Regulatory Differences between Banks and Securities Markets: Implications for Crisis Prevention and Management
Asian Development Bank Institute and Wharton School of University of Pennsylvania
26-27 July 2001, Tokyo, Japan
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Introduction
1. The Asian Development Bank and the Wharton School of the University of Pennsylvania organized a seminar in Tokyo, Japan between July 26 and 27, 2001. This seminar was held for the second time, providing a forum where academicians, officials from international financial institutions, government agencies, and members of the business community could discuss and exchange views and ideas about various aspects of financial market development in the region. The central theme of this year’s seminar was “Regulatory Differences between Banks and Securities Markets: Implications for Crisis Prevention and Management,” reflecting a strong and increasingly prevalent view that has emerged since the occurrence of the East Asian crisis, namely, that banks are no longer functional and that economic development should rely on domestic capital markets, particularly domestic bond markets.

2. According to such views, the East Asian crisis was caused by the heavy dependence by firms on bank loans for investment, and that Asian commercial banks did not function as properly as those operating in some advanced countries, due to crony relations among banks, firms, and governments. These views conclude that policies should place less emphasis on bank loans and that Asian countries should develop domestic capital markets as alternative and more important sources of financing. While such views are understandable from an intuitive point of view, it has been increasingly recognized that factors explaining the underdevelopment of corporate bond markets in many Asian countries need to be carefully examined. In this context, detailed discussions on the fundamental differences between bank regulation and securities regulation are essential in order to develop detailed and practical policy proposals. Reflecting this recognition, the ADB Institute and the Wharton School chose to focus on fundamental differences between bank regulation and securities regulation.

3. During the opening ceremony, Professor Sayuri Shirai, Visiting Scholar, ADB Institute and Associate Professor, Keio University, welcomed the participants and the speakers and called upon Dr. Masaru Yoshitomi, Dean, ADB Institute to open the seminar.

4. Dr. Yoshitomi welcomed the participants and stressed the importance of this seminar, which promotes a dialogue be-
between policymakers and renowned scholars and researchers in order to produce realistic policy recommendation on urgent issues confronting us. Dr. Yoshitomi went on to point out that the East Asian crisis can be characterized as a capital account crisis, the origin of which was massive capital inflows, followed by a sudden and massive reversal of these flows. The largely unhedged foreign-currency-denominated short-term debt created a serious double mismatch (a currency mismatch coupled with a maturity mismatch), rendering the balance sheets of local financial institutions and enterprises extremely vulnerable to both currency devaluations and bank runs. The outbreak of the crisis caused a large swing of the capital account from a surplus to a deficit, accounting for 15-20% of GDP in a year or so, having a very devastating impact on the balance sheets of financial institutions and firms. The result was a twin crisis (international liquidity crisis and domestic banking crisis).

5. In the aftermath of the crisis, he stressed that the double mismatch problem was unlikely to go away soon in the region, because the problem is more or less inherent in the financial markets. First, countries will have to continue to borrow in foreign currencies to finance projects that generate revenues in local currency, creating a currency mismatch problem. Second, the supply of funds is largely in the form of short-term deposits, while the demand for funds is long-term. Furthermore, weak corporate governance and inappropriate financial regulations and supervision worsen the double mismatch problem.

6. Developing capital markets has the potential to mitigate the maturity mismatch problem and at the same time produce desirable outcomes such as the efficient mobilization and allocation of savings, better management of risks, improvement of corporate behavior, etc. In spite of these advantages, Dr. Yoshitomi stressed that it would take time to develop sound capital markets, and thus that it is important to examine concrete policies that address a situation in which banks are not properly performing and capital markets are simultaneously underdeveloped.

7. In particular, he emphasized that it is important to develop policies that can be applied during the long transition period from the present bank-dominated financial structure to a full-fledged capital market-based financial structure. Considering financial market structures in Asia, countries need to seek a balanced and more robust financial market structure based on both banks and bond markets, by strengthening banks and nurturing bond markets. In this regard, he added that the banking sector and the capital market could play complementary roles to support sound economic development, as would be discussed in detail by Professor Shirai later in the seminar.

8. Finally, Dr. Yoshitomi listed four issues that would be discussed in the seminar: (1) basic differences in legal, regulatory, and informational infrastructures between banking systems and securities markets, and factors affecting such differences; (2) whether a one-size-fit-all approach with regard to the infrastructures required for prudential banking behavior and preventing systemic crisis could be implemented in Asia; (3) why it would take time to establish the legal and informational infrastructures needed for sound securities markets; and (4) what specific legal and other measures should be adopted in post-crisis Asia in order to prevent banks from becoming so powerful that they hindered the full development of sound capital markets, and also to play complementary roles in developing bond markets.

