You cannot see the forest for the trees

Speech by Nobuchika Mori,
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It is a great pleasure to deliver my remarks on the occasion of the annual general meeting of IBA Japan.

I would like to begin by talking about a proverb that relates to me. My family name is “Mori”, which in Japanese means “Forest”. As the proverb “You cannot see the forest for the trees” goes, a regulator has to grasp the condition of the whole financial system, not just specific aspects of individual institutions. On the other hand, it can also be said that “You cannot see the trees for the forest.” Each and every bank matters. The devil is often in the detail. In short, it is always important to have both micro- and macro-perspectives. I suppose similar things may apply to running a bank as well.

Today, I would like to talk about three topics both from the micro- and macro-perspectives: First, about the capital market reforms we are pursuing; second, about the supervision and inspection of foreign banks and securities companies operating in Japan; and lastly, about the global regulatory reforms. In the course of the discussion, I would also like to express my expectations for foreign financial institutions in Japan.

Capital Market Reforms

Amid the changes in markets, economic conditions and regulatory environments the global financial crisis had triggered, global financial institutions have changed their strategies and restructured their businesses. Activities of offices abroad have often been cutbacks or closed. Unfortunately, offices in Japan were no exception.

However, since the start of the *Abenomics* three years ago, Japan’s capital market, as epitomized by the buoyant stock prices, has been reactivated, and business performance of local offices in Japan is also recovering. Some of you are even expanding the businesses in Japan.

One of our key initiatives under the *Abenomics* concerns the capital market reforms. I suppose our efforts may be of interest to you as they may work to improve the environment for financial business in Japan.

Japan's long-lasting deflation has incentivized market participants to make safer asset allocation. Households predominantly kept their savings in cash and bank deposits, and banks and institutional investors, including public pension funds, continued to buy JGBs. The financial products provided by securities houses did not necessarily fit to the customers' long-term investment needs. Broker-dealers encouraged their customers to repeat turnover transactions carried over in short term, largely to acquire brokerage commissions. This trick may work in a short term but is detrimental to all in a longer term. This might have contributed to Japanese households' continued attachment to bank deposit.

Allocating one's portfolio largely to cash, bank deposit and JGB may have been a justifiable strategy in the environment of continued deflation. However, if we are to exit from deflation and stagnation, we also need to exit from the fund flow structure currently entrenched in our economy. Portfolio mix best suited to the new economic environment would also be different from the previous one. To attain the transition, the FSA has already implemented variety of measures addressed to each stages of the investment chain: the households, financial institutions including institutional investors, and the corporate sector.

We have introduced the NISA tax-exemption program to encourage household portfolio reallocation. If successful, this will help household to adapt to the environment with moderate inflation and also will contribute to the increased supply of risk money for growth. As of June 2015, the total balance of NISA accounts has reached to over five trillion yen, and the number of accounts exceeded nine million. Steadily, household asset rebalancing has been progressing.

Institutional investors have changed themselves as well. The Government Pension Investment Funds, GPIF, for example, has changed its benchmark portfolio, or the "policy asset mix", significantly. Before, 60% of its benchmark portfolio was comprised of domestic bonds, 12% domestic equity, 11% foreign bonds, and 12% foreign equity. Now, domestic bonds comprise only 35% of the total benchmark portfolio, domestic equity 25%, foreign bonds 15%, and foreign equity 25%. Other public pension funds have adopted asset allocations similar to that of the GPIF as well.

Securities houses have also changed their strategies. Flagship products are shifting from those bet on narrow specific risks, which may attract transaction fees due to short average holding period, to those suited to longer-term investment purposes with well diversified portfolio. Their employees are rewarded based less on the commission they earn and more on the aggregate size of the balance of their customer accounts.

However, a longer-term investment strategy can succeed only when the invested companies attain sustainable growth in their corporate values. Corporate governance reforms thus have a critical role in transforming the flow of funds.

As late as three years ago, investors with voices were comprised mainly of short-term activists, and many CEOs were reluctant to engage with investors. We introduced the Stewardship Code last year to encourage institutional investors to have constructive engagement with invested companies with longer-term perspectives.

It takes two to dance. A constructive dialogue requires changes on the side of the invested companies as well. The Corporate Governance Code, which was implemented this year, urges listed companies to adopt governance practices conductive to transparent, timely and decisive actions. Many Japanese firms have not been committed to changing their business models to cope with rapid changes in their competitive environment. We hope that the corporate governance reforms would contribute to the formation of a mindset and culture oriented towards the sustainable growth of the corporate value.

We believe that our reforms, underpinned by monetary easing, have contributed to the reactivation of our capital market. The NIKKEI index and the average corporate ROE have both doubled since 2012. The mindset of corporate CEOs has significantly changed. The number of external directors on the boards has also risen.

However, we should not stop here. We should continue to add momentum to the reforms. The FSA is embarking on further policy measures.

First, the Junior NISA, a tax-incentive framework which further encourages a family with children to invest, will be introduced, and the current annual investment limit will be raised next year. These measures will double the NISA-eligible annual investment amount from 2 million yen to 4 million yen in the case of a family with two children.

