SYMPOSIUM ON
BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY

AN AGENDA FOR JAPAN & THE UNITED STATES
GOTEMBA, JAPAN • SEPTEMBER 30-OCTOBER 2, 2005

FRIDAY, SEPTEMBER 30

18:00-19:00 Cocktail Reception – Main Lobby

19:00 Dinner – Room A

GREETINGS

Hal Scott, Nomura Professor & Director, Program on International Financial Systems, Harvard Law School

Robin Radin, Associate Director, Program on International Financial Systems, Harvard Law School

Tasuku Takagaki, Senior Advisor, The Bank of Tokyo-Mitsubishi; Chairman, Board of Trustees, The International House of Japan, Inc.

KEYNOTE ADDRESS

Hiroshi Watanabe, Vice Minister of Finance for International Affairs, Ministry of Finance

21:30-23:30 After-dinner Cocktails – Main Lobby

SATURDAY, OCTOBER 1

7:00-8:00 Breakfast – Fuji View Room

8:00-8:15 **GREETINGS**

Hal Scott, Nomura Professor & Director, Program on International Financial Systems, Harvard Law School

Tasuku Takagaki, Senior Advisor, The Bank of Tokyo-Mitsubishi; Chairman, Board of Trustees, The International House of Japan, Inc.

8:15-8:35 **SESSION 1: CAPITALISM IN JAPAN AND THE UNITED STATES: THE PURPOSE OF CORPORATIONS AND THE CONTESTABILITY OF CORPORATE CONTROL** – Conference Room A

Japan Panelist: Hideyuki Takahashi, President & CEO, Nomura Securities International, Inc.
U.S. Panelist: Robert Feldman, Chief Economist, Morgan Stanley Japan Limited

8:35-10:10 **SMALL GROUP SESSIONS**

Group / Room	*Facilitators*	*Reporter*
1 Room B1	Tadashi Nakamae, William Jarvis	Andrew Conrad
2 Room B2	Isao Kubota, Allan O'Bryant	William Grimes
3 Room C	Joseph Schmuckler, John Vail	David Sneider
4 Room D	Akira Kojima, Curtis Milhaupt	Christopher Wells
5 Room E	Tomoo Nishikawa, Laurence Bates	Robin Radin
6 Room G	Masaru Yoshitomi, David Asher	Akihiro Wani
7 Room H	Mikio Wakatsuki, Alicia Ogawa	Mineko Sasaki-Smith

10:10-10:20 Refreshment Break

10:20-10:40 **SESSION 2: MANAGEMENT AND REGULATION OF LARGE COMPLEX FINANCIAL INSTITUTIONS** – Conference Room A

Japan Panelist: Takahiro Moriguchi, Advisor to the President for International Affairs, The Bank of Tokyo-Mitsubishi

U.S. Panelist: Michael Brown, Managing Director & COO – Japan, JPMorgan Securities Asia Pte. Limited

10:40-12:15 **SMALL GROUP SESSIONS**

Group / Room	*Facilitators*	*Reporter*
1 Room B1	Yasuhiro Harada, Brett Goodin	Robin Radin
2 Room B2	Hiroyuki Kamano, Geoffrey Matsunaga	Mineko Sasaki-Smith
3 Room C	Akinari Horii, Michael Brown	Andrew Conrad
4 Room D	Shuji Yanase, Don Kanak	Christopher Wells
5 Room E	Naoko Nakamae, David Hale	Akihiro Wani
6 Room G	Hiroshi Ota, Michael Wilson	William Grimes
7 Room H	Yasuo Kanzaki, John Makin	David Sneider

12:15-13:30 Lunch – Fuji View Room

KEYNOTE ADDRESS

Taizo Nishimuro, Chairman of the Board, Tokyo Stock Exchange, Inc.

Introduced by: Tasuku Takagaki, Senior Advisor, The Bank of Tokyo-Mitsubishi; Chairman, Board of Trustees, The International House of Japan, Inc.

13:30-15:00 **SESSION 3: REFORM OF JAPAN'S POSTAL SAVINGS AND INSURANCE SYSTEM AND FANNIE MAE AND FREDDIE MAC IN THE U.S.** – Plenary Discussion Only – Conference Room A

Japan Panelist: Yo Takeuchi, Director-General, Customs and Tariff Bureau, Ministry of Finance

Japan Panelist: Naoyuki Yoshino, Professor, Department of Economics, Keio Unversity

U.S. Panelist: Charles D. Lake II, Vice Chairman, Aflac Japan

U.S. Panelist: William Shipman, Chairman, Carriage Oaks Partners LLC

15:00-17:45 Free time

15:00-17:45 Reporter's meeting – Conference Room E

18:00-19:00 Cocktail Reception – Main Lobby

19:00 Dinner – Room A
KEYNOTE ADDRESSES
Masamoto Yashiro, Chairman, Shinsei Bank, Limited

