

**Building the Financial System of the 21st Century:
An Agenda for Japan & the United States
Harvard Law School, Cambridge, Massachusetts, September 14-16, 2007**

The tenth Japan-U.S. Symposium was held at the Harvard Law School. Sessions considered the competitiveness of Tokyo and New York as global financial market centers, financial regulatory enforcement systems in Japan and the United States, and retrospective views of both the symposium itself and a decade of financial reform in Japan. Participants recognized significant improvements in the Japanese financial regulatory system and the health of the Japanese financial sector over the previous decade, while expressing concerns about aspects of financial market regulation in both Japan and the United States. There was also considerable concern and uncertainty as to the implications for US, Japanese, and global financial markets of the ongoing subprime mortgage-backed securities crisis.

Session 1: The Competitiveness of Capital Markets in Japan and the United States

An important theme of this year's symposium was the growing feeling that US capital markets may no longer be leading the world as a model of financial market and regulatory efficiency. Similarly, there were questions raised about the attractiveness of Japanese financial markets. The premise of the first session was that US and Japanese financial markets may be in danger of losing their attractiveness to market participants. Thus, it addressed whether and how this might be reversed. Discussions ranged over a variety of issues, including the measurement and meaning of financial market center "competitiveness," as well as the roles of regulation, enforcement, human resources, and other factors in determining the attractiveness of specific financial markets.

Competitiveness

There was considerable debate about the concept of competitiveness as it applied to capital markets. While participants agreed that the specific issues highlighted in recent reports on competitiveness of US, Japanese, and UK markets were important, a number expressed concern about whether the overall concept helped to further reform on those issues or simply to divert attention from fundamental values such as efficiency, liquidity, transparency, and fairness. They strongly expressed the view that the point of financial market regulation is to contribute to efficient capital allocation, not to selectively nurture a domestic financial sector. Some were also skeptical of whether it was meaningful to focus policymaking attention on the national level when finance is becoming ever more global.

An additional criticism of the concept came from participants who felt that the measures of competitiveness, such as IPO shares and delistings, were of only minor importance in and of themselves. They were also skeptical that these metrics corresponded to problems in the broader marketplace. They concluded that addressing these sorts of issues with large-scale regulatory change would be unwise.

Advocates of the concept of competitiveness argued that there was no fundamental difference of perspective. They reasoned that competitiveness as a financial market center could only be a reflection of the more fundamental factors. They pointed out that their policy recommendations focused on increasing transparency and reducing transaction costs, both of which should contribute directly to greater efficiency.

With regard to metrics, they agreed that the number of international IPOs or delistings *per se* may be trivial, but argued that they indeed indicated broader problems – as one participant put it, they constitute a "canary in a coalmine," providing visible evidence of deeper

problems. Foreign firms' decisions about where to list and delist are made based on cost and benefit, and show that at the margin costs are increasing in New York and Japan relative to London and other markets. Also, they pointed to additional metrics that demonstrate the growing disillusionment of US firms with US markets. These included both an apparent retreat from public to private (144A) markets and the limited but growing willingness of US-based firms to list outside the country despite considerable regulatory impediments. Some participants also expressed concern that the difficulty and costs of IPOs in Japan and the United States would have negative knock-on effects for venture capitalists, due to the heightened cost of exit.

An additional defense of the concept of competitiveness addressed the criticism that financial market policies should consider only efficiency of capital allocation. Several participants countered that financial sector promotion was a worthy policy goal because of the sector's high value-added and because of the quality of jobs that are associated with competitive financial markets. They also suggested that positive externalities might arise as a result of improved legal and accounting services that could contribute to corporate governance and efficiency throughout the economy. Finally, several participants spoke of the potential positive impact on tax revenues, especially in Japan, where financial services have to date been underdeveloped and deindustrialization is still in progress.

Competitiveness of Japanese Financial Markets

Despite historic changes and improvements over the last decade, Japanese financial markets were the focus of much of the discussion of financial market center competitiveness. This reflected continued concerns over the regulatory and tax environment, market infrastructure, human resources, and corporate culture.

A starting point to the discussion over Japanese competitiveness was the question of "Competition against whom?" Despite the size of Japanese equity, government bond, and foreign exchange markets, most participants did not see Japan as a major center for global finance like New York or London. Rather they argued that Japan should focus on enhancing its role in regional financial intermediation in East Asia. Thus, the main markets against which Tokyo should seek to compete would be Shanghai, Hong Kong, and Singapore. Of these competitors, Hong Kong and Singapore were recognized as the most important international market centers currently, but participants agreed that Shanghai was likely to emerge as a major regional market as China's regulatory and market infrastructure improves and the RMB becomes fully convertible. The expected rise of the Shanghai market was seen by many participants as making the need for effective reform in Japan much more urgent. Pointing to previous opportunities for full-scale reform in the late 1980s and the mid-1990s, one Japanese participant asserted, "We had one strike in 1987 and a second strike in 1997. We need to hit a home run now. If we don't get it right this time, we strike out."

Several participants made the point that this interpretation could be useful politically in pushing through politically difficult reforms. Even some who were hostile to the concept of competitiveness thought that the perception of competition could induce political support to improve efficiency and transparency.

