Japan's capital market regulation in the aftermath

(Introduction)

Thank you very much for the kind introduction. I am Nobuyuki Kinoshita, currently serve as the Secretary-General of the Securities and Exchange Surveillance Commission, SESC for short.

It is a great pleasure for me to speak at this international conference, 'Regulation Crossing Borders,' before an academic audience. As I have had a long career in overall financial regulation and have studied financial economics, today I would like to make a presentation under the topic of 'Japan's capital market regulation in the aftermath', which is a little broader than my present area of work.

(Bird's eye view of the recent global financial crisis)

First of all, I would like to offer a bird's eye view of the recent global financial crisis. Comparing this financial crisis with Japan's past one I struggled, I can see that the feature of this crisis is that the turmoil in the capital market and the collapse of financial institutions work together in a vicious cycle. First, the confidence in the quality of mortgage-backed securities was spoiled by the deterioration in the subprime loan market. Next, the rapid fall of prices of related securities led to enormous losses at financial institutions. These institutions had such difficulty with cash management, that they were compelled to squeeze credit and to desperately sell their securities. This credit squeeze and fire sales, in turn, brought about the drying up of liquidity and the loss of the price discovery function of the whole capital market. This paralysis of the market function, then, caused the free fall of securities prices, which damaged the balance sheets of financial institutions even further. Thus, the interaction between the depression in the capital market and the credit crunch by the financial institutions caused a downward spiral into the financial crisis. Now we can find many articles by various scholars that describe the process and build up a model for this vicious cycle.

(Originate-to-distribute model)

In such articles, many factors are pointed out for the symptoms of the crisis, such as the shadow banking system, the high leverage of financial institutions, and weak regulations. But, the most significant and distinctive contributing factor to the turmoil in the capital market was the originate-to-distribute model, the OTD model for short. The weakness of this model is that originators, arrangers of securitization, distributers and investors had insufficient incentives to provide information on the quality of underlying assets.

Now I would examine the problem of the OTD model in detail from an economic point of view.

In the first place, the key subject of financial intermediation is how to mitigate the asymmetry of information between borrowers and lenders. In the case of traditional loans, this subject is addressed solely by commercial banks, with their information creation function. Commercial banks hold loans until maturity, and take 'Quasi-rent' profit based on their private information concerning the borrower. In the case of capital market products, the subject should be addressed by many institutions separately. First, issuers must disclose information on the quality of products they issue, with the assurance of audit firms on their financial reports. Without reliable disclosure and fair sharing of information, financial products can not be transferable because investors may fear the 'Lemon' cost. Only based on public information can the capital market maintain its integrity and carry out its core function of price discovery and liquidity provision.

Furthermore, this function of the capital market should be supported by securities firms, institutional investors and so on. They must make profit themselves as private enterprises, but are not allowed to rely on private information. They make profit through various financial businesses, such as the transmission of clients' orders to the market, the arrangement of financial products, advice on investment strategy and utilization of risk management technology. Moreover, there are various institutions that assist market participants, such as credit rating agencies, CRAs for short, hedge funds and providers of derivatives such as credit default swap, CDS for short. Because of fierce competition, they are always driven be innovative in their businesses. Such innovation gave birth to the OTD model.

(Response of financial intermediary activities to regulation)

Now I would like to question the response of financial intermediary activities to regulation.

The integrity of the capital market cannot be maintained automatically. There should be a delicate combination of public and private information in the market that can be maintained only by good coordination among the various market participants. In order to facilitate this coordination work, we need good regulation. According to my study, most scholars agree that 'regulation matters'. If the coordination didn't work, the market would not function well, and in the worst case, the market would disappear, as the established economic theory of the 'Market for Lemons' predicted.

With respect to recent structured products, they didn't work well in the end. First of all, inadequate public disclosure by financial institutions damaged market confidence by amplifying anxiety. Second, CRAs, which should bridge the information gap, performed poorly. Hedge funds, which had brought abundant liquidity and diversified strategies to market transactions, accelerated the turmoil through their own crisis management measures. Furthermore, CDS providers, which had complemented the creditworthiness of structured products and market participants, caused an enormous disturbance in the middle of the crisis. Thus, misaligned incentives along the securitization chain destroyed the integrity of the capital market.

In the background of the OTD model, I believe that financial intermediary activities are shifting from traditional and regulated entities to less regulated market participants. I recently found an article that focuses on the effectiveness of current U.S. regulation in light of changes in the financial system and argues that reframing regulation is necessary. I would also like to point out the co-evolution of financial intermediary activities and regulation, which I have noticed during my long career.

The most traditional and regulated financial institutions are commercial banks. They provide the monetary settlement service and the financial intermediary service jointly so as to transform the fundamental infrastructure of economic society. Therefore, they are strongly regulated with restrictions on scope of business, capital requirements and other supervisory interventions. At the same time, they enjoy reputational merit through their licenses, and protection by the safety net, such as the deposit insurance.

