A brake pedal alone cannot guarantee safety

Speech by Nobuchika Mori,
Commissioner, Financial Services Agency,
at the Spring Membership Meeting of the Institute of International Finance
May 9, 2017, Tokyo

Good morning, everyone. Welcome to Japan. It is a great pleasure to have the opportunity to speak before the members of the Institute of International Finance.

Rethinking regulatory reforms

About a year and a half ago, I made a speech titled *Rethinking regulatory reforms* in Hong Kong and made several proposals.[1] I argued that we should aim to achieve both sustainable growth and financial stability, not the latter alone. We should put a stop to the endless stream of new regulations being produced by a myriad of working groups. We should assess the cumulative effects of the whole reform package. And, although generals tend to fight the last war, we should look at emerging risks to financial stability as well.

At that time, some considered me as an outlier in the regulators' universe. Today, however, I do not feel isolated. Recent G20 communiques make it clear that sustainable growth is the end and financial stability is a means to the end. The recent US executive order on financial regulation cites fostering of economic growth as one of its core principles. Although previous G20 communiques stated that "critical work *remains*," recent ones emphasize the commitment to "*finalizing* regulatory reforms." The Financial Stability Board (FSB) lists the work to evaluate the effects of regulatory reforms as one of its priorities. Many forums study financial stability implications of FinTech and cyber security. I am pleased to see these developments.

About one year ago, I also argued that we need to assess the consequences of regulatory reform from seven perspectives, in alphabetical order: A. aggregate effects of the total reform package; B. behavioral changes induced by new regulations; C. cross-sectoral effects; D. dynamic multi-period analysis; E. eco-system inherent in the financial system; F. feedback loop; and G. general equilibrium perspective.[2]

The FSB, in its consultation document published in April[3], proposes to evaluate the

---

[1] Nobuchika Mori, "*Rethinking regulatory reforms*," October 13, 2015, Hong Kong
[2] Nobuchika Mori, "*From static regulation to dynamic supervision*," April 13, 2016, Tokyo
[3] Financial Stability Board, "Proposed Policy Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms," April 11, 2017

interaction and coherence among reforms and overall effects of the whole reform package, as well as the effectiveness of individual reforms. It also aspires to conduct general equilibrium type analysis. I support the direction proposed in the document.

I continue to believe that these points are all important. However, today, I will refrain from repeating them further.

The journey and the destination

This year is the anniversary of several financial crises. Thirty years ago, in 1987, stock markets crashed on Black Monday. Twenty years ago, in 1997, the Asian financial crisis erupted in September and the Japanese banking problem developed into an acute crisis in November. And, it is ten years since the subprime mortgage problem surfaced in 2007 as a precursor to the global financial crisis.

Each of these had a major impact, but it was the experience of the Japanese banking crisis that defined and shaped me as a regulator.

In 1994, I was assigned to the position of deputy director of the bank supervision division at the Ministry of Finance, which was then Japan's financial regulator. The non-performing loan problem was already looming large at the time. In hindsight, what we should have done in those days is obvious: we should have built a robust safety net so that we could embark on prompt and decisive resolution of non-performing loans, rather than waiting for economic recovery to resurrect borrowers. I still feel the pain of regret when I look back on those days.

Given the seriousness of the disease, the Japanese financial system needed a major surgical operation, rather than a prolonged treatment with medication. When doctors perform a surgical operation, they must have an operating room ready for their use and blood to transfuse if needed. Japan, however, did not have an adequate operating room, or a well-developed resolution framework.

And it was feared that disclosure of the critical condition of the banking system, which should be indispensable in seeking support for the necessary budgetary and legislative measures, would trigger a full-blown crisis before a new resolution framework could be enacted. The fears delayed action, and the delay aggravated the problem. In the end, a major banking crisis erupted in November 1997, and the long-needed revision of the Deposit Insurance Act was attained only in 1998.