Market Characteristics

Participants discussed a variety of market characteristics in the context of the competitiveness of Japan as an international financial center. Most participants characterized Japanese trading platforms and settlement systems as being below global standards. Others countered that well-publicized problems at the Tokyo Stock Exchange were being addressed with the planned introduction of new systems (and possibly by its partnership with the New York

Stock Exchange), but participants expressed dissatisfaction with the technological infrastructure of financial markets outside the TSE. Although the agricultural and commodities futures markets were described as the most obsolete, participants expressed concern that other Japanese financial markets were supported by less than state-of-the-art systems.

Liquidity was also an issue of concern for some participants. This was not true of equity and government debt markets, but they expressed disappointment at the limited variety and liquidity of corporate bonds. Asset-backed securities were also seen as underdeveloped. A number of participants felt that Japanese financial markets did a poor job in general of servicing the needs of solvent borrowers with less-than-perfect credit ratings. They expressed the concern that the ongoing global turmoil that began in US subprime mortgage-backed securities would dissuade Japanese regulators and market players from nurturing high-yield bond and commercial paper markets.

Additionally, given the increase in protection of retail investors, many participants expressed concern about the lack of segmentation between wholesale and retail financial markets. They argued that there was a need to allow institutional investors to participate in a less restrictive environment. Drawing from the experience of the UK, they called for a “light touch” approach to professional investors.

Tax policy was also seen as retarding the growth of some sectors of the financial markets. In particular, withholding tax requirements on most foreign holdings of bonds were seen to contribute to lower foreign participation. Anomalies of the capital gains tax and dividend tax were also noted by some participants as important. Such tax issues could lead to significantly lower liquidity in those markets. This was seen as particularly important as protections for retail investors were soon to be significantly expanded with the Financial Instruments and Exchange Law.

Finally, some participants worried that the continuing extremely-low interest rate environment in Japan were retarding its financial markets’ competitiveness (although they observed that the carry trade was keeping Japanese foreign exchange markets active). They felt that the situation made financial institutions and investors less interested in clearly differentiating the risk of various assets. This was seen as bad both for the development of bond markets and for efficiency of capital allocation. Others felt that low interest rates remained essential from a macroeconomic perspective, however, whatever effects they may have on financial markets.

Human Resources

As in previous symposiums, participants expressed concern over what they saw as the lack of access to high-quality human resources. One stated, for example, that there were only about 17,000 CPAs in Japan, as opposed to approximately 330,000 in the United States. Participants pointed to similar shortages of lawyers, IT professionals, and financial professionals with sophisticated risk management and deal structuring expertise.

While there have been efforts to train and recruit more professionals in these areas, participants pointed out that it would take years or even decades not only to reach the numbers needed, but also for those currently entering the workforce to be prepared for leadership positions. They continued to urge more proactive training programs, however. Participants also agreed that Japanese immigration policies unnecessarily constricted the supply of highly-qualified individuals. In particular, many felt that income tax policies discouraged high-income professionals from staying in Japan for extended periods of time. It was also pointed out that

certification requirements for foreign lawyers made it impractical to hire foreign lawyers directly out of law school.

Many participants argued that the problem was even more serious in terms of creating a corps of capable regulators, despite significant progress in officials' professionalism and knowledge over the previous decade. At the policymaking level, they expressed concern that many bureaucrats involved in policy formulation did not have a strong grounding in economics and finance, leading them to recommend policies that did not always contribute to financial efficiency. Politicians, meanwhile, were seen as ill-prepared to make sound judgments about financial sector policies. In terms of enforcement, participants felt that there was still a serious shortage of capable inspectors. Indeed, a number of participants stated that inspectors often did not understand the principles underlying the rules they were enforcing, leading them to concentrate on minor infractions of rules instead of the bigger picture. There was some disagreement on this point, however. It appeared that the biggest problems were to be found in the inspection of financial institutions with complicated structures that were dealing with the most innovative financial products and risk management.

Finally, there was a general agreement that Japanese investors and potential investors were financially unsophisticated and thus had not made optimal use of financial markets. There was not a clear consensus as to whether there was a solution to this problem. Some participants emphasized the need for financial institutions themselves to educate investors, while others suggested central roles for government agencies and universities.

With regard to universities, which were also seen as central to educating financial professionals, the same problem of human resources arose. Not only did participants note that it was difficult to find qualified individuals to teach courses, they also pointed to personnel policies at Japanese universities that made it even harder – in particular, an inability or unwillingness to pay significantly higher wages for scarce skills, as well as inertia within economics and business departments.

Language and Culture

A related issue was that of language. Participants noted that all of the major international financial centers other than Japan (i.e. US, UK, Hong Kong, and Singapore) operated in English, which has therefore become the de facto language of global finance. With few foreigners able to function effectively in business Japanese, this has limited the attractiveness of Japanese financial markets to foreign players. Moreover, the need to translate documents was seen as adding significant additional costs to any new listings or registrations.