Wilbur L. Ross, CEO & Chairman, WL Ross & Co. LLC

21:30-23:30 After-dinner Cocktails – Main Lobby

SUNDAY, OCTOBER 2

7:00-8:00 Breakfast – Fuji View Room

8:00-9:00 **SESSION 1: CAPITALISM IN JAPAN AND THE UNITED STATES: THE PURPOSE OF CORPORATIONS AND THE CONTESTABILITY OF CORPORATE CONTROL** – Presentation & Discussion – Conference Room A
Japan Chair: Hiroyuki Kamano, Partner, Kamano Sogo Law Offices
U.S. Chair: Satoru Murase, Partner, Bingham McCutchen Murase LLP

9:00-9:10 Set-up for next presentation

9:10-10:10 **SESSION 2: MANAGEMENT AND REGULATION OF LARGE COMPLEX FINANCIAL INSTITUTIONS** – Presentation & Discussion – Conference Room A
Japan Chair: Akinari Horii, Director-General of the International Department, Bank of Japan
U.S. Chair: Robert Grondine, Partner, White & Case LLP

10:10-10:25 Refreshment Break

10:25-11:30 **SESSION 3: REFORM OF JAPAN'S POSTAL SAVINGS AND INSURANCE SYSTEM AND FANNIE MAE AND FREDDIE MAC IN THE U.S.** – Presentation & Discussion – Conference Room A
Japan Chair: Tadashi Nakamae, President, Nakamae International Economic Research
U.S. Chair: Mario Ugoletti, Acting Deputy Assistant Secretary for Financial Institutions Policy, U.S. Department of the Treasury

11:30-13:30 Closing Lunch – Fuji View Room

SYMPOSIUM REPORT

BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:

AN AGENDA FOR JAPAN & THE UNITED STATES

September 30-October 2, 2005
Gotemba, Japan

BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR JAPAN & THE UNITED STATES
GOTEMBA, JAPAN SEPTEMBER 30-OCTOBER 2, 2005

The eighth Symposium was held at the Keidanren Guesthouse in Gotemba. Sessions considered the purpose of corporations and markets for corporate control in Japan and the United States, the management and regulation of large complex financial institutions, and reform of the Japanese postal financial institutions in the context of lessons from GSE regulation in the United States. A substantial majority of participants expressed positive evaluations concerning the short- to medium-term prospects of the Japanese and U.S. economies, and so discussion was able to focus on more long-term and fundamental issues of concern. Much of the discussion concerned general principles, while discussion of specific issues focused on Japan. On the one hand, considerable optimism was expressed regarding improvements in market discipline of corporations in Japan. On the other, concerns were raised about the benefits of financial conglomeration and the privatization process of postal savings and insurance.

Session 1
Capitalism in Japan and the United States:
The Purpose of Corporations and the Contestability of Corporate Control

Discussion of the purpose of corporations and contestability of corporate control revolved around several main points. With regard to the basic question of the purpose of corporations, both continuing differences of perception and increasing convergence between the U.S. and Japanese models were noted. Much of the discussion in this session focused on how best to ensure that corporations fulfill their purposes, and the various roles and responsibilities of markets, corporate governance structures, regulators, and courts. Some of the areas of contention included the relationship of form and substance in corporate governance, role of hostile takeovers, and the implications of the Livedoor-Nippon Broadcasting System and other court cases.

What is the Objective of the Corporation?

Many participants noted the traditional difference between Japanese focus on stakeholders versus American focus on shareholders. While participants largely agreed on the need to emphasize shareholder value, many felt that Japanese firms still see themselves as needing to concentrate on the needs of their labor forces as well. Moreover, a number of participants, citing the principle of corporate social responsibility, felt that it was appropriate for corporations to look to interests outside of shareholders.

Another stream of thought saw attention to the interests of stakeholders as being in the ultimate interests of shareholders. Several participants argued from this perspective that Japan's traditional corporate culture of retaining even redundant workers had benefits in terms of worker morale and loyalty that could outweigh the straightforward efficiency losses of cutting quickly. With regard to the notion of corporate social responsibility, while some participants advocated it on ethical grounds, others pointed out that it could make a corporation's products more attractive to consumers and could aid in the recruitment and retention of employees, many of whom wish to feel that their work contributes to the community or the environment.

While it has long been a truism that U.S. firms favor shareholders and Japanese firms favor stakeholders, some participants felt that the two models might be converging. On the U.S. side, recent interest in corporate responsibility as well as the recognition of company specific

skills has modified the focus on profit maximization for the benefit of shareholders. On the Japanese side, it was widely agreed that more and more companies are paying attention to share prices and the demands of increasingly activist shareholders, and thus placing a much greater emphasis on profitability.