Second, our monitoring activities will focus on how securities dealers and other financial institutions implement their fiduciary duties. Here we use the word "fiduciary duty" in a wider sense to mean the roles those who are entrusted to perform tasks for others are expected to play, not just their legal obligations. As stated in our "Strategic Directions and Priorities for 2015-2016" published in September, we will review whether the intermediaries that produce, sell or manage financial products put their customers' interests first. Our review will extend to the issues related to customer protection, employee performance evaluation system, and the relationship between asset managers and its affiliated sales entities. We intend to foster best practices in the industry.

Third, we will monitor how the Stewardship Code and the Corporate Governance Code are implemented. As I mentioned, the two codes have already had considerable impacts on the Japanese corporate sector, but some firms still appear to focus more on the form of their governance frameworks and less on how they function in substance. We have established an advisory council to monitor the effective implementation of the codes. Issues which need to be addressed include reduction in the cross-shareholdings and transparency in the top management succession processes.

I have outlined the specific measures we have taken or are taking to transform the direction of the flows of funds, addressing households, intermediaries and business corporations. By fostering the growth of each tree in the forest, we aim to turn the forest from deflationary brown to bright, rich green, showing sustainable growth.

Supervision and inspection of foreign financial institutions in Japan

I believe your global networks and expertise have key roles to play in this ongoing transformation in the Japanese financial market and the economy. Full realization of this potential would require sound management, compliance and customer protection conducts on your side. In this regard, I now would like to discuss how the JFSA intends to monitor branches and subsidiaries of foreign banks and securities companies in Japan.

At the outset of the JFSA in the late 1990s, we frequently encountered compliance breaches at foreign institutions' local offices. We had to address legal compliance issues as a matter of priority. Since then, most local offices have much improved their systems and structures for compliance and internal control.

Our monitoring approaches have also evolved. Before, we conducted on-site inspection to a local office once every few years and followed-up the issues identified on-site in off-site supervision. Inspection reports often focused on detailed and trivial findings. The dialogue between local offices and the JFSA was infrequent. With these approaches, we were not able to gauge the risk profile of local offices in a timely manner or identify the root causes of issues found.

We are changing our monitoring approaches to address such weaknesses. We have shifted our resources from comprehensive but infrequent visit to more frequent off-site interviews and monitoring. On-site inspections are conducted in a more focused manner than before, informed by the issues identified by off-site monitoring. We expect our inspectors to spend time less for ticking boxes and more for discussing the business models and the effectiveness of governance, compliance and risk management frameworks.

This year, we intend to further enhance the coordination between the Inspection Bureau and the Supervisory Bureau of the FSA and support off-site monitoring of individual institutions by system wide analysis and risk-based inspections.

Neither had our past approaches been conductive to the formulation of an integrated view on the whole operations of a financial conglomerate in Japan, as banking and securities entities had been monitored separately.

To address this weakness, we will also enhance the coordination among the Securities and Exchange Surveillance Commission (SESC) and the Supervisory and Inspection Bureaus.

I have discussed our approaches. Now I would like to talk about the safety and soundness of local entities and also about their conduct and compliance. In doing so, I may have to make some overgeneralization given limited time available, but please be assured in conducting inspection and supervision we will be mindful that foreign banks and securities houses in Japan are diverse in their sizes, business models and their risks and require tailored approach in monitoring.

In general, the safety and soundness of local offices are susceptive to the group-wide conditions, but a host supervisor has limited access to group-wide information. Some jurisdictions allow entry only in the form of subsidiary, and others set limits on the access to retail deposits by a branch. We, however, set no such limitations whereas our deposit insurance system does not cover local branches of overseas banks. It is therefore imperative for us to closely monitor how retail deposits are accepted and how funds are transferred from branches in Japan to the headquarters or other entities outside of Japan.

Currently, many global financial groups are reconsidering their group strategies. We at the FSA are keen to be informed of such changes in a timely manner as they affect entities in Japan. But we sometimes find information gaps between the headquarters and entities in Japan. I would like to reiterate here that we want to see no surprise.

With regard to conduct and compliance, cross-border operation requires coordination between group compliance activities and local ones. A Tokyo office has to abide by local rules, while respecting home rules and group wide policies. In the cases where local offices have weakness in local compliance framework, breach minimum legal requirements or have problems in customer protection, we will request you to identify the underlying root causes and address them to attain fundamental improvements.

Unfortunately, compliance problems have been identified in local offices from time to time. In some groups, compliance problems occurred repeatedly and we found that the root causes lied mainly in the group risk appetite and group risk culture, not confined to Japan. In such cases, we would see to it that the group as a whole establishes a proper governance framework. In other cases, root causes were both in the weakness in Tokyo's compliance and in the headquarters' weak grip on Tokyo operation.

In both types of cases, we closely communicate with the headquarters and the home regulators along with local offices.

I mentioned these matters as soundness and compliance would form a foundation for greater roles we expect you to play in the Japanese market. I hope that you will maintain tight coordination with your headquarters, secure high compliance standards, and further contribute to the development of financial markets in Japan.