In some ways, the language issue was seen as having contributed to Japanese firms' preferences for raising funds in the domestic financial markets, and participants noted that Tokyo had not previously felt as much competition for domestic issuers as might otherwise have been the case. But in a world of increasing capital mobility, in which investors and other financial market players could choose where to do business, concerns were raised that the lack of an English-language infrastructure would retard the competitiveness of Tokyo as a market center.

To address the competitive challenge created by limited English-language infrastructure, a number of participants proposed that regulators should allow some official documents to be submitted in English, as well as internal documentation. Others pointed out that this would increase the challenges for FSA inspectors when they examined foreign financial institutions.

Cultural issues were also seen by some participants as an impediment to more open and competitive financial markets. Several argued that Japanese society remained suspicious of financial activities, due to concerns over income inequality, a belief that finance and speculation are less honorable than manufacturing, and cultural norms against greed. Other participants felt that broad generalizations about culture were not useful, but still felt that corporate culture continued to impede financial innovation and entrepreneurship. They used the phrase “capitalism without capitalists” to express the idea that, while good regulations and systems were in place, Japanese financial actors had not yet been willing or able to take advantage of them to create a vibrant market.

Competitiveness of US Financial Markets

Despite the historic role of US financial markets as leaders in innovation and liquidity, a significant number of participants argued that the United States was losing its competitiveness against other international market centers, especially London. They pointed to foreign (and even limited US) firm delistings, reductions in the share of global IPOs, increasing numbers of firms going private, and the growth of private trading, as well as surveys showing a preference for doing business in London. Indeed, they argued that if the US government did not maintain restrictions on the ability of US firms to list abroad, many more firms would have chosen to do so – an indication of the relative inconvenience and costliness of current US regulation.

Other participants disputed the importance of those changes. For example, they suggested that the trend toward foreign firms delisting was the result of improvements in home markets and global opportunities for trading, rather than anything specific to the US markets. They also argued that the trend toward taking firms private was a global trend and not confined to the United States. Finally, they argued that US financial markets remained the most liquid and innovative in the world.

Regardless of how they felt about the competitiveness debate *per se*, one point on which all participants agreed was that the pace of change in financial innovation and global markets called for constant efforts on the part of lawmakers and regulators to address changing conditions and business models. Some participants did caution, however, that there may not be a need for policy responses to all changes – in fact, they noted that financial innovation has tended to occur most rapidly in the least regulated markets. It was agreed that finding an appropriate balance would not necessarily be easy, but that the key to successful financial systems was to rely as much as possible on the market mechanism.

Deficits of US Financial Markets

Participants who were concerned about the declining competitiveness of US financial markets concentrated much of their discussion on regulatory issues, including most notably regulatory burden and fragmentation. But they were also critical of other aspects of the legal environment, including class action lawsuits and travel restrictions on foreigners.

Shareholder class action suits were cited as being particularly bothersome for firms. Participants noted that they were expensive to litigate and that in many cases firms felt compelled to choose expensive settlements over even more expensive litigation. The uncertainty of jury verdicts, they argued, only made matters worse.

Over time, it has become common wisdom that the US financial markets have benefited tremendously from its access to high-quality personnel. That reflected the quality of US higher education and the openness of the United States to immigration, as well as the fact that there

was money to be made. However, some participants argued that post-9/11 policies have made it more difficult – and in some cases impossible – for financial institutions to assemble optimal teams. The easier immigration standards in London, they argued, contributed to a greater ability to attract the best talent from all over the world.

Finally, it was noted that there had been a crisis of confidence in the major US rating agencies. Some participants argued that this was unfair, since rating agencies set up their models to forecast default risk, and not liquidity risk or volatility.

Politics: Crisis and Response

Participants saw politics as underlying many of the concerns raised about the competitiveness of both Japanese and US financial markets. Three issues received particular focus: protection of retail investors, the structure of vested interest, and responses to crisis.

A keen concern about the protection of retail investors on the part of politicians was seen as a theme in both countries, although Japan had come to it much more recently than the United States. Participants debated the proper extent of protection, recognizing both that adequate protections were necessary to ensure confidence in the market, but also that investor protection could impose unnecessary costs and undesirable limits to market innovation.

The structure of vested interests was seen as a serious obstacle to changes in regulation and tort-law. Participants bemoaned the inertia and lack of proactive change in both economies, although the nature of the inertia appeared to differ. US regulatory agencies were seen as more responsive to changing financial and economic conditions than Japanese regulators (albeit less so than the UK FSA). On the other hand, US policymakers appeared more unable to change laws in the absence of an actual crisis than Japanese policymakers. The federal system inevitably complicated issues of regulatory authority, but even problems that could be handled without recourse to constitutional change – such as amalgamation of federal financial regulators or stricter limitations on class-action suits – were seen as non-starters.

Finally, participants agreed that crises were often catalysts for large-scale changes in the United States and Japan, especially when political stalemates had deferred effective responses to recognizable problems over time. Unfortunately, they agreed, responses to crises tend to overshoot, as political leaders scramble to regain the trust of markets and (perhaps especially) retail investors. Many pointed to Sarbanes-Oxley as one example. market- Nonetheless, many participants expressed the wish that a system could be put into place in both countries that would allow for incremental, market-based reforms; some argued that the UK and Hong Kong authorities came relatively close to that ideal, possibly because of their relatively small domestic investor base and the primarily international nature of their markets.