How Can These Objectives Be Best Achieved?

In order to maximize corporate value, participants discussed the roles of a variety of disciplinary mechanisms, including markets, corporate governance structures, the role of regulators, and the role of banks. While opinions varied concerning the importance of each mechanism, there was a clear consensus that prompt, accurate, and broad disclosure of relevant information about corporations is indispensable to maximizing corporate (or shareholder) value. Below, disclosure is addressed in the context of each of the disciplinary mechanisms.

Market Discipline

Participants agreed that market discipline was central to the mission of maximizing corporate value, and more broadly to efficient resource allocation throughout the economy. Markets have the advantage of aggregating the evaluations of a large number of actual and potential shareholders with a strong financial interest in making correct choices, and thus are more likely to accurately judge the worth of a firm than any single actor or organization could.

Under the general category of market discipline, participants discussed several issues, including the role of takeover bids (TOBs); poison pills; the voices of shareholders, especially institutional investors; and management compensation schemes. With regard to takeover bids and poison pills, much of the specific discussion addressed aspects of the Livedoor and other recent court cases.

<u>Role of Shareholders</u>

Central to the effectiveness of market discipline is the role of shareholders. Participants noted that that role has changed considerably in Japan in recent years, in terms not only of reductions in stable cross-shareholding relationships and the rise of foreign institutional investors, but also of changing behavior on the part of both individual and institutional investors. While the changing composition of shareholders was not discussed at length, the differing preferences of different types of shareholders was noted several times. With the decline of

relationship-oriented shareholding in favor of profit-oriented shareholding, the conditions for true market discipline were seen to have improved.

As noted, shareholders have changed not only in composition, but also in terms of activism. Activism on the part of smaller shareholders is most apparent in the rise of shareholder derivative lawsuits, which have held the management and directors of many firms accountable for malfeasance or negligence over the last decade. While such suits were originally seen as rare events with few systemic implications, many participants agreed that they have developed into an important role in disciplining Japanese corporations. Another indicator of shareholder activism is the increasing willingness to reject management proposals at shareholder meetings. (This point is addressed again below in the discussion of poison pill defenses.)

As significant as the increasingly assertive behavior of individual shareholders has become, participants agreed that the role of institutional investors has been central to increasing management responsiveness to shareholder value. Institutional investors of many sorts, from pension funds to investment trusts to the broad array of hedge funds, have pressured management to pay greater attention to their preferences. Examples given included improvements in corporate governance techniques, better information provision, and higher payout ratios.

Takeover Bids and Poison Pills

While participants agreed that market discipline in the form of voice or exit by shareholders is essential to ensuring that managers act responsibly, opinions varied on the respective benefits of takeover bids and poison pills. While some argued that takeovers are the logical and necessary conclusion of market discipline, others responded that both successful and unsuccessful TOBs may be just as likely to destroy value as to create it. This basic difference of opinion also was reflected in discussions of the costs and benefits of poison pill defenses.

The case in favor of takeover bids as a means of positive market discipline was straightforward. Proponents pointed out that TOBs are essentially bets that a given corporation's value can be significantly increased by a change of management or strategy. Since takeovers directly threaten incumbent management, managers are challenged to

constantly maximize shareholder value lest they lose their jobs. To illustrate, one participant quoted Oscar Wilde to the effect that "Nothing concentrates the mind like a hanging in the morning." In the end, these participants argued, even low stock valuations would not be sufficient in and of themselves to change the behavior of management since boards are often complacent or otherwise unable to fully fulfill their responsibilities as monitors.

Other participants felt that TOBs are often counterproductive. Some argued that this was particularly true in the Japanese context. It was noted that takeovers, especially hostile ones, do not systematically improve corporate performance. This was seen to be a particular problem in cases where an important part of the target company's value is based on company-specific skills of employees or on high levels of functional integration with suppliers or customers. It was argued that new owners would have to carefully respect firms' corporate cultures. It was suggested that this was particularly true in Japan. Advocates of the role of TOBs in maintaining corporate discipline did not in all cases deny that many takeovers fail in their basic objective of increasing shareholder value. But they argued that the threat of takeover improved performance throughout the system.