Global regulatory reforms

Having talked about regulation and supervision in Japan, I would also like to touch upon the global efforts to reform financial regulations. I suppose the topic may be of particular interest to you, as the global regulatory reforms have impacts both on your global group strategies and on the regulatory environment here in Japan.

Now that the regulatory reform measures conceived in the wake of the global financial crisis have largely been agreed upon and are being implemented, I believe that the time has come for the global regulatory community to think whether to extrapolate the past activities and continue to add additional layers of new regulations, or to review what have been done and rethink where we should go from here.

I believe we should choose the latter and I have advocated three principles to guide financial regulatory work in the coming period: we should aim to i) shift our regulatory focus to supporting finance for growth, ii) address the unintended consequences of reform, and iii) while heeding the lessons of the past, look to the future of finance.

Some observers may consider Japan as a front-runner in entering the secular stagnation which may now be spreading to other advanced economies, but what is not well understood is that Japan's stagnation period has had two distinct phases.

The first part of the story is well known. It was a direct consequence of bad loans causing bank failures and financial instability: the asset price bubble went bust in the early 1990s and impaired the balance sheets of both borrowers and banks, which in turn resulted in a credit crunch, dragging down growth.

The second phase was, however, less dramatic: I believe it was the creation of a risk-averse collective mindset. As I have already touched upon, households kept their savings in bank deposits, and firms kept repaying their debts and hoarding more cash. The banks stopped lending to riskier firms and purchased government bonds. Growth finance was not forthcoming in the economy, despite the fact that the financial system was largely repaired and stabilized following the first stage of the crisis. Individually each participant behaved in a rational and prudent manner, but collectively this actually caused and prolonged stagnation.

Ten days ago in Antalya, Turkey, G20 Leaders in their communiqué stated, "Strengthening the resilience of financial institutions and enhancing stability of the financial system are crucial to sustaining growth and development." Stability is a precondition for sustainable growth, which is our ultimate goal. Stability is not a goal in itself. And too much emphasis on stability can prolong and even perpetuate stagnation. Based on our own painful experience, we believe a shift to supporting finance for growth is needed now.

This is also why we must assess and address, as necessary, the unintended consequences of regulatory reforms.

Regulatory laboratories have greatly been expanded since the global financial crisis, and even seven years after the crisis they are operating at their full capacity. In fact, I can count some 140 work streams taking place under the auspices of the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). All those work streams have been producing a vast number of new standards or keeping watch over their implementation. Individually each of those rules may make sense, but we have yet to know what effects they may have, collectively and cumulatively, on finance for growth. Too much medicine might make the patient sick rather than healthy. Work streams have focused on individual trees, but we need to turn our eyes to the forest now.

We welcome that the G20 Leaders in Antalya expressed their determination to look at the forest. They said, "We will continue to review the robustness of the global regulatory framework and to monitor and assess the implementation and effects of reforms and their continued consistency with our overall objectives, including by addressing any material unintended consequences, particularly for emerging markets and developing economies (EMDEs)." The JFSA intends to make our contribution to the review building on the lessons we have learned from our experience.

I also believe that this is the moment not only to heed the lessons of the past, but also to look to the future. Generals always fight the last war, as people say, but the next war will most likely start from a different front, and could take a completely different guise.

In order to enable finance for growth, we must make the best use of new technologies. We all stand to benefit from innovative financial channels and new products, but we also see increased threats to our financial systems from cyberspace. The growing prevalence of algorithmic trading may bring benefits, but it could also harm investor interests in financial markets. FinTech brings both new advantages and new risks. It is certain to become a game changer, affecting consumers, industries, and regulators in many fundamental ways in the years to come.

Preventing the recurrence of the last crisis is of course an imperative, but having largely heeded the lessons of the past, we should now turn to the future.

We are discussing these issues with our colleagues abroad and are making proposals to the global regulatory community. Your knowledge and expertise will greatly help us formulate more effective proposals, particularly on cross-border issues. We are keen to have a good dialogue with you.

In conclusion

This evening, I solicited your contribution to the efforts to transform Japan's fund flow structure, asked for closer coordination among the JFSA, the Tokyo office and the global headquarters, and sought your inputs on the future direction of the global regulatory reforms. As stated in our “Strategic Directions and Priorities,” we are determined to become a regulator open to comments and criticisms given by our stakeholders and to change and improve our way of business continuously reflecting inputs from outside.

IBA has provided us with valuable comments and suggestions. Taking this opportunity, I would like to express our appreciation. Most recently you gave us a proposal concerning agency services conducted by foreign banks. As you may be aware, the Financial System Council is discussing the matter. We carefully look at the proposal and examine possible ways for improvements.

I understand that IBA aims to bring together the views of foreign banks and securities companies operating in Japan to promote and achieve an effective market. IBA also aims to provide a forum where members can share information, experiences and best practices. We highly appreciate your activities, and hope to continue active and constructive dialogues with you.

Thank you indeed for listening.