Report by the Roundtable Committee on Fundamental Issues of the Financial System Council

-Designing the Japanese Financial System in Light of the Global Financial Crisis-

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【Executive Summary】

The financial crisis that started in the United States has had a significant impact on the financial and capital markets in countries around the world. While Japan's financial system itself has remained stable compared with the U.S. and European systems, the financial crisis has had a serious impact on several areas, including the real economy, stock prices, corporate financing and the government bond repo market, and the impact is still lingering in some areas.

Since the bursting of the so-called bubble economy in the 1990s, Japan has been seeking to establish a two-track financial system oriented toward the development of both the banking and market sectors. However, the banking sector still has a large presence and, although this mitigated the initial impact of the financial crisis, it is one of the factors behind the fact that the impact of the crisis later expanded in Japan compared with in other countries.

These circumstances have reminded us that Japan faces the challenge of further enhancing the banking sector's financial intermediary function and developing the market sector's financial intermediary function while increasing the resilience of the banking sector against stock price fluctuations, and other sudden changes in markets.

Specifically, first of all, it is urgent to reform the financial intermediary function of the banking sector, which is deemed to have relied on credit security based on collateral. It is desirable that banks will aim for a business model of supporting value creation by companies. The social responsibility of the banking sector is attracting renewed attention, and the significance of the banking sector's financial intermediary function has been recognized anew.

At the same time, it is necessary to establish a well-balanced financial system by strengthening the financial intermediary function of the market sector, whose weight in the Japanese financial system is still small. In other words, the efforts to establish a two-track system that have continued since the 1990s should be maintained. These efforts are intended to contribute to the formation of the people's assets.

Although there are some differences in the recognition of, and the response to, the crisis between Japan and other countries, countries around the world are cooperating in the implementation of measures to prevent the accumulation of imbalances that could trigger a financial crisis originating in the markets and to curb the spread of a crisis.

While it is necessary to continue promoting such measures, it is also essential to make use of the experiences and knowledge so far accumulated in order to deal with potential risks that could lead to a new financial crisis. Related to this matter, for example, regarding emissions trading, it is important for Japan to make active contribution to the establishment of international rules, accounting standards and monitoring systems in order to ensure the appropriateness and transparency of transactions, while paying due attention to the impacts on economic activities.

It is also important to take care to avoid the situation where the efforts to improve the soundness of the banking sector in major countries produce the unintended effect of hurting the real economy or the financial intermediary function. In particular, if the strengthening of regulation produces an excessive impact on the economies of the G-20 countries, including Japan, which have a significant weight in the global economy, it would not be beneficial for the global economy as a whole. A gradualist, pragmatic approach is therefore warranted.

Moreover, it is important to enhance the regulation and supervision that focus on the interconnectedness among financial institutions and markets, in addition to the financial supervision that focuses on the soundness of individual financial institutions.

In light of the above, in future efforts to build a financial system, the “3S” approach (ensuring “Suitability,” “Sustainability and “Stability”) is important.

In addition, given that the impact of the financial crisis on the real economy is serious in Japan compared with in other major countries, the authorities are making every effort to take policy measures to control the routes through which the impact of a financial crisis could spread to the real economy.

The government and the central bank must take great care, at the same time, to avoid the situation in which fiscal or monetary imbalances would have adverse effects on the Japanese economy as a result of such measures. As countries around the world are confronted with the need to deal with huge fiscal deficits and take unconventional monetary measures, they must come up with creative policy measures expanding the frontiers of effective policy-making to tackle unprecedented challenges that cannot be dealt with by conventional economic theories and conventional economic measures. This situation is especially pronounced in Japan, so it is desirable for the country to play a pioneering role in tackling such unprecedented challenges through expanding the frontiers of effective policy making.

The Roundtable Committee on Fundamental Issues of the Financial System Council

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I. Introduction

While the global financial crisis has been triggered by the subprime mortgage problem in the United States, it has had a widespread impact on the financial and capital markets of countries around the world and dealt a significant blow to the global economy.

Although the impact of the financial crisis spread to Japan, the country's financial system has remained stable compared with the U.S. and European systems. Nevertheless, stock prices have shown more volatile movements in Japan than in the United States and Europe and many other problems have occurred, including a tightening of the loan market and the turmoil in the government bond repo market (repurchase agreement market).

In its eight rounds of deliberations held since July this year, our roundtable committee has examined what Japan's financial system should be like in the future in light of the financial crisis.[1] This report summarizes the results of our roundtable committee's deliberations. We hope that the people and organizations concerned will make efforts to build a more robust financial system that provides an enhanced financial intermediary function.

II. Progress of Japan's Financial System Reform

In the periods of postwar economic reconstruction and high growth, Japan introduced the systems of specialization and division of work into its financial sector, maintaining strict walls between the banking and securities businesses and between the long-term and short-term financing businesses. Japan also introduced various regulations, including the regulation on interest rates. It has been pointed out that this financial framework enabled financial institutions to ensure stable provision of funds from their limited funds to meet active demand from various economic sectors, thereby contributing to Japan's economic development.

Around the time of the oil crises of the 1970s, the Japanese economy shifted from a period of high growth to one of stable growth. Against the background of the internationalization of the economy and the financial sector as well as technological innovation, Japan gradually implemented a variety of financial system reforms,

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[1] The Roundtable Committee on Fundamental Issues received a presentation from Professor Makoto Saito of Hitotsubashi University Graduate School of Economics, as a guest speaker, and used the presentation as a reference for our discussion.

including the liberalization of interest rates, the diversification of financial products and improvement and expansion of the financial and capital markets, thereby changing the financial system so as to ensure efficient allocation of funds through flexible interest rate movements.

