Between the past and the future

Speech by Nobuchika Mori,
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Thank you, Jonathan, for your kind introduction. Good evening, everyone. It is my pleasure to have an opportunity again to deliver my remarks to the distinguished members of the IBA.

The Financial Services Agency is currently undertaking a review of our supervisory approaches. Today, I would like to outline our current thinking and seek your comments and suggestions.

The genesis

18 years have passed since the creation of the Financial *Supervisory* Agency amid Japan's financial crisis and 16 years since its transformation into the Financial *Services* Agency. Today, many people still seem to believe that all through the long years we have single-mindedly grilled bankers to expose non-performing loans and misconduct: Television dramas still often depict an FSA inspectors' visit as a calamity to bankers. I would like to emphasize, however, that we have made and are making many significant changes in our supervisory approaches, responding to the changing environment and learning from the consequences of the past practices.

When the Financial Supervisory Agency was inaugurated, Japan was in an acute financial crisis. The new-born agency pledged to conduct transparent, rule-based supervision focusing on *ex post* checks. The JFSA was determined to preclude any discretionary forbearance or any expectations that banks would be rescued from failures if they follow regulators' *ex ante* guidance. The policy helped the agency restore much impaired confidence in financial supervision.

The immediate priority at the time was cleaning up the mess created in the past. The JFSA had to start by identifying non-performing loans accumulated over many previous years. Inspectors were instructed to think only about taking an accurate X-ray photograph during their on-site visits. With its devotion to asset classification and provisioning, the agency accomplished its first mission of ending the crisis. This was the genesis of the JFSA.

Upon the stabilization of the financial system, the agency extended its supervisory focus to conduct issues. To protect consumers and market integrity, the JFSA resorted to frequent enforcement actions. Some of you even started to call us the Financial *Sanctions* Agency. Being a sanctions agency has certain drawbacks, as I will mention later today, but I believe that the agency contributed to significant improvements in internal controls and compliance.

The evolution

In short, the agency's focus in its early years was on restoring confidence in financial supervision, attaining financial stability and enhancing compliance with rules on consumer protection and market integrity. Our predecessors designed their *modus operandi* to meet such challenges of the crisis days. It is a common nature of a bureaucracy, however, to mechanically repeat approaches once they are established and have proved effective. Typically, that can generate three habits: the habit to indulge in form while forgetting substance, the habit to be meticulous about the past but timid in discussing the future, and the habit to analyze elements without having a holistic view.

Supervisors' habit to indulge in form while forgetting substance may provide perverse incentives to bankers. Bankers may believe that lending based on collaterals and guarantees rather than on borrowers' business prospects would make it easier to demonstrate the banks' safety and soundness. Bankers may prioritize documentation proving compliance to conversation with customers and better identification of their needs.

Supervisors may also indulge in the past and forget the future. They may look only at the bank's recent balance sheet without discussing the sustainability of its business model. They may take a microscopic view of past misconduct while ignoring whether the bank is meeting changing customer needs.

One also can easily indulge in elements without an effort to have a holistic view. Supervisors may spend most of their time debating whether individual loans need to be reclassified or not when the largest risk to the bank is market risk. They may be obsessed with individual misconduct incidents while failing to address underlying root causes.

This is the first reason why we should not blindly repeat the past *modus operandi:* We need to be attentive to these three habits and review the supervisory approaches to mitigate them.

Another reason requiring changes is that the issues supervisors and bankers face today are different from those in the past.

In the good old days, a bank could be profitable just by taking deposit short and lending long, and the balance sheet size was a source of strength. Today, the demographic changes and the globalized "low for long" is making some of the past business models unsustainable.

In the past, banks failed mostly due to lax underwriting practices. Today, banks face new risks which change their locus and guise all the time. A forward-looking capability to identify emerging risks and address them is gaining critical importance.

Banks and supervisors need to find new approaches to meet these new challenges.

To weed off the three habits and to orient ourselves to today's priority issues, we have made efforts over the last decade to upgrade our approaches and widen our perspectives. The Better Regulation initiative we launched in 2007 marked the start of the transformation. The initiative advocated the best mix of rules and principles, early identification of and responses to emerging issues, and incentives to foster banks' own initiatives.

A series of specific measures have also been taken to operationalize the principles. We now leave classification of individual loans to banks' judgement. We spend more time discussing potential future issues than past incidents. We feedback information on best practices observed among banks. We conducted interviews and questionnaire surveys with over 3,000 borrower corporations to find out how banks meet customers' needs.

