Financial Regulation in Japan: Recent Trends and Issues

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I. Introduction

In today's economy, globalization of financial markets inevitably affects, and is affected by, one country's financial markets and activities of financial institutions in that country. Globalization of financial markets does not mean that there is one market on the earth. It means that many markets coexist in a multi-layer fashion, from a local domestic market to an international wholesale market. These multiple markets interact with one another. Also, financial transactions take place across country borders and financial institutions act across country borders in these multi-layer markets. Under this environment, a risk arisen in one market can easily be transmitted to another market, but from a regulatory standpoint, it is difficult to regulate these multi-layer financial markets.

The global financial crisis showed inadequacy of financial regulation around the world. Since the crisis, Group of 20 (G20), the Financial Stability Board (FSB) and associated organizations, such as the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissioners (IOSCO), have been struggling in search for a new regulatory framework and seeking an international agreement on the key aspects of a new regulatory regime. In this presentation, I call these post-crisis regulatory measures discussed and agreed at the G20/FSB the "new regulation." Countries have implemented some of the measures of the "new regulation" and are currently considering the remaining part of them.<1>

In this presentation, I describe the current status of financial regulation in Japan. In Japan, the reform of financial regulation has been made in two tiers. One is a response to the global discussion after the financial crisis, and the other is a response to domestic issues. In this presentation, I discuss the former.

II. New Regulation after the Global Financial Crisis

This is hardly the place for full discussion on the global financial crisis, but several words may be appropriate.

As a background, imbalance in macro economy on our planet is important. Today, wealth is accumulated in oil producing and other courtiers, and such excess money runs quickly all over the world in search for a high return. In response to this demand, many financial products were invented with computer-assisted financial technologies. Sophisticated (or too complex) derivatives and securitized financial products were invented and marketed worldwide. Return was everything, and no one cared about the stability of the financial system. It turned out that many exotic financial products were invented, but notably those who ended up with holding those products were financial institutions. Once a bubble burst, financial institutions began to get in trouble, and many financial institutions in the U.S. and Europe had to corrupt or otherwise ask for a help by the states. Lehman Brothers and AIG are notable examples, and many financial institutions got in trouble in Europe as well. Once the credit risks of large financial institutions began to materialize, market participants began to refuse to deal with such institutions, which then led to a liquidity crisis in many markets.<2>

In response to the crisis, the regulators agreed to adopt two basic approaches which were not emphasized before the crisis. One is macro prudential policy, which means that protection of the financial system is now the key and regulation must focus on it. Second, behavior of participants in the market place is pro-cyclical, and thus regulation must bear this in mind and must be designed to be counter-cyclical. Also, the crisis was considered as failure of regulation, and regulators now want to be better informed of the market. This led to proposing a regulation for increased transparency, asking market participants to provide the regulators with more information.<3>

It is important, however, to recognize that in the global discussion, it is not thought that derivatives and securitization are bad for themselves. The common understanding is that they were badly used. In other words, derivatives and securitization are useful but how to use them should be subject to proper regulation and public control.

III. Major Items of New Regulation and Japanese Response

I describe the major items of the "new regulation" proposed by and agreed on at the G20/FSB, and how Japan has been responding to them.

1. In General

As briefly noted above, the primary focus on the new regulation is macro prudence and counter-cyclicality. In this vein, large financial institutions are important in the sense that they affect the stability of the financial system. Such institutions are known as "systemically important financial institutions" (SIFIs), and globally important institutions are called "globally systemically important financial institutions" (G-SIFIs). In November 2011, the FSB published the list of 29 G-SIFIs.<4> This list will be updated annually and published in November every year. The initial list contains only banks, but the FSB says that it may include non-banks in the future. These institutions will be required to hold higher levels of capital from 2016, in line with the implementation of Basel III (described later). These institutions are also required to submit resolution plans to the FSB by the end of 2012, in accordance with the FSB's "Key Attributes of Effective Resolution Regimes."<5> The FSB also published measures for more "intensive and effective" supervision of all SIFIs.

Initial G-SIFIs are the following 29 banks and include three Japanese banks: Bank of America, Bank of China, Bank of New York Mellon, Banque Populaire CdE, Barclays, BNP Paribas, Citigroup, Commerzbank, Credit Suisse, Deutsche Bank, Dexia, Goldman Sachs Group, Credit Agricole, HSBC, ING Bank, JP Morgan Chase, Lloyds Banking Group, Mitsubishi UFJ FG, Mizuho FG, Morgan Stanley, Nordea, Royal Bank of Scotland, Santander, Societe Generale, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group and Wells Fargo.