In the 1980s through 1990s, the economic bubble arose and then collapsed just as Japan was implementing the reform measures and improving the framework of regulation and supervision. As Japan's financial system was structured in a way that concentrated risks in the banking sector, the system suffered a significant blow and the real economy was also seriously affected.

In light of these experiences, Japan took the following measures.

(i) Under the Financial System Reform Act, which was enacted in 1998, financial market reforms were implemented in preparation for the aging of the Japanese population, including the development of an institutional framework for the provision of various products, the improvement of the quality of financial intermediary services, the establishment of a user-friendly market and the development of an institutional framework and rules that ensure fair and transparent transactions, so as to make a variety of products available for investors and diversify the means of fund-raising for companies.

Meanwhile, the Study Group on New Trends in Finance recommended in the same year that the financial intermediary business in which the banking sector has a large presence be diversified so as to create a favorable environment for the widespread provision of a variety of financial products.

In 2002, "Vision for the Future of the Financial System and Policy" was set forth with a view to building a two-track financial system, which ensures an appropriate provision of funds through the market to businesses with growth potential and relatively high risk and disperses risks widely (market-based finance), in addition to the bank-centric financial intermediary activity based on deposit-taking and lending.

(ii) Later, based on these plans, institutional reforms were implemented over several years in order to develop the financial and capital market infrastructures, secure fairness and transparency over the market, provide thorough protection to users and improve user convenience. In line with the Program for Further Financial Reform, which was announced in 2004, a comprehensive and cross-sectoral legal framework for the protection of users was established in 2006 through the enactment of the Financial Instruments and Exchange Act. In 2007, the Better Market Initiative (the

Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets) was adopted, and it has been gradually implemented.

(iii) In addition, in order to stabilize the financial system, the Act concerning Emergency Measures for the Revitalization of the Financial Functions and the Act concerning Emergency Measures for Early Strengthening of Financial Functions were established in 1998. Financial-sector safety nets were established through the amendment of the Deposit Insurance Act (intended to introduce measures to deal with a financial crisis on a permanent basis) and the amendment of the Insurance Business Act (intended to make permanent government guarantee concerning the borrowings made by insurance policyholders protection corporation) and the establishment of the investor protection fund system based on the Financial System Reform Act in 2000. In 1997, the Bank of Japan Act was amended so as to clarify the role of the Japanese central bank.

Despite these measures, risks still remain concentrated in the banking sector, as the flow of funds through the banking sector still accounts for a significant portion of financial intermediation in the Japanese financial system.

Namely, (i) deposits account for about 50% of financial assets held by Japanese individuals (52% in fiscal 1998 and 53% in fiscal 2008), (ii) borrowings from the banking sector account for more than 30% of overall funds raised by Japanese companies (41% in fiscal 1998 and 36% in fiscal 2008) and (iii) the banking sector holds nearly 50% of corporate bonds (32% in fiscal 1998 and 48% in fiscal 2008) and more than 30% of commercial paper (CP) (47% in fiscal 1998 and 35% in fiscal 2008).

Ⅲ. Notable Features of the Global Financial Crisis and its Impact on Japan’s Financial System

Just as the Japanese financial system was in the above-shown situation, the global financial crisis was triggered by the U.S. subprime mortgage problem, with its impact spreading to markets in countries around the world, including Japan.

The financial crisis broke out against the background of such macroeconomic factors as “great moderation” of the economic and price volatility around the world, global current-account imbalances, and a rise in U.S. housing prices due to aggressive U.S. measures to promote home ownership.

As for financial products and transactions involved in the outbreak and spread of the crisis, subprime mortgage-related loans were provided and securitized recklessly based on lax risk assessment under the originate-to-distribute business model, a situation that led to an increase in unrecoverable subprime mortgage-related loans and frequent defaults on subprime-related securitized products. Also because of abrupt downgrading of credit ratings assigned to securitized products, confidence in securitized products in general declined rapidly, shrinking and disrupting the market for such products.

Regarding over-the-counter derivatives, such as CDS (credit default swaps), a number of credit events occurred while the risk assessment was not necessarily adequate. As a result of insufficient development of market infrastructures for the settlement and clearing of such derivatives, the counterparty risk grew, leading to a decline in the trading volume.

As for the situation of financial institutions, some banks and other financial institutions in the United States and Europe that relied in large part on the market funding and expanded their business operations through excessive leverage faced solvency or liquidity problems. Behind this situation was their excessive pursuit of short-term profits under lax risk management systems.

The financial crisis also spread worldwide via financial and capital markets through the following process:

* As the cancellation of contracts with hedge funds increased due to the above-mentioned situation surrounding financial products and transactions as well as financial institutions, aggressive sales hit financial assets, leading to a decline in asset prices, which in turn induced fire sales of such assets in a short period of time;
* In line with a rise in the volatility of asset prices, the level of risk measured for the purpose of risk management increased, leading to across-the-board sales of financial assets by financial institutions;
* Liquidity in the markets dried up rapidly in the absence of buyers of financial assets.
* As a result of uncertainty and increased counterparty risk, confidence in the entire financial system was lost; and
* The crisis not only spread across borders via globalized financial and capital markets but also produced a widespread impact on individual investors and fund-raisers, including companies, as well as on the financial sector.

On the other hand, Japan’s financial system has remained stable compared with the U.S. and European financial systems, although the impact of the global financial crisis spread to Japan. This relative stability is attributable to the following factors:

* Early implementation of the Basel II regulatory framework and thorough risk

management by financial institutions have produced some positive results.

