

4. Keynote Speech

Prof. Hideki Kanda

Professor, Faculty of Law and Graduate School for Law and Politics, the University of Tokyo

Good morning, ladies and gentlemen. My name is Kanda. I am pleased to be here. Thank you very much for giving me the opportunity to talk to you today.

I understand that your focus today will be on the borrowers' side—the consumers' side, and each of the country reports will be about this issue; but, I would rather like to talk about the Investor Services Legislation, which Commissioner Gomi just mentioned. The consumers are not borrowers here, but are lenders of money. I would like to talk in rather an abstract way about how regulations can be designed, and how they can be enforced. If time permits, I would also like to refer to some of the past experiences in Japan—what lessons we can learn from Japan's experiences—including of my personal impression.

My point today is that there are the bank-centered system and the capital market-based system for the financial system. These are two major systems before us. That is what people often say. Although some academics say recently that such a distinction is not so appropriate in describing the current situation, I would like to talk about the cost of the regulation and the cost of enforcement for each system. I hope this would help you look at the world more clearly. In other words, in each of the countries, in order to draw up and maintain proper regulations, it is necessary to look at the cost of drawing up the regulations and the cost of enforcing the regulations (which are not free.) If you look at these costs, probably your conclusion is that the proper regulations for each of the countries differ from one another.

Now, why have I come to harbor these notions? For the past 20 years or so, or maybe over the shorter time span of 10 years, we had in 1997 and 1998 in Asia the currency and economic crises, which had triggered much discussion on corporate governance, proper regulations and so forth. In the circumstances, as Mr. Gomi mentioned, Japan too pursued various reforms, and the pursuit is still continuing.

In my experience of talking about these issues with people from various countries, I have come to realize that people tend to neglect the cost involved in enforcement. As you can see here on my slide, any capital market-based system does not function well

unless it is accompanied by proper regulations and enforcement. It may sound as a given, but come to think of it, it is very difficult to prove what is the proper regulations and enforcement. What I would like to emphasize today is that there are costs involved in making regulations and enforcing, which is not zero. Needless to say, then, that we need to focus on the cost, and think about how to realize the effective regulations and enforcement. This is the key point. In short, this is the message I would like to convey to you today.

My presentation may be a bit abstract, and the financial and capital markets serve a very important role for the economy of each of the countries concerned. But what about the legal rules and the regulations, or regulatory laws? Maybe one line will do, as I have written here: "Do not do bad things." If there is this line then nothing more may be necessary. In Japan we used to have a 17-article constitution and the pledge of the five articles, and all the rules tended to be expressed in short sentences. The same is true for the Western countries, too; all the rules have been written in 10 articles or so.

The cost involved in writing "Do not do bad things" is almost nil. But the cost of enforcing this rule will be prohibitively high. We have to first decide what is bad and what is good, and applying this decision to actual cases would require infinite and limitless costs.

This is why, today, in the financial and capital markets of all the countries, voluminous rules have been written. This is because voluminous rules supposedly lower the enforcement cost.

The most developed capital market in the world is that of the United States, and they have, of course, written rules, and they have regulators like U.S. Securities and Exchange Commission (SEC), which also makes rules in addition to the law. There rules are so voluminous it is very difficult to carry them. I have a booklet that has at least 3,000 pages. Why have such voluminous rules been written? It is because the rules lower the enforcement cost, I believe. To put it more plainly, the more detailed the rules are, the easier it is to apply such rules.

However, it may not be that easy to enforce 3,000 pages rules. First of all, writing 3,000-page rules is not easy. One may make mistakes in writing the rules, so there is obviously a trade-off. Maybe 1,000 pages are better than 3,000 pages, and 100 pages are

better than 1,000 pages, but one line may not be enough. To what extent rules should be written with details is something that we cannot be sure of.

I often cite speeding as an example. There is a 40 km/h speeding limit in many places in Japan, but a line of rule, “do not drive dangerously,” should suffice. The objective of the law here is to prevent traffic accidents. Or in economic wording, to minimize the cost of accidents and the social cost is the policy target. A single line of rule, "one should not drive dangerously," is a proper rule, I would say. But then someone must decide what is dangerous and what is not.

Then pedestrians need to take care of themselves, too. They should avoid walking on dangerous streets or boulevards other than designated crossings. So one rule—the same rule—could do for both drivers and pedestrians, but it does not in reality. That is because the enforcement cost is high. For this reason, there is the rule that drivers shall drive at 40 km/h maximum. That is the rule with details, which is easy to understand, but would it be effective? I am sure the Japanese know what I am talking about.

