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Special Edition

Japan's Role in an Increasingly Global Financial Market

- Interview with Hirofumi Gomi (Former FSA Commissioner) -

Nomura Research Institute, Ltd.

Interview with Hirofumi Gomi (Former FSA Commissioner)

We are finally emerging from the financial crisis that rocked markets around the world. Inasmuch as Japan was relatively unscathed compared with other developed economies, one would expect other countries to turn to it for guidance. Yet it appears to have contributed little to the numerous proposals for global financial regulation. What role is expected of Japan going forward? To answer this question, we spoke with Hirofumi Gomi, former commissioner of the Financial Services Agency.

Hirofumi Gomi

Chairman, PricewaterhouseCoopers Research Institute (Japan)

Joined Ministry of Finance in 1972. Graduated from Harvard Law School (LL.M.) in 1981. Served as director of the Special Banks Division and the Research Division in the Ministry of Finance Banking Bureau before becoming Director-General of the Inspection Department at the Financial Services Agency. Appointed Secretary-General of Executive Bureau, Securities and Exchange Surveillance Commission in 2000. Subsequently named Director-General of the Inspection Bureau and Director-General of the Supervisory Bureau before serving as FSA Commissioner from 2004 to 2007. Began working as consultant to Nishimura & Asahi in October 2007. Appointed chairman of PricewaterhouseCoopers Research Institute (Japan) in October 2009.

Sadakazu Osaki

Head of Research, Center for Knowledge Exchange and Creation, Nomura Research Institute

Joined Nomura Research Institute (NRI) in 1986. Graduated from University of London School of Law (LL.M.) in 1990. Became Head of Research at NRI's Center for Knowledge Exchange and Creation in April 2008. Currently visiting professor at Waseda Business School and University of Tokyo School of Law. Also serves as ad hoc member of FSA's Financial System Council and METI's Industrial Structure Council.

Conditions in US and Europe similar to Japan's financial crisis

Osaki

A year has passed since the collapse of Lehman Brothers. I would first like to ask whether you think the financial crisis is well and truly over.

Gomi

If you define "financial crisis" as a crisis-like state characterized by the threat of systemic risk, I think it is safe to say that the US and Europe have put it behind them. However, conditions have yet to return to normal. Central banks continue to supply tremendous amounts of liquidity, without which it would be difficult for the financial sector to function as intermediary.

Lack of disclosure makes it difficult to say much about the situation in Europe. In the United States, financial institutions have stabilized to some extent but have made little progress on removing bad loans from their balance sheets. And with the economy thus far unable to return to a self-sustaining growth trajectory, I expect further increases in bad loans.

Osaki

One area of concern for the United States is bank failures—more than 90 lenders have already gone bankrupt in 2009. If this trend continues more than 100 banks will have failed by the end of the year.

Gomi

That is correct. The United States has experienced a string of failures at banks that were not bailed out by the government, and the trend shows no signs of weakening. While economic stimulus measures and infusions of government funds have helped stabilize the US economy, the economy has yet to embark on a self-sustaining recovery, the unemployment rate remains high, and capex—a key component of domestic demand—remains lackluster.

Having experienced Japan's financial crisis and the aftermath, I think conditions in the US today are very similar to those in Japan from 2001 to 2002. It was in the year ended March 1999 that the Japanese government conducted a major recapitalization of the banking system using taxpayer money.

Osaki

That came after the injection of public funds by the Sazanami Committee in March 1998.

Gomi

That's right. The initial capital infusion did not have the desired effect. The Long-Term Credit Bank of Japan and Nippon Credit Bank subsequently collapsed, forcing the government to make a larger and more pronounced capital injection in March 1999.

The United States has been engaged in a similar effort since last autumn. Although US authorities have placed a greater focus on individual institutions, both countries carried out a recapitalization of the banking sector using public funds. On the surface, at least, concerns about the balance sheets of US financial institutions appear to have diminished. But the real economy is not recovering as hoped. In Japan's case, the economy actually began to contract following the recapitalization, leaving banks unable to take on new risk in spite of the infusion of fresh capital.