* Market-based finance has not spread as widely in Japan as in the United States and Europe.
* Japanese banks have had a stable funding source and faced no liquidity crisis in relation to yen funds, as deposits accounted for a large portion of the funding.
* Japan has promoted the facilitation of financing for companies, including small and medium-size enterprises (SMEs), through an expansion of the quota for emergency credit guarantee by credit guarantee associations and the enhancement of emergency operations by Japan Finance Corporation.
* The Bank of Japan has implemented measures including the provision of ample liquidity in order to ensure the stability of the financial markets and facilitate corporate financing.

However, the vulnerability of Japan's financial system was also exposed, as the following problems arose in the country during the financial crisis.

* As the investor base in the stock market was not broad enough, fire sales by hedge funds led to a steeper stock price drop in Japan than in the United States and Europe.
* As a result of stock price drops, the capital adequacy ratio of banks that hold a large amount of shares declined, fueling concern over their lending capacity.
* The government bond repo market was thrown into turmoil due to reduced liquidity and a sharp increase in the number of fails, as the market infrastructure had not been sufficiently developed.
* The markets for corporate bonds and CP also malfunctioned, and this problem was all the more serious because of an insufficient breadth of the investor base which the investment by the banking sector is largely relied upon. Major companies that found it difficult to issue corporate bonds and CP raised funds in the loan market, which caused a squeeze in the overall market for loans, including those to smaller companies.
* In the funding markets for internationally active financial institutions, Japanese financial institutions' ability to raise foreign-currency-denominated funds declined because of a significant drop in foreign financial institutions' capacity to supply such funds.

IV. Future Challenges for Japan's Financial System and Financial Industry

(1) Challenges for the financial system

(Concept of a two-track financial system)

As we mentioned in II above, Japan has taken a variety of measures aimed at establishing a two-track financial system[2], and in light of the financial crisis, the following points have been under debate:

(i) Even though around 10 years have passed since the vision for the establishment of a two-track financial system was set forth, Japan has not made as much progress as was initially expected. In relation to this fact, it has been pointed out that the fact that a large proportion of funds is provided through the banking sector is attributable in no small part to the national traits of the Japanese people and the Japanese culture. It has also been argued that it is a reasonable decision for Japanese individuals to hold funds as interest-bearing deposits that are highly secure due to the protection provided by the deposit insurance system amid the continued low inflation and the aging of society.

(ii) In light of the fact that the financial crisis broke out and spread within the framework of market-based finance that was well advanced in the United States, there is concern that if the weight of market-based finance grows in Japan, the risk of a financial crisis originating in the markets may increase.

Our roundtable committee conducted an in-depth debate on the above points.

A two-track financial system does not excessively depend on market-based finance but is based on the right balance between market-based finance and financing made through deposit-taking and lending in the banking sector.

Japan's own financial crisis of the 1990s and the global financial crisis have given us an important lesson: appropriate risk management is necessary and excess must be avoided, either in the market sector or in the banking sector.

It is true that a global financial crisis originating in the markets occurred without

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2 The Vision for the Future of the Financial System and Policy, issued in 2002, defines (i) "the industrial financing model" as financing mainly through intermediation based on bank deposits, and (ii) "the market financing model" as financing through market-based intermediation in which the pricing mechanism functions, and states that "we will (hereinafter) refer to the new financial system as a two-track system, of which the market functions constitute its core because, although the industrial financing model based on bilaterally-negotiated transactions continues to exist under the system, the role of the market financing model becomes more important."

being widely predicted and, as will be mentioned in V below, there is no doubt that it is essential to implement measures to prevent a recurrence of such a crisis.

However, as funds provided via the banking sector still account for a significant proportion of overall financial intermediation in Japan, as we mentioned in II above, it cannot be denied that the structure of the Japanese financial system is not well balanced. In light of the following points, it is important to continue to make efforts to establish a two-track financial system:

(i) Although the Japanese economy experienced a temporary period of recovery, its growth has generally remained weak. It is therefore a critical challenge for Japan to achieve sustainable economic growth. To this end, it is necessary to provide households with appropriate investment opportunities and to secure the supply of the seed money for growth to companies amid the trend of low fertility and the aging of society. The establishment of a two-track financial system is an important means for doing so. That is also important from the perspective of strengthening the international competitiveness of Japan’s financial and capital markets so as to meet the needs of their users in Japan and abroad.

As the establishment of a two-track financial system provides companies and investors with a variety of fund-raising and investment options, it will allow them to choose the option best suited to them, thereby contributing to economic development and the formation of the people’s assets. The lack of change so far in the flow of funds does not diminish the importance of making many options available in Japan’s financial system.

It should be noted that the vision of promoting the part of market-based finance of the two-track financial system will not be achieved immediately. It can be achieved only after a lengthy process of developing institutional frameworks relating to disclosure, business operators, exchanges, settlement, trading rules and implementing a series of reform measures related to business practices and customs. Therefore, it is necessary to continue strenuous and patient reform efforts.

(ii) A two-track financial system has a merit in that the banking and market sectors complement each other in withstanding shocks: when the banking sector has sustained a shock, the market sector continues to function, and vice versa.

Especially, in light of the fact that fire sales by foreign hedge funds triggered a steeper stock price decline in Japan than in the United States and Europe, it is important to broaden the investor base beyond foreign investors to include investors who make investment from a long-term perspective, including Japanese individual investors and institutional investors engaging in asset management on behalf of individuals, thereby overcoming the vulnerability to shocks.

(iii) The market-based part of the two-track financial system has an advantage that the participation of people with a diverse range of expertise enables the markets to exercise the function of identifying companies to which funds need to be supplied and making them excellent investment targets (the origination and investment target-spotting functions). Adequate exercise of this function will contribute to sustainable economic growth and enable the provision of high-quality investment products to investors.