9. Professor Franklin Allen, Nippon Life Professor of Finance and Economics, The Wharton School of the University of Pennsylvania, added his welcome to the participants and highlighted the importance of this seminar in Wharton School’s Agenda. He then pointed out that this seminar was an opportunity to exchange views between people from outside Asia and people from outside the Asian region. He said the topic for this seminar was also timely as it focused on the extent to which the Asian economies should move towards market-based financial systems. Finally, Professor Allen stressed the need for Asia to develop innovative solutions specific to its circumstances rather than simply adopting existing models.

Session 1: Differences between Bank Regulation and Securities Regulation, and the Role of Banks

The Intermediate Financial Structure and Regulatory Implications

10. Professor Shirai presented a paper titled “Searching for New Regulatory Frameworks for the Intermediate Financial Market Structure in Post-Crisis Asia.” She mentioned that this study was part of her work conducted jointly with the Asian Policy Forum (APF). The first part of the presentation would describe the “intermediate financial market structure,” while the second would focus on implications for regulatory frameworks under this structure.

11. In a number of Asian countries, commercial banks are already playing an important role in the corporate bond market as issuers, underwriters, investors, and guarantors. This reflects their already dominant financial position in financial markets, their solid reputations, and their informational advantages. Although the issuance of corporate bonds has increased in some crisis-affected countries, the corporate bond market is largely underdeveloped because issue sizes are small; secondary markets are highly illiquid; maturity is concentrated on the short-term; and the investor base is concentrated and narrow. These characteristics could affect the maturity structure and pricing of bonds.

12. Professor Shirai listed some of the factors responsible for the underdevelopment of corporate bond markets in Asia. First, since government bond markets are underdeveloped, reflecting sound fiscal policies, there is an absence of bench-
mark assets which could be used for pricing corporate bonds. Second, government policies such as low interest rate policies, transaction taxes, and stringent minimum asset requirements have been responsible for the illiquidity of secondary markets. Third, due to the dominance of small and medium enterprises (SMEs), there is a lack of large, reputable firms that could issue corporate bonds at reasonable costs. Fourth, individual investors have a strong preference for liquid, safe assets, such as bank deposits. Furthermore, institutional investors are largely underdeveloped or concentrated. Finally, the inadequacy of informational, legal and judiciary infrastructures weakens public investors’ confidence.

13. Professor Shirai then categorized financial market structures into three stages: Stage I, Stage II, and Stage III. Stage I is characterized by a bank-dominated financial structure, where banks are not only the dominant financial institutions but also provide traditional banking services (such as accepting deposits, extending loans, and managing settlement accounts). In this stage, the ultimate creditors are depositors and the ultimate borrowers are mostly SMEs, with banks acting as intermediaries. Furthermore, banks bear the risk with respect to providing credit to ultimate borrowers. On the other extreme, Stage III is characterized by a full-fledged capital market-based financial structure, where firms have access to capital markets and there are diversified public investors. Furthermore, public investors bear the risk with regard to extending credit to ultimate borrowers, while investment firms act as intermediaries.

14. Then, there is an intermediate financial market structure (Stage II) that lies somewhere between Stage I and Stage III. In this structure, banks are better able to handle problems arising from information asymmetry than other intermediaries, since they already have inside information about the ultimate borrowers through relationship banking. Thus, they can play a crucial role as underwriters, guarantors, and investors in the corporate bond market. They attempt to mitigate agency problems such as adverse selection, moral hazard and liquidation costs by reducing the extent of information asymmetry between themselves and the ultimate borrowers. In particular, they obtain inside information about creditors and monitor their performance by conducting repetitive transactions and thereby forming long-term relationships. Such informational advantages enable them to become investors and guarantors of corporate bonds. In addition, because of their solid reputation, public investors are willing to purchase bonds issued by banks.

15. In Stage II, therefore, banks can complement the issuer and investor base. Furthermore, so-called “long-term credit banks” can issue medium-term bank debentures, assisting in the transformation from short-term bank deposits to long-term private sector financing. In this structure, bank loans act as substitutes for fledging corporate bond markets, but are compatible with the complementary development of the corporate bond market. This stage has a life span of 10-20 years, after which the financial market structure moves to Stage III.

Professor Shirai stressed that many Asian countries have already entered Stage II.