In the wake of the Global Financial Crisis in 2008, the global regulatory community embarked on a reform program to prevent the recurrence of a systemic crisis. The program had four pillars. First, stronger prudential regulations to make banks more resilient by making them hold more capital and liquidity. Second, an effective resolution framework to allow authorities to resolve financial institutions in an orderly

manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions. Third, making the derivatives market safer. Fourth, transformation of toxic shadow banks that caused the crisis, such as structured investment vehicles (SIVs), to market-based finance.

I have just described the critical importance of having a good operating room in advance, based on the experience of the Japanese banking crisis. Among the four pillars, the efforts to secure an effective resolution framework, the second pillar, corresponds to this requirement. Regulators and resolution authorities around the world are working to equip themselves with the necessary resolution powers, make G-SIBs issue TLAC, prepare recovery and resolution plans and form and operationalize cross-border crisis management groups. In addition, the derivatives market reforms, the third pillar, will also work to limit contagion resulting from a resolution.

In Japan, the Deposit Insurance Act and the Financial Instruments and Exchange Act were amended to allow us to implement the second and the third pillars fully.

I believe these were major achievements by the global regulatory community. We have expanded the range of situations in which authorities can resolve a bank without putting taxpayers at risk or harming life on Main Street.

However, we must not be complacent. The new framework has not been tested in real life. In 2011, Denmark tried a bail-in but the outcome was not necessarily encouraging. True, we have made many improvements in our resolution framework since then. But there may be remaining issues to be addressed. For example, Professor Charles Goodhart[4] at the London School of Economics discussed the aftermath of the use of TLAC and pointed out issues both on the operation of recapitalized banks and on TLAC refinancing by other banks.

There can be an idiosyncratic failure of a G-SIB arising from its unique problem, but such would be exceptional. When a major bank fails, that is usually in times of severe market volatility and economic instability, and other banks are likely to be vulnerable as well. The destination of our journey is being ready to implement resolutions even in such a situation, without using public funds and without triggering a systemic crisis.

When the Bank of England announced new rules in November, Governor Mark Carney described them as a "significant milestone on the journey to end 'Too big to fail.'"[5] I agree with Governor Carney that we are still on a journey and have many milestones to cross before reaching the destination. The 2016 annual report of the FSB summarizes the global situation: "[S]ubstantial work remains to build effective

[4] Charles Goodhart, "Bank Resolution under T-LAC: The Aftermath," VOX CEPR's policy portal, December 24, 2014

[5] Bank of England, "Press release: New Bank of England rules bring UK closer to ending taxpayer bailouts," November 8, 2016

resolution regimes and to operationalize resolution plans for cross-border firms."[6]

We already know where we want to go. We will continue our efforts to find solutions to the remaining issues. But in the meantime, regulators and resolution authorities still have responsibilities to protect Main Street from a systemic financial crisis. We must figure out what should be done if a financial crisis strikes on the way to the destination. Ralph Waldo Emerson, an American poet, famously observed, "Life is a journey, not a destination." When it comes to the prevention of a systemic crisis, both the journey and the destination are important.

If a tail event hits and develops into a crisis, the market's price discovery function will be impaired and the market may cease to correct itself. Then market participants will believe in nothing but cash and may be mired in a spiral of contraction. Such system-wide dynamics should be a key consideration in discharging the government responsibility to protect Main Street from the consequences of a systemic financial crisis. As the global financial crisis clearly demonstrated, it is people on Main Street who are hit hardest by a systemic financial crisis.

The resolution framework we have designed is yet to be tested in real life. We are still on our journey. I believe that we should not rule out the possibility of using a public backstop at least while we are on the journey. The lesson from Japan's banking crisis two decades ago is that we need a robust safety net if we are to avoid too-little-too-late.

Some may say, however, if we are still halfway through the journey to end too-big-to-fail, we should tighten regulations further to make it absolutely sure that no big bank will fail. In my view, that is not the right approach.

In my speech in April last year, titled "*From static regulation to dynamic supervision*,"[7] I proposed that the focus of the global post-crisis efforts should shift from regulation to supervision. Speaking about the finalization of Basel III, Chairman Stefan Ingves of the Basel Committee on Banking Supervision said, "It is time to get the job done, to move forward, and focus more on supervision and implementation."[8] I fully agree with Chairman Ingves.