Participants' views of poison pill defenses mirrored their analyses of TOBs. Those who emphasized the importance of takeovers as a market disciplining mechanism generally opposed poison pills on principle, while those more skeptical of the utility of takeovers were more accepting of poison pills. There also was some middle ground. A number of participants felt that mild forms of poison pills could be beneficial by slowing down the process of a takeover. Non-Japanese examples were given of cases in which offer prices were raised during negotiations that had been slowed down by the existence of a poison pill. (This is not currently allowed under Japanese law, which might prevent some potentially productive takeovers from occurring.) In other cases, the delay might make apparent that a given takeover bid was either inappropriate or greenmail. Even some participants who basically opposed the idea of takeover defenses saw benefits in such cases, as long as poison pills were not designed to make takeovers impossible or to privilege or reward management at the expense of shareholders. There was no consensus on whether it was indeed possible to design poison pills of that sort. Finally, there was a clear consensus that poison pills should be subject to approval or rejection by shareholders, although that is not a legal requirement in the United States. The example of the June 2005 shareholders' meetings at Japanese companies, at which a number of poison pills were rejected, was noted with approval.

Aligning Incentives of Management and Shareholders

Rather than relying entirely on outside monitoring of management, some participants called for greater attention to aligning their incentives with those of shareholders, though compensation schemes (restricted stock and options). There was no clear consensus on this issue. Proponents argued that Japanese management still lacks proper incentives to maximize shareholder value or to be fully honest with investors. Other participants expressed skepticism about the ability of boards to create appropriate systems of compensation, noting that executive compensation in the United States has not been shown to be systematically associated with performance at either the firm or economy level. They warned against two dangers: board capture by management and ratcheting upwards caused by recruitment based on above-average compensation. The former concern related closely to broader questions as to whether it is possible to create truly independent boards.

Corporate Governance Rules

There was considerable discussion of formal means of discipline, focusing on the roles of boards and regulators. As in previous Symposiums, corporate governance rules received considerable attention. Japanese Corporate Law as recently amended allows two alternative forms of corporate governance—the traditional type, with monitoring the responsibility of a statutory auditor, and U.S.-style committee system, with a majority of independent directors on the auditing committee.

A number of participants argued that only a board based on independent directors could be expected to act in the interests of shareholders. They worried that the traditional Japanese system of recruiting directors and auditors from within the firm significantly raises the likelihood that shareholders' interests will be sacrificed for the benefit of management. Some advocates of this point of view called for Japanese law either to require a majority of outside directors, as under NYSE listing rules in the United States, or to provide justification in public statements if a majority of directors were not independent, as in the United Kingdom. Japanese boards were also criticized for being too narrowly focused on executive decisions rather than on oversight. Some participants suggested that this made them less likely to deal with issues of fundamental corporate strategy.

While the belief in the value of boards with a majority of independent directors has been dominant in the United States in recent years and had also been widely expressed at previous

Symposiums, at Gotemba many participants argued that it should not be accepted without examination. Much of the discussion about corporate governance principles focused on Japan, but it was also noted that there is no systematic evidence demonstrating the superiority of independent boards even in the United States. This point was of concern to participants, since meeting the requirements of corporate governance rules (especially in the United States) can be costly for firms.

Participants were split on the question of whether the problems with boards in the United States resulted from inherent weaknesses in corporate governance rules or just from the perversion of sound governance principles in specific instances. The case for the latter was straightforward: either top management had been allowed to capture boards (often by being the *de facto* recruiter of board members) or individual board members had not been up to the task of effective monitoring. Those taking a more fundamental view argued that there is sometimes a trade-off between depth of knowledge and experience on the one hand, and independence on the other. In this respect, a number of participants argued that efforts to recruit independent directors in U.S. firms had in some cases meant that the directors had minimal knowledge of the industry or firm, and that this would lead to less shareholder value than less independent alternatives.

Meanwhile, with regard to Japanese corporate governance, while many participants expressed the belief that independent directors would help to shake up corporations and improve profitability, others cautioned that the jury was still out on the relative benefits of statutory auditor vs. committee systems. Indeed, some of Japan's most successful corporations, such as Toyota, have retained the traditional structure. One explanation offered for why statutory auditor systems might be more appropriate was that Japanese firms tend to be less transparent, so only insiders would be able to get the information necessary to effectively monitor them. As noted, however, this requires that the auditor be willing and able to act independently in the interests of shareholders over his former colleagues.

Building on the criticisms of both the committee and statutory auditor systems, some participants argued that it is simply impossible to create a foolproof system of corporate governance. Instead, they argued, effective corporate governance depends not only on structure, but also on the example set by top management, attention to internal controls, and market discipline on the basis of widely available and accurate information disclosure.

Regulators

Regulators have a ubiquitous role in the way corporations are run, and were seen by most participants to be essential to the broader system of discipline. Four main issues were raised: regulation of information disclosure, the locus of regulation, the role of self-regulating organizations, and costs of regulation.

One issue on which there was widespread agreement was the need for regulators to ensure prompt and accurate information disclosure, and to punish misrepresentation of information. While most participants agreed that without clear legal sanctions for misrepresentation, markets and even conscientious directors or auditors would be unable to discipline companies, others argued that excessive regulation would create a straightjacket for firms, and that self-regulation via market exposure should govern most aspects of information disclosure.