The problem is the balance between merits and costs of the financial intermediary activities to be carried by a commercial bank. For example, from the view point of stock investors, bank stocks are one of the alternatives to their arbitrage investment. If the return on bank stocks would be expected to fall because of increased regulation costs, investors would sell bank stocks and purchase the stocks of another category of entities that provide financial intermediary activities without the regulatory burden. In particular, the capital requirement for commercial banks might have a direct effect. Under such investor pressure, the financial intermediary activities move out of commercial banks and other regulated financial institutions. There are many channels for the moving out, such as unbundling the balance sheet to the market, shifting the business to less regulated entities, and outsourcing the function to separated entities. I believe the OTD model is a phenomena based on this background.

(International regulatory responses to CRAs, hedge funds and CDS)

Now let me focus on post-crisis capital market regulation hereafter, particularly the regulatory responses to CRAs, hedge funds and CDS. The reform of capital market regulation was agreed at the G20 Pittsburg Summit, and further international discussions were carried out mainly in the International Organization of Securities Commissions, the IOSCO for short. The IOSCO formed several technical committees, including 'the role of credit rating agencies in structured finance market', 'hedge fund oversight' and 'unregulated financial markets and products'. Each committee published its respective recommendation to the member countries.

As for CRAs, the IOSCO committee published a report in May 2008 recommending reforms to ensure

i) Quality and integrity in the rating process
ii) Independence and avoidance of conflicts of interest
iii) Responsibilities to the investing public and issuers
iv) Disclosure of the code of conduct and communication with market participants

As for hedge funds, the IOSCO committee published a report in June 2009 recommending the introduction of the regulations such as,

i) Mandatory registration of hedge funds
ii) Regulatory requirement relating to disclosure to investors, prudential regulation and so on
iii) Mandatory registration and supervision of related prime brokers and banks
iv) Provision of information for systemic risk purposes

As for unregulated financial markets and products, the IOSCO committee published a report in September 2009 recommending the reforms such as,

i) Requiring originators to retain a long-term economic exposure to the securitization
ii) Improvements in disclosure by issuers to investors
iii) Review of investor suitability requirements

With regard to the CDS market, the report also recommends

i) Establishment of central counterparties, CCP for short

ii) standardizing CDS contracts

iii) Facilitate appropriate and timely disclosure of CDS

iv) International co-operation and information sharing among regulators

Moreover, at the G20 Pittsburg Summit, G20 leaders agreed that all standardized OTC derivatives contracts should be traded on exchanges or electronic platforms, where appropriate, and cleared through central counterparties by end 2012 at the latest.

(Reform measures in Japan)

While contributing to these discussions, the Financial Services Agency, the FSA for short, has been making efforts to introduce and implement appropriate regulatory reform measures.

The first example is the regulation of CRAs. Japan has introduced a new regulation on CRAs by making amendments to the Financial Instruments and Exchange Act, FIEA for short, in June 2009 based on a proposal by the FSA. Brought under the registration system, CRAs are required to ensure appropriate control over the quality of ratings, prevent conflicts of interest and enhance disclosure. The new regulation will take effect this April.

The second reform concerns hedge funds. Japan already has in place a system which requires registration of hedge funds under the FIEA. As the FIEA covers most financial products seamlessly, distributers of hedge funds' equities are subject to the regulation. Although hedge funds operating in Japan are not necessarily taking excessive risks as to raise systemic concerns at the moment, the FSA will continue to make effort to improve the quality of the regulation. The agency published a document called 'Development of Institutional Frameworks Pertaining to Financial and Capital Markets' in January this year. This is the blueprint of the proposal for FIEA amendment made by the cabinet this March. This blueprint includes the expansion of the reporting requirements pertaining to the risk management of hedge funds.

Regarding the unregulated market, the Japan Securities Dealers Association already made a contribution with respect to rules for distributers and standardized disclosure formats to enhance the transparency of securitized products. In addition, the blueprint made by the FSA includes the mandatory clearing of over the counter derivatives, OTC derivatives for short, with large turnover at domestic CCPs, foreign CCPs, or using a link system between a domestic and foreign CCP. As for CDS, which has a close relationship with execution under Japan's legal system, currently, transactions of iTraxx Japan CDS index, should be subject to the mandatory clearing at domestic CCP. Furthermore, the blueprint includes a revision of the professional investor system with regard to local governments.

(Detailed design of the regulatory reforms)

Now let me examine these reforms, taking the above mentioned shift from traditional and regulated entities to less regulated market participants into account. I find considerable puzzles in the detailed design of these regulatory reforms. CRAs, hedge funds, and CDS providers do not belong to fixed categories like commercial banks. They can transform themselves flexibly, and the activities they carry out can slip through the system easily. The regulation should provide a certain incentive for such entities to stay in the category while complying with the obligations. On the other hand, we must be quite careful with the side effect of the regulation.