There are two reasons why I believe we should now focus on supervision. First, regulation alone cannot attain the objective. If we are to rely solely on regulations and require banks to hold buffers which can withstand every possible tail event, such would stifle banks' intermediary functions and would not be optimal for the long-term growth of the economy. It could also foster arbitrage and undue accumulation of risks in toxic form of shadow banking, and thus can make the financial system more

[6] Financial Stability Forum, Implementation and Effects of the G20 Financial Regulatory Reforms, 2nd Annual Report, August 31, 2016

[7] Nobuchika Mori, "*From static regulation to dynamic supervision*," April 13, 2016, Tokyo

[8] Stefan Ingves, "Reflections of a Basel Committee Chairman," November 30, 2016, Santiago

vulnerable.

Second, supervision can play roles which regulation cannot play. Financial institutions that have survived the global financial crisis have done so not necessarily due to the size of their capital or liquidity buffers but largely due to their solid risk governance, which allowed them to flexibly change their course of business responding to early signs in the marketplace. Monitoring financial institutions' risk governance is an important task for the supervisory authorities.

Supervisory activities check if new business schemes, such as subprime loans, entail risks not captured by existing regulations. We need supervision to find if regulations provide perverse incentives for banks and induce them to accumulate excessive risks.

It is not easy to monitor the adequacy of banks' risk governance, hidden risks in new products or accumulation of risks resulting from perverse incentives provided by regulations. Supervisory authorities can thus be tempted to rely on simple and mechanical regulations rather than assume these difficult tasks.

I would call it moral hazard if supervisors rely on regulatory buffers to alleviate their own supervisory responsibilities. Authorities may let imbalances grow freely, hoping Basel III will protect the system, but no amount of bank capital is enough if the economy accumulates major imbalances. Micro-prudential supervisors monitor changes in behavior of banks and customers. They have an important role in identifying early signs of distortion and imbalances and in alarming bank management about emerging vulnerabilities.

In short, we must explore the best mix of supervision and regulation if we are to minimize the unintended consequences of regulations and to prevent the accumulation of excessive risks and imbalances.

I believe, however, there is another important potential role supervisors can play. They can initiate dialogue with bankers to explore ways to enhance the quality of financial intermediation. If we have better intermediation, we may have a better balance between debt and growth. Monetary policy may find a better transmission channel. Now, let me elaborate a little more on this point.