Especially, funds involving high risk, such as funds for business start-ups, are better suited to market-based finance, in which the risk can be shared by a diverse range of investors, than to financial intermediation through the process of deposit-taking and lending in the banking sector.

In the financial intermediation through market-based finance, dividing the origination and investment-target spotting functions and the asset ownership function through securitization is an important financial technique for making effective use of those functions. Even so, financial institutions should give consideration to such issues as: to what extent they can undertake the origination and investment target-spotting functions in cases where they do not own assets themselves and whether the division of the functions does not cause the conflicts of interest by complicating the relationship between the final provider of funds and the fund recipient.

It should be noted that, when seeking to establish a two-track financial system, it is important to do so from the perspective of strengthening the market and banking sectors at the same time. Therefore, as was pointed out in “The Vision for the Future of the Financial System and Policy” issued in 2002, a report entitled “Towards Enhancement of Relationship Banking Functions” issued in 2003, and others, it will continue to be important to implement measures to strengthen the financial intermediary function exercised through the banking sector, such as promoting locally-focused financing that takes into consideration medium- and long-term relationships with SMEs and financial intermediary activity that takes into consideration the risk-return balance, while taking measures to enhance the market sector.

Banking-sector financial intermediary activity that takes into consideration the risk-return balance helps to better exercise the pricing mechanism of the market sector, and the appropriate exercise of the pricing mechanism of the market sector, in turn, helps the banking sector exercise the financial intermediary function that takes into consideration the risk-return balance.

In relation to this, it has been pointed out that the market-based finance which triggered the global financial crisis was the type that had inclined toward highly leveraged derivatives transactions and re-securitization businesses in pursuit of short-term profits, and therefore it was far from the type of market-based finance that is expected to meet the demand for credit of the real economy and contributing to the formation of the ordinary people's assets. Given that numerous cases of illegal practices and manipulation of information have come to light, we may presume that information asymmetry has been a deep-rooted problem in the type of market-based finance that triggered the financial crisis.

(2) Challenges for the financial services industry

(Importance of measures to strengthen Japan's financial industry)

In addition to establishing the above-mentioned two-track financial system, it is important for us to strengthen the financial intermediary function of the Japanese financial industry as the major players of the country's financial system, and enhance the business foundation of Japanese financial institutions as a prerequisite for the exercise of that function, if we are to ensure that Japan's financial system functions adequately. Moreover, in light of the public nature of the financial industry as prescribed in the Banking Act and other laws, financial institutions must properly perform their social responsibility.

The stability of the foundation of funding in Japan's banking sector due to the large weight of funding made through deposit-taking enables the banking sector to provide support for the creation of value by companies from the medium- to long-term perspective. This is an advantage of the Japanese financial industry.

On the other hand, the heavy dependence on deposits has led to a structural problem: because the companies' demand for funds weakened during the transition from a period of high economic growth to one of stable growth, particularly after the collapse of the bubble economy, the amount of deposits has far exceeded the amount of loans in the banking sector, prompting financial institutions to hold a vast amount of government bonds and stocks.

In addition, it has been frequently pointed out that the Japanese financial industry is vulnerable in terms of profitability and the level of capital.

The profitability of the financial industry depends on financial institutions' specific business operations and the level of their risk exposure, and it should be up to each financial institution to set its profit target. At the same time, as the profits of the financial industry also depends in part on the profits generated by the entire economy, it is difficult to enhance the profitability of the financial industry separately when the profitability of the entire economy is low.

Meanwhile, when the profitability of the financial industry is low, financial institutions may fail to fully cover losses caused by shocks with their current profits and face problems that undermine their financial soundness, such as an erosion of their capital base and difficulties of raising equity capital. In addition, when their foundation for profits is fragile, they may face difficulty starting new businesses flexibly or performing their social responsibility.

Moreover, when the level of their capital base is weak, financial institutions' soundness may be undermined by shocks, and this situation could make it difficult for them to start new businesses flexibly.

(Importance of value creation-oriented financing)

It is desirable that the Japanese financial industry aims for a business model featuring financing that supports the creation of value by companies, rather than a business model that depends on arbitrage transactions focusing on the distortion of the price system and price volatility. The value creation-oriented approach will be beneficial for borrowing companies as well, as it may contribute to improvement in their profitability and competitiveness.

In relation to this, it has been argued that, as the loan business of Japan's banking sector has relied on credit security based on collateral, it does not necessarily provide funds in an appropriate manner while ensuring the appropriate return commensurate with the risk taken, and that the scope of financial institutions' lending to companies has been limited as a result. It is important for financial institutions to seek to exercise the financial intermediary function in an appropriate manner while taking into consideration the balance between risks and returns, including when taking middle risk.

Moreover, in order for the Japanese financial industry to properly provide funds, it is necessary to secure not only the fund supply route that goes through the banking sector but a diverse range of fund supply routes suited to various corporate life stages and corporate characteristics, including the routes for the provision of venture capital for business startups and the provision of expertise in diversified investment to companies in the growth stage.

The opportunities for providing the above-mentioned financial services that support the creation of value by companies are not limited to those in the domestic market. For example, if Japanese financial institutions provide financial intermediary services in Asia and other regions where high economic growth is expected and repatriate the benefits of the high growth to Japan, it could contribute to enhancing the Japanese financial industry’s profitability and increasing the assets of Japanese households and companies as a whole. However, to engage in such activities, Japanese financial institutions will need to improve their internal systems for ensuring appropriate business management and risk control by strengthening their information-gathering capability through more effective use of local staff, establishing a mechanism for evaluating personnel with a high level of expertise essential for foreign operations and promoting the localization of foreign operations.