2. Bank Capital Regulation

The BCBS has a long history of providing capital adequacy standards, known as the Basel Accord, since 1988. The original version, Basel I, has been implemented in many countries, even in courtiers which are not the members of the BCBS. The BCBS then offered Basel II and Basel II.5. As a part of the new regulation after the global financial crisis, the BCBS proposed Basel III.<6>

Japan implemented Basel II from March 31, 2007 and Basel II.5 from December 31, 2011.

As to Japan's implementation plan of Basel III, the recent FSAP Report by the IMF, which was released in August 2012, describes as follows.<7>

First, the Basel III framework will begin to enter into force at end-March 2013. In Japan, new regulations have been finalized and issued in March 2012. Japan has chosen an implementation strategy whereby it will finalize different parts of the Basel III framework by 2019, and typically one year ahead of the internationally agreed implementation dates. The first part being introduced includes changes in the definition of capital and risk coverage under Basel III. The next amendments would be on the capital conservation buffer and on the liquidity coverage ratio, for which the exact timeline will depend upon the outcome of the international discussions.

Second, as of end-2011, Basel II.5 applied only to internationally active banks. Whether Basel III will also have the same limited application is still under discussion. If Basel III were to be applied to other banks, it might be in whole or only in part.

Note that in Japan, Basel II and II.5 are also applied to non-internationally active banks, but their minimum capital ratio is set at 4 percent instead of 8 percent. However, those banks are not allowed to include unrealized gains of available for-sale securities into their Tier 2 capital.

Third, the FSA (Financial Services Agency) and the BOJ (Bank of Japan)'s intention is to implement Basel III regulation as much as possible with the same level of detail as agreed upon internationally. Only where national discretion is allowed or where the text may be insufficiently clear, would the FSA provide extra guidance. The FSA, which is the governmental branch principally responsible for Basel III implementation, does not intend to introduce any form of gold plating or set super equivalent rules. The BOJ is also preparing for Basel III, given its role in onsite and off-site bank supervision, and plans to adapt its reporting framework, including on liquidity, to Basel III concepts. Banks have been preparing for some time for Basel III rules, focusing mainly on the new capital requirements. The banks that are currently covered by Basel II.5 have indicated that they would be able to meet the revised capital requirements according to the Basel III timetable.

Finally, major Japanese banks seem well positioned to meet the new capital requirements because of already issued equity capital in 2008-2010, the scope to rely on retained earnings, and the ability to access other sources (such as the mandatory conversion of preferred stocks into equity capital).

Also, the banks indicated that they did not expect to have difficulties in meeting the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), scheduled to be introduced in 2015 and 2018 respectively. However, their ability to meet liquidity requirements in foreign currency should be monitored, especially given their ongoing expansion overseas. The possible impact of the leverage ratio, once agreed upon, is still being examined, given that the international discussions are still ongoing and banks are in the process of developing internal mechanisms for balancing adequately this ratio in relation to the Basel III capital requirements and the LCR and NSFR.

4. Regulation of Rating Agencies

Rating agencies play an important role in many financial products being marketed, but historically they used to be unregulated. The new regulation introduces regulatory interventions on rating agencies. Japan implemented the regulation of rating agencies by the amendments to the FIEA (Financial Instruments and Exchange Act, the Japanese counterpart of the U.S. Securities Act of 1933 and Securities Exchange Act of 1934) in 2009.

5. Bank Resolution

Experiences showed that once a bank fails, its resolution faced many difficult issues, especially where the bank acts in more than one jurisdictions. The FSB made proposals on the effective bank resolutions, and asked countries to comply with their proposal. As noted above, G-SIFIs are required to submit resolution plans to the FSB by the end of 2012, in accordance with the FSB's "Key Attributes of Effective Resolution Regimes."

In general, Japan does not have to change its current legal regime on bank resolution in order to comply with the FSB's new regulation (in my view, with certain small exceptions, such as permitting a temporary suspension of closeout netting). In any event, there may be some areas where Japan needs to change the relevant current laws, and a working group at the Financial Council at the FSA is currently considering whether such amendments are necessary.

Under the current legal framework for the resolution of banks (or deposit taking financial institutions), the Financial System Management Council (FSMC) is activated when government intervention in a troubled banks is necessary. The FSMC consists of the Prime Minister (chair), the Chief Cabinet Secretary, Minister for Financial Services, the Minister of Finance, the Commissioner of Financial Services Agency and the Governor of the BOJ. It is convened by the Prime Minister to deal with banks that face serious liquidity or solvency pressures. Since its creation, the

FSMC has been used only twice, and since the blanket guarantee for bank deposits was lifted, the general bank resolution measure of providing partial depositor protection has only been used once. Also, the Prime Minister and the Minister of Finance may request BOJ to take actions, when they find it especially necessary for the maintenance of stability of the financial system. When the request is made, BOJ may undertake the necessary actions, including the provision of uncollateralized loans.