The story is not simple, but I would say this is the key point, and that is the essence of my presentation. Enforcement, in my presentation, has a broad meaning. Litigation cost is not everything. When the rules are written, rules need to be enforced, and the regulatory body will be established and regulators will serve their function to maintain that regime. All these activities cost money. At the very end, issues may be brought to the court in a country ruled by the law, so the judicial system is also an important infrastructure to be set up and maintained.

I would like to talk a bit that the focuses of the bank system and the capital market system are different. Let us look at the bank system first. It is a very simple system. There is a depositor who provides funds on the right-hand side, and through the banks, the funds flow to someone who is in need of borrowing. Bank system per se is simple, but problems brought about by the bank system are not. I think I have written that the bank system is simple, but regulating the bank system is not.

First of all, banks are destined to continue lending until they fail. Why is it so? Because in most countries banks may overlend and go bankrupt without causing any inconvenience to the depositors. This is something called the deposit insurance system. Of course there is a limit to the amount, but within the limit, banks may overlend and go

bankrupt without any inconvenience to the depositors. In other words, the losses will be covered for by the taxpayers' money in the end. I believe many countries have a similar system. Of course, there are slight differences from country to country, and we need to examine the differences and the coverage provided by various parties. In any case, banks tend to lend until they fail.

When banks make loans, they take not only the credit risk of the borrowers. Nowadays, they also take the market risks and the operational risks including those some people call IT risk. But when something fails, who would bear the costs? It is eventually banks, not the depositors, to the extent covered with the deposit insurance.

The bank regulations are designed and drawn up with these issues in mind, or in accordance to the degree of involvement of the banks in the system. First and foremost, we have to ensure banks perform proper risk management, because banks are the risk-takers and banks tend to lend until they fail. That is the basic problem with regard to banks. In other words, banks must make sure that no bad loans would emerge, or if certain bad loans emerged, then they must manage the bad loans properly.

Compared with the market-based system, it is relatively easy to regulate the bank system because the regulatory body has a focal point to oversee. All regulators have to do is to look at the banks properly. Of course if the regulation is not proper, then this leads to a disaster.

In the capital market system, we use the word "direct financing" or "disintermediation" in English. That means there is no bank. On the right-hand side, there are investors or consumers and on the left-hand side, we have borrowers. But even with the capital market system, someone usually comes in between the investors and borrowers. It is not banks that come in between, but other financial institutions. In a highly-developed market system, the intermediaries are mutual funds, pension funds and the like.

What are the problems of the capital market system as opposed to the bank-based system? Generally, the capital market system is said to be better than the bank-based system. I need to cover this more in detail, but compared with the bank system, the funding cost is lower in the capital market system. There are certain conditions to be met, but it is also possible to raise larger amounts of funds in the capital market. The largest assumption in this kind of discussions is usually that the cost of setting up the

regulations and enforcing them is zero. In Western countries, there have been many kinds of economic studies and empirical research, but most of them assume that the cost of regulations and enforcement is zero. I would like to question this point, but as I have time limitations, let me move on.

Under this system, intermediaries are not the risk-takers but investors are. Another issue is that there are institutions that sell investment vehicles to investors, and that there are always some fraudulent institutions cheating investors. This is one of the reasons that we are preparing the Financial Instruments Trading Act as Mr. Gomi mentioned earlier, which, hopefully will be submitted to the Diet as early as next week.

Compared with the bank system, I think regulations and supervision in the capital market is more difficult, because it is hard to have a focus. Under the bank system, there is only one focus and that is the bank. But in the capital market system, the regulatory authority needs to focus on everything—investors, intermediaries if any, and borrowers. The authority should not solely focus on fraudulent conduct, but there are cases of frauds conduct against investors or users, at the intermediaries as well as at the issuers level. It may be a little exaggerated if I say there are always such cases, but it is true that there have been many such examples.

Let me repeat myself. Focusing just on fraudulent conduct is one-sided. The capital market has the function of promoting financial innovations, leading to a better and more efficient resource allocation, and we need to promote and ensure such innovations.

In any case the regulations in the capital market are not as easy as in the bank system. One needs to be watchful of all the corners, because there is no single focus. In the capital market system, too, an error in regulations could lead to a disaster. Now, let us look at the specific regulations of the capital market itself. I do not have enough time to cover all the aspects, but in general, there are three different types of regulations. The first is strong investor protection; the second is a strong enforcer, the watchdog of the market, such as the SEC; and the third is regulations on institutional investors, such as pensions and investment trusts, which is commonly called fiduciary duty. I noted here “strong enforcers” and “strong regulations”. It is not self-evident why “strong regulations” are needed. In the academic world, some people maintain that no "strong regulations" are needed. In each of the industrialized countries, however, in line with the progress in the capital market, there is a tendency that all the three types of regulations

get stronger. The United States is an example. It is not, however, limited to the United States, it is true with other countries as well. Empirically, it can be said that with the development of the capital market, stronger regulations become necessary.