It has also been pointed out that, although Japanese companies’ international business operations have expanded over the past 10 years or so on a consolidated basis, Japanese financial institutions have failed to provide sufficient financial services to support international business expansion of companies. Therefore, how to meet the needs for such services is also a critical challenge.

The approach of seeking to achieve the development of the financial industry by supporting the creation of value of domestic and foreign companies represents a departure from an expansion of the financial industry far outpacing the economic growth that was observed in some jurisdictions before the financial crisis. Japan should continue to implement measures to strengthen the functioning of the Japanese financial industry so that financial institutions, amid the trend of low fertility and the aging of society, can promote the creation of value of both domestic and foreign companies and mediate the needs of households and companies for the formation of assets, thereby enhancing value added to financial institutions themselves.

V. Addressing the Financial Crisis Originating in Markets

As mentioned above, Japan has implemented a variety of measures to ensure the stability of the financial system, drawing the lessons of its own financial crisis in the 1990s. Thus, it is important to review the effectiveness of these measures in light of the lessons of the global financial crisis, in an attempt to make Japan's financial system more resilient and stable.

In the course of such a review, a number of perspectives should be particularly noted: (i) adapting the global regulatory agenda to the circumstances of the financial system and financial industry in Japan, rather than adopting them as they are; (ii) supporting the sustainable functioning of financial intermediation and sustainable economic growth; and (iii) ensuring consistency with international efforts in view of the global connection of economies and markets.

From these perspectives, the guiding principle in participating in international deliberations on financial regulation and supervision should be the pursuit of the following objectives: enhancing international cooperation to prevent the recurrence of a financial crisis and to establish a robust financial system, while avoiding a one-size-fits-all approach in regulatory reform. It is essential to establish regulatory and supervisory frameworks, properly reflecting the risks associated with diverse businesses of various financial institutions as well as taking into account the particular circumstances of various jurisdictions, including Japan.

In sum, the “3S” approach is important in our efforts to design the future financial system: i.e., (i) ensuring the suitability to the actual circumstances of the markets and the financial industry (“Suitability”), (ii) supporting the sustainable functioning of financial intermediation and sustainable economic growth (“Sustainability”) and (iii) securing the stability of the financial system (“Stability”).

In this relation, some members of the roundtable committee pointed out that international deliberations on redesign of the regulatory framework may tend to reflect only the circumstances of jurisdictions where the current financial crisis originated, expressing concern over the possibility that proposals for regulatory reform as a result of such deliberations would be applied in an across-the-board manner without any regard to circumstances of other jurisdictions or to difference in the business model of each financial institution. In redesigning the global regulatory framework, it is expected that each jurisdiction adds value by providing experiences and knowledge of its own. It is therefore important for Japan to make further active contributions to this end.

(Prevention of another financial crisis originating in the markets)

In light of the lessons learned from the financial crisis, we believe that, when we are to prevent a recurrence of a financial crisis originating in the markets, it is necessary to ensure that the following measures are taken according to the causes of the financial crisis, the route of its spillover and other factors.

(1) Measures to prevent an excessive accumulation of imbalances that could trigger a financial crisis (measures to prevent an excessive accumulation of imbalances, such as an expansion of leverage due to the pursuit of short-term profits and underestimation of risk), including:
 (i) Appropriate regulation and supervision of unregulated sectors (entities, transactions and products);
 (ii) Improvement in the prudential regulation and supervision of the banking sector;
 (iii) Correction of the incentive structure that could encourage the pursuit of short-term profits; and
 (iv) Appropriate regulation and supervision of so-called “systemically important financial institutions”.
(2) Measures to curb the spread of a crisis (measures to curb the spread of a crisis that could be caused by a loss of the markets’ price-discovering function, the drying-up of liquidity and a significant weakening of the market functions), including:
 (i) Strengthening of market infrastructures; and
 (ii) Improvement of a crisis management framework.
(3) Enhancement of regulation and supervision from macro-prudential perspectives (measures taken from the perspective of macro-prudential supervision that takes into consideration the interconnectedness among financial institutions and between financial institutions and financial markets, as well as the feedback loop between the real economy and the financial system)
(4) Measures to deal with the impact of a financial crisis on the real economy (measures

to prevent a vicious cycle in which a financial crisis produces negative impact on the real economy, which in turn triggers an increase in credit costs, stock price drops and other market problems, thereby hurting the financial system)

Our roundtable committee has considered what the Japanese financial system should be like in the future in light of the lessons from the global financial crisis and has summarized basic concepts for the redesign of the framework of financial regulation intended to prevent the recurrence of a financial crisis originating in the markets. We hope that, when adopting specific measures to improve the regulatory framework, the authorities will fully examine the necessity of regulations in light of the actual circumstances of Japan's financial and capital markets and the state of business operations, and design the regulatory framework carefully.

Also, it should be kept in mind that, in implementing the above-mentioned measures, it is important to consider how to ensure orderly de-leveraging in the medium term while taking short-term, emergency measures to prevent market turmoil from being caused by a rapid de-leveraging and an acute credit crunch in the event of a financial crisis. The authorities should be determined to maintain the two perspectives of preventing market turmoil in the short term and stabilizing the financial system in the medium term.

Moreover, as it has become clear that a financial crisis originating in the markets abruptly breaks out and spreads due to the drying-up of liquidity in the markets, it is important to deal with solvency-related issues and liquidity-related ones at the same time in order to stabilize the financial system.

In addition, as the Japanese financial markets are exposed to competition with the Asian markets, not to mention the U.S. and European markets, it is essential to continue promoting innovation in the Japanese markets and the Japanese financial industry. Therefore, when redesigning the regulatory framework so as to prevent the recurrence of a financial crisis originating in the markets, the authorities should take care to choose the right timing for the implementation of regulations and strike the right balance between the implementation of regulations and the promotion of innovation.