In the end, Japanese authorities decided that the major banks had substantial bad loans hidden on their balance sheets and carried out special inspections of loans to key borrowers in a bid to identify the bad assets. Heizo Takenaka subsequently appeared on the scene and set the process of bad asset disposals in motion as official policy.

Inasmuch as the current situation in the US resembles this period in Japan's history, it is a concern. It appears as though many more regional financial institutions will fail, and that, in turn, will delay any recovery in the real economy.

"Removing bad assets from bank balance sheets will require public sector involvement."

The central bank also played similar roles in both countries, in my view. The Bank of Japan adopted a zero interest rate policy and supplied liquidity to the banking sector, but the intermediary function of financial institutions was not restored. The situation in the US today is quite similar. Although the large banks have reported profits in recent quarters, the earnings have come from trading activities. More specifically, those profits are derived from a plentiful supply of liquidity, an absence of competitors, and the central bank's willingness to buy risk assets at high prices. Meanwhile, credit costs continue to rise. That is why regional financial institutions that did not receive government capital injections are failing in such large numbers.

Osaki

So you are saying that, although the timeframe may differ somewhat from Japan's case, we cannot rule out a double-dip recession, to use the phrase in vogue.

Gomi

That's correct. In addition to concerns that the economic stimulus is running out of steam, many are worried that the financial intermediary function—a key component of the economic infrastructure—has yet to be restored.

Osaki

In order to allay those concerns, I think a thorough disposal of bad loans will be needed, as you noted earlier. US observers have pointed out that financial institutions do not appear to be writing off bad loans on their own. Is there anything the government or the financial authorities can do in this regard?

Gomi

I think a full removal of these assets from bank balance sheets will require public sector involvement. In Japan, the public and private sectors jointly contributed to the Industrial Revitalization Corporation to remove large bad loans from bank balance sheets. This effort eventually succeeded after many twists and turns.

The United States is trying to do something similar with the Troubled Asset Relief Program (TARP). For some reason, however, the program remains largely dysfunctional, and the results have been inconclusive.

Removing bad loans from bank balance sheets reassures the public that banks have nothing left to hide and gives lenders a fresh start, in the sense that they need only concern themselves with whether new risks (loans) succeed or fail. I think this kind of "reset" of the banking sector requires public sector involvement.

Osaki

Is there a reason why government has been unable to take that step?

Gomi

This is only conjecture, but I think political issues stand in the way. Choosing to address the problem of bad assets raises the possibility or further losses that will require additional injections of taxpayer money. But with concerns about the amount of money that can be provided under TARP, the authorities would probably have to go back to Congress for more funds. And Congress would not say yes. So I think this kind of constraint exists.

Osaki

That is also reminiscent of the situation in Japan. In effect, the government postpones dealing with the problem because it is politically difficult to authorize repeated infusions of taxpayer money into the banking sector.

Gomi

Given the large number of regional bank failures in the US, the authorities should be thinking about using public funds to recapitalize the banks. Even if bank rescues are not required, such action could be justified by the financial unease created by such failures or the potential impact on banks' financial intermediary function.

Some of the large US institutions that have recovered have already repaid the government. In my view, the authorities should not have allowed that to happen. Even if the banks were able to raise the necessary funds from the market, they should have been forced to keep the government money and use it to bolster their capital bases.

Environment encouraging self-discipline is necessary

Osaki

Congress is now discussing a variety of reforms, including regulation of the rating agencies, OTC derivatives, and compensation of financial institution executives. How do you view these efforts? Do you think they will help prevent another crisis, or do you think they are lacking in some basic way?

Gomi

I believe the current crisis was caused by a combination of two factors: (1) gaps in the regulatory framework in areas where trading was driven by sophisticated 21st century financial technology and (2) institutions that took advantage of those gaps to do things that they should not have done. Regulatory gaps alone will not generate a crisis. In effect, I believe the crisis was caused by a lack of self-discipline within these gaps.

Two things must be done to eradicate the causes of the crisis. First, the regulatory gaps need to be filled somehow. Second, structures to promote an environment characterized by self-discipline are needed because there is nothing to prevent new gaps from opening up in the future.