6. Shadow Banks

Institutions affecting the financial system are not limited to banks, or deposit taking institutions. They include non-banks, such as investment banks and insurance companies. Thus, the new regulation reaches those non-banks, and the new regulation must be addressed to the group level where various financial activities are conducted in the form of a group of entities. Japan has a group based regulatory scheme for banks, but did not have such for securities firms until two years ago. It was introduced by the amendments to the FIEA in 2010.

The FSAP report noted above indicates a couple of points for the improvement of Japan's legal and regulatory regime in this area. For instance, with regard to resolution, unlike for banks, there is no "systemic risk exception" (see above) for non-banks under the current legal regime, and this may be a matter of future consideration in Japan.

7. OTC Derivatives

Derivatives play an important role in the economy. But they are also associated with risks. The global financial crisis, including the default of Lehman Brothers and the bailout of AIG, highlighted that these risks were not sufficiently mitigated, particularly in the OTC market where almost 95% of derivatives are traded.<8>

At the G-20 Pittsburgh Summit in September 2009, the leaders of the 19 biggest economies in the world and the European Union agreed that "all standard OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest." They also acknowledged that "OTC derivative contracts should be reported to trade repositories and that non-centrally cleared contracts should be subject to higher capital requirements."

Thus, the new regulation of OTC derivatives are aimed at increasing transparency in the derivatives market and addressing financial stability concerns.

Japan responded to these new measures of regulation by the amendments to the FIEA in 2010 (for CCP clearing and reporting to trade repositories) and 2012 (for trading platforms).

8. Executive Compensation

In certain jurisdictions, it was pointed out that the level of compensation to executives of financial institutions is too high and encourages them to invent and sell complicated financial products having risks that cannot be dealt with easily. Thus, the new regulation includes certain control of the level of executive compensation in financial institutions.

In Japan, as compared to other jurisdictions, the level of compensation to executives of financial institutions is not high, and thus no new rule has been implemented in Japan in the past years. However, as an effort to enhance the transparency of corporate governance, for all listed companies (not limited to financial institutions), the FSA adopted a disclosure rule in 2010 which requires disclosure of the amount of annual compensation for individuals who received 100 million yen or more annually.

IV. More General Perspectives on the Japanese System

1. Bank-based or Capital market-based Systems

It is well known that financial systems around the world can be roughly distinguished as either of the bank-based system or the capital market-based system. From a regulatory perspective, two prototypical forms of regulation correspond to the counterparts of this distinction, and thus we observe regulatory differences between the bank system and the capital market system.

I once argued that while it is difficult to assess exactly the costs of regulation and its enforcement in the bank system and the capital market system, it seems that capital market regulation is more costly than bank regulation.<9> Capital market regulation must reach a wider range of matters, and particularly the effectiveness of regulation very much depends on other legal infrastructure such as the existence of a strong enforcement agency and a well-functioning and reliable judicial system in which private litigation is effectively enforced.

Thus, I argued that while many reservations may have to be made, as a prescriptive matter, in countries whose economies are small, the bank system is probably better. The relative costs of regulation and its enforcement between the two systems may matter more in such countries. In contrast, as the size of an economy becomes larger, the benefit of the capital market system, that is, providing capital at cheaper cost, may offset or outweigh the costs of regulation and its enforcement. If so, in a country whose economy is relatively large the capital market system is better.

Note that in reality, there is almost no country where only one of these systems exits. In all industrialized countries, the bank system and the capital market system coexist. There, banks primarily provide borrowers with liquidity and capital markets provide them with capital. Thus, in the real world the costs and benefits of the two systems must be considered in aggregate rather than separately for each of the systems.

Additionally, globalization of financial markets may have an impact on even small economies. Borrowers in small countries may go out and fund in capital markets outside their own countries more cheaply if effective capital market regulation is in place in the economies where they fund. In other words, a country may be able to "borrow" regulation from outside, although I will not further address the costs associated with such borrowing in this paper.

Japan maintains a mixed system, but have been putting more emphasis on the capital market system in the past fifteen years since Japan's Big Bang program in 1996. However, as the FSAP Report noted above points out, the Japanese financial system remains predominantly bank-oriented. Banks hold 60 percent of all financial sector assets, and relative to GDP, the banking sector is larger than other G-7 countries, except for France and the U.K.. The global financial crisis showed the defects of the mixed system of banks and capital markets. Yet Japanese financial institutions did not suffer much, while Japanese capital market did suffer in the form of a large decline in the stock market.

