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Bank of Japan

Financial Regulations: Asian Perspectives

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Kiyohiko G. Nishimura
Deputy Governor of the Bank of Japan

First of all, I would like to express my sincere gratitude to the hosts for inviting me to the Lujiazui Forum and especially to this panel on financial reforms. I am particularly delighted to be given the opportunity to discuss the pressing issue of financial reform, which will shape the future landscape of the global economy. In this short presentation, I would like to argue the following two points:

Firstly, the financial innovations of the past quarter century have blurred the dividing line between banks and non-banks. These developments have made it possible to shift risk back and forth between the banking system and capital markets. It has become difficult to locate exactly where ultimate risk lies, and the banking system has found itself so often vulnerable to the volatility of capital markets. The Volcker Rule and related financial reform proposals are designed to rectify these problems. Secondly, however, we should recognize the significant regional differences in banks' business models along this bank/non-bank spectrum. Financial reforms should thus follow a carefully-timed and well-balanced approach, taking explicit account of regional and functional heterogeneity.

Banks More Like Non-banks and Non-banks More Like Banks: Rationale for the Volcker Rule

It may sound a bit farfetched, but the global financial crisis of the last few years might have been brought about partly by banks becoming more like non-banks and non-banks becoming more like banks. Some banks are now non-bank-like, as exemplified in the current financial jargon used to describe these banks' business practices, such as "originate to distribute model" and "prop trading", while some non-banks have become bank-like, as the phrase "shadow banking system" suggests.

The financial innovations behind these changes are in essence welcome developments, helping to improve efficiency by shifting risk among economic agents. However, they have made it increasingly difficult to locate the whereabouts of ultimate risk. Vital information regarding banks' risk exposures has been literally "lost in transformation" in the originate-to-distribute model and various proprietary derivative trades. We have been unable to identify what risks a particular bank has been exposed to, and, as a consequence, those facing the financial system as a whole. As we all know only too well, heightened concern over counter-party risks led to severe dysfunction in financial markets, particularly after the collapse of Lehman Brothers and the bailout of AIG in September 2008.

The problems surfaced most acutely in the United States. Thus we have observed the bold attempts at regulatory overhaul in the U.S., of which the so-called Volcker Rule has become something of an icon.

In my understanding, the Volcker Rule is designed to deter banks from taking excessive risk in capital markets, where volatility is inherently high and in which bankers do not necessarily have informational advantage in predicting market developments. Rather, the Volcker Rule urges banks to return to their traditional stronghold of commercial banking business, in which they can utilize their informational advantage based on long-term relationships with their customers. In other words, the rule attempts to insulate long-horizon relationship banking from the occasional brutality of the sometime short-horizon capital markets. In this way, we can prevent the possible misuse of public assistance given to banks.

The rationale for the Volcker Rule could be applied to liquidity risk management as well. That is, commercial banks should not rely too much on fickle wholesale funding, but should focus more on stable deposits based on long-term relationships with their customers.

Asian Perspectives of Heterogeneity: Don't Put Carnivorous Lions and Herbivorous Elephants in the Same Cage

Here I cannot help feeling that this rule is quite congenial to the traditional Japanese, and probably Asian, view of what banks are. In Japan, loans constitute roughly half of corporate debt financing, and deposits roughly three quarters of banks' balance sheets. Long-term relationships are the rule, not the exception. I believe this dominant role of the banking sector in the financial system is more or less similar in the rest of Asia as well. It is no coincidence that financial systems in the Asia region have remained relatively stable during the current crisis: we have not suffered a serious deterioration in confidence or market dysfunction, since our banks have largely remained as traditional banks, and shadow banking had at most a limited presence.

In order to prevent another global financial crisis of this magnitude, we truly need a thorough and internationally harmonized overhaul of financial regulations, as is currently being undertaken by various international regulatory bodies. However, as mentioned before, proper consideration must be given to the regional heterogeneity of banks' business functions, especially in the bank/non-bank spectrum. The difference is not arbitrary but reflects real structural differences between regions. In particular, it would be unrealistic to always assume that "one size fits all": We should not put carnivorous lions and herbivorous elephants in the same cage. We should also follow a well-balanced approach that properly recognizes the synergetic cross-effects of item-by-item regulations. An appropriate criterion should be the combined effects of all item-by-item regulations. Simply focusing on the “marginal effects” of individual measures may be misleading, even though they have good individual rationale.

At the same time, we should be aware of a possible trade-off between the long-term benefits and short-term costs of stronger regulations. Such regulations may indeed enhance financial stability and economic prosperity in the long run, but the hasty implementation of stringent regulations may hamper a fragile recovery, such as we find ourselves in now.

Let me stop here for further discussion. Thank you for your kind attention.