2019 Japan-U.S. Symposium on Building the Financial System of the 21st 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
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
deferece 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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