But the transformation is not easy. Once established, a supervisory approach becomes instilled in behavior, precedents, training, manuals, and the organizational construct and culture, and tends to sustain itself. It is all the more so as thinking about the substance, the future and the holistic view is much more difficult than focusing on the form, the past and the individual elements.

I have to admit that we are still in the middle of our journey. The JFSA is evolving out of the past but the desired future is not ours yet.

A parallel?

I have just sketched our past. One might be inclined to draw a parallel with what we have witnessed in the wake of the global financial crisis: the accumulation of new regulations focusing on each symptom of imbalances manifested in the balance sheet numbers may signal an orientation toward the form, the past and the elements.

I have argued in public speeches, including the one here at the IBA last year, that the global regulatory community should pay more attention to the substance, the future and the holistic view. Our efforts towards financial stability should be designed so that the resultant stable financial system could contribute to sustainable economic growth, which is our ultimate goal.

Although many working groups focus on specific elements of the reform, we should have a holistic view on our reform efforts. We need to assess consequences of the reforms paying attention to the A, B, C, D, E, F and G: A, aggregate effects of the total reform package; B, behavioral changes induced by new regulations; C, cross-sectoral effects; D, dynamic multi-period analysis; E, eco-system inherent in the financial system; F, feedback loop, and G, general equilibrium perspective.

Also, we should prepare for the next crisis in addition to heeding to the lessons from the last one. Static regulations based on the past balance-sheet numbers need to be supplemented by dynamic supervision tailored to future prospects of each specific bank.

While last year in Antalya, G20 leaders declared that critical work *remains*, this year in Hangzhou they emphasized their commitment to *finalizing* regulatory reforms. They decided to finalize Basel III without further significantly increasing overall capital requirements. I am pleased that they emphasized the monitoring of implementation and effects of reforms to ensure their consistency with the overall objectives, including by addressing any material unintended consequences. The Financial Stability Board have embarked on the analysis of the cumulative effects of the reforms including cross-sectoral unintended consequences.

The thinking of the global regulatory community seems to be evolving in the right direction, but, in my view, the direction has not yet been articulated enough. In her book *Between Past and Future* published in 1961, political philosopher Hannah Arendt argued that the gap between past and future is the only region perhaps where truth eventually will appear. The global community is closing the gap it identified in the past *regulations* and the future ones, but the gap between the past *supervision* and the future one still is the region where we need to continue our thinking. The JFSA intends to contribute to the articulation of the future by reflecting the outcome of the efforts to find the future of our own supervisory approaches.

The future

Then, the question is what our future supervisory approaches should look like. I believe they should satisfy two conditions: they should be consistent with our ultimate goal and should be able to cater for emerging issues in the new environment.

Our ultimate goal is to enhance national welfare by contributing to the sustainable growth of the national economy and wealth. Ideally, these should be attained by the market mechanism, as a result of free competition among financial institutions and informed rational choice by consumers and other market participants.

In reality, however, the financial market is prone to many forms of market failure. We also observe failure of economic agents due to principal-agent problem. There thus may be room for regulators to help the market work better by mitigating market failure and agent failure. But regulators themselves often create government failure by unnecessary, excessive or counterproductive intervention – indeed this is where the A, B, C, D, E, F and G I mentioned should work as a check. We need to minimize the sum of market, agent, and government failures so that the market mechanism can realize its full potential.

Regulators tend to try to eliminate every individual source of market or agent failure, but such can easily lead to a large government failure and prove to be counterproductive to our ultimate objective. To avoid this, I believe we should achieve three types of balance: the balance between financial stability and effective financial intermediation, the balance between consumer protection and consumer benefit, and the balance between market integrity and market vigor.

First, the balance between financial stability and effective financial intermediation.

The financial system can propagate shocks through the network among financial institutions and runs arising from information asymmetry between financial institutions and their counterparties. Regulators have an important role in containing the risk of large negative externalities.

But we also need effective financial intermediation to attain sustainable economic growth: what we want is not the stability of a graveyard. I have repeatedly argued that the global regulatory reform should aim to attain both financial stability and sustainable economic growth. We will aim at the same in designing our future supervisory approaches. Financial stability is a precondition for sustainable economic growth, but the reverse is also the case.

Second, we need balance between consumer protection and consumer benefit.

