of necessary revisions. The Councils believe in the need for

[1] Asian Development Bank estimates that investment of USD 1.7 trillion per year is needed in developing Asia until 2030 to maintain growth momentum. Additionally, according to the Organization for Economic Co-operation and Development, total global infrastructure investment requirements from 2007 to 2030 will come to USD 71 trillion.

https://www.adb.org/publications/asia-infrastructure-needs

http://www.oecd.org/daf/inv/investment-policy/Fostering-Investment-in-Infrastructure.pdf certain guiding principles in designing the optimal regulatory framework based on an ongoing cross-sectoral discussion. These guiding principles include the following:

- Regulatory reform must not place excessive emphasis on eliminating risk to the detriment of the appropriate risk-taking necessary to finance growth, as the ultimate goal of regulation is to contribute to sound economic growth and sustainable economic development
- While consistency among different jurisdictions is an important consideration, regulators and global standard setting bodies must recognize that application of uniform, one-size-fits-all regulations may not be appropriate in certain cases
- Regulation should be proportionate to relevant risks, and the necessity for a given regulation should be supported by a clear demonstration of the link between intent and substance
- Counter-cyclical macro-prudential regulation should be encouraged and pro-cyclical regulation should be avoided

■ **Insurance Regulations:** Insurance companies pool and transfer risks on behalf of society, thereby serving as a source of financial strength and stability during times of distress, including the 2008 financial crisis. However, regulatory changes since the financial crisis threaten to undermine insurer's ability to continue to fulfil that role and to serve their customers. The Councils call on the U.S. and Japanese Governments to ensure that the International Association of Insurance Supervisors' (IAIS) global insurance capital standard (ICS), and all other recommendations for policy measures, promote, rather than inhibit, the ability for insurers to fulfil their vital role. With respect to global insurance capital standards, any standard should: achieve comparable levels of capital and a level playing field among all market participants; be appropriate for the variety of insurance business models; and be capable of easy implementation in each jurisdiction. Development of such IAIS policy measures must be done in a deliberate and transparent manner and not beholden to arbitrary G20, Financial Stability Board (FSB), or IAIS imposed deadlines that could increase the likelihood of standards that produce unintended consequences.

With regard to the ICS of the IAIS, the Councils urge the two Governments to ensure the standard – and its market-based approach in particular – does not cause unwarranted volatility that is at odds with the stable, long-term nature of most life insurance liabilities. Such unwarranted volatility could force companies to exit long-term guaranteed businesses that are prudently managed with sophisticated risk management techniques and essential to consumers in our markets. In addition, fundamental issues, such as the balance between simplicity and risk sensitivity, and between the need to account for the diversity of insurance markets around the world and comparability, must be appropriately recognized to avoid adversely impacting the role the sector plays in capital markets and for consumers. Sensible approaches to valuing insurance liabilities, qualifying capital resources, and calibrating stresses are essential for avoiding unintended consequences.

The Councils agree potential sources of systemic risk should be addressed to preserve financial stability. As with capital standards and other policy measures for the insurance sector, the approach to assessing systemic risk must account for inherent differences between insurance and other financial service sectors. Further foundational elements for an appropriate approach include: a comprehensive cross sectoral analysis; recognition of both micro and macro-prudential regulatory reforms successfully implemented since the global financial crisis; and a focus on activities that may give rise to systemic risk across the sector rather than individual entities. The Councils urge both governments to explore an activities based approach to assessing systemic risk in the insurance sector, which is still an early stage concept, at the IAIS and FSB and within their respective jurisdictions, while paying due consideration to the need for this new approach to not create additional undue regulatory burdens or unintended consequences.

The U.S. state-based regulatory system for insurance has been responsive to the needs of the local marketplace for over 150 years. The Councils welcome continued efforts to further modernize U.S. state-based insurance regulation, including the recently announced NAIC Macro-Prudential Initiative (MPI).

■ **Banking Regulations:** The Councils welcome the series of regulatory reforms successfully implemented in the aftermath of the global financial crisis. Overall these reforms have resulted in a more stable, better capitalized and more liquid global banking industry far better positioned to withstand even the most challenging market and economic conditions. However, the Councils believe that any further regulatory reforms need to be considered carefully in the context of their impact on economic growth and job creation.

New proposals should not result in an increase in overall capital requirements for the banking sector, consistent with the commitment made by the Basel Committee on Banking Supervision (BCBS) and supported by the Group of Central Bank Governors and Heads of Supervision and the G-20.

Moreover, in view of the significant amount of complex new rulemaking in recent years, existing rules should be subject to ongoing assessment to determine their effectiveness in striking the appropriate balance between ensuring financial system stability on the one hand, and not creating an unnecessary drag on economic growth and innovation, on the other. As Commissioner Mori of the Financial Services Agency (FSA) stated at the Thomson Reuters Pan Asian Regulatory Summit in 2015, “If dozens of specialized doctors surround a patient and inject different strong medicines for every symptom, what would be the combined effects on the patient?”. It is important that this assessment and adjustment process also take in to account the specific characteristics of banking models in different jurisdictions to avoid unnecessarily adverse outcomes.

To this end, the Councils welcome recent actions by the Trump administration in the U.S. to assess existing financial industry regulations and consider prudent modifications to those rules that constrain economic activity and innovation without delivering commensurate stability benefits. While the Councils do not endorse a broad rollback of the basic framework global regulators have worked hard to implement since the crisis, they do believe that incremental rulemaking would not yield further benefits and that selected areas, such as the current highly complex rules on bank trading activity, could be clarified or simplified in ways that would eliminate unnecessary constraints on banks' ability to facilitate end-user needs, without increasing risks to stability. In addition, the Councils are hopeful that the post-crisis tendency of U.S. supervisors to "gold plate" Basel regulations will be reconsidered in favor of more global consistency.