16. Professor Shirai discussed various advantages that may arise from banks’ engagement in securities businesses in Stage II. One of the major ones is that a double mismatch can be mitigated. Secondly, in recent years, banks have been experiencing increasing declines in their incomes from traditional banking services in the process of domestic banking sector and capital account liberalization. As a result, they find it difficult to sustain their profitability and acquire the implicit rents that enable them to offer discretionary, repetitive, and flexible banking services to their borrowers. Therefore, if they are able to maintain long-term relationships with their clients throughout the latters’ life cycles—starting with bank loans and later switching to securities underwriting, they can be encouraged to spend more resources in generating inside information about their clients and prudently monitoring their performance. Furthermore, their information advantages and economies of scope (based on branch networks and staff) help lower the costs of underwriting securities, which encourage the investment growth of firms.

17. On the other hand, the engagement of banks in securities businesses may give rise to disadvantages to the banking sector, the ultimate borrowers, and investors. First, banks may end up lending to small firms if the large, reputable firms increasingly raise funds through issuing securities. This tendency becomes more pronounced for small banks if large banks increase their lending and securities businesses with large clients and cut their lending relationships with small clients. This suggests that banks face a higher default ratio on average bank credits, strengthening the need for them to improve their internal risk management system. Second, conflicts of interest between banks and investors may arise. For example, banks may underwrite securities for troubled borrowers whose proceeds may be used to pay off the firms’ loans to the banks, affecting investor confidence. Third, issuers may find it difficult to switch from bank underwriters to independent underwriters when they have already formed long-term relationships with the banks, resulting in high switching costs. Fourth, when banks engage in large-scale securities and derivatives activities as dealers and/or end users, they bear various risks such as the risk of buying up unsold securities underwritten by themselves, counterparty risk, market risk, etc. Thus, the failure of these businesses may weaken the solvency of these banks and trigger systemic banking crises. Finally, a concentration of power in the banking sector may occur, deterring the development of full-fledged capital markets.

18. Professor Shirai argued further that strengthening the banking sector is a even more important issue in Asia given that many countries are already in Stage II. Furthermore, regulatory frameworks should include: (1) measures to contain the disadvantages discussed above; (2) measures to address the complications and problems arising from derivatives activities; (3) coordination among relevant regulators; and (4)
measures to improve the informational, legal and regulatory infrastructures that are necessary to shift from Stage II to Stage III.

19. With respect to strengthening the banking sector in Asia, three separate steps are required. The first is to remove government intervention both in directing private bank credit to special industries selected by the government and in bailing out banks in distress. The second is to limit banks’ lending on favorable terms to firms that are connected to each other through holdings of shares-connected lending. After government intervention and connected lending are dealt with, a third step is to adopt prudential regulations and supervision similar to those in industrial countries. This sequence is important because until the first two steps are taken, the soundness of the banking system will not improve meaningfully even if sophisticated prudential regulations are introduced.

20. Moreover, it should be recognized that the traditional indicators used in industrial countries to estimate the soundness of banks (e.g. capital adequacy ratios, liquidity ratios, and non-performing loan ratios) are not necessarily effective in Asia. Therefore, these indicators should be supplemented with market-related indicators (e.g. interest rate spreads, interbank lending rates, etc.) if the soundness of Asian banks is to be evaluated in a more realistic manner. Finally, due to the poor quality of bank loans arising from the ownership structure of banks, it may be important to consider strengthening capital requirements.

21. As one of ways to contain the disadvantages arising from the engagement of banks in securities activities, Professor Shirai stressed the need to pay attention to the corporate organizational structure of banking and carefully examine whether such disadvantages could be dealt with by separating securities activities from banking activities by establishing legally separated subsidiaries. In Asia, it may be desirable to separate securities and banking activities by setting up subsidiaries owned by banks or bank holding companies, given that inadequate accounting, auditing, and disclosure standards are in place and that regulatory capacity is weak.

22. As banks increasingly engage in derivatives businesses, they—particularly large banks that are the origin of large-scale business loans—need to enhance their internal credit rating systems. This will require highly skilled expertise and manpower. Given this trend, regulators should adjust to the new environment by directing their supervisory methods towards more risk-focused rather than balance sheet-based monitoring. Also, imposing limits on large-scale derivatives activities may be desirable. Furthermore, regulators may need to examine whether they should take an umbrella (functional) approach in which banking and securities regulatory authorities are separately established and coordinated, or an integrated approach in which all relevant regulators are combined under a uniform authority. It may be desirable for Asian developing countries to select an umbrella approach at this stage, since they have not sufficiently strengthened prudential regulations and supervisions in the banking sector.