Session 2: Financial Regulatory Enforcement Systems in Japan and the United States

Participants agreed that systems of regulation and enforcement were central components of the competitiveness and efficiency of financial markets. In Session 2, there was more in-depth discussions of the strengths and weaknesses of those systems in Japan and the United States.

There was a consensus among participants that considerable progress in Japanese financial regulation and enforcement had been made, but they cautioned that global best practices were a moving target and that Japan would need to keep improving regulations and enforcement in order to catch up with market leaders. In addition, several concerns were raised concerning the ways in which Japanese regulation and tax policy continued to stifle financial innovation and market efficiency.

Opinions about the United States varied more broadly. Many participants believed that US regulation and enforcement had a mixed record, characterized by high technical capability but also by increased regulatory burden and an inability to overcome regulatory fragmentation. They cited fragmentation, excessive role of courts, and lack of cost-benefit analysis in rule-making as key problems. As in previous years, Sarbanes-Oxley Section 404 was a target of specific complaints. Other participants felt that, while there were some problems with US regulation and enforcement, for the most part the system did an effective job of supporting market efficiency, disclosure, and fairness. There was little sympathy even among this group for regulatory fragmentation, but they felt that this feature of the US system was not an insurmountable impediment to efficiency.

Common Problems

Many of the criticisms of Japanese and US regulatory and enforcement systems were common to the two countries. In making these complaints, participants referred not only to theoretical ideals, but also to existing systems elsewhere in the world. The UK system in particular was held up as a model to which other systems should aspire. (Participants were nearly, but not completely, unanimous in their regard for the UK system.) Key points of discussion included regulatory burden, enforcement approaches, quality of communication, and the meaning and implications of principle-based vs. rule-based regulation.

Regulatory Burden

Many participants complained of excessive regulatory burden in Japan and the United States. In both cases, but especially in Japan, there were complaints of excessively intrusive and picayune rules. The costs of compliance were also seen as problematic, with Sarbanes-Oxley Section 404 being a common example of a particularly expensive rule. Generally, participants were unhappy with the lack of cost-benefit analysis in US and Japanese regulatory policymaking, contrasting the situation unfavorably with that of the UK.

Participants argued that a key reason for high regulatory burden in both countries was what they saw as excessive attention to the protection of retail investors. Participants felt that there needed to be a sharper distinction between the needs of institutional and retail investors, instead of requiring equally onerous conditions across the board. In the United States, where investor protection had always been an important element, participants noted the irony that requirements had gotten much tighter even as the role of retail investors in the financial markets had significantly declined. Some participants argued that these requirements had been strengthened in the wake of Enron and other corporate scandals in 2001 and 2002 because of the political benefits to legislators of championing the rights of individual citizens against corporate abuses. Others suggested that such changes had been essential to regain investor

confidence in the markets. But few felt that the benefits outweighed the costs anymore. While most participants felt that protection of retail investors had gone too far, some pointed out that the burdensome nature of these regulations was somewhat balanced by the availability of 144A markets for qualified institutional investors.

Some participants noted additionally that anti-money laundering legislation in the United States had significantly raised the regulatory burden. While they agreed with the goals of the rules, they felt that the reporting requirements were unreasonably onerous.

In Japan, it was noted, protection of retail investors had not traditionally been a major element of financial market regulation. This had retarded the growth of markets. Thus, financial market development called for stronger protections, and this had indeed been a feature of Japanese financial regulation over the previous decade and a half, culminating with provisions of the Financial Instruments and Exchange Law, scheduled to come into effect at the end of the month. For example, financial institutions selling products to retail investors would be required under the new law to make extensive disclosures to all investors (even, initially, existing ones) before selling them a new type of product. Japanese privacy laws were also seen as significantly increasing the costs of servicing retail investors.

Enforcement

Participants reserved some of their strongest complaints for enforcement (although a significant minority defended the integrity and professionalism of inspections in both countries). Several who had experienced inspections in both countries felt that the level of intrusiveness was similar, although they noted various differences in the experience. In both cases, a major complaint was excessive focus on adherence to rules rather than on actual economic effects of a given activity. Moreover, participants complained that inspectors in both countries often had a prosecutorial approach. Both of these observations contrasted with participants' experiences and understanding of UK inspections, which were seen to more focused on improving financial institutions' compliance than on punishment. On the bright side, there was a clear consensus that there was no discrimination against foreign financial institutions in either country.

To begin with Japanese enforcement, there was a clear consensus that the inspection process had improved significantly over time in terms of fairness, thoroughness, and competence. Still, participants expressed mixed evaluations. The most common complaint was that Japanese inspectors, perhaps because of lack of trained manpower, were excessively picky about minor rules, while missing the big picture. Many participants complained that there had been a return to item-by-item inspections and that inspectors were unwilling to leave until they had found at least some infractions, no matter how small. (This led some participants to conclude that the key to a quick and successful inspection was to provide inspectors with some minor infractions or errors in compliance up front, so that they would not have to extend their stays just to find something.) One reason given for this was the backlash against Japan's past experience of excessive bureaucratic discretion; unfortunately, some participants argued, regulators had overreacted by giving inspectors no discretion at all. In contrast, others asserted that this had been a necessary aspect of earlier FSA enforcement, but that it had decreased considerably as FSA had gained credibility for strictness and integrity.