As for CRAs, I should point out that anyone can evaluate the quality of a financial product and publish her own opinion. Typically, analysts of investment banks actually play similar roles. If the regulation would cause excessive burden, the role of CRAs in structured finance would cease to exist. On the other hand, existing CRAs have profited by the financial regulation such as the employment of their ratings in the calculation of capital requirement for banks. They occupy oligopolistic position in the market currently. In the amendment of FIEA under these circumstances, the balance was struck by prohibiting securities firms from using the credit ratings provided by unregistered CRAs without informing customers of the fact that those CRAs are not registered and the significance and limitations of credit ratings.

The balance for hedge funds regulation is different. So far hedge funds have accepted no advantage from governments. As the raison d'etre of a hedge fund is its own unique investment strategy, they are opposed to being monitored by someone else. Besides, there is no fixed border between hedge funds and industrial corporations. As the FIEA covers a broad range of financial products comprehensively, the act requires substantially all hedge funds to register regardless of their titles or investment schemes, as a discretionary investment manager, an investment trust manager or a collective investment scheme, although there is no definition for hedge funds

As for CDS, the situation is more complicated. The overwhelming majority of CDS transactions are traded across nations, where foreign-affiliated institutions are major players in the field. On the other hand, as information concerning company defaults is local by nature, Japan needs its own CCP of CDS for Japanese companies. The domestic CCP of OTC derivatives is ideally established based on the economic rationality of market participants, taking the current international transactions and future development of Japan's market into consideration.

(Implementation of the new regulations)

Now, I would like to make some comments on the implementation of the regulations. Generally speaking, the most important subject for a regulator is the decision of whether he or she can apply a particular rule to a particular transaction of a market participant ex post. For this purpose the regulator must obtain sufficient evidence which is not always available, while the languages of regulatory legislations are mostly precise. The second challenge for the regulator is communication with market participants, which can provide the good principle of financial practices ex ante. However regulators must be very careful about being consistent during the individual procedure.

As for CRAs, regulators shall oversee their method of business, including a rating procedure, while avoiding intervention in rating results. This oversight is similar to that of audit firms, but there is no established rule for rating procedure like the International Standard on Auditing for account auditing. The regulator must be careful to keep consistency between the measures against individual CRAs and the cooperation with foreign authorities.

As for the collective investment schemes, there is a side effect of the regulation. Bad guys swindle money out of amateur investors by cheating as if the registration was a kind of governmental certification that can be accepted as long as they submit the formalities. The regulator investigates them intensively, but the number of entities is enormous and the process is exhausting. Besides, there is concern about the existence of Ponzi schemes that no one has noticed yet just like Mr. Madoff's fund. Furthermore, the strongest penalty for a collective investment scheme is the cancellation of the registration. This is a very severe measure for an established market player, but for a swindler it just put them back where they started. Therefore, the regulator makes much use of public relations to warn general investors by publishing investigated affairs, while considering the amendment of related statutes.

By the way, I made a presentation four years ago at a symposium in New York held by Columbia University. The theme of the symposium was 'Should hedge funds be regulated?' At that time, I told the American audience that the design of regulation for hedge funds would be quite complicated. Now I am facing my own claim in the current situation facing Japan.

As for CDS, the government is going to prepare a framework for the CCP, but the standardization of CDS contracts and the management of CCP must be done by relevant market participants. On the other hand, regulators must survey the CDS market. As CDS is the product on the borderline of the private information and public information, there is a remarkable risk for the market participants to abuse their private information. The SESC is preparing to investigate suspicious transactions in the market.

(Enforcement of the capital market regulation)

Finally, I would like to mention private enforcement of capital market regulation. As far as I know, most scholars agree that a capital market works well only with the effective enforcement of regulation. Furthermore, active discussions have been held on the relative importance of private enforcement, such as private litigation and investor's discipline, versus public enforcement. Some scholars insist that the private one is superior because of the incentive structure and information advantage.

According to my understanding, both enforcement mechanisms have own their defects and advantages, but there is room for improvement in the private enforcement in Japan. The private securities litigation is not so popular yet, although the FIEA has many provisions to assist the plaintiffs. Besides, the internal control systems of information management are not being precisely checked by audit firms in accordance with the Japanese SOX system. Furthermore, the accounting and audit system could be exploited more as the core infrastructure of the capital market. The governance of institutional investors and the self discipline of investors supported by these private enforcement mechanisms are essential foundations for the integrity of the structured products market.

Besides, I believe that good public enforcement can contribute the efficiency of private enforcement. In this context, the SESC, where I am working now, can play a significant role. The SESC shall devote itself to the integrity of the market not only through its own activities to enhance public disclosure, but also through providing information to the public and communication with the capital market participants.

Thank you for your kind attention.

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