23. Finally, Professor Shirai pointed out the importance of promoting informational, legal and judiciary infrastructures suitable for the intermediate financial market structure. In order to identify appropriate infrastructure, it is necessary first to understand the differences in the regulatory regime between banking systems and bond markets. The regulatory system for the intermediate financial structure should be formulated so as to facilitate the transition from Stage I to Stage III. Since it will take time to reach Stage III, it is important to make efforts to gradually build informational, legal, and judiciary infrastructures conducive to capital market development.

24. Dr. Philip Turner, Head of the Secretariat Group, Bank of International Settlements expressed appreciation for the views of Professor Shirai and continued by giving his own comments. He pointed out that the institutional failings in Asia function as a constraint for developing a credible regulatory regime. Also, it may be difficult for Asian countries to impose restrictions on bank ownership due to the underdevelopment of capital markets. He also acknowledged that the size of the Asian economies is a constraint for the development of bond markets.

25. Dr. Turner pointed out that while it is true that local banks have informational advantages, as indicated by Professor Shirai, this does not necessarily answer the question of whether such banks can be trusted without independent corroborative checks. Furthermore, he added that there is a systemic risk if banks are seen as the guarantors of bonds they underwrite. Moreover, a more fundamental point to bear in mind is that helping banks survive in a changed climate is not a prime or fundamental objective of policy. The underlying aim is to achieve greater efficiency and safety for the financial system—an aim that is achieved through the increased use of capital markets, which may or may not work through banks. Also, the engagement of banks in securities businesses may not necessarily reduce the variance of expected returns if prospective returns or risks are closely correlated. Lending to, and supporting bond issuance by, the same corporation may leave banks with more concentrated rather than more diversified exposures.

26. Dr. Turner went on to express appreciation for Professor Shirai’s assessment of banking problems in Asia and the risks involved when banks play a dominant role in developing the bond market. Given these risks, Dr. Turner pointed out that the government and the central bank can play important roles, particularly in improving the liquidity of the capital market. He also proposed other methods, such as increasing the investor base and encouraging independent credit rating agencies.

27. Furthermore, Mr. Turner was of the view that banks can also move into areas other than securities businesses. Two recent growth areas in some Asian developing countries have been home mortgages and consumer credit. Decisions about, and pricing of, such loans tend not to depend on any special knowledge or relationship, but rather on “objective” criteria (such as income, valuation of the collateralized assets, age,
etc.). As indicated by Professor Shirai, this has allowed many different bank loans to be packaged and sold in capital markets. As she also mentioned, the growing credit card industry and the emergence of credit bureaus could enable consumer loans to be rated and liquidated; and information technology would make it easier for banks to evaluate the credit risk of their borrowers with more objective measures. These trends are of first order importance and will have much more of an effect on small loans to households.

28. With respect to the application of fair value accounting to banks, Mr. Turner pointed out that there is, in theory, a strong case to be made for as full an application of fair value accounting as possible. Using market prices can be seen as an eminently objective, verifiable and transparent methodology. Moreover, it can ensure that banks quickly recognize any deterioration in asset quality. In practice, however, there are major difficulties: market prices may be much more volatile than the true underlying risk, and the setting of quasi-market prices for non-traded assets is open to manipulation. Therefore, in practice, fair value accounting methodology might prove to be misleading and subjective.

29. The second issue related to fair value accounting is whether institutions that hold assets to maturity should worry as much about day-to-day variations in market prices as should institutions which typically turn over assets rapidly. This is a complex issue. The view that loans are best valued at the historic cost with a variance of zero is clearly too extreme. Equally, the argument that fair value accounting should not be applied to banks because it would make their balance sheets more volatile is incomplete. Banks, however, need to take account of the fact that the volatility evident in the market price of an asset is a marker of the riskiness of that asset. While this debate is far from over, Mr. Turner expressed the view that the use of market prices to value a bank’s assets would grow over time and that the intermediate financial market structure in Asian would reinforce this perception. Therefore, he concluded that more attention needs to be given to how the use of market prices is implemented in considering the regulatory and accounting framework for Asian financial market structure.

30. Mr. Liu Ker, Deputy Director, Securities Firms Administration Division and Securities Research Division, Securities and Futures Commission, Taipei, China expressed his appreciation for the paper presented by Professor Shirai, and continued with his own comments. Mr. Ker pointed out that increases in national income do not always lead to deepening bond markets due to investor preferences. For example, in Taipei, China an increase in national income led to increased investment in equities rather than in bonds. In such a case, government policies may be required to make investment in bonds more attractive. Furthermore, specific financial infrastructures and knowledgeable human resources must be in place to enable capital markets to operate efficiently and engineer products. Moreover, if the banking sector plays the sole primary role in the capital market, it is doubtful whether yields of debt can be properly determined, and whether resources can be efficiently allocated.