Some participants also complained about the adversarial nature of the FSA. They stated that there was no benefit to financial institutions to notify inspectors when they had discovered internal problems, as they would just be cited for the violations anyway. They felt that this significantly reduced the incentives for self-policing when the FSA should instead be encouraging it. Others disagreed, saying that while inspectors had an obligation to cite the

violations, the willingness of financial institutions to come forward with the information would have a large effect on what kind of penalty would be imposed, or even whether there would be an explicit penalty. They argued that some people, especially in the foreign financial institutions, had misunderstood the distinction between inspection and enforcement – all infractions needed to be incorporated into the inspection report in order to maintain the integrity of inspections, but such findings did not automatically mean penalties.

Finally, there were concerns about the effects of enforcement on business. One complaint was over the use of business suspensions as a major tool of enforcement. Another was that financial institutions may have managed their business in a defensive way out of fear that any non-standard activities might trigger sanctions. This was seen as particularly problematic for those institutions offering innovative products or using sophisticated internal controls. These participants felt that there was still considerable uncertainty over how rules might be applied in new situations, and they saw a need to avoid suspension orders or other penalties. Part of the reason they gave for this situation was insufficient expertise of inspectors (for example, over how Basel-2 historical default models are supposed to work). Another major reason given was that the FSA remained reluctant to provide no-action letters in response to advance consultation.

In the case of the United States, a major complaint involved the use of the court system as a means of enforcement. A major concern was that authorities were too quick to threaten criminal prosecution for violations. This was seen to reduce the incentive for voluntary cooperation on the one hand, and to increase incentives for individuals and institutions to admit to wrongdoing in order to avoid criminal penalties on the other. Participants felt that this contributed to an unnecessarily adversarial enforcement system. This added to a general sense that post-Enron financial supervision had shifted from being business-promoting to being more focused on maintaining strict adherence to rules.

Communications

Communications were seen as another area where improvement was needed. Participants expressed concerns not only about communications between financial institutions and regulators in both countries, but also between rule makers and inspectors, especially in Japan. The result, they argued, was that regulations were not being established with a clear understanding of the effects they would have on financial institutions and markets, and thus in many cases they unnecessarily raised the regulatory burden. Participants contrasted this situation with the UK, where regulation and inspection were seen as opportunities for discussion as well as of legal enforcement.

In Japan, both aspects of the lack of communication were seen as explicit reactions to problems in the earlier MOF oversight of financial supervisions. They pointed out that the FSA was created partly in reaction to scandals in which MOF inspectors had been too friendly with the financial institutions they regulated, Japanese financial institutions had had too much influence on the formulation of policy, and policymakers had often sought to affect inspection reports. Thus, the 1997 law had the objective of reducing informal and inappropriate communications. While participants understood the origins and logic of these arrangements, they agreed that there needed to be significant easing in order to improve information flows and quality of information.

Several participants offered evidence of changes in this regard, although not everyone agreed that these changes were significant. They pointed out the inspection manual had been made public and in fact had been created through a process that involved public comment.

Meanwhile, supervisors were increasingly engaging in structured dialogues with regulated institutions, for example by attending meetings of industry associations. Supervisors themselves made a point of inviting participants from financial institutions to speak with them directly about any concerns or complaints they might have. Regarding communication between supervisors and inspectors, a number of participants strongly defended the practice of maintaining no communication during inspections, but pointed out that there were opportunities for useful discussions after inspections were completed. They felt that the post-inspection review process was an opportunity for all parties to discuss what had gone well or poorly. While generally welcoming these procedures, however, other participants expressed skepticism that they would lead to honest interactions, particularly between financial institutions and the FSA. They reasoned that any complaints about the inspection process might be held against them in the future, or perhaps even lead to more severe penalties.

In US markets as well, there was a general sense that useful communications between federal regulators and financial institutions had deteriorated considerably, despite the existence of well-established channels such as public comment periods and requests for no-action letters. This was linked to the increasingly adversarial nature of interactions, as noted above. With regard to state regulators, particularly in New York, the use of the court system as a primary avenue of enforcement had significantly reduced voluntary cooperation.

Principles- vs. Rules-Based Regulation

Many participants felt that one of the problems of US and Japanese financial regulation was that it was rules-based, unlike the principles-based regulation in the UK and Hong Kong. They argued that rules-based systems had a tendency to be excessively rigid about minor compliance issues, while missing the bigger picture of promoting efficiency and risk management. Moreover, they felt that principles-based regulation was better equipped to handle dynamic situations, since the appropriateness of principles would change much more slowly than the appropriateness of specific rules.

Others countered that a shift to principles-based would not necessarily achieve the aims of advocates. They pointed out that even in the UK system, inspectors had thousands of pages worth of rules to enforce. (Advocates of principles-based regulation estimated that the rulebooks in Japan – and especially the United States – were vastly larger and more unwieldy.)

