# 2019

# *Japan-U.S. Symposium on Building the Financial System of the 21$^{st}$ Century*

# PROMOTING CROSS-BORDER LENDING FOR ECONOMIC GROWTH: REGULATION AND STABILITY

# Status of Cross-Border Lending

- Range of cross-border funding activities
  - Both bank and non-bank
  - Other financial flows (including impact of derivatives markets)
- Measurement and data issues
  - Insufficiency of data and info channels – counterparty, concentration, credit quality (risk premium)
  - Data quality – weak disclosure and standards in many jurisdictions
  - Limits to access by market participants and regulators
- Pressures on cross-border lending
  - Dollar funding squeezed – even Japan affected
  - Unmet needs for investment in emerging markets
    - Financial infrastructures often lacking
    - Is it possible to recycle trapped capital?
  - Fragmentation of global credit markets, regulatory capital, derivatives

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# Regulation and Fragmentation

- G20 standards and domestic responses
  - Basel capital and liquidity standards raise costs of compliance
  - Differential implementation across jurisdictions
  - Ring-fencing of capital and liquidity drives fragmentation
    - Also weakens principle of SPOE
- Cross-border regulatory issues
  - Inconsistent standards for equivalence and mutual recognition
  - Rise of extraterritoriality (Volcker Rule, GDPR, IBOR, unbundling)
  - Proposed reform to Japan’s Foreign Exchange and Foreign Trade Act may stifle cross-border investment
  - Data localization in some jurisdictions impedes cross-border capital flows (but TPP and recent US-Japan agreement are more positive moves)

# Trust and Regulatory Cooperation

- Is fragmentation driven by lack of trust among regulators?
  - Interpersonal trust among regulators important for communication and coordination, but will not ensure effective cross-border resolution
  - Weakening of LOLR function, esp. in U.S., increases need to protect own taxpayers' money; disincentivizes coordination
  - Regulators ultimately accountable to citizens, not foreign counterparts
  - If not trust, can at least strive for transparency, predictability, understanding
- Political challenges
  - Age of anti-globalist populism
  - Perception that banks evaded responsibility for financial crisis
  - How to be accountable to citizens, stakeholders, and foreign partners?
  - Concerns regarding excess global liquidity, destabilization of emerging markets (à la 1997)

# The Road Forward

- Global standards
  - Are gains in financial stability worth costs of compliance?
  - Need to develop common approach to equivalence, regulatory deference based on principles or outcomes
- Mechanisms of coordination
  - Do we need more or fewer regulatory bodies?
  - Can extraterritoriality be avoided through better consultation?
- Technical alternatives
  - Potential of new technologies (e.g., blockchain) to improve settlement processes
  - Alternative channels for financial intermediation, Libra or other stablecoins
  - How do these change the need for trust and formal cooperation?

# Passive/Active Investment Strategies and Implications for Market Functioning and Corporate Governance

# Rise of Passive Investment

- What is meant by passive investment?
  - Composition of indexes varies widely; rise of bespoke indexes
  - ETFs may or may not be passive investment
- Advantages of passive investment
  - Cost, efficiency, performance
  - Transparency of assets
- Disadvantages
  - Concerns about price determination, herd behavior, concentration of ownership
  - Evidence is limited
    - Passive is still minority of assets even in US, share of trading even smaller
    - Retail investors in passive investment vehicles don’t show herd behavior
- Rise of passive funds may open opportunities for active and activist investors

# Institutional Investors & Corporate Governance

- Passive investors
  - Can support good governance through engagement and voting
  - Concentrated holdings can lead to greater influence
  - But is quality high?
    - Low fees mean lack of inventive to build capability => reliance on proxy advisors
    - May result in checkbox approach
- Active and activist investors
  - Active ≠ activist
  - Engagement may carry greater weight due to possibility of exit
  - "Engagement fatigue"
- Private equity
  - Is private model inherently better for governance and performance?

# Corporate Governance in Japan

- What is good corporate governance?
  - Mixed evidence of effects on corporate performance
  - Corporate governance for whom?
    - Business Roundtable: from shareholder value to stakeholder
    - ESG increasingly demanded by authorities, investors – environmental, stewardship
- Corporate governance in Japan
  - Significant top-down transformation
    - Stewardship Code, Corporate Governance Code
  - Practical effects
    - Increase in independent directors, committee structure
    - More shareholder proposals, proxy fights, M&A
    - Possible positive effects on productivity, ROE
  - How transformative are structural changes?
    - Lack of director diversity, persistence of informational asymmetries

# Investment by Japanese Official Actors

- BOJ and GPIF have become largest equity holders
  - Each holds about 5% of Japanese equities
  - Asset management largely passive, outsourced to professionals
- GPIF is vigorous in promoting corporate governance
  - Has taken leadership in corporate governance reform
  - Strict adherence to Stewardship Code
- BOJ takes passive approach to investing and governance
  - Outsources voting and engagement to outside managers who rely on proxy advisors
  - Does this weaken corporate governance reform in Japan?

# UPCOMING EVENTS

**Europe-U.S. Symposium**
***Washington, DC***
March 5-7, 2020

**China-U.S. Symposium**
*Hong Kong*
June 3-5, 2020

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