31. To a large extent, he pointed out, it is only institutional investors and high net-worth individuals that can participate actively and directly in bond markets. He also said that the differences in investment preferences due to age differences (younger investors are less risk adverse) might affect the choice between equity markets and bond markets in a particular country. Furthermore, he stated that the notion that a bond market can attract funds from the retail investor via the issuance of entitlement certificates is also worth contemplating.

32. Mr. Ker went on to emphasize the role of government in developing the bond market. Further, the globalization of capital markets could make financing SMEs a less attractive investment choice from the perspective of investors, as exemplified by the case of Taipei, China. Recent developments in financial instruments and information technology have accelerated capital movements and created “virtual money.” These developments must be considered when policies and regulatory frameworks for bond market are formulated. Finally, Mr. Ker pointed out that the lack of expertise of domestic firms in terms of dealing with bonds and derivative products in Asian economies is a constraint on the development of bond markets.

33. In response to a question on the intermediate financial market structure, Professor Shirai stressed the transitory nature of this stage. She pointed out that the limited investor base, underdevelopment and lack of diversification of institutional investors, and lack of the necessary informational, legal, and judiciary infrastructures in Asian economies, are the main reasons for the failure of these countries to reach Stage III in the short to medium term. Some of these limitations, however, can be overcome when banks play a key role in the corporate bond market due to their credibility and informational advantages. This makes the intermediate financial market structure a reasonable sequence to go through while developing the capital market. She also reiterated that there is a risk of banks becoming too powerful to deter the development of full-fledged capital markets in the intermediate financial market structure, and stressed the importance of measures to limit this potential risk.

34. In response to a question on the position of banks in Stage III, Professor Shirai explained that while they continue to exist and to play a role in providing traditional banking services and managing settlement accounts, the ultimate borrowers will have a choice to make between bank loans and various securities. In this context, banks loans are a substitute for corporate bonds.

35. Dr. Joao A C. Santos, Economist, Federal Reserve Bank of New York, added his comments on the development of bond markets in Europe since restrictions have begun to be dismantled with the launch of the euro. He pointed out that the disappearance of segmentation that existed before the in-
introduction of the euro is one of the major reasons for the development of the bond market in Europe. Ms. Tipsuda Thavaramara, Director, Department of Market Intermediaries Supervision, Securities Exchange Commission, Thailand, added comments on the need to promote investors’ understanding and developing effective risk management tools, based on the experience of Thailand. Professor Hideki Kanda, Professor, Tokyo University, stressed that the problems (e.g., conflicts of interest) arising when banks underwrite securities may damage the confidence of public investors. He also stressed the importance of establishing a solid securities settlement system in order to develop sound capital markets. Professor William Goetzmann, Yale University, stressed the importance of mortgage-backed securitization and the need to incorporate this issue in the intermediate financial market structure.

Regulatory Differences and the Regulation of Internationally Active, Large Financial Conglomerates

36. Professor Franklin Allen and Professor Richard Herring, Jacob Safra Professor, The Wharton School, University of Pennsylvania, presented a paper titled “Banking Regulation versus Securities Market Regulation.” Professor Allen emphasized that banking regulations and central banks had failed to prevent the banking crisis in Asia. The failure of traditional methods has led to the view that Asian countries should move toward more market-based finance and away from bank finance. While bank regulation aims at controlling systemic risks and eliminating crises, it is usually argued that the main purpose of securities regulation is the protection of investors and the enhancement of efficiency. However, this does not imply that a switch from banking to market finance reduces systemic risk. The purpose of this presentation, he stated, is to consider the relationship between bank regulation and securities regulation, in order to consider whether a move away from a bank-based financial market structure towards a market-based structure is desirable in terms of crisis prevention.

37. Intermediaries play an increasingly important role in modern financial markets. Since these intermediaries are subject to bankruptcy risk, the market-based financial market structure also has systemic risk. Therefore, it is not regulation that is the best tool for preventing systemic risk, but rather it is the bankruptcy law.

38. Professor Allen then provided a background to bank regulations and the experiences of different countries. Central banks were originally founded with a number of different purposes that diverge among countries. For example, the Reserve Bank of Sweden was founded in 1656 due to the difficulties of making payments under a system where the reserve specie was copper. The Bank issued bank notes to overcome this difficulty. On the other hand, the Bank of England was founded in 1694 with the primary purpose of raising money to fund the war against the French.

39. In the 19th century, the focus of the central banks shifted towards financial stability and the prevention of financial crises. The Bank of England was the first to develop techniques to skilfully manipulate the discount rate after the incidence of the Overend and Gurney Crisis in 1866. Since then, the Bank of England has been able to successfully prevent the worst effects of many severe crises such as the major international crisis of 1873. The techniques then spread to other European countries, and by the turn of the century, crises had become relatively rare in Europe.