Skeptics also argued that principles-based systems gave significant discretion to regulators that might not be appropriate in Japan or the United States. In Japan, it was pointed out that reduction of discretion was one of the major goals of the establishment of the FSA in the first place, and that minimization of discretion was in fact part of the way in which professionalism had been defined for inspectors and supervisors. There were also concerns about the ability of the FSA – whose personnel were characterized by many participants as overextended and under-trained – to interpret principles in an effective manner. In the United States, the problem was seen as using principles when courts had the final say. Financial institutions preferred clear rules as protection from lawsuits. This was not the case in Japan or the UK.

Enforcement through the Media

A number of participants also expressed concern about what was termed “enforcement through the media.” By this, they meant the use by regulators of leaks and announcements of possible violations or punishments in order to put pressure on financial institutions to accede to charges or demands. US examples most prominently included the very public pronouncements of investigations and charges by former New York Attorney General Eliot Spitzer, as well as

some leaks to major newspapers about possible violations or enforcement actions. In Japan, the major concern was over leaks, with participants noting examples in which confidential inspection results had shown up in major newspapers. (There was some discussion of whether this practice had declined in recent months.) The publicity surrounding questioning of financiers and investors such as Takafumi Horie and Yoshiaki Murakami was also cited as an inappropriate use of the media.

This was seen as a problem for several reasons. Participants noted that it might create the presumption of guilt among readers. Financial institutions that do business with the public or with government entities would face serious business costs due to the damage to their reputations. Thus, it was argued, financial institutions were not only treated unfairly and capriciously, but also would be willing to make admissions of fault (in Japan) or monetary settlements (in the United States) that they might otherwise contest. Additionally, some saw Japanese media leaks as a scare tactic against some types of legal financial activities.

In contrast, some participants were skeptical of the importance of “enforcement through the media,” particularly in Japan. They argued that there was no systematic pattern to leaks and no evidence that media exposure had changed the outcome of investigations or had a chilling effect on financial innovation.

Distinct Patterns in Japan and the United States

In addition to common concerns about regulatory policy and enforcement in Japan and the United States, participants also pointed out problems that were specific to one country or the other.

Class Actions

Perhaps even more urgently than in previous years, participants expressed concern about the effects of litigation on US financial markets and institutions. Many portrayed shareholder class-action lawsuits as being one of the major costs facing listed companies. Because of the ease with which complainants could gain standing and with which such suits could be filed, they argued that corporations and financial institutions operated under a constant shadow of second-guessing. Most importantly, such lawsuits were seen as being extraordinarily costly. Not only did they see the costs of litigation and actual court decisions as high, they argued that the costs were significantly increased because the system encouraged out-of-court settlements to avoid protracted and expensive litigation and discovery. They also suggested that the threat of class-action lawsuits had the effect of encouraging excessive legal precautions and conservatism. Finally, they pointed out that such lawsuits penalized one class of shareholders for the benefit of another (often peripheral) group, leading to undeserved and inefficient economic transfers.

There was little sympathy for what were seen as excesses in the system. However, some participants argued strongly that the basic principle of shareholders' right to challenge management was an important backbone of investor protection in the United States, and that therefore any reforms should focus on frivolous suits and on lowering the payoffs to lawyers specializing in such suits, rather than restricting access to the courts for legitimate complaints.

Due Process

In contrast to the excessive legalism and rampant misuse of the court system they saw in the United States, a number of participants expressed concern about lack of due process in the Japanese financial regulatory enforcement system. They argued that when there were disagreements about the interpretation of a given regulation, financial institutions were confined

to administrative appeals within the FSA itself. While in theory supervisors could overrule inspectors' judgments, these participants stated that in practice there was no incentive to do so, apparently due to internal politics. Some participants went so far as to say that inspectors were functionally above the law, pointing out that they could bar financial institutions from consulting with outside counsel before agreeing to the text of an inspection report.

Other participants countered that this view was exaggerated. They pointed out that not only was there an internal appeal system, but that post-inspection reviews by supervisory branch officials provided additional opportunity to register complaints. Several participants with direct experience of inspections stated that when they made a strong case based on the regulations, they had generally succeeded in having initial decisions reversed at some point in the process. Even with regard to restrictions on consultation with outside counsel, which was generally agreed to be very problematic, some participants pointed out that there were no restrictions on consultation with internal counsel. Since the size of general counsels' offices varies considerably, not all financial institutions were seen to be equally vulnerable.

Firewalls

Finally, one of the biggest complaints raised by participants concerning the Japanese regulatory system was the excessive focus on firewalls. Firewalls were seen to adversely affect business and operations by eliminating opportunities for synergy and reduction of duplicative spending. With regard to synergies, participants complained that firewalls and privacy rules prevented, for example, the sharing of customer information between banking and securities operations. A few participants spoke of situations they had observed in which a representative of one division of a financial institution had been asked to leave the room temporarily in the middle of a sales pitch to a client, due to fears about violating firewalls. Given the low profitability of banking, they argued, cross-marketing was essential to making it economically viable, but firewalls had made that nearly impossible. These rules also prevented effective consolidation of IT systems across divisions, generating significant costs. Coordination was seen as a problem as well.