(1) Measures to prevent an excessive accumulation of imbalances that could trigger a financial crisis

(i) Appropriate regulation and supervision of unregulated sectors (entities, transactions and products)

The accumulation of the imbalances that triggered the global financial crisis had proceeded mainly in areas that had not necessarily been regulated properly from the viewpoint of the stability of the financial system (over-the-counter derivatives transactions, securitized products, hedge funds, etc.).

Regarding hedge funds and derivatives transactions, Japan has already introduced regulation from the viewpoint of the protection of investors under the Financial Instruments and Exchange Act. However, it is necessary to consider whether the regulation is adequate from the viewpoint of the stability of the financial system as well in light of the lessons learned from the financial crisis, while taking into consideration the actual circumstances of the Japanese market and developments in the United States and Europe.

Regarding securitized products related to subprime mortgages and other loans, which triggered the global financial crisis, it has become clear that there are problems like the conflicts of interest involved in the origination of such products and the difficulty in identifying the source of risk due to the increasingly complex structures of transactions. Japan has already introduced measures to ensure the traceability of the underlying assets of securitized products ahead of other countries and has also adopted a legal framework that requires the registration of rating agencies. From now on, it will be necessary to keep a close watch on the status of enforcement of these measures. Moreover, it has been pointed out that requiring the originator (holder of the underlying assets) to continue to hold a portion of risks associated with the assets removed from its balance sheet may reduce the conflicts of interest related to securitized products. It will therefore be necessary to examine the effectiveness of this measure.

It will also be necessary to examine whether the measures taken to protect investors and ensure the fairness of transactions in relation to over-the-counter derivatives transactions are adequate as they are. In addition, it will be necessary to make use of the experiences and knowledge so far accumulated in order to deal with potential risks that could lead to a new financial crisis. Related to this matter, for example, regarding emissions trading, it is important for Japan to make active contribution to the establishment of international rules, accounting standards and monitoring systems in order to ensure the appropriateness and transparency of transactions, while paying due attention to their impact on economic activities.

It should be noted that, regarding the expansion of the scope of regulation and supervision to cover unregulated areas, it is important for Japan to actively participate in international efforts to ensure compliance with international standards of regulation and supervision so as to prevent any particular countries and regions from escaping the coverage of regulation and supervision.

(ii) Improvement in the prudential regulation and supervision of the banking sector

Given that imbalances which could have constituted a potential cause for a financial crisis were also accumulated in the regulated banking sector, it is necessary to improve their prudential regulation and supervision by:

* Building up more capital with a particular emphasis on securitization and the trading activities, which were major causes of the accumulated imbalances;
* Enhancing liquidity risk management through introduction of benchmark indicators for ensuring adequate liquidity in times of stress.

In implementing these measures, it is also necessary to give due consideration to mitigating procyclicality (amplifying effect upon the business cycle).

In this regard, there are globally high expectations for strengthening of capital and liquidity requirements. However, it should be noted that strengthening of regulation and supervision from a broader perspective is necessary, including enhancement of risk management by financial institutions. As business operations of the banking sector in each jurisdiction show a certain extent of diversity, placing excessive emphasis on strengthening capital and liquidity requirements as a means to prevent recurrence of a financial crisis could harmfully constrain financial intermediation that provides necessary funds to the real economy.

Therefore, in international deliberations on how to improve regulation and supervision of the banking sector, it is crucial to: (i) take a broader perspective to include further enhancement of risk management by financial institutions; (ii) design capital adequacy regulation to properly reflect the different levels of risks associated with the diversity of business of various financial institutions; and (iii) have grasp of the quantitative impact of the regulatory reform package.

As regards strengthening capital requirements, the G20 Leaders stated that they “commit to developing by end-2010 internationally agreed rules” and “these rules will be phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012.” This phased-in implementation should be carefully timed subject to confirmation of sustainable improvement in financial conditions and economic recovery in each jurisdiction. Strengthening of financial regulation must not have a harmful impact on the economies of the G20 countries, including Japan, particularly because these economies constitute a significant share in the global economy. This is why a gradualist and pragmatic approach is vital.

As for the soundness of Japan’s banking sector, it has been pointed out that the risk involved in banks’ shareholdings is excessive relative to their capital base and profitability. Mitigating this problem is important for making the entire financial system more robust and ensuring the stable functioning of financial intermediation.

Therefore, it is desirable that banks strictly examine whether the level of risk involved in their shareholdings is appropriate relative to their capital base and continue strenuous efforts to mitigate this risk, including through the active use of Banks’ Shareholdings Purchase Corporation. It is also desirable to encourage investment by individuals and domestic institutional investors, such as pension funds, which will form a base of long-term shareholdings.

As for banks’ holdings of government bonds, it is desirable to continue appropriate management of interest rate risk and ensure the soundness of their financial position, as the amount of such holdings is huge.

In addition, it is necessary to diversify the range of government bond holders to increase the share of individuals and foreign investors in light of the fact that the banking sector holds about 40% of the outstanding Japanese government bonds.

It has also become clear that, in the insurance sector as well, imbalances that could trigger a financial crisis may be accumulated through group companies. Although a framework is in place for regulating and supervising insurance companies and insurance holding companies on a consolidated basis, it is essential to consider whether it is necessary to introduce a framework to measure insurance companies’ financial soundness on a consolidated basis.