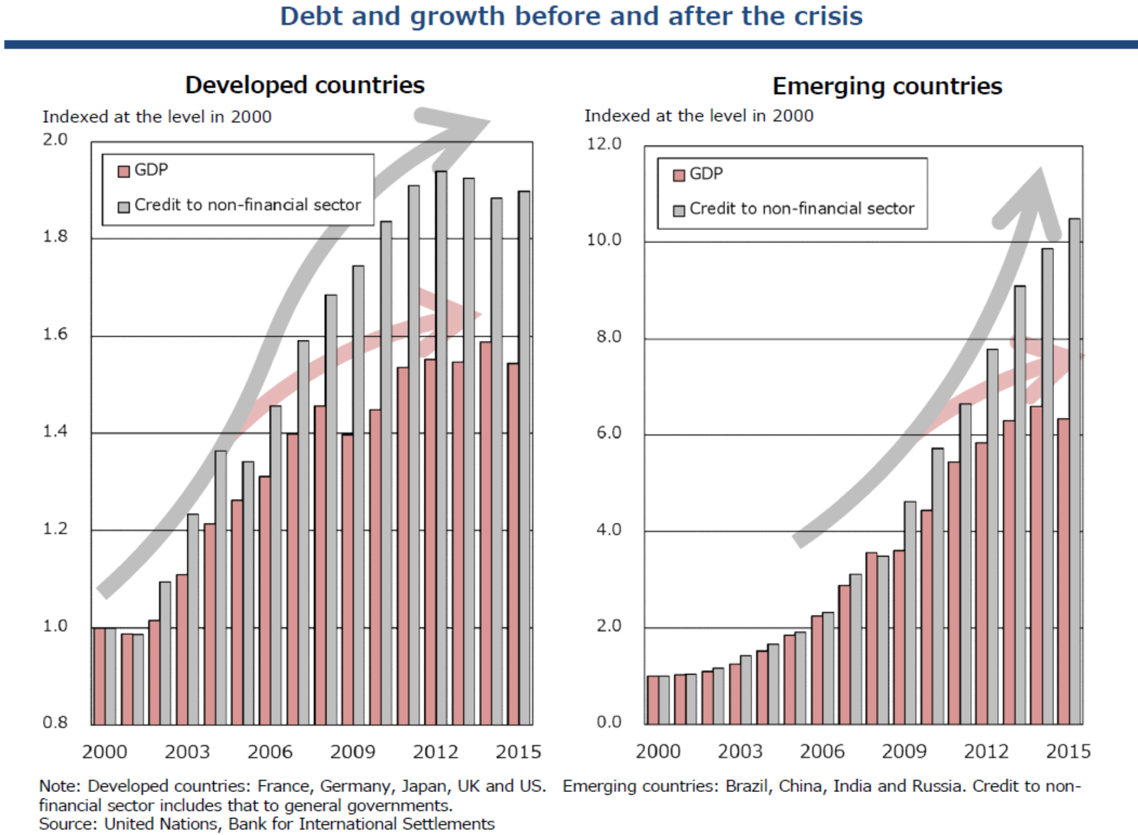
Debt and growth

The regulatory community has addressed fault lines that caused the global financial crisis: weak regulatory standards, weak resolution framework, vulnerable derivatives market and toxic form of shadow banking. The biggest fault line, however, is yet to be addressed.

The biggest driver behind the last crisis was US leveraging. During the six years from

2001 to 2007, the ratio of credit to the non-financial sector to GDP rose by 38 points (from 190% to 228%) in the US. During the four and a half years from 2011 to mid-2016, the same ratio for all BIS reporting countries rose by 54 points (from 193% to 247%). We are witnessing more rapid global leveraging than we saw in the United States during the period of irrational exuberance.

Please look at the charts on the screen. Before the financial crisis, credit expansion generated economic growth. Since the crisis, we see credit expansion without growth, both in developed and emerging economies.



Post crisis, countries needed rapid debt growth to sustain mediocre economic growth. This situation should be even more problematic than the pre-crisis combination of rapid economic growth and rapid debt growth. So long as this situation continues, we have yet to truly put behind us the crisis that shook the world a decade ago.

We have fully stepped on the gas pedal of monetary policy. Credit has grown accordingly. Nevertheless, we have not seen buoyant growth of business activities. The problem may thus rest with the quality, rather than the quantity, of financial intermediation. Perhaps funds are not being provided in ways that really contribute to economic growth.

If that is so, there may be room for improvement. If credit is provided in ways that

enhance borrowers' productivity, revitalize the industry, foster innovations and create new industries, we might be able to lessen our dependence on monetary policy.

If we need to fully step down on the gas pedal all the time to get the car going, an effective brake pedal would not be enough to guarantee safety. Safe driving would require a higher performance of the car as a whole.

We have enhanced the effectiveness of our financial regulations. We have fully mobilized monetary policy. But we see only fast credit growth and not robust economic growth. We need something more to attain our dual goals of financial stability and sustainable growth. My hypothesis is that we need better intermediation.

Bank supervisors monitor micro behavior of a bank and how it discharges its financial intermediation function. They are in a position to know why the car is not going. So far their attention may have been focused on brake pedals and air bags. I would like to suggest that they should also be interested in how the overall performance of the car could be enhanced. This would not be a subject fitted to a command and control style of supervision, but supervisors may be able to play a useful role by having a dialogue with bankers.

Creating shared values

The traditional prudential policy may consider a bank as sound even if its balance sheet is composed mainly of assets which do not lead to sustainable economic growth, so far as the assets are likely to be repaid. Also, a bank selling investment products that do not contribute to steady formation of investors' assets may be regarded as financially sound so long as the products bring in lucrative fees.

However, unless debt growth leads to sustainable economic growth, the financial system will not be sustainable over the longer term. Financial leverage in the economy cannot continue to grow forever, and the time for adjustment will come sooner or later.