With regard to more specific issues, one question was whether it would be better to have a single regulator (the U.K. model) or multiple, overlapping regulators (the U.S. model). While some participants championed the cause of regulatory competition to prevent arbitrary behavior on the part of regulators, others felt that this would lead to a loss of comprehensiveness or efficiency. With regard to Japan, two issues were raised. One was whether there should be a Japanese-style SEC, since some participants felt that information disclosure and fairness issues in financial markets cannot be treated adequately by the FSA. There was no clear consensus on this idea. The other point made was that the FSA is in practice not a single regulator, since it does not yet cover postal savings or insurance; thus, Japanese financial institution regulation is still somewhat fragmented for the time being.

Participants meanwhile argued that self-regulating organizations (SROs), especially the Tokyo Stock Exchange, should be taking a greater role in financial regulation in Japan. Participants expressed the hope that the TSE would become more proactive under its new management, though a number were frustrated by the slow pace of rule change.

Finally, there were serious concerns raised about the costs of compliance, in particular with the U.S. Sarbanes-Oxley law. Participants complained that the need for comprehensive auditing for internal controls made compliance very costly for smaller firms, and worried that it would stifle the ability of start-up companies to go public.

The Role of Courts in Japan

While the role of courts in the United States in setting and enforcing rules for corporate and financial market behavior is well-established, it has been much more limited in Japan due to different legal and regulatory traditions. This has been changing for the last decade, with the rise of shareholder derivate suits, as noted above. More recently, three important judgments in 2005—the most famous concerning the attempted takeover of Nippon Broadcasting System by Livedoor—addressed the issue of poison pills, and affirmed that courts have the ability to limit takeover defenses to those that support the interests of shareholders. It was expected that these judgments would create an important precedent for future judgments on those questions.

There has been considerable controversy within Japan as to whether these judgments were correct, but Symposium participants overwhelming were approving of both the rulings and the principles on which they were based. In the Livedoor and other cases, judges stated clearly that shareholder rights had to be respected by managers seeking to defend against takeover bids. The judgments were based on the twin principles of maximization of corporate value and equality among shareholders. Interestingly, one other decision had permitted the poison pill in question, based on the judgment that the defense in question was not discriminatory among shareholders and was too mild to protect management against the wishes of shareholders.

Many participants additionally felt that the Livedoor case in particular had helped to raise positive awareness of takeovers within Japan, and that the judgment had been instructive for many potential investors. Other, however, expressed concern that Livedoor had provoked an anti-takeover backlash that had contributed to the profusion of poison pills adopted in the June 2005 shareholder meetings.

Finally in this regard, it was noted that recent years have seen the biggest overhaul of corporation-related laws since the Occupation period. Participants appeared to agree that it will take several years before the full impact of that overhaul is clear.

Session 2

Management and Regulation of Large, Complex Financial Institutions

The question of how best to manage and regulate large, complex financial institutions has become increasingly urgent in recent years with the rise of mega-banks and other financial conglomerates globally. The merger of MTFG and UFJ, as well as the impending privatization of Japan's postal savings, served to focus particular interest on Japanese management and regulation. Participants discussed a variety of issues related to this topic, including the efficiency of financial conglomerates, systemic risk, monopoly power, regulatory firewalls, and coordination of national regulators regarding the regulation of multinational financial institutions.

Causes and Consequences of Increasing Size and Scope

A major theme of discussion was whether increasing size and scope actually improves the efficiency and profitability of financial conglomerates. Many participants were skeptical, arguing that large, complex financial institutions were particularly susceptible to problems of weak internal controls, lack of flexibility, and poor integration. These problems were seen to be exacerbated by the difficulties of regulating them. Participants pointed to negative external effects as well, including concerns about unfair competition, conflicts of interest, and systemic risk resulting from their becoming too big to fail. These concerns informed additional debate over the challenges of appropriate regulation both on national and transnational levels.

Synergy or Sticking Point?

In light of the significant rise in multinational financial conglomerates in recent years, as well as the presence at the Symposium of representatives of both financial conglomerates and niche players, questions of costs and benefits were front and center. Participants considered the question both generally and with an eye to differences between Japan and the United States.

While there was no clear consensus as to the benefits and costs to financial institutions of increasing size and scope, participants agreed generally on how best to analyze the question. The potential benefits of increasing size included cost reduction through consolidation of redundant personnel and infrastructure (especially IT), more resources to devote to their business, and access to business opportunities for which smaller players would not be eligible. The potential benefits of increasing scope were synergies between different areas of business—

either because expertise could be shared across areas or because of cross-marketing benefits, including customers' preferences for "one-stop shopping."