But what are the real substance of the strong regulations, and how can the strong regulations be enforced? It is not an easy job. Details are on my next slide and on my paper too; and you can read them if you like. The regulations should include strong investor protection, regulations on broker-dealers. I use the word enforcement in a very broad meaning and hence it is very difficult. The basic rules for the capital market include disclosure of information. The law obligates disclosure requirement, but in order for it to function properly, such systems as accounting and auditing must be in place properly, which means that in each of the countries, there must exist a reliable system of the certified public accountant (CPA). Otherwise, even if the system is put into place, it will not function.

The rest is written on my paper. At the very bottom, I wrote that rules have to be made, and enforced. Part of the enforcement is borne by private parties, or victims. This means that, for example, if a person is defrauded, then that person must be able to file litigation by him/herself. Infrastructure for such litigation therefore must also be needed and function. And of course, it is costly to set up and maintain such systems socially.

The third pillar is institutions, or intermediaries in the capital market, such as investment trusts and pension funds. If they are to be regulated, then it too produces costs.

Lastly, I would like to briefly mention a system that is half way between the bank system and the capital market system. In Japan, we used to have the long-term credit bank system (LTCB). On the left-hand side of the chart, there is "borrowers" who can of course tap the capital market for funding. Instead, the corporate borrower may have the long-term credit banks to issue bonds or debentures for funding on its behalf. In place of the borrower on the left-hand side, the long-term credit bank in the center issues debentures, or "bank notes." The long-term credit bank raises funds through issuance of debentures and lend the funds to the borrower. One of the differences from the regular bank system is that legally the long-term credit bank issues debentures, instead of taking deposits. More important, however is that the funds for lending have a

long-term nature—10 years, 20 years, or even 30 years. Those long-term funds were one of the drivers for Japan's high economic growth in the past.

Thus, I believe that some countries may be able to make use of such a system of long-term credit banks. But speaking from the Japanese experience, during the 1990s, the system has almost vanished, and now Japan is moving towards eliminating the system. In terms of regulation cost, there is a focal point, because at the center, there is the long-term credit bank for regulatory authorities to supervise. I will not be able to talk much, but compared to the simple bank system, the long-term credit bank system is more complex. The regulations and supervision will not be, therefore, exactly the same as for the simple banks because stronger regulations are required on certain occasions in the long-term credit bank system.

Now, let me summarize. Which system is better, the bank system or the capital market system? Which is the direction Japan is heading for? Right now, we have both of the two systems at the same time. Clearly, the bank system was the mainstay for decades after the war. During the 1990s, Japan started to shift gradually to the capital market. Now we are in the 21st century, and Japan intends to have the bank system and the capital market system with equal importance.

I have a feeling that in a small economy, the bank system tends to be better and superior because if you think about regulations and enforcement, these cost more, relatively, in a small economy. But if the size of the economy is larger, then the capital market system appears to be better or superior, because the benefits of the capital market outweigh the costs of regulations and enforcement. However, even if that is the case, in reality, both of the systems co-exist at the same time, as is the case in Japan. We therefore have to look at the costs and benefits of the two systems at the same time.

The market globalization brings about many changes. I noted here one point: if you copy rules set up in other countries, then the cost of writing those rules would be zero. Of course you must make sure that other countries' system would work properly in your country. Accordingly, the point would be how to combine the bank system and capital market system for each of the various countries.

It all depends on the situation of the country concerned. Each country has to pick the best format for their needs. One element will not decide which one of the two systems is

better, or more desirable; there are in fact many factors. What I would like to emphasize today is that it is important to consider the costs to set up, maintain, and enforce regulations. The costs should be more focused on, and should be discussed more seriously.

Lastly—it is not only a matter for Japan—if a country is to make a transition from an existing system to a new one, then the transition would also entail some costs, which should not be neglected. Perhaps you may already have known what I presented today, but let me emphasize: in making and enforcing regulations, costs are incurred, and in accordance with the costs, the systems need to be designed properly for each of the countries. The point to stress should be different between countries with their focus on the bank system and those with the capital market system. Thank you very much for your attention.