The Councils also want to express support for efforts by international bodies to conduct similar assessments on the effectiveness of post-crisis rule making. The FSB's framework for evaluating the effects of the G20 financial regulatory reforms, published in July, will, the Councils hope, help guide regulators in remediating rules that are not achieving their intended outcomes or that are producing unintended detrimental consequences for the proper functioning of capital markets and growth.

More specifically, the Councils urge the BCBS to ensure that requirements be designed and calibrated appropriately, especially regarding capital floors and maintenance of the Basel III leverage ratio as a supplement to the risk-based capital framework. Finally, the Councils reiterate support for the commitment by the BCBS to finalize regulatory reforms at the earliest possible date, thus enabling markets and the banking industry to stabilize around a common global framework.

■ **Cross-border Data Flows:** As the digital economy creates vast new business opportunities, promoting the flow of data and information across borders allows businesses to freely operate and innovate anywhere in the world. However, the Councils are concerned about a trend in many jurisdictions to force localization of data processing and storage as well as restrict the transfer of certain data offshore. Although it is argued that the aim is to protect consumers, in fact placing servers in each country weakens data security and increases operating costs, ultimately increasing costs to consumers. Furthermore, placing limitations on the transfer of data offshore between companies often prevents them from transferring data internally to home offices or an affiliate offshore, and inhibits financial service providers from performing fundamental activities such as managing: employee information; financial and management information; information for fraud prevention, anti-money laundering, and tax planning; disaster recovery; reinsurance; and more.

Given the economic significance of cross-border data flows, the Councils strongly oppose requirements to locally host data processing and storage facilities as a condition of doing business in a particular country. Likewise, the Councils are of the view that any restriction on the transfer of data offshore should not inhibit reasonable business operations or management.

In this context, the Councils support efforts for the Governments of the U.S. and Japan to work together for more open data architecture in markets in Asia and beyond.

■ **International Coordination and Regulatory Consistency:** The Councils support a healthy, vibrant financial system based on sound regulation, and fully support the letter and spirit of the agreements reached at the 2009 Pittsburgh Summit of the G-20. There remains concern, however, that the cumulative impact of new regulation – new liquidity, funding, leverage and risk-based capital requirements, as well as overlapping and complex methodologies – impose severe burdens and limitations on financial institutions, which raise costs and impair market access for end users. The Councils remain concerned that the cumulative effect of this extensive rulemaking will be to constrict credit availability and constrain capital markets, impacting both economic growth and the ability of end users to hedge risk.

In light of the number of new and globally significant regulations implemented following the global financial crisis, it is critical to give full consideration to whether there are possible unforeseen negative effects on financial markets or the financial system, and whether such effects could set the stage for a new type of financial crisis. The Councils appreciate that some work has begun by international regulators to examine this potential, but considerably more analysis remains to be done.

In addition, it is crucial to take further steps to enhance the consistency of regulations between jurisdictions in order to avoid fragmentation and rising costs to end users of financial services, thereby impeding economic growth. However, while consistency among different jurisdictions is an important consideration, regulators and global standard setting bodies must recognize that application of uniform, one-size-fits-all regulations may not be appropriate in certain cases. When local conditions in different jurisdictions necessitate separate paths, regulators in any given jurisdiction should avoid applying rules on an extraterritorial basis. In this context, the Councils see considerable potential for US-Japan cooperation in the regulatory space. For example, as global standard-setting bodies continue the rapid development of international insurance regulations, the United States and Japan have a common interest in communicating closely to share best practices and advocate on areas of common ground.

■ **Level Playing Field:** Like-regulation for like-products and service providers, i.e., a level playing field, is a key regulatory principle for strengthening financial and capital markets and avoiding market inefficiencies and distortions. The Councils urge both governments to avoid distortions that arise when one market participant enjoys favorable treatment over another. It is important to establish a level playing field between mutual aid cooperatives (*kyosai*) and FSA-regulated private sector financial service providers. The Councils also look forward to the Japanese government's further steady progress on postal privatization and stand ready to play a constructive role as the Government continues to take steps to create a level playing field between the postal financial institutions and the private sector.

■ **Neutrality in the Consumption Tax:** The Government of Japan should ensure that its consumption tax regime is consistent with global best practices for value-added taxes (VAT). In particular, the consumption tax law and related regulations should be revised to ensure neutrality in the treatment of sales of financial services offered through sales agents.

■ **Support for Measures to Increase Economic Growth by Enhancing Tokyo's Role as a Global Financial Center:** The Councils support efforts at both the national and local levels to spur economic growth in Japan by taking measures to promote healthy growth of the financial industry and expand the role of Tokyo as an international financial hub.

For example, in line with its commitment to further develop Tokyo as a financial center, the FSA launched a consultation desk in April to give advice on Japan's financial regulations to foreign financial businesses seeking to establish Japan operations. More broadly, the initiative led by the Tokyo Metropolitan Government (TMG), in collaboration with the national government and the private sector, to expand financial activity in Tokyo has the potential to implement a range of constructive policy measures that could lead to a more diverse, steadily growing and sustainable financial industry, contributing meaningfully to economic growth.

The Councils support such efforts to pursue a robust agenda that focuses on identifying barriers to innovation and healthy growth of the financial industry. The Councils will spare no efforts to help realize the measures that would most effectively make Tokyo a more vibrant, innovative and internationally relevant financial center.