The Japan's response to the post-crisis global discussion is somewhat not drastic, and Japan is following the global discussion on the regulatory reform. Post-crisis new regulation may not change the regulatory landscape in Japan very much. I predict that Japan continues its efforts to find a best (and stable) mix of the banking and capital market systems in the coming years.

2. More Fundamental Legal Regimes

I once wrote that while many characteristics were pointed out about the Japanese legal system in the past decades, three distinctive features existed during the period when Japan experienced high economic growth in the 1960s and 1970s: (1) solid basic laws, (2) strong bureaucracy and (3) small judicial system.<10>

<u>Solid Basic Laws</u> Japan imported basic statutes in the early Meiji era from Europe, and thus prepared solid basic statutes as early as the late 19th century. Japan enacted basic statutes such as the Civil Code, Commercial Code, Civil Procedure Code,

and so on. Japan also prepared a Western-style solid judicial system, including the court system. While how these imported components of the legal infrastructure contributed to the high economic growth in Japan may be a separate question, it is noteworthy that the process of these imports was relatively smooth and Japan was quite successful in the transplantation of basic components from the Western legal system to its legal system.

Strong Bureaucracy Aside from the existence of solid basic laws, however, it must be noted that strong bureaucracy played a significant role during the post-war high growth period. The Japanese economy, including the financial sector, was controlled, protected and carefully taken care of by the government, which was armed with a strong bureaucracy. Universities successfully sent their qualified graduates to the central bureaucracy in the government, and rules made by, and developed under the initiative of, this strong bureaucracy governed the business and financial sectors in Japan, which in turn led the Japanese economy to unprecedented success.

Small Judicial System Under the above-mentioned circumstances, while the judicial system was kept solid since its inception in the Meiji era, the actual role or activity of the judicial sector remained "small." The business sector, including the financial sector, developed rulemaking and dispute resolution mechanisms within themselves and without resorting to courts or the judicial sector. Most bureaucratic rules were promulgated by business participants and bureaucrats, and were almost never challenged before the courts. Also, disputes tended to be resolved within the business sector under the influence of the strong bureaucracy, rather than by means of court litigation. As a result, the national budget allocated to the judicial sector was very small, and the number of judges and private attorneys remained minimal in Japan, compared with other major industrialized countries.

Over the past 10 years, these characteristics have changed. Basic laws have changed. Apparently, bureaucracy has become less powerful. And the amount of court litigation in the business and financial sector has increased. In my view, however, these changes have less to do with the global financial crisis. These changes are taking place gradually, and I do not think that post-crisis global discussion has any significant impact on the process of these changes in the Japanese fundamental legal regimes.

V. Conclusion

Elsewhere I examined the Japanese financial regulation until 1996, and made the following tentative conclusion: (1) a country which suffers from scandals, market crashes or unfavorable economic conditions within the country has a stronger stimulation to move toward "global standards"; (2) the speed of a particular country's move toward these standards depends on its domestic situation; and (3) what is happening is not that everything is moving toward these global standards.<11>

Developments in the financial regulation in Japan have been gradual and incremental, rather than drastic, and even Japan's response to the global discussion after the financial crisis can be viewed as a part of this gradual and incremental process.

NOTES

<1> For my view (written in Japanese) on the global rulemaking after the financial crisis and Japan's response, see Hideki Kanda, Global Rulemaking for Financial Regulation after the Financial Crisis, Horitsu Jiho Vol. 84 No. 10 at 24 (2012).

<2> See Financial Services Authority, The Turner Review－A Regulatory Response to the Global Banking Crisis (March 2009).

<3> See International Law Association, Committee on International Monetary Law, Report at Sofia Conference (2012).

<4> Financial Stability Board, Policy Measures to Address Systemically Important Financial Institutions (4 November 2012).

<5> Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011).

<6> Basel Committee on Banking Supervision, Report to G20 Leaders on Basel III

Implementation (June 2012).

<7> International Monetary Fund, Japan: Financial Sector Stability Assessment Update (August 2012).

<8> See, for example, European Commission, Regulation on Over-the-Counter Derivatives and Market Infrastructures - Frequently Asked Questions (29 March 2012).

<9> Hideki Kanda, Regulatory Differences in Bank and Capital Market Regulation, in Scott Kieff and Troy Paredes (eds.), Perspectives on Corporate Governance (Cambridge University Press, 2010).

<10> Hideki Kanda, Global Importance of Financial Sector Reform, in Say Goo, Douglas Arner and Zhongfei Zhou (eds.), International Financial Sector Reform: Standard Setting and Infrastructure Development (Kluwer, 2002).

<11> Hideki Kanda, Globalization of Financial Markets and Financial Regulation in Japan, Zeitschrift für Japanisches Recht, 1997 Number 4, at 9.