There is an asymmetry in the information held by bankers and consumers. Regulators need to secure bankers' compliance with consumer protection rules so that consumers will not be unduly disadvantaged by the asymmetry.

Our activities in the era of the so-called Financial Sanctions Agency, however, may have made bankers focus their efforts on protecting themselves by documenting compliance with minimum standards, rather than on developing better practices to identify and meet customer needs. Some even devoted their creativity in finding ways to exploit customers while fully comply with the letters of the rules. We need to protect consumers, but protection is not enough. We should like to see financial industry serve the best interest of its customers.

Third, we need to attain balance between market integrity and market vigor.

In capital markets, information asymmetry exists between issuers and investors, and even among investors. To allow all market participants to make rational investment decisions, market regulators enforce rules on disclosure and conduct and protect market integrity and transparency, which is a precondition for an efficient market.

But capital markets cannot contribute fully to sustainable economic growth or to the accumulation of household assets just with integrity and transparency. We need vigorous, dynamic capital markets where asset managers, intermediaries and information gather from around the world and a variety of opportunities are offered to issuers and investors.

To be consistent with our ultimate goal, we would like to build supervisory approaches which strike a right balance between stability and growth, protection and benefit, and integrity and vigor. The ultimate objective and the need for the three types of balance do not change over time. But the priority issues we need to address do change. This is why the second condition is needed: Our future supervisory approach needs to be able to cater for emerging issues in the new environment.

As I have described, non-performing loans and misconduct were the two priority issues in the first decade of the JFSA. We cannot be complacent on these issues, but we are facing new issues as well.

The population in Japan is aging and declining. Globally, yield curves have become flat and low. Customer needs are changing and diversifying. Information technology is transforming the production and the delivery of financial services. Failure to build a business model adapted to these new environments will in the end endanger financial stability and effective financial intermediation.

Bankers and supervisors used to be preoccupied with containing excessive risk taking, but now they need to think also about smart risk taking, profit sustainability, and diversity in business models. For example, the past stress tests focused on one time shock, but in the new environment we need to think more about the effects of persistent changes.

In addition, as the pace of change in character and source of risks accelerates, the required risk management capability is also changing. Bankers need to be agile and capture signs of changes all around the world, identify possible transmission channels and secondary effects, canvass implications on their business and rebalance their business portfolio.

There is no single answer or pre-defined pass mark which would allow bankers to meet these emerging challenges. Each financial institution must find its own answer and continue to enhance its practices repeating diagnosis, innovation and implementation. Regulators also have to change.

Since the time of the financial crisis, the JFSA has assembled and enhanced its toolbox designed to monitor banks' compliance with minimum standards. Though indispensable, checks on minimum standards alone would not meet the challenges of the day. The conventional combination of regulation, inspection and enforcement action may not be conductive to market participants' own initiative and innovation, which is the foremost critical success factor in meeting the new challenges. We must supplement our past approach with a new toolbox needed for dialogue with banks on questions with no single answer, on best practices beyond the minimum, on business models, profitability, and forward-looking risk management.

The JFSA is currently developing tools to be included in such a toolbox. We have introduced a set of benchmark indicators showing how banks implement their policy to meet their customers' needs. We plan to enhance disclosure on the quality of the financial services provided. Codes and principles may be developed instead of minimum standards. We will supplement Basel Pillar One regulations with dynamic, forward-looking supervision tailored to each bank and the changing environment. We publish our *Strategic Directions and Priorities* at the onset of our business year and a report summarizing the progress, key findings and remaining issues at the end of the business year.

Between the past and the future

Let me conclude. Banking supervision needs to change. If we are to attain both sustainable growth and financial stability, we need to expand our supervisory perspective from form to substance, from the past to the future, and from elements to a holistic view. Minimum standards policing risk taking will not be enough to meet the challenges of the day: regulators need to have effective dialogue with bankers about how they can create value shared with their customers and play useful roles in society. In addition to a standard check on the resilience to the recurrence of past shocks, bankers and regulators should explore the implications of emerging risks and structural changes.

Standing between the past and the future, this is what I can offer today. In August, the JFSA established an advisory group consisting of external experts to explore supervisory approaches we are to adopt. In addition to the group's advice, I am keen to have your suggestions. All of you who are present here have a special advantage in answering the types of questions I raised this evening, since you have experienced various approaches taken by supervisory authorities around the globe.

I am looking forward to continued dialogue, and I will stop here. Thank you.