Potential costs of size and scope were also recognized. Primary among these was the difficulty of controlling a vast and varied enterprise. While some participants pointed to the potential for better control through IT, most agreed that in reality there was a strong tendency toward bureaucratization as a means of internal monitoring and control, particularly within Japanese financial institutions. Adding layers of management was seen as likely to lead to less flexibility and greater conservatism. Bureaucratization was also seen as making it increasingly difficult to evaluate the performance of managers, leading to potentially inefficient management of the firm. The alternative to bureaucratization was seen as delegation. But while delegation was seen to have the benefit of reducing administrative overhead and improving flexibility, participants agreed that it could also lead to poorer central coordination and monitoring. One resulting concern would be that any potential synergies of scope might be lost. Another was that poor controls or accountability in a given division could lead to irresponsibility or malfeasance, which in turn might negatively affect the financial institution as a whole, harming even unrelated divisions.

Expanded scope was also seen as likely to increase potential conflicts of interest within the institution, which would not only be problematic on their own terms but could also lead to the loss of business opportunities. Regulatory issues (addressed in more detail below) were also seen as having the potential to increase costs of size and scope, whether due to growth of compliance costs, the difficulty of coordinating multiple compliance requirements by multiple regulators, or firewall regulations that reduce potential synergies. Finally, since financial conglomerates have in many cases increased their size and scope through mergers and acquisitions, participants pointed to the typical difficulties associated with M&As, including meshing corporate cultures, information systems, and business models.

Looking at the record of large, complex financial institutions over the last decade or so, participants agreed that many if not most had clearly not fulfilled the objectives expressed at the time of their establishment. For U.S. and European institutions, the key problems were identified as the difficulty of finding an appropriate balance between bureaucratization and delegation, lack of flexibility, and initial overestimation of the potential synergies. It was argued that niche players such as hedge funds have been able to be more successful due to their

flexibility and ability to innovate while the financial mega-conglomerates have been more conservative. Japanese financial conglomerates were additionally criticized for having been slow to realize costs savings through eliminating redundant offices and functions, as well as having particular challenges in managing mergers from a personnel management point of view. Some participants argued that in mergers among equals or near-equals serious cost-cutting would be nearly impossible. This was seen to result from the strong internal labor markets and corporate cultures that remain typical of major Japanese firms. However, a number of participants argued that Japanese financial institutions were improving their ability to handle such merger issues as a result of careful planning based on their own recent experiences. Some participants also noted that although Japanese financial institutions were often slow to realize cost savings following a given merger, they were less likely to have to backtrack, through divestitures or spin-offs, than U.S. financial institutions.

A related discussion addressed the rationale for the mergers that have created mega-bank and financial conglomerates. While official statements have invariably emphasized the increased resources and the synergies to be achieved, many participants had more cynical explanations. In the case of Japanese mega-bank mergers, four likely ulterior motives were noted—the benefits of becoming "too big to fail," anti-competitive advantages, political power as a result of size, and defense against rivals. For example, some participants argued that MTFG was prompted to merge with UFJ because it felt threatened by SMFG's bid. To the extent that the bank mergers were not executed with positive synergies in mind, it was not seen as surprising that they had had a hard time handling integration in a strategic or effective manner. With regard to the U.S. mega-mergers, some participants expressed the suspicion that they reflected more the egos or desires for higher compensation of the executives involved than a true concern for shareholder value. Other participants were less cynical about the motives behind mergers. One possibility raised was that mergers were being driven by success—successful financial institutions saw opportunities to use their retained profits or extend their superior business models by entering new business areas. Others suggested that, despite the often disappointing results of mega-mergers, management and boards had miscalculated rather than acted cynically in initiating them.

Finally, it was noted that large, complex financial institutions can create external problems as well. The most important of these potential problems are systemic risk ("too big to

fail") and unfair competition. Participants agreed that these aspects should be scrutinized closely.

Regulating Financial Conglomerates

Large, complex financial institutions pose special problems for regulators. Key among these are questions of coverage, coordination with other regulators (either domestically or internationally), and imposition and maintenance of firewalls.

The sheer complexity of accounts at financial conglomerates itself calls for what participants at previous Symposiums characterized as "armies of accountants." More fundamentally, functional and geographical diversity of financial conglomerates makes it unavoidable that they must deal with multiple regulators at all levels, and sometimes even within single business units. This problem is aggravated in the United States by regulatory fragmentation. Given lack of regulatory harmonization across countries, international coordination is an ongoing problem as well. The problem is made more acute by the possibility that financial conglomerates may seek to conceal problems or profits by accounting techniques that transfer expenses and revenues between units and across national boundaries.