Session 3: Retrospective Views on 10 Years of the Symposium and of Financial Reform in Japan

The final session looked back at the previous decade, reflecting on both the symposium itself and on the progress of financial sector change in Japan and the United States. There was also considerable discussion of present and future challenges for Japanese and US financial regulators.

Participants spoke positively about the symposium and how it had evolved. They congratulated the organizers for their vision and for having created an atmosphere that was both collegial and relevant, and that succeeded in bringing together top financial professionals and regulators. Several applauded the symposium for having helped to create networks of trust that allowed for frank but civil discussions. They asserted that symposium discussions over time had contributed in concrete ways to financial reforms in Japan, while also helping to inform the views of participants about how to understand the changing financial environment in both countries.

Looking Back

Participants pointed to a number of major changes in Japanese and US financial systems over the course of the previous ten years. These included the fortunes of the two economies and financial systems, regulatory reforms, reaction to crises, and the rise of alternative financing options. They also pointed to areas of apparent inertia, such as the relatively slow development of a credit culture in Japan and the incremental nature of Japanese financial institutions' reactions to globalization and liberalization.

Fluctuating Fortunes

The most striking change noted over the decade was that Japan's long struggle against economic stagnation and financial crisis had been overcome. Previous symposiums had wrestled with the problems of deflation, bankruptcies, weak or negative growth, and massive non-performing loan and capital adequacy problems among banks. In response, and often with the encouragement of symposium discussions, Japanese authorities had explored radical policies such as quantitative easing, bank recapitalizations and nationalizations, and the establishment of government organs to encourage industrial revitalization and unwinding of banks' shareholdings.

By 2007, only deflation persisted among the problems noted in the previous paragraph, and even that no longer applied across the board to all asset prices and was of a relatively low magnitude. Corporate profitability had recovered, banks were no longer losing money, and extensive financial consolidation had occurred both within and across sectors. While many of the previous symposiums had been pessimistic about Japan's economic and financial prospects, there was now a general sense that the worst was behind.

For the United States, the story was less linear. The economy had experienced the tech bubble, its bursting, the challenge of 9/11, recovery, housing bubble, and now the subprime crisis. Meanwhile, the US fiscal picture had changed from surplus to unprecedented deficits, all the while accompanied by high current account deficits and unease about the dollar. Many participants marveled at the resilience of the US economy and financial markets throughout this roller coaster ride, while continuing to express concerns about the future.

Financial Reforms and Markets

The history of the symposium coincided with the history of the implementation of the Big Bang and succeeding financial liberalizations. Financial and corporation laws had been

completely transformed and dispute settlement mechanisms improved. Participants agreed that as a result of that process Japanese financial markets had become substantially free and fair, and in some respects global. Competition had increased across all financial sectors, Tokyo markets were heavily penetrated by foreign ownership, and increasingly liberal regulations were perceived as being fairly administered across domestic and foreign financial institutions. Moreover, Japan's financial system had increasingly become one characterized by market-based indirect financing.

At the same time, participants also expressed several dissatisfactions about how events had proceeded. Most notably, they pointed out that, although Japanese financial markets were an excellent place to make money, there were still no Japanese financial institutions that could be considered global leaders. Moreover, there was still no meaningful market for corporate control, and many Japanese financial institutions were seen as remaining highly bureaucratized and not properly creating incentives for employees to push innovation and profitability. This led some participants to characterize the Japanese economy as "capitalism without capitalists." Some sought to explain this phenomenon as a result of Japanese cultural conservatism and distaste for greed, while others focused more on institutional factors. Some participants also argued that recent high-profile takeover attempts by foreigners had been excessively aggressive or even greenmail, reducing the legitimacy of contests for corporate control.

Participants were also dissatisfied with the lack of progress in making Tokyo a global market. Over the course of the decade, there had been a massive increase in foreign participation on Japanese exchanges, but the sense persisted that Japan had lagged in taking advantage of financial globalization. Indicators included the lack of foreign listings (and indeed, substantial delisting), lack of foreign ownership of JGBs and corporate bonds, and the lack of regional fund-raising within the Tokyo markets. In some ways, Tokyo was seen lagging not only New York and London, but also Hong Kong and Singapore. Some participants questioned whether Japanese leaders were really willing to make the kinds of policy changes that would be necessary to create a truly global market, and to risk the possibility of a "Wimbledon effect."

Finally, participants questioned the extent to which Japan was developing a credit culture. Several expressed disappointment about what they saw as an unwillingness or inability to balance risk and return, as evidenced both in banks' lending practices and the relatively low level of household ownership of risky assets. They worried that this prevented worthy but somewhat risky borrowers from gaining access to appropriately priced capital and also that there was insufficient market discipline on corporations throughout the economy, particularly small and medium-sized enterprises. (These participants also expressed concern that the current subprime problems in the United States may further retard the development of high-yield financing options in Japan.) They saw this as reducing Japan's economic growth potential.