Simple requests for institutions to display greater self-discipline would be ignored by aggressive people at Western financial institutions. It is therefore important to create an environment that fosters self-discipline. But it is difficult to tell from the solutions currently being proposed whether the authorities are looking at the problem from this perspective. If anything, they appear to be leaning towards regulation that ties the hands of banks and other financial institutions.

A high degree of freedom is necessary for the market to perform all its functions perfectly. But unless institutions are also made to bear responsibility for that freedom, mistakes will occur. That is what happened in the current crisis. Attempting to prevent future crises by curtailing institutions' freedom will have some impact, but it will also have the side effect of restricting market functions. As such, the first goal should be to create a framework that is conducive to self-discipline or that brings in the authorities when self-discipline is not functioning, while adopting regulation designed to minimize constraints on market freedom.

What the authorities must do, therefore, is to pursue regulation that is conducive to self-discipline.

Osaki

I think that perspective is largely missing from the debate in Japan as well as in Europe and the US. At the moment, all roads seem to lead toward heavier regulation. At the risk of exaggerating, one gets the impression that the authorities might even outlaw securitization.

So what can we do to improve self-discipline?

Gomi

It's quite simple, really. I think we need to go back to the basics and improve disclosure and transparency.

With regard to the regulation of executive compensation, for example, we could force financial institutions to disclose how compensation is determined and how much they pay their executives in total. That information would then become public knowledge among market participants. If a firm uses a method of determining compensation that is lacking in common sense or—as was common during the crisis—uses compensation systems or amounts that tend to lead the institution's behavior in one direction, the authorities need simply point out that "what you are doing is not illegal but it does run against standard practice." That can be done in a principles-based—but not a rules-based—regulatory framework. There are unwritten rules, which some what might call common sense or ethics, that must be observed if stability is to be maintained in the financial sector. When the authorities observe behavior that does not live up to these standards, they need to point it out and demand that the behavior change. As long as the actions taken by the authorities are based on publicly available information, they will be easy for market participants to understand and therefore more predictable.

I often use the expression "drying in the sun." Letting things dry out in the sunlight kills germs without the need for chemical disinfectants, and can take care of simple problems like mold and mites.

The same, I think, is true of efforts to raise minimum capital adequacy ratios for banks. Some argue that we should require banks to maintain a minimum ratio of core Tier 1 capital to assets. Clearly, a higher core Tier 1 ratio means greater stability of bank operations. But increasing the core Tier 1 ratio can create its own problems and difficulties. If pursued recklessly, it can lead to dilution. For example, it appears increasingly likely that preferred equity will not be included in core Tier 1 capital. Yet there is no fundamental difference between the capital characteristics of preferred and common equity. I question those who would draw a distinction between the two and create a new regulation for banks based solely on core Tier 1 capital. Raising funds by issuing preferred equity represents one approach to capital structure, and from an investor standpoint there are cases in which preferred equity is more attractive than common equity. In fact, I think that is probably more often the case than not.

How would we approach this issue under a principles-based regime? All we would need to do is define a best practice—that in principle Tier 1 capital should consist of core Tier 1 capital. Institutions could then be asked to disclose the status of their core Tier 1 capital or to explain why they have decided on the current ratio of core Tier 1 capital vs. non-core Tier 1 capital and basically to explain their capital structure policy. That would give financial institutions the right to set their own capital structure policy, but only to the extent that it could be justified to the authorities. The inability to justify reckless increases in preferred equity would force institutions to adopt an approach that is closer to best practice. Given the absence of a wonder drug, I believe transparency is the best medicine.

Japan's role in the debate on globally based financial regulation

Osaki

In the ongoing global debate on a review of bank capital requirements, I get the impression that Japan's voice or influence is not as strong as it should be as countries strive to revamp existing regulation. Do you agree?

Gomi

Japan is playing no role at all, something for which I think the politicians are responsible. Debate regarding the tightening of regulation—in the sense of finding ways to address the aftermath of the current crisis and prevent a recurrence in the future—is extremely political in nature.

Osaki

So what you are saying is that although it may look as though these discussions are taking place between national authorities, in fact there are important political dynamics at work?

Gomi

That's right. In the US and the leading countries of Europe, the economic damage and social unease caused by the financial crisis are political problems for which governments will be held accountable. As such, governments need to present a political message saying exactly how they intend to address the crisis. That is why at forums like the G20, G7, and G8, prime ministers, finance ministers, and others with political accountability are leading the debate on tightening regulation. These issues are meant to be discussed by people at the highest level of government.