40. The experience of the United States (US) was different from that of Europe. The US believed in the decentralization of power and dismantled its central bank in 1836, though it was re-established in 1914. During this interim period, the US experienced frequent major banking and stock market crises. In spite of these crises, the US economy grew faster than its European counterparts. This observation can be compared with the notion of higher risk corresponding to higher returns: crises may be more frequent though the economy grows faster. Hence, while frequent crises have devastating impacts in the short run, the economy may follow a higher growth path in the long run. The crisis of 1907 marked a turning point, and the US found it necessary to establish a central bank. The Federal Reserve System was set up in 1914. However, the distrust of centralized power continued, and the Federal Reserve was set up as a decentralized institution very different from European central banks. This, together with a lack of experience and skills, was a major reason behind the Federal Reserve System’s failure to prevent crises, particularly that of 1933. After the 1933 crisis, there was a radical reform in US bank regulation.

41. The Glass-Stegall Act, enacted in 1933, introduced a deposit insurance system and required the separation of commercial and investment banking activities. This changed the US financial system in a dramatic way. Another reform was the introduction of the Banking Act of 1935, which extended the powers of the Federal Reserve System and changed the way it operated. In many other countries, governments began to directly intervene in the financial market with intensive regulations and the limitation of market forces. Although these regulations and measures were very successful in preventing crises, they also resulted in an inefficient allocation of resources. Because of these inefficiencies, many countries started to liberalize their financial sectors in the 1970s and 1980s. With these changes, crises seemed to occur more frequently.

42. With respect to securities regulation, the US introduced a comprehensive set of regulations following the precedents of other countries such as the United Kingdom (UK). The UK passed the Company Act of 1844, that required companies to actively disclose information. It then introduced the Directors Liability Act of 1890 to expose directors and promoters to civil liability for untrue statements in a prospectus. Furthermore, the UK passed the Companies Act of 1900, that required companies to provide a considerable amount of information in the prospectus. Following the UK regulations,
in the US, the state of Kansas passed a “blue sky law” in 1911 in order to protect investors through antifraud provisions, the regulation of brokers and dealers, and the registration of securities. Other states followed it.

43. Over the years, the US passed seven acts on the regulation of securities. The first was the Securities Act of 1933, which concerned the issue of securities. The second was the Securities Exchange Act of 1934, which required firms that had publicly traded securities to periodically disclose/issue various types of accounting information and to cease market manipulation and insider trading activities. The third, the Public Utility Holding Act of 1935, was concerned with the regulation of electric and gas holding companies. The Trust Indenture Act of 1939 supplemented the Securities Act of 1933, dealing with bond and debt issues. The Investment Company Act of 1940 was introduced to ensure honest management; participation in management by securities holders; adequate and feasible capital structures; and the prevention of abuses in sales. In the same year, the Investment Advisers Act was passed, requiring all investment advisers to register with the Securities Exchange Commission. Finally, the seventh act, the Securities Investor Protection Act of 1970, was introduced to protect investors from bankruptcies.

44. Historically, crises were prevented by central banks rather than regulations. However, the US experience was different, since the central bank was not initially effective. After the 1933 crisis, the US came up with simultaneous measures to increase the power of the central bank and regulate the securities market. In Asia, it is necessary to take an approach similar to that of the United States, by preparing a comprehensive set of measures. Nevertheless, the issue that needs to be resolved is how to effectively deal with systemic risk in the market. This is because regulations alone are not enough to reduce this risk. Also, the brief look at history illustrates that it was systemic risk manifested by crises that became the focus of most central banks.

45. Professor Herring reiterated the fact that the regulatory policies of the securities market do not deal with the issue of systemic risk. This is mainly because the firms that are regulated are fundamentally different from banks, and are not subject to the same problems that banks face such as bank runs, cumulative loss of confidence, spillover effects, etc. He also cited some of the explicit differences between securities firms and banks. First, securities firms act as agents for their clients and are expected to strictly segregate customers’ funds from their own funds. Therefore, changes in firms’ funds do not cause their customers to flee. Second, securities firms have a capital structure that is less vulnerable than that of banks, since they do not rely on deposit liabilities that are essentially first-come first-served non-contingent claims. Third, securities firms’ assets consist mainly of liquid, tradable assets, which are marked to market, as contrasted with those of banks, which are largely illiquid loans. This enables securities firms to flexibly scale down their sizes when they find it necessary to do so. Finally, a collapse of a securities firm has a less serious impact on the payment system.