(iii) Correction of the incentive structure that could encourage the pursuit of short-term profits

It has been argued that, in the United States and Europe, remuneration systems linked to short-term profits encouraged business management that relied on excessive risk-taking, thereby amplifying the impact of the financial crisis. This situation may be regarded as representing a failure of corporate governance in that it led to generous remuneration for managers and some traders at the expense of shareholders' interests. In the Japanese financial industry, the case of a remuneration system causing a similar problem has not been generally observed. However, it is necessary for each financial institution to implement appropriate measures to develop a remuneration system that adequately takes into consideration the risks involved in its business operations so as to prevent a situation in which business management is distorted by the remuneration system. The authorities should also implement measures to encourage financial institutions to take appropriate actions.

In this connection, it has been pointed out that the typical remuneration system of Japanese financial institutions is not necessarily designed for providing positive incentives. Each financial institution may wish to consider the review of its remuneration system from broad perspectives, e.g. promoting innovation and improving the profitability of the Japanese financial industry, to the extent that it would not encourage business management toward excessive risk-taking. At the same time, it is desirable that a Japanese system under which shareholders, investors and other stakeholders monitor company managers be improved further through the revisions of the regulations on disclosure and the rules of stock exchanges in light of the "Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets," which was issued in June this year.

(iv) Appropriate regulation and supervision of so-called systemically important financial institutions (to be explained later)

(2) Measures to curb the spread of a crisis

(i) Strengthening of market infrastructures

Given that the financial crisis has rapidly spread and expanded through the markets and that it has also disrupted the government bond repo market and others, it is necessary to take measures to develop market frameworks and infrastructures that ensure the safety and facility of transactions in order to halt the spread of the crisis in the process of each transaction. They include:

* Developing a clearing system concerning over-the-counter derivatives transactions, including CDS (credit default swaps);
* Reducing the settlement interval in the bond market;
* Strengthening the foundation of the securities clearing organization and increasing its use; and
* Improving the Japanese government bond repo market.

The securities settlement and clearing organizations support markets as the linkage points of securities transactions. In particular, it is difficult for other organizations to quickly substitute their functions, especially the functions of the clearing organization. Based on the lessons from the financial crisis, it is appropriate to regard the securities settlement and clearing systems as systemically important infrastructures that play the role of halting the spread of a crisis. Japan will need to actively consider how to strengthen the functions of those systems, including providing a regulatory framework.

(ii) Improvement of a crisis management framework

In the process of the rapid spread and expansion of the financial crisis through the market, Japanese financial institutions faced difficulty securing foreign-currency liquidity in their overseas business operations because of a considerable weakening of foreign financial institutions' capacity to provide foreign-currency-denominated funds and an increase in the counterparty risk in interbank transactions. In light of this fact, it is important to take measures to develop an international framework for securing not only yen liquidity but also foreign-currency liquidity in case of a crisis.

It is also necessary to consider the measures to be taken when a systemically important financial institution faces a business crisis (to be explained later).

(3) Enhancement of regulation and supervision from macro-prudential perspectives

In relation to the global financial crisis, the major authorities around the world have come to recognize the importance of the perspectives of macro-prudential supervision that take into consideration not only the financial soundness of individual financial institutions but also the interconnectedness among financial institutions and between financial institutions and the markets, as well as the feedback loop between the real economy and the financial system. These perspectives are also important in considering the above-mentioned (1) measures to prevent an excessive accumulation of imbalances that could trigger a financial crisis and (2) measures to curb the spread of a crisis.

In Japan, a framework for cross-sectoral, integrated regulations and supervision has already been established in the Financial Services Agency (FSA), and the following measures have been taken from the perspectives of macro-prudential supervision:

* Grasping and disclosing the exposure of the banking sector as a whole to subprime-related and other securitized products;
* Measures to facilitate financing, including encouraging financial institutions to actively consider the use of the capital injection scheme based on the amended Act on Special Measures for Strengthening Financial Functions; and
* Measures to deal with systemic risk based on Article 102 of the Deposit Insurance Act (the systemic risk exception clause).

Going forward, it is also necessary to advance the following efforts, based on the lessons from the global financial crisis:

* Further enhancing the capability to collect and analyze information on both macro- and micro-economic fronts and, to this end, strengthening the institutional capacity of the FSA to deal with macro-prudential issues, including the enhancement of cooperation between relevant bureaus and divisions and increased resources;
* Promoting appropriate cooperation with the Bank of Japan, the Ministry of Finance and other relevant organizations; and
* Strengthening cooperation with foreign regulatory and supervisory authorities and international organizations, including the Financial Stability Board.

(4) Measures to deal with the impact on the real economy

While it will continue to be important for financial regulators and supervisors to take into consideration the interaction between the real economy and the financial system, there is a risk that, if a crisis occurs, fueling fears of significant financial and economic damage, it could damage the real economy by causing a credit crunch. To mitigate such damage, it is important that not only the FSA but the government as a whole quickly implement a comprehensive package of measures to deal with the crisis.

In the financial crisis, the Japanese authorities quickly acted to minimize the negative impact of the instability of the financial system on the real economy based on the lessons learned from its own financial crisis of the 1990s. For example, the government promoted the facilitation of financing for companies, including SMEs, by grasping the state of the provision of funds by financial institutions, requesting financial institutions to facilitate corporate financing, expanding the quota for emergency credit guarantee and enhancing the emergency operations of Japan Finance Corporation. In addition, the government acted swiftly to support the economy through fiscal policy measures, while the Bank of Japan cut its policy interest rates and implemented measures to ensure the stability of the financial markets and support the facilitation of corporate financing.

(5) Handling of so-called systemically important financial institutions

Of the above-mentioned measures to deal with a financial crisis, those concerning the regulation and supervision of so-called systemically important financial institutions and the response to the crises of such financial institutions ((1) (iv) and (2) (ii) above) are set to be deliberated internationally. Therefore, it is necessary to conduct a study on what measures to be taken in light of Japan’s experiences and circumstances and to make active contribution to international deliberations.