Unless the Prime Minister becomes more proactive in his communications, Japan will be left out of the discussion.

Japan needed to participate in this discussion starting with the Hokkaido Toyako Summit, and Western nations expected it to do so. Today Europe and the US are exhausted and don't know what to do. Japan alone among the industrialized nations was mostly untouched by the crisis and therefore had the opportunity to present a variety of proposals, but it did nothing.

Japan is in an excellent position to offer advice to the rest of the world. It is able to assess matters objectively because it

"Regulation that directly constrains the freedom of financial institutions and markets should be considered only when truly necessary, and then carefully."

did not suffer great economic damage from the crisis and its flagship financial institutions have not collapsed—in short, it does not find itself in a crisis situation. To the extent that the debate is led by politicians, it will always flow in the direction of excessive regulation. Japan had the opportunity to stop the discussion and say "let's take a step back and review the situation from a professional standpoint."

Senior Western politicians are not in a position to say that. The public and elected representatives are telling the government, "Wait a minute—you still haven't reflected on what you've done. Politicians are partly responsible for this mess, and they should tightly restrain the banks to ensure this never happens again. After all, they've already given the banks access to taxpayer money." At times like this, it is next to impossible for a politician to say, "let's calm down and wait until things settle down, and *then* we can think about our next move." Governments that do not clamor for tighter regulation of financial institutions risk losing their political bases.

If the decision-making is left to such people, there's no telling where we will end up. That is why the largely unscathed Japan needed to stand up and fight against these tendencies. Western policymakers do not actually believe that excessive regulation is best practice—they, too, wanted Japan to come out and declare that suppressing market freedoms will not help anyone.

But because Japan said nothing, it turned into a regulation-tightening competition that was more political theater than anything else. Those in continental Europe and elsewhere who had long argued that the kind of loose regulation prevalent in the US would lead to problems took advantage of the opportunity to increase regulation dramatically. And the situation only escalated from there.

Osaki

In that sense, what that Japan needed to communicate to the world was not detailed technical theories or advice on the creation of a legislative framework but rather recommendations regarding the overall regulatory framework, such as the need to base the framework on disclosure or the need for principles-based regulation.

Gomi

I agree.

Politicians need to set out a number of basic principles, such as that regulation that directly constrains the freedom of financial institutions and markets should be considered only when truly necessary, and then carefully. What Japan should have done is to provide firm leadership and offer advice on creating a forum for discussion. It should have said, "Let's bring practitioners together at the Financial Stability Board and discuss these issues based on the following timetable." But because Japan did not fulfill this role, the Financial Stability Board has now become merely a subcontractor of sorts to the G20 and G8.

The tightening of regulation is not an issue that should be discussed while the market is still in turmoil. Japan could have communicated that message and thereby enabled an orderly and professional discussion, but it did not, and that is extremely unfortunate.

Osaki

To summarize, one point is that the Japanese government viewed financial regulation as a technical issue and forgot that it also had a political dimension. Another is that public opinion in Japan was leaning towards tighter regulation because the US experiment with market fundamentalism and free-market ideology appeared to have failed. That made it difficult for the Japanese government to present a balanced message.

Gomi

If I were to add one more point, it would be that Japanese politicians were of the view that whatever problems Japan experienced were due entirely to what had happened in Europe and the US.

For better or for worse, Japan's financial system was not damaged by the crisis. Putting aside for a moment the issue of whether that is something to be proud of, Japan did not experience a financial crisis. That is why the government decided something must be done about the economy and politicians felt their first responsibility was to enact measures to boost the economy.

While there is nothing wrong with that, there was one more thing the government could have done. We are now seeing proposals for a tightening of financial regulation that would drive Japanese financial institutions into a difficult position. No one came up with the idea that this process had to be brought under control by the politicians, because Japan's financial system was in stable condition.

Osaki

I agree. In the aforementioned debate on core Tier 1 capital, we appear to be heading towards the conclusion that the person with the lightest wounds must receive the most extensive treatment. This doesn't make sense. I can't help but feel that Western nations have been "actors" in a sense and have handled the situation quite skillfully.