If the prosperity of the financial industry does not lead to an improvement in people's welfare, it erodes the social foundation of sound financial business by aggravating the schism between the industry and society and weakening the functioning of democracy. A financial system that allows such to happen is neither sound nor stable.

In addition, in many markets around the globe, population is shrinking and aging, the yield curve is flat and low, and technologies are introducing new competitions. To sustain profitability and stay sound, banks need to find ways to create values shared with their customers. Banks need a business model that enables them to grow with society.

If a bank exercises debt governance on small and medium-size enterprises, on which it

is usually difficult to exercise equity governance, and provides advice and finance combined to raise their productivity, it can create shared values, grow with its customers and improve its sustainability. If many banks do this, they will contribute to the revitalization of local communities, make wage increase possible, and help the economy get out of prolonged deflation. In Japan we do need to create such a virtuous circle. I suppose that may be the case in many parts of the world as well.

We at the Financial *Services* Agency of Japan, or JFSA, formulated our supervisory approach in the midst of the banking crisis two decades ago. The rule-based approach focusing on ex-post check and corrective supervisory actions, which some called a Financial *Sanctions* Agency approach, helped us solve the non-performing loan problem and protect consumers.

But if we blindly repeat applying the same approach, banks may be induced to rely excessively on collaterals and guarantees, and to look only at a borrower's balance sheets rather than the viability of its business model. Banks may be induced to allocate more time to the creation of detailed evidence of their compliance with the letters of customer protection rules rather than to the efforts to identify customers' needs.

In August last year, the JFSA established an advisory group of experts to discuss these matters. In March this year, this panel presented a set of recommendations in a report titled *Transforming JFSA's Supervisory Approaches*.[9]

The panel's three key recommendations are as follows:

- First, regulators' ultimate goal is enhancing national welfare by contributing to the sustainable growth of the national economy and wealth. Ensure that the Agency's supervisory approaches are consistent with its ultimate goal, not just with intermediate goals. Aim to attain both financial stability and effective financial intermediation, both customer protection and customer benefit, and both market integrity and market vigor.

- Second, do not focus only on form: see substance. Do not focus on backward-looking check: be forward-looking. Not be satisfied with the analysis of elements: have holistic views.

- Third, in addition to securing financial institutions' compliance with minimum requirements, have dialogue with them on best practices. Shift from a framework dominated by static regulation to that complemented by dynamic supervision.

The panel also recommended us to update our supervisory processes and techniques; our organizational structure, human resource policies and information infrastructure; and inspection manuals and supervisory guidelines.

[9] Advisory Group on Financial Monitoring, *Transforming JFSA's supervisory approaches*, March 17, 2017. Translation forthcoming.

The JFSA agrees with the panel’s recommendations and intends to implement them in the coming periods. We plan to publish a white paper that outlines how we intend to implement the panel’s recommendations and a series of discussion papers on key areas of reform including prudential policy, conduct policy and enhancement of the quality of financial intermediation. We intend to use them as tools for our dialogue with our stakeholders. I look forward to the opportunities to hear your comments on them.

Conclusion

Let me conclude.

Major achievements have been made during the last decade. Banks now have much larger capital and liquidity buffers. Resolution frameworks have been strengthened. Derivatives markets are being made safer. Toxic forms of shadow banking have been transformed into resilient market-based finance.

However, important tasks remain.

First, we are still on the journey to end too-big-to-fail. We have so far focused on how we can reach the destination. But we should be prepared to respond to a crisis that may hit us on our way to the destination.

Second, we should aim to achieve the best mix of regulation and supervision, rather than trying to resolve everything by regulation. It is time to get the regulatory job done, and focus more on supervision.

Third, we need to find a way to restore balance between debt and growth. Supervisors may have a role in fostering quality intermediation by which banks create values shared with their customers. Supervisors may want to explore how they can play this role.

All three of these tasks are highly difficult. That is precisely why they stay unresolved after ten years of reforms. But I believe we cannot fully attain stability and growth without discharging them. I hope to continue dialogue on these matters with all of you.

Thank you for your kind attention.