Rethinking Regulatory Reforms

Remarks by
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It is my great pleasure to deliver my remarks at the Pan Asian Regulatory Summit.

Since the global financial crisis, colossal international efforts have been made to attain financial regulatory reforms, and most of the initially planned reforms have reached agreement. This indeed is an impressive achievement.

Today we are joined in a meeting titled “Regulatory Summit”, but there is no summit in sight in the current global regulatory landscape: Even though we have been climbing up the mountain for the last seven years, the road to the top still seems to continue, and a summit, where the regulatory requirements stop go higher, seems beyond our sight.

Would such endless regulatory reforms contribute to sustainable economic growth? Would the combined effects of the whole range of well-intended reforms not betray the original good objectives? Would our focus on the prevention of recurrences of the past crisis not make us poorly prepared for the next crisis, which may come with a totally new outfit? Today I would like to talk about these three questions. I believe the time has come for us to review the entirety of the regulatory reforms we have pursued so far and think where we should go from here.

Stability and growth

The Japan FSA (Financial Services Agency) was established in 1998 amid the Japanese financial crisis, and the nation tasked us to stop the crisis and to attain financial stability. We required banks to conduct a tightened loan classification, encouraging them to promptly identify losses and take toxic assets off the balance sheet. Since then, the Japanese financial system has overcome many difficulties, such as the spillover from the global financial crisis and the Great East Japan Earthquake.

On the other hand, we have seen subdued Japanese economy over the past 17 years. Some argue that the advanced economies as a whole may be entering into secular stagnation. Unfortunately Japan has been a front-runner in this context. Our efforts have made banks sound, but banks' dedication to the maintenance of their clean balance sheets has led to lending practices relying on collaterals and guarantees. We at the Japan FSA are taking measures to encourage banks to lend on their assessments of borrowers' business prospects, but past practices may have caused inadequate flow of funds for economic growth. Financial stability needs to be achieved, but it should be achieved in a manner which can foster economic growth. This is the lesson we have learned from our experience.

I believe the sense is not only ours. The communique of the Brisbane summit in last November indicates the latest views of the G20 leaders. At the beginning of the communique, leaders declared that ultimate goal was attaining growth. I quote,

"Raising global growth to deliver better living standards and quality jobs for people across the world is our highest priority."

Leaders also stated:

"Strengthening the resilience of the global economy and stability of the financial system are crucial to sustaining growth and development.

As declared, financial stability is not a goal in itself. It is a means to ensure sustainable growth. The reforms should be designed to ensure resilience of financial system as well as to enable the financial system to contribute to economic growth.

Total picture and individual parts

The G20 leaders also said,

"We have delivered key aspects of the core commitments we made in

response to the financial crisis. The task now is to finalise remaining elements of our policy framework and fully implement agreed financial regulatory reforms, while remaining alert to new risks."

I think the leaders intended to move from the phase of adding new regulations to that of implementing them.

However, the factories manufacturing new regulations are still operating at their full capacity. Around 50 expert groups established by the Financial Stability Board, 40 by the Basel Committee on Banking Supervision, 30 by the International Organization of Securities Commissioners, and 20 by the International Association of Insurance Supervisors, are drafting new regulations or monitoring their implementation. For instance, at the Basel Committee, eight different projects to strengthen the Basel 3 framework are progressing in parallel, and each project contains wide range of initiatives. In addition to the 140 expert groups working for the global standard setters, each jurisdiction is drafting its own national regulations.

The production lines of the regulation factories have been significantly expanded after the global financial crisis. The augmented product lines, or expert groups in the international standard setting bodies, produce innumerable and highly technical new regulatory proposals, rendering it difficult for top policy makers to exert proper governance and control. Might it not be the case that factories and production lines have gained their own momentum and that even leaders' instructions cannot slow them down?

Of course, each new proposal is well intended, has good justifications, and is persuasive enough to convince people of its contribution to financial stability. However, 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?

Rethinking financial regulatory reform

Now I would like to discuss whether massive reforms have collectively achieved optimal regulatory frameworks for the global economy. Please refer to the slide, which lists three questions and 10 issues I would like to discuss. Let's look at each of them.

A. Do benefits outweigh costs?

Regulation involves costs. Higher capital and liquidity requirements, as well as enhanced system for risk management, compliance, disclosure and reporting, all incur costs on banks. If new regulations are introduced every year, implementation costs would be multiplied as banks have to run after moving targets. These costs are incurred on banks, and banks transfer the costs to their customers. Direct burden is on Wall Street, but the ultimate bearer of the burden is Main Street.

Particular attention may be warranted to the impacts on relationship banking with SMEs, long-term infrastructure finance, and trade finance. Customers in these areas have to depend on bank loans as they usually cannot resort to capital markets. Banking activities in the areas are indispensable for real economy, and are not culpable for the recent financial crisis. Nevertheless, tougher regulation will have direct bearing on these activities, which are operated on banks' balance sheets. It is reported that in the US the number of community banks has declined by 41% over the past seven years.[1] Several major players have exited from infrastructure finance and trade finance.

In addition, if regulatory burdens make banks shy away from risk taking, monetary policy would see its transmission channels clogged and may become less effective in saving the economy from recession and deflation.

Effects on emerging economies are another important aspect. At the time of stress, multinational banks tend to protect their lending in home market with the sacrifice of lending in emerging markets. Some authorities even instructed their banks to prioritize their home markets in their recapitalization plan. Regulation induced credit crunch may thus fall disproportionately on emerging markets. This may exacerbate the capital outflow which are already happening and may be accelerated by the potential rate lift off. Impact may be heavier as emerging economies rely more on banking finance than on market-based finance.

[1] McCord, Simpson and Sablik, "Explaining the Decline in the Number of Banks since the Great Recession", *Economic Brief*, Federal Reserve Bank of Richmond, March 2015

These points may imply that further study would be warranted to see if the benefits from reduced crisis probability really outweigh the costs of regulation.

B. Resilient banks, stable system?

Some of you may have read the story of the steamship Eastland, which Randall Kroszner, a former Federal Reserve governor, retold in his recent op-ed piece.[2] Two years after the tragedy of the Titanic in 1912, the International Convention on Safety of Life at Sea introduced the "lifeboats for all" regulation, requiring that enough lifeboats be equipped for all passengers and crew. The United States applied the international rule to domestic liners as well. SS Eastland, a sightseeing steamship on the Great Lake, therefore equipped lifeboats for her 2,500 passengers. Three weeks after, the steamship, with extra weight of lifeboats on her, was suddenly capsized during her trip on Lake Michigan and 841 of her passengers lost their lives, more than in the Titanic disaster.

The Titanic tragedy called for a new regulation, and the burden of the regulation caused an even bigger tragedy. Lifeboat for all, which was intended to allow an orderly rescue from a capsized ship, may have served to create a false sense of security. But it simply did not work.

The episode would lead us to think that paying attention to regulatory cost is not enough. We should also determine if regulations really work to contain another crisis.

It is one thing that we promulgate a heavy regulation, and it is another that capital market allows banks to raise capital required. If banks fail to raise capital, we would just see a credit crunch, rather than stronger banks. Even if they succeed and individual banks become more resilient, they would start to behave differently than before and the aggregate effects in their collective behavioral changes may impair stability and resilience of the financial system and market. There may be a fallacy of composition: a system composed of more resilient banks becoming less

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[2] Randall Kroszner, "A shipping disaster's lessons for Dodd-Frank", *Financial Times*, July 30, 2015

stable.

For example, first, we are aware of the rapid growth of the non-bank sector, such as Mutual Funds and ETFs, to which stronger banking regulations may have contributed. Inherently Mutual Funds and ETFs are highly liquid, but under low-interest environments, the asset managers of these funds increase the investment in illiquid assets such as emerging country bonds and low-rated bonds sharply. If the market situation deteriorates, asset managers will be forced to sell these assets responding to the redemption request, while recent tougher regulatory reforms affecting the trading position of market makers may shrink their market making activities. What will occur in these scenarios is uncertain. Consequently, many observers express concerns that the financial system may lead to lower market liquidity and higher volatility for times of stress. We have witnessed a series of unusual episodes of market volatility in recent periods. A number of market participants have withdrawn from market making activities. We observe declines in trading volumes and dealers' bond inventory. Would banks be able to counter market overshoots in the next stress times? The risk of negative feedback loop between market overshoot and bank balance sheet impairment may have increased rather than decreased.

Second, now that regulatory capital requirements are higher than economic capital, banks are induced to conduct their risk management activities more as a matter of compliance and less on their own initiatives. Many risk managers are occupied with the task of complying with complex and evolving regulations and second guessing supervisors' expectations. However, banks are expected to proactively pursue proper risk management in line with their business strategy, and widely varied risk management among banks can lead to different reactions to particular market conditions. Contrarily, if the risk management is pursued merely from the perspective of compliance with regulations, we may face growing risks of banks' herd behavior taking similar risk positions based on similar risk views. The herding behavior can result in unilateral market movement, and even destabilize markets in a crisis.

Third, we are also witnessing a trend towards an oligopoly in global capital market activities. If a bank prepare itself for the task of providing full investment banking services across the world, it is likely to be assessed as G-SIFIs and put under tougher regulations. It also needs to meet diverse requirements jurisdictions impose on their own. Entry barriers are higher than before, and some G-SIFIs have exited from capital market activities. Survivor G-SIFIs are becoming “too un-substitutable to fail,” and their orderly resolution may be becoming more difficult.

C. Have reforms addressed root causes?

I also would like to discuss whether recent reforms have addressed not just symptoms but root causes of the global financial crisis.

First, while banks’ balance sheets and operations have changed, the way of thinking seen among some bankers, or the culture of greed and short termism, may still stay intact. The ratio of fixed and variable pay may have changed and "malus" and "clawback” may have been introduced, but after all we are witnessing an upward trend in the level of compensation again. No matter how it is paid, a 20 million dollar a year compensation should work to fortify the culture as well as the public perception of bankers.

Second, would regulatory reforms achieve the intended goals of mitigating the pro-cyclical effects of bank capital regulation? The new regulation requires banks to add on capital buffers. If a bank breaches the level of the capital buffers, its reputation will be damaged and the market may start to attack it. Therefore, the capital buffers are effectively regarded as a minimum level of capital requirement, while the buffers are meant to cushion banks against any form of shocks affecting their operations and earnings. The higher minimum requirement including the capital buffer may have intended to make banks hold more shock absorbing resources, but it in fact reduces the banks’ capacity to stabilize the market in times of stress. Furthermore, banks increasing their capital level by offering new equities will be forced to pay larger dividends. Possible unintended consequence is that banks will engage in more risk taking to respond to shareholders’ pressure. While newly introduced countercyclical buffer is expected to work in a counter cyclical manner, it is uncertain that the buffer is effective enough to address pro-cyclicality.

In addition, we do not have consensus if we should contain emerging asset price bubbles and how. Central bankers are still debating whether monetary policy should aim to “lean against the wind” or “clean up the mess after the bust”. Macro-prudential measures are still in an experimental stage and some want to use them to contain a bubble but others say that their main purpose is to equip banks for busts. I would say that prescriptions for irrational exuberance have not been found yet.

Third, I think we are yet to discuss whether banks should be prepared for any tail events or the public safety net should play some roles in meeting extreme tail events. The public safety net should not lead to moral hazard, but to contain the next systemic crisis before it gets out of control.

The past and the future

So far I have discussed the ongoing regulatory reforms, which are designed to prevent recurrences of the last crisis. Perhaps, however, what is more important is preventing the next crisis, which may visit us wearing a totally different contour. It is said that generals always prepare for the last war, but we may face enemies coming from different directions.

Cyber-attacks may be today’s largest risk to financial stability. Regulatory authorities around the world are making their utmost to keep up with the ever growing sophistication of attackers, but so far cross-border cooperation is relatively limited.

Algorithmic trading and other IT assisted transactions that are traded by funds in high-leverage have been changing the market structure, but we do not know yet their full ramifications on market fairness, transparency and stability.

The FinTech can be a game changer and may transform the whole construct of the financial industry. New entries from non-financial industry and unbundling of banking functions are proceeding. While these new technology may contribute to enhance efficiency in financial markets and reduce trading costs, we do not know how the new world would look like yet, but risks and crises there may be different from those in today’s world.

Capital and liquidity alone might not prevent new types of future crisis.

Risk based approach may suggest that many of the 140 expert groups had better be transformed into groups focusing not on the past but on the future.

In conclusion

The second slide summarizes what I tried to propose today.

First, let's think about growth as well as stability.

Second, let's think about the total picture as well as individual parts.

Third, let's think about the future as well as the past.

These are easy to be said but hard to be done. I believe they would take the global community's joint efforts, and the Japan FSA intends to contribute to the efforts. I hope the discussion at this Pan Asian Regulatory Summit today would also give us some clues to pave the way for a new paradigm of financial regulation.

Thank you for your listening.