In the United States, participants recognized that the resilience and innovation of financial markets had been demonstrated repeatedly over the period. Nonetheless, there remained serious concerns. Some of these were continuations of much longer-standing issues, while others had developed over the course of the decade.

A concern that had inspired discussion in all the symposiums to date had been the sustainability of US deficits. Few were willing to make predictions about when or how global imbalances would be unwound, but many participants pointed to US macroeconomic policies and consumer behavior as creating severe pressures on the international system, even as they had shored up global demand over the period.

A more recent concern was overregulation of financial markets. While participants agreed that the overall financial environment in the United States was extremely open, they argued that over the previous five years, regulation in the post-9/11, post-Enron environment had become increasingly cumbersome and intrusive. Examples included Sarbanes-Oxley, anti-money laundering legislation, and immigration rules.

There were also some concerns that benign global credit conditions had reduced incentives to create robust systems of risk management. Indeed, as one participant put it, some financial institutions had apparently shifted their focus from risk-adjusted rate of return to “risk-ignored” rate of return. Risk-spreading mechanisms like mortgage-backed securities had, according to this interpretation, given financial institutions excessive confidence that they could strip away risk from their holdings.

Policymaking and Political Will

In looking back over the previous ten years, participants also discussed the political processes by which changes had come about. Four points stood out: the role of private-sector actors, the role of crisis, the role of momentum, and the dangers of complacency.

Participants pointed out that many of the changes in financial markets in both Japan and the United States were not driven by regulation, but by innovation by financial actors. Indeed, some argued that innovation had progressed the furthest in areas in which regulation had been the lightest. New products and models of risk management had substantially changed the financial landscape, with banks increasingly off-loading risk to investors of all sorts, the rise of venture capital, hedge funds, and private equity, and even substantial participation in foreign exchange markets by Japanese households. All these changes exposed new opportunities and vulnerabilities for financial institutions and financial regulators alike.

While private-sector activity was seen as changing constantly and responding rapidly to the shifting environment, participants expressed concern that many of the most consequential regulatory changes had been crisis-driven. For Japan, whose financial system had experienced ongoing crises during the decade, the effect of this dynamic was much less jarring than in the United States, where corporate scandals and 9/11 had been the cause of major re-regulation (or in the opinion of many participants, over-regulation). Participants worried about three aspects of crisis-driven policymaking. First, they were concerned about the costs associated with the onset and resolution of crises. Second, they feared overreaction by authorities, particularly by the US authorities. Third, such policymaking is by definition not forward-looking, possibly increasing the likelihood of future crises.

Thus, there was considerable discussion of whether political will was in place to continue needed reforms. This was seen as particularly an issue in Japan, where regulatory reform was considered still to have further to go than in the United States. Nonetheless, there was a general sense among participants that at least incremental reforms would continue and that there would be no major backtracking. The reason given was momentum: that financial reforms had unleashed market forces that required continuing attention to gaps. Some participants also argued that political will for reform could be gathered under the banner of making Japan an international financial center and avoiding becoming a peripheral market in East Asia relative to Shanghai and Hong Kong. Many participants, meanwhile, were pessimistic about the ability of the US system either to adapt gradually or to respond correctly to crises – indeed, there were serious concerns expressed about how courts and federal and state governments would react to the subprime crisis.

In the end, participants agreed that the previous decade had demonstrated repeatedly the dangers of complacency. Regulators and policymakers would need to be vigilant to try to stay abreast of market changes and risks, even if they could never completely anticipate the next crisis.

Alternative Financing Options

One more point made by participants in their retrospective was the ways in which alternative financial products and institutions had remade the financial market landscape. The rise of asset-backed securities as well as other derivative products had substantially changed the risk management practices and business models of financial institutions of all sorts. Meanwhile, venture capital funds, hedge funds, and private equity had proliferated beyond anyone's predictions over the decade.

There were differing opinions as to whether these changes would make the financial system more or less robust or crisis-prone. However, participants agreed that all of these shifts created new challenges for regulation and supervision, and that these would be topics for continuing debate.

Looking to the Future

Finally, the session also sought to look to the future. The ongoing subprime crisis was on the minds of many participants, some of whom expressed concern that its impact might rival crises with which previous symposiums had dealt, including the Asian Financial Crisis and Japan's own financial and deflationary crises. Most participants appeared to have a cautious optimism about the resilience of global financial markets, but agreed that a global crisis of confidence could lead to a liquidity crisis of a sort that central banks and regulators had limited powers to address.

They also feared overreaction by financial authorities in the United States and elsewhere. In particular, some participants predicted that there would be calls for tighter regulations on hedge funds and credit rating agencies.

Regarding the future development of the Japanese and US financial markets, opinion seemed to be split. Some were convinced that Japan had a viable chance to become a regional financial market for East Asia and for Japanese financial institutions to become competitive on the global stage. Others felt that its chance had passed, and that the best that could be expected was a more efficient domestically-oriented market. Regarding the United States, many expected that the inherent strengths of US markets and financial institutions would guarantee that its financial markets too would remain global leaders; others predicted that US policymakers would be unable to summon the political will to meet the challenges of financial globalization, and financial activity and innovation would increasingly move offshore.