46. Professor Herring illustrated the case of Drexel Burnham Lambert Group (DBLG) in relation to the above arguments. DBLG was a very profitable investment firm in the 1980s, but was mortally wounded in March 1989 when it pled guilty to six felony charges and agreed to pay the government US$650 million in fines. DBLG had a number of subsidiaries, two of which were federally regulated: one was Drexel Burnham Lambert (DBL), the broker/dealer subsidiary, and the other Drexel Burnham Lambert Government Securities (GSI), a primary-dealer subsidiary. Starting in 1977, DBLG began initial public offerings of low-grade bonds. This contributed to the growth of the junk bond market.

47. However, the liquidity of the secondary junk bond market deteriorated sharply, after a series of events that occurred in 1989. First, DBLG was found guilty of felony charges and subject to a major fine, undermining the confidence of public investors. DBL conducted about 50% of its trading in low-grade bonds, and thus the impact of these charges on investor confidence was non-negligible. Second, Congress ruled in 1989 that thrift institutions, which held 7% of the outstanding stock of low-grade bonds, had to sell their holdings. Third, some innovative covenants that were expected to protect investors against default risk proved ineffectual. The decline in the liquidity of the secondary market in low-grade bonds made DBLG’s financial structure unsustainable. The possibility of managing the liquidity of the holding company through asset sales or collateralized loans diminished as the liquidity of the secondary market in low-grade bonds evaporated. After Standard & Poor’s reduced it’s company’s rating on commercial papers, DBLG lost its major institutional investors. In the end, DBLG ended up with a large inventory of illiquid assets, thereby inheriting most of the problems that banks would generally face.

48. DBLG was obliged to file for protection under Chapter 11 of the bankruptcy laws, since the authorities offered no assistance. The authorities limited their role to facilitating the orderly unwinding of DBLG’s affairs and trying to prevent its collapse from disrupting the financial system. These goals were accomplished, since the flight to quality was slight and quickly reversed. Because of concern over settlement risks, some difficulties were experienced in winding down DBLG’s positions in markets that did not clear and were settled through the delivery of instruments against payment. To allay fears that the settlement process would be aborted after the delivery of payment to the trustees for DBLG, but before the delivery of the securities to the counterpart, both the Bank of England and the Federal Reserve Bank of New York intervened in order to assure market participants that transactions with the trustee of DBLG would be completed.

49. From the experience of DBLG, one might justify the argument that securities firms need not be regulated, since systemic disturbances were avoided. However, this conclusion may be premature, because many changes have taken place over the last decade.
Professor Herring listed four changes that have taken place in the last decade which have increased the risk of failure of a securities firm. First, firms today have become more complex and international in terms of their presence and operations. Second, there has been a huge increase in the formation of financial conglomerates which have combined their securities operations with banking and insurance. Third, there has been an enormous amount of consolidation, leading to fewer players in the market. Although a larger firm is a safer institution, its failure is more likely to have systemic consequences. Fourth, there has been an increasing emphasis on global trading, particularly in the over-the-counter (OTC) derivatives market, which has also become a concentrated activity controlled by a few major firms. Due to these developments, it may be more difficult to let any one firm fail without affecting the whole system.

The experiences of the 1990s further indicate that some of these dangers are quite genuine. First, the collapse of BCCI, a smaller institution, indicated the difficulties in closing an internationally active large banking organization. There were differences in the approach to dealing with the consolidation of assets among countries. Second, the collapse of Barings highlighted problems dealing with the failure of internationally active financial conglomerates. Although Barings’ banking and securities businesses were lodged in separately incorporated units of the bank, Barings Bank was used to fund massive losses in Barings Securities. The separate functional regulators lacked a full picture of the group’s consolidated positions, and failed to share information that might have flagged emerging problems before the losses mounted. Moreover, the losses in Barings Securities threatened to spill over to the exchanges on which it traded. This foreshadowed the potential collateral damage that might occur if procedures for sharing the losses in securities exchanges were activated. Third, the near collapse of the Long-Term Capital Management Fund (LTCM) highlighted the difficulty of winding down a large player in international derivatives markets. If LTCM had applied for bankruptcy, its counterparties would have had the right to terminate net and set-off derivatives contracts with it. This might have led to a massive liquidation of LTCM’s positions in relatively illiquid markets, further depressing prices.