Against this backdrop, do you have any thoughts about the future of financial supervision and administration in Japan?

Gomi

Recent events have made it clear that financial crises can occur on a global level, and I think we would be better off assuming that future financial crises will probably take this form as well. If so, Japanese financial authorities need to establish deeper ties with regulators in other nations. In particular, they need to participate in the discussion on global macro-prudential oversight. I think the questions of how the Bank of Japan, the Financial Services Agency, and even the Ministry of Finance are to approach this debate and how to create better opportunities for the exchange of views and information with overseas regulators and central banks are important ones.

What I would like to see in this regard is for Japan to take a leadership role in proposing ideas for a framework of global oversight. How do we build a framework that does not impose excessive regulation on the financial sector but at the same time allows for the exchange of information and makes possible concerted action when necessary? I think this is an important issue.

The Europeans are more likely to recommend the creation of a global Financial Services Agency because of their experience in creating the EU. But while such an organization might be needed within the EU, it is not what the global financial system needs.

No matter how great the domestic focus of Japanese financial institutions, they cannot ignore global regulation. In the future, regulations will no longer be created with the ulterior motive of hampering Japan institutions. New regulations will be forced on Japan with the argument that "this is the way the world does things," regardless of their impact on Japan. Japan risks being left out of the loop unless it takes a more proactive role in the ongoing discussions.

While the financial authorities need to assume leadership in this area, I think politicians also have a significant role to play in the post-crisis environment.

Impact of new government on financial administration

Osaki

That is just the subject I was hoping to ask you about. Do you think the recent change of government in Japan will bring about changes in financial supervision or financial administration?

Gomi

Financial administration will naturally be affected. The fact that the minister for financial services comes from a non-DPJ faction and from a party that campaigned based on its own "manifesto" suggests changes are likely[1].

As you know, financial administrators have two main roles: to enforce existing regulation and to plan and draft new legislation. The former function consists of exercising the supervisor's authority under the law. Absent armed revolution, a change of government or a new minister will not change the direction of these activities. However, it is quite possible that the focus of enforcement priorities or the way or order in which laws are enforced will change. In fact, I think they will almost certainly change.

Since its time as an opposition party, the DPJ (Democratic Party of Japan) has set financial institutions against consumers and small businesses and tried to ensure favorable outcomes for the latter groups. The FSA has from the beginning been a pioneer in the field of consumer protection and was basically told by DPJ officials that "you're doing a good job, but try to do better." As such, I don't think the DPJ's new status as the ruling party will change its approach to these matters. It may, however, adopt more concrete timetables.

On the other hand, I think the planning function will be greatly affected by the change of government, because this is a political process.

Osaki

In terms of its direction?

Gomi

Yes. Because laws are made through the legislative institution of the Diet, the intentions of the current administration have a major impact. I think the financial authorities may now study certain issues for the first time or look into issues that the LDP (Liberal Democratic Party) decided not to investigate.

Given the DPJ's campaign manifesto, the new government is almost certain to consider a law to facilitate the provision of credit in regional areas. This will be a new challenge as it was something the former government had looked at and decided not to pursue.

I think the new government may also instruct the authorities to consider the establishment of a Public Company Law, which although not included in the campaign manifesto is one of the items in the DPJ's policy compendium. This had not been expressly rejected by the LDP coalition when it was in power, but little progress had been made. This would also be an entirely new challenge, and I think it would be a fairly difficult piece of legislation to compile.

An even greater challenge will be the three-year moratorium on debt repayment proposed by the new minister of financial services. I think this will leave staff in a cold sweat, as it potentially involves the constitutional question of property rights.

Fields touched upon by these rules will be heavily affected. What I would like to ask of my former colleagues in Kasumigaseki and other public servants is that they make sure the relevant politicians—be they ministers or vice ministers—communicate these major changes to the market in as simple and predictable a manner as possible. Predictable disclosure is necessary if we are to avert exreme reactions and misunderstandings by market participants.

Osaki

Thank you for providing a variety of new perspectives today.

Note

1) Financial services minister Shizuka Kamei is a member of the People's New Party.

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