(Need to deal with systemically important financial institutions in particular)

In the global financial crisis, the crises of financial institutions in the non-banking sector triggered a chain reaction of crises among other financial institutions through the markets, producing a widespread impact on market participants.

As the banking sector is responsible for operating the payment system, the framework for regulating and supervising banks and handling their crises have been especially well developed. However, in anticipation of cases where a business crisis of a financial institution in the non-banking sector could produce a significant impact on the stability of the financial system by causing the drying-up of market liquidity or an increase of the counterparty risk, it is necessary to conduct a study on the following measures:

* Regulation and supervision that ensure the soundness of the business operations of financial institutions in the non-banking sector and reduce the probability of such financial institutions facing business difficulties.
* Measures to prevent a business crisis of a financial institution in the non-banking sector from triggering a chain reaction of business crises among other financial institutions.

However, as competition has been promoted in the non-banking sector in recent years under relaxed requirements for market entry and eased business regulation, it is necessary to consider how to strike the right balance between the benefits of increased competition and the need for regulating and supervising financial institutions in the non-banking sector.

In addition, as a chain reaction of business difficulties spreading through the market could also occur in the banking sector, it is necessary to review the existing regulatory and supervisory framework of the banking sector with that possibility in mind.

(Definition of systemically important financial institutions)

While it is necessary to clarify the definition of systemically important financial institutions if the authorities are to regulate and supervise such institutions specifically, a further study should be conducted on the following points in this regard:

* What criteria should be used to judge whether a financial institution is systemically important: e.g. the size of a financial institution; the interconnectedness between the financial institution and other financial institutions; and/or the level of difficulty of another financial institution substituting the functions of the financial institution; and
* Is it possible to set predetermined criteria for a systemically important financial institution in terms of the types of businesses and the size of the institution? Is it not

difficult to apply one-size-fits-all criteria for systemically important financial institutions across national borders, because there are various factors, both domestic and international, that could cause a financial crisis; the size of a financial institution's international business operations is not necessarily proportional to the size of its domestic operations; and the robustness of the frameworks for managing a financial crisis and dealing with the failure of a financial institution varies from country to country?

(Regulation and supervision that ensure the soundness of systemically important financial institutions' business operations and reduce the probability of such financial institutions facing business difficulties)

Regarding the regulation and supervision of systemically important financial institutions, it is first and foremost important to reduce the probability of such financial institutions facing business difficulties. In relation to this, the Japanese supervisory authorities are keeping track of the state of the group-wide financial position of Type I financial instruments business operators (e.g. securities houses) engaging in cross-border operations, as supervisory measures. In light of the importance of reducing the probability of systemically important financial institutions facing a business crisis, it is necessary to consider establishing legally-enhanced regulation on a consolidated-basis that would build on the current practice of group supervision applicable to business operators that meet prescribed criteria.

(Measures to prevent a business crisis of a systemically important financial institution from triggering a chain reaction of business crises among other financial institutions)

From now on, it will also be necessary to conduct wide-ranging deliberations on what measures to be taken when a systemically important financial institution in the non-banking sector faces business difficulties despite the implementation of measures to reduce the probability of such an incident occurring. In doing so, it will be necessary to keep in mind the following points while giving due consideration to the outcome of international deliberations:

* As a financial crisis originating in the markets abruptly breaks out and spreads through price volatility and the drying-up of liquidity in the markets, the time allowed for responding to it may be very short;
* If a financial institution that faces a business crisis tries to unwind its positions at

once, it could have a considerable impact on the market, including excessive price fluctuations, in the absence of sufficient liquidity. Therefore, it may be necessary to ensure orderly unwinding;

* To do so, it may be necessary to quickly provide abundant liquidity to a financial institution facing a business crisis; and
* If measures are to be taken to prevent a business crisis of a systemically important financial institution from triggering a chain reaction of business difficulties are to be taken, the problem of moral hazard may arise with regard to the financial institutions to which those measures are applied.

It should be noted that, in order to prevent the breakout and spread of a financial crisis, it is not sufficient to take the measures targeting systemically important financial institutions only. It is also necessary to consider strengthening market infrastructures with a view to halting the spread of a crisis in the process of each transaction. Especially, as mentioned in (2) (i) above, it is necessary to consider strengthening the foundation of organizations responsible for the settlement and clearing of securities and derivatives transactions from the perspective of ensuring secure settlement and clearing in the event of a crisis.

Moreover, from the perspective of reducing the probability of a business crisis of a financial institution producing a serious systemic impact, it is desirable that a wide-ranging study is conducted on the desirable form of provisions for the automatic forfeiture of the benefit of time regarding derivatives transactions in parallel to international deliberations on the redesigning of the framework of regulation.

Ⅵ. Conclusion

The impact of the global financial crisis has had a severe impact on the economy and employment in Japan, and the situation continues to be uncertain. In our economy, significant macroeconomic constraints exist, such as the huge outstanding public debt and the continuation of the long-standing low interest rate policy, in addition to structural problems such as the trend of low fertility and the aging of society, and the decline in population. As countries around the world are confronted with the need to deal with huge fiscal deficits and take unconventional monetary measures, they must come up with creative policy measures to tackle unprecedented policy challenges that cannot be dealt with by conventional economic theories and conventional economic policy measures. This situation is especially pronounced in Japan, so it is desirable for the country to play a pioneering role in tackling such unprecedented policy challenges through expanding the frontiers of effective policy making.

Of course, it will be difficult to deal with those challenges through financial-sector policies alone. However, we hope that further efforts will be made to achieve a sustainable economic growth by enabling the Japanese financial system to exercise the financial intermediary function to a higher level and by making the system more robust.