The fundamental problem revealed by the above three instances is that there is a growing category of financial conglomerates. They are well managed in a well-integrated way, but pay very little heed to legal entities or corporate structure, national borders and functional legal domains, resulting in a very complex intra-group transfer of funds. This means that there is a mismatch between the ways these businesses are run and the policy tools used to deal with emerging problems. This is because all the policy tools focus on the legality of the entity, national entity or regulatory functional entity. Therefore, when one of these conglomerates falls into severe difficulties, conflicting approaches can arise as to bankruptcy across and within countries, as well as across regulators. Thus, coordination and information sharing are gaining importance owing to the differences in bankruptcy procedures across different jurisdictions. Derivatives contracts are likely to further complicate this, particularly when a player is in trouble has large positions in illiquid markets.

Professor Herring emphasized that these problems exist even among the most homogeneous countries due to differences in bankruptcy procedures. Even in the US, different states have different bankruptcy procedures, indicating the complexity of the problems and the potential for conflicts. Thus, in today’s world, a failure of an internationally active financial entity can cause a large spillover effect. He reiterated that applying standard bankruptcy procedures is inadequate because of the nature of assets held by financial firms (whose values are preserved by dynamic trading). If the trading is stopped, then the value of assets of these firms falls rapidly. In such a circumstance, it is difficult to maintain investor confidence.

Professor Herring went on to explain the consequences of the lack of proper bankruptcy procedures. It is likely that regulators will bail out such firms out of necessity, creating serious moral hazard problems in the financial system. Further, this may undermine most of the useful measures that are taken to augment market discipline in the system. Hence, the inability to manage crises efficiently can also undermine efforts to prevent crisis. He argued that there should be special bankruptcy procedures for systemically important firms. This should involve authorizing the establishment of a bridging institution that can unwind the affairs of a failing firm in an orderly way without causing damage to other firms. In order to make market discipline work better in the world economy, it is critical to have a credible way of removing major players.

Dr. Santos expressed appreciation for the views of Professor Allen and Professor Herring, and expressed his own comments. He agreed that it is important to design a bankruptcy procedure that takes into account the specificity of financial institutions, particularly internationally active financial conglomerates, and allows the unwinding of their businesses in an orderly manner in order to avoid giving the affairs of a failing firm in an orderly way without causing damage to other firms. In order to make market discipline work better in the world economy, it is critical to have a credible way of removing major players.
and may appear unnecessary. The adequacy of monitoring is not likely to be observable at a given time by parties outside of the supervisory authority. In contrast, a bank’s failure is publicly and widely observed, and is likely to have political costs for the regulator.

57. Thus, conflicts between the objectives of various regulatory authorities are likely to lead to different implications for different institutional allocations. For example, giving the authority to close banks to an agency other than the deposit insurance may result in a looser closure policy, because that agency does not bear the full costs of delaying closure. These costs will fall on the bank’s residual claimants, often the deposit insurance fund.

58. Some countries have addressed certain conflicts of interest between bank regulatory agencies through regulations. For example, regulations which give the deposit insurance provider the right to withdraw insurance coverage to a bank and which gives legal priority to insured depositors are likely to protect the insurance fund from the policies of the agency in charge of closing banks. Prompt correction action schemes, in turn, have the effect of reducing the discretion of the agency charged with the authority to close banks.

59. Furthermore, moving toward a market-based financial structure is likely to raise new problems, such as conflicts of interest between banks and investors, for regulators with the mandate to protect investors. Therefore, it has become ever more important to have regulations in place that require the disclosure of information. The expansion of banks into the securities business is said to give rise to conflicts of interest because of the bank’s advisory role to depositors and because of its role as a trust fund manager. Conflicts of interest may also develop because of the bank’s opportunity to impose tie-in deals on customers and because of its ability to design deals aimed at transferring bankruptcy risks to outside investors.

60. Dr. Santos pointed out that the critical issue regarding potential conflicts of interest is whether the parties involved in the transaction have incentives to exploit it. Conflicts of interest can be reduced through appropriately designed regulations, for example requiring the disclosure of information aimed at protecting investors. One should recognize that as banks expand into new businesses, new conflicts of interest arise. At the same time, as banking organizations become more complex, new opportunities to exploit such conflicts emerge. This increases the need for an effective investor protection regulation in order to avoid distortions in market-participation incentives.

61. As banks enter into non-traditional banking activities, they usually choose to place these activities either in departments, in subsidiaries, or in holding companies that also own the bank. Universal banks tend to be very integrated organizations and, for that reason, are often very complex. In contrast, in the bank-parent and holding-company models, various activities are conducted in legally distinct corporate entities, each with separate capitalization. As a result, it is often argued that these organizations are less complex than universal banks. However, the difference is more apparent than real, since markets generally do not perceive the units of these conglomerates to be independent, despite their corporate separateness.

62. Therