Timothy D. Adams
President and CEO

April 5, 2019

Mr. Ryozo Himino
Vice Minister for International Affairs
Financial Services Agency, Government of Japan
3-1-1 Kasumigaseki, Chiyoda-ku
Tokyo 100-8967

RE: Addressing Market Fragmentation

Dear Mr. Himino:

Thank you again for inviting the Institute of International Finance (IIF) and many of our member firms to participate in the Financial Stability Board (FSB) Market Fragmentation workshop on January 28, 2019. We thought it was a great opportunity for authorities and industry to discuss this important issue in more detail. We also appreciated the opportunity to present our views and share the recommendations from our own report on market fragmentation: "Addressing Market Fragmentation: the need for enhanced global regulatory cooperation."[1]

The international financial system is experiencing increasing levels of fragmentation, which undermine the progress that has been made to rebuild the resilience of the global financial system since the financial crisis and which result in negative consequences for financial stability, economic growth, and job creation.

Fragmentation resulting from excessive regulatory and supervisory divergence can trap capital, liquidity, and risk in local markets, create significant financial and operational inefficiencies resulting in additional unnecessary costs to end-users, and reduce the capacity of financial firms to serve both domestic and international customers. To a large extent, financial fragmentation plays the same role as tariffs by building obstacles to efficient allocation of capital in a globalized economy.

It is critical that financial fragmentation be addressed to avoid these consequences and the correlated impact on the global financial system and the world economy. Examples of current types of fragmentation include ring-fencing initiatives (IHC in the U.S. and IPU in the EU), internal TLAC (diverging calibration levels), derivatives trade reporting, benchmarks, and extraterritoriality (e.g. the U.S. Volcker Rule and MiFID II.)

[1] IIF 2019. "Addressing Market Fragmentation" January 2019

It is also critical that the FSB emphasize the importance of enhancing global regulatory, supervisory, and resolution cooperation, which can help reduce fragmentation and regulatory arbitrage and also help ensure the effective functioning of supervisory decisions in a crisis, with the view of protecting global financial stability, rather than acting with a narrower view of domestic interests.

It is therefore very welcomed that the FSB has deemed "Cross-border consistency of reforms" one of its main priorities for 2019, to be undertaken by the FSB Standing Committee on Supervisory and Regulation Cooperation (SRC), exploring what market fragmentation is, under what conditions it can emerge, and its potential impact.[2]

As the FSB continues to detect and address market fragmentation, including through a report that will be presented to the 2019 G20 Osaka summit (June 28-29), the IIF would like to reiterate a number of key recommendations from an industry perspective, and seek to identify which priority areas could be addressed relatively quickly, and which ones are important to address over the longer term.

You will see in the accompanying Annex, that we expand further on the recommendations and include additional and specific action items that can be considered by the G20, FSB, global standard setters, and member jurisdictions to address market fragmentation. We hope that you will find our comments useful and constructive.

Finally, let me say that we very much appreciate that you will be participating in our upcoming IIF Market Fragmentation Roundtable on April 10 in Washington, DC, and we look forward to discussing these issues with you then in more detail. If you have any questions in the meantime, please do not hesitate to contact me or Andrés Portilla (aportilla@iif.com).

Sincerely,

Attachment

[2] FSB 2019. "FSB work programme for 2019" February 2019

ANNEX: IIF Recommendations to G20, FSB and global standard setters

Overarching and Timely Priorities:

There are a number of overarching and timely priorities, focused specifically on addressing market fragmentation, that the IIF would like to suggest are considered immediately by the FSB and global standard setters to support the success of this new FSB initiative:

Continue FSB focus on Market Fragmentation: Given that "Market Fragmentation" is an area of critical importance for the financial system, we would encourage the FSB and the G20 to continue to prioritize this work going forward, including beyond the delivery of the first report to the G20 in June, and a handover to the next G20 presidency.

Coordinate solutions among standard setters: The FSB, through the FSB Standing Committee on Supervisory and Regulation Cooperation (SRC), should work to bring the Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissions (IOSCO), as well as member jurisdictions, closer together to address this problem in a coordinated approach. Each of the standard setters are addressing market fragmentation in their own areas, but the markets would benefit from closer cooperation.

Undertake broad assessment of current fragmentation: The FSB should develop a set of indicators to monitor the degree to which the financial system and its various components are fragmented. The report regularly published by the ECB on the progress of euro-area integration provides examples of the types of indicators to consider. Measurement by the FSB could help support a proper diagnostic and an identification of the root causes behind fragmentation. The FSB should regularly report on this monitoring, with potential oversight by the G20 Finance track to provide guidance and political priorities. That work could also include holistic evaluation of reforms through the use of quantitative impact assessments.

Consistent implementation of international standards: The FSB should review the existing processes at BCBS, IAIS and IOSCO, that assess the degree to which each jurisdiction is implementing internationally agreed standards. Such assessments should evolve from a rules-based to an outcome-based approach, with fragmentation being potentially one of the outcomes that results from diverging implementation. Assessments should also include the degree to which supervisory authorities implement the core principles for banking supervision (currently handled in a separate process, though IMF FSAP) as well as the implementation of cross- border resolution principles.

Encourage jurisdictions to address fragmentation where it already exists: The FSB and G20 should encourage jurisdictions to pledge to make necessary alignments in national regulations, or supervisory practices, where there are clear divergences, not justified by specific risk characteristics, to bring them in line with international standards. Similarly, member jurisdictions should also be urged to avoid creating rules that diverge from international standards, especially if there are possible impacts on financial stability, or potential for regulatory arbitrage. Member jurisdictions should also be urged to avoid developing standards with extraterritorial reach, that overlap with local standards and that undermine trust.

Revive and expand the Basel Core Principles framework: The Basel Committee's "Core Principles for Effective Banking Supervision" provides a useful framework for minimum standards for sound supervisory practices, helping countries assess their supervisory systems and identify areas for improvement, and provides mechanisms for home and host cooperation.[3] It would be valuable to re-visit and expand these Core Principles to address Market Fragmentation.

Streamline cross-border supervision: Fragmentation occurs in particular within cross- border financial groups, due to the lack of harmonization of regulation and supervisory practices between home and host supervisors, lack of equivalence and supervisory deference. The recent trend toward ring-fencing by host jurisdictions, materialized by the IHC/CUSO requirements in the U.S., and the future IPU requirement in the EU, significantly increases the cost of doing business in foreign jurisdictions. Conflicting supervisory expectations should be avoided by a dialogue between supervisors. Supervisors should remain "neutral" vis-à-vis business operating models. Colleges and crisis management groups, while valuable as forums for information sharing, should also address cross border supervisory inefficiencies. Data sharing issues should be addressed between supervisors, for example through MoUs, reducing the burden of multiple overlapping and conflicting reporting requirements.

Include industry and stakeholder input to solutions: The FSB SRC should hold an annual stakeholder conference that brings together the public sector and industry to identify both progress in reducing market fragmentation and remaining obstacles in this area and to discuss the types of tools that can be used by regulators and supervisors, such as mutual recognition and equivalence, to encourage greater comparability of regulatory regimes.

[3] Basel Committee 2012. "Core Principles for Effective Banking Supervision" September 2012.

IIF Priorities from the IIF Market Fragmentation Report:

In the IIF Market Fragmentation Report, we identified 11 specific measures to be considered that would help promote a level playing field and reduce opportunities for regulatory arbitrage.

These measures fall into two broad policy areas that require further action: (i) addressing market fragmentation; and (ii) enhancing international cooperation among authorities. Among these recommendations, we consider 8 to be relatively urgent priorities that can be addressed more quickly:

BOX: IIF Recommendations to G20, the FSB and global standard setters

A. Priority Recommendations to Addressing Market Fragmentation

- Anticipate the extent and impact of national discretion.
- Promote impact assessments and include stakeholder involvement.
- Formulate specific objectives towards greater cooperation among regulators and policymakers.
- Facilitate increased coordination among supervisors, especially around cross-border supervision and resolution.
- Promote information and data sharing among regulators.
- Enhance transparency and accountability of international bodies developing rules and regulations.
- Enhance accountability in adoption of previously agreed global standards.
- Place additional emphasis on supervision and promote supervisory coordination among home and host.

B. Additional Recommendations to Consider Over Time

- Refine monitoring of implementation of internationally agreed standards.
- Encourage greater comparability of regulatory regimes through mutual recognition and equivalence rather than line-by-line comparability.
- Ensure consistency of regulatory and supervisory frameworks across the new competitive environment.

A. Priority Recommendations to Address Market Fragmentation

When regulators and supervisors favor local considerations over global and systemic considerations, the result can be forced subsidiarization, ring-fencing, and the trapping of capital and liquidity, which can have a negative impact on the global financial system and economy. As the global regulatory agenda moves from the development of post-crisis reforms to assessment and implementation of these reforms, it is especially important to ensure full regulatory cooperation. Below are priority recommendations that can help address market fragmentation:

Anticipate the extent and impact of national discretion.

The FSB should discourage the use of national discretion in regard to banking products or risk types where there is a sufficient level of global consistency in practices and risk characteristics. For example, this would include markets such as trade finance, derivatives and wholesale banking.

The FSB and global standard setters, given the differences in underlying risk drivers, could consider in certain circumstances that divergences from the international standards may be deemed acceptable provided there is a clear risk-based approach, and a consistent outcome in terms of financial stability.

Member jurisdictions should, when drafting new regulations, consider any potential spill-over effects (e.g. OTC Derivatives, US Volcker Rule, MiFID II in the EU) and the impact they might have on cross-border activities and in other jurisdictions themselves. Such consideration may need to be achieved through a "Call for Advice" that the local jurisdiction may send to the appropriate international standard setting body, who would be better placed to assess the cross-border implications of a divergent local rule.

Promote impact assessments and include stakeholder involvement.

The FSB should ensure a holistic evaluation of reforms, taking into account: (i) cumulative effects and conflicting incentives; (ii) a transparent methodology; and, (iii) greater use of market data. Ideally these assessments would be both ex-ante/ex-post and include stakeholder involvement.

The FSB's work to evaluate the impacts of overall regulatory reform should go further and on a faster pace to provide cumulative impact analysis.

Global standard setters should introduce similar impact assessments, that evaluate the impact of the overall regulatory reforms, including unintended consequences, and these should include stakeholder involvement.

Formulate specific objectives towards greater cooperation among regulators and policy makers.

The FSB could encourage new types of regulatory cooperation, beyond supervisory colleges and crisis management groups (CMGs).

Jurisdictions, in cases where one or more banks face conflicting national regulations and supervisory actions, often between home and host, could consider a mechanism devised by the Japanese FSA where the supervisors could formulate a structural mechanism that collects evidence of fragmentation and potential solutions. The FSB should also promote greater coordination between prudential and markets regulators when they develop regulation.

Facilitate increased coordination among supervisors, especially around cross-border supervision and resolution.

The FSB could produce guidance around the supervisory responsibilities and interests of host and home authorities, to ensure that supervision is adequate and consistent across member jurisdictions.

The FSB can promote the important role of CMGs in the work that remains to be done to: (i) ensure local ring-fencing of resources (capital and liquidity) remains limited and does not endanger the CMG's recovery and resolution strategy; and (ii) prepare communication and decision-making within the CMG in a crisis.

For example, CMGs could have been better utilized to develop coordinated approaches to internal TLAC requirements.

Promote information and data sharing among regulators.

The FSB and global standard setters should define and implement a more cooperative approach to financial data collection and sharing. This should include data and information-sharing for the purposes of combating financial crime and improving cyber security where national players are faced with common global challenges and adversaries.

The IOSCO Multilateral Memorandum of Understanding is a good example of promoting the need for mutual cooperation and consultation among IOSCO Members to ensure compliance with, and enforcement of, their securities and derivatives laws and regulations.

The FSB should encourage constant and real-time collaboration, which is more efficient for both authorities and for the banks themselves, and probably more likely to be successful as it gives authorities broader and faster actionable information.

Enhance transparency and accountability of international bodies developing rules and regulations.

The FSB and standard setters could include industry and other stakeholders earlier in the process when making rules and evaluating reforms which would in turn benefit from the data, industry knowledge, and experience.

The FSB could consider an annual (or semi-annual) working group or conference to discuss issues of mutual concern on a commonly agreed agenda and provide a status update.

Enhance accountability in adoption of previously agreed global standards.

The FSB or a similar body should assess and report on the state of adoption by all member jurisdictions of the various global reference data and reporting standards that have been created (e.g. LEI, Unique Transaction Identifier, Unique Product Identifier and the Critical Data Elements.)

The FSB, through the Standing Committee on Standards Implementation (SCSI), could broaden the scope of its monitoring to effect change in this area.

Place additional emphasis on supervision and promote supervisory coordination among home and host.

The FSB could emphasize supervision and promote supervisory coordination. International standards should allow a wide range of practices and approaches while building trust among supervisors and promoting transparency and comparability.

Home and host supervisors should work more closely together to address the existing gap between a global banks' scope of operations and a supervisors' scope of responsibility, which is limited to a territory. From this perspective, the current supervisory college is insufficient. However, exploration of other avenues should be subject to adequate confidentiality protections.

The FSB should encourage a more comprehensive discussion on the respective roles for home and host supervisors, to ensure both have sufficient oversight according to their respective responsibilities. In a legitimate manner, the home supervisor focuses on the consolidated group solvency while the host supervisor focuses on local financial stability and protection of national stakeholders' interest. Host supervisor initiatives (ring-fencing of capital and liquidity) should remain limited. Host supervisors should also ensure that the efficiency of a branch operating model, and the ability to serve local clients, is maintained.

Finally, it would be valuable for the FSB to encourage a debate around the use of branches, what purpose they serve, how they differ from subsidiaries, and how branches should be supervised both by home and host countries. This would help encourage more consistency around how branches are treated across jurisdictions and might avoid the need for specific capital and liquidity measures, which has been the subject of recent discussions.

B. Additional Recommendations to Consider over Time

There are a number of other helpful actions that can be taken to reduce the negative impact of fragmentation.

<u>Refine monitoring of implementation of internationally agreed standards.</u>

The G20 and FSB should urge jurisdictions to implement the globally agreed reforms in a consistent manner, both in terms of outcome and timing, to avoid fragmentation.

Given the differences in national banking systems, the FSB and global standard setters should aim to produce rules in a way that the outcome can be consistent across jurisdictions, rather than using a purely "rules-based" approach.

Member jurisdictions should aim to implement the agreed reforms in a consistent manner.
The G20 and FSB should evaluate the opportunity to expand the Basel Committee Regulatory Consistency Assessment Programme (RCAP) framework to include analysis of whether the local implementation of rules is leading to any material differences in outcomes.

The Basel Committee RCAP framework should be evaluated to include an explanation of any divergence from the Basel approach to help identify regulatory fragmentation.

Standard setting bodies should consider, as has been suggested by the Japanese FSA, how standard setting could incorporate considerations for timely implementation across jurisdictions, including by proposing standards that are simpler and clearer.

Encourage greater comparability of regulatory regimes through mutual recognition and equivalence rather than line-by-line comparability.

The FSB should target fragmentation by defining a consensus approach and overall framework for cross-border regulatory cooperation and coordination in banking, markets and insurance regulations.

The FSB should encourage fair and proportionate regulatory and supervisory treatment of foreign subsidiaries of financial groups, to enable them to compete on a level playing field with local competitors, which enhances competition, diversification of financing sources, reduces costs to end-users and enhances financial stability. Such a level playing field should be achieved preferably through recognition of equivalence of the home regulatory and supervisory regime, whenever deemed prudently justified, rather than imposing burdensome overlapping host regulations. Streamlining should also include licensing requirements, where a host supervisor should avoid unnecessarily burdensome processes whenever a home regulation framework is adequate.

Jurisdictions should make more use of mutual recognition and equivalence between home and host supervisors to recognize the oversight in jurisdictions where regulation has a comparable outcome. In making equivalency decisions, the FSB should encourage jurisdictions to consider existing FSB, BCBS or other compliance assessments to achieve a greater level of accountability and stability of outcomes.

Ensure consistency of regulatory and supervisory frameworks across the new competitive environment

The G20 and FSB should encourage the principle of "same activity, same risk, same rules, same supervision."

The FSB and standard setters should, when introducing regulatory and supervisory frameworks, target the activity undertaken, rather than focusing exclusively on the entity, given the risks introduced in the new digital environment.

The FSB and standard setters should, when assessing fragmentation, include financial activities that are offered by non-banks and new entrants, including BigTech and FinTech firms.