Conflicts of interest have already been noted as a serious concern inherent to large-complex financial institutions. The main issues at the corporate level have to do with the ways in which they service clients and the possibility of losing business as a result. For regulators, too, this is a major challenge, which is typically addressed though the imposition of firewalls. Firewalls have been adopted in a variety of situations—for example, keeping bank capital separate from other accounts, or separating financial analysts from investment bankers. Firewalls are also required in some cases to restrict transfer of information between sections to prevent unfair competition. Determining appropriate firewalls was seen to be a subtle balance between prudential/competitive policy on the one hand and excessive intervention on the other. It was widely agreed that Japanese regulators have created unnecessarily strict and cumbersome firewalls, by requiring separation among different business units within a financial conglomerate.

Participants stated that Japanese regulators were especially strict in terms of firewalls, perhaps because they had become excessively conservative and risk-averse as a result of over

a decade of financial institutions' weakness and scandals. Indeed, it was argued that universal banking is essentially impossible in Japan.

Many participants agreed that one of the dilemmas of managing large, complex institutions is that the business itself calls out for decentralized management, but regulation creates a need for centralized compliance. With regard to coordination of national regulation, participants from multinational financial conglomerates expressed frustration about the difficulties of satisfying a variety of regulatory regimes and agencies. There was unanimous agreement that this was a problem that should be addressed, but there was little concrete discussion of possible solutions. Two principles that were enunciated were harmonization of regulation and better communication among national regulators.

A final concern was raised regarding a specific issue of regulation, which would apply to any financial institution doing business in Japan. In response to leaks of inspectors' reports, the FSA has imposed extremely stringent rules on the release of information about inspections. Participants complained that they are unable to share the inspection reports with other relevant business units (including the home office, for foreign financial institutions), regulators in other countries, or lawyers. They expressed deep concern about their lack of access to due process, and the difficulties placed even on complying with inspectors' orders. It was suggested that financial institutions should better communicate their concerns to the FSA, but most appeared unconvinced.

Session 3
Reform of the Postal Savings and Insurance System in Japan and Fannie Mae and Freddie Mac in the U.S.

The final topic concerned the appropriate structure and oversight of government-related financial institutions. With the future of Japan's postal savings and life insurance system in play, discussion naturally focused on postal privatization. Participants also sought to draw lessons from the U.S. experience in analyzing the postal reform bill and the likely future course of the postal financial institutions. Key questions addressed included concerns about how their mammoth size might create systemic risk or unfair competition, whether it would be possible for them to be regulated effectively by FSA, and what types of services they should be allowed to offer. Some participants, especially non-Japanese ones, expressed frustration that postal financial institutions were not simply going to be abolished, but it was generally recognized that this was not politically realistic.

Size, Risk, and Competition

The sheer size of postal finance (about 30% of deposits and 40% of life insurance) concerned participants, who noted that the Koizumi reform bill does not seek directly to limit its size. Some participants argued that deposits and insurance policies are likely to shrink during the course of privatization, as preferential government guarantees are eliminated, record-keeping is improved, and government savings bonds become more attractive and prevalent. Nonetheless, postal savings and postal insurance were seen as likely to be the largest players in their respective areas of business even after privatization, unless additional reforms are introduced.

One widespread concern among participants was that failure of postal savings or insurance would have severe impacts throughout the system. The U.S. experience with GSEs in the mortgage industry was noted as a relevant example. At multiples of the sizes of its competitors, many argued that it would be too big to fail, leading to moral hazard and perhaps irresponsible management. Moreover, it was seen as likely that management would need to maintain positive relations with political leaders, raising the possibility of operations that will be more politically than economically-oriented. Even if there were never a need for a bailout, politically-oriented management would likely not contribute to optimal allocation of resources in the Japanese economy.

The other issue raised by size is that of unfair competition. By their sheer scale, the postal financial institutions will be in a position to squeeze rivals and business partners. And yet, as several participants pointed out, there is no provision for examination of their impact by the Fair Trade Commission. (The same criticism was made of the establishment of other Japanese financial conglomerates, such as the MTFG-UFJ merger.) That problem would be exacerbated if implicit guarantees remained in place even after they join their respective private sector guarantee schemes.

The competition issue extends to the sales network as well. Legally, the network will be separate from postal savings and finance, and post offices will have the option of selling any combination of products they wish. But many participants were uneasy about this point, expressing concern that in fact the network may function as an exclusive sales network that could be used to gain competitive advantage. Both the holding company ownership structure of the privatized (or more accurately, "partially privatized") postal companies and the tax provisions with regard to post offices (and possibilities of transfer pricing among the various postal companies) will be of relevance in this respect.

To reduce the distortionary effects of excessive scale of postal finance companies, some participants argued that their size should be capped, perhaps through a limit on the size of deposits or insurance policies. These proposals paralleled those of Alan Greenspan for U.S. GSEs. Disallowing certain types of accounts would have the effect not only of limiting size, but also of limiting the postal corporations' ability to compete with private sector financial institutions. At least some of the participants felt that such limits would be appropriate from a competition policy standpoint, at least until it is clear that the postal corporations are no longer receiving special privileges and that regulators are able to effectively supervise them. Finally, some participants called for a more proactive stance by the FTC in monitoring competition in the financial sector.

Regulation of the Privatized Postal Finance Corporations

By and large, participants noted with approval the requirement that postal savings and insurance be subject to the same regulations and regulatory authorities as other financial institutions, although there was concern about the establishment of a government reinsurance agency. This decision stood in partial contrast to the regulation of the U.S. mortgage GSEs, which are regulated by a dedicated agency, even though they are required to meet the same

standards as other financial institutions. There were concerns expressed that a dedicated regulator raised the likelihood of collusion between regulator and regulatee. An additional issue raised was that regulation is to be shared between FSA and the Ministry of Internal Communications until privatization is complete in 2017.

The designation of FSA as the regulator for postal finance corporations was seen as reducing the likelihood of regulatory capture, but many participants cautioned that there were still reasons for concern. Fundamentally, the long-standing relationship of postal finance to the government was seen as raising the likelihood of significant political pressures on inspectors. That relationship was expected by many participants to be likely to be closer in reality than in the language of the Koizumi bill, based on the government's ownership stake through the holding company, the long history of subordination of postal finance to the postal ministry (now Ministry of Internal Communications) and the Ministry of Finance, the continuing albeit indirect role in funding government functions of all sorts through JGB and FILP bond purchases, the large stock of potentially problematic credit already made to government entities under the FILP rubric, the deep political interest already shown in the survival and operations of postal savings, and the possibility that postal finance corporations would be put in a position to cross-subsidize each other or one of the other postal corporations.

Another key issue regarded guarantees. Participants welcomed the inclusion of postal finance corporations in the existing deposit and insurance guarantee systems with no explicit preferences, but many expected that unlimited implicit guarantees would persist. A few additionally cautioned that it might not be fair to other financial institutions to have to share risks with postal savings and postal insurance if they were not regulated with equal stringency—in this regard, it was noted that the privatized firms will be deemed to have fulfilled licensing requirements rather than having to qualify through a rigorous examination process. An additional reason given for concern was the experience of the United States, where even though the GSEs' debt is explicitly not guaranteed, markets have priced in a substantial implicit guarantee.

Management and Areas of Operation

With regard to management of the postal finance corporations, discussions addressed both operational management itself and whether there should be limits on areas of operation. One concern that was raised by many participants was that postal finance has not to date been

characterized by professional management. Rather, financial operations have been based on simple purchase of government and FILP bonds as well as a limited number of investment trusts. With little or no experience in risk management or investment evaluation, not to mention financial accounting standards, current management was seen to be ill-equipped to be competitive or efficient in the marketplace. The fact that decisions on personnel and other important matters are to be left to an ambiguously defined postal privatization commission did not did not reassure those participants.

From a different perspective, participants wondered whether the postal financial corporations would continue to direct most of their deposits and premiums toward the government in the form of JGB and FILP bond purchases or loans to government corporations. It was noted that, despite the decoupling of FILP from postal savings several years ago, FILP is still almost entirely funded by various government trust funds.

With regard to whether limits would be appropriate, discussion centered on two questions: whether the postal savings bank should be allowed to lend to the private sector, and whether the postal insurance corporation should be allowed to provide a full range of insurance products. Opinion on lending to the private sector was split, with an apparent majority feeling that there should be significant limits on such activities. Others, however, felt that limits would go against the letter of the law as well as the spirit of reform, which called for the postal financial institutions to compete at an equal level with other financial institutions as long as they met the basic regulatory requirements for any given activity.

The case for limits on lending was based on two separate, but non-exclusive, concerns. One was that postal savings bank management was unlikely to be capable of adequate risk management and credit evaluation, and thus its involvement in lending to the private sector was likely to lead to irresponsible lending and systemic risk. The other was that postal savings would use its market power and/or implicit government guarantees as a tool for unfair competition. Those in favor of allowing lending to the private sector countered that risky or anti-competitive practices would be subject to the full extent of Japanese financial regulation, and were therefore not a reason to deny entry.

With regard to insurance products, the discussion focused on fairness or unfairness of competitive practices. This appeared to reflect at least partly the fact that insurance products

would be sold at the retail level, while lending to the private sector would at least initially likely be at the wholesale level (e.g. syndicated loans). There was considerable concern among insurers that postal insurance would be able to use the post office network as an exclusive distribution channel that would give it unfair advantage. One solution suggested was to allow post offices to sell a range of private-sector insurance products as an alternative or in addition to postal insurance, but there appeared to be lingering doubts as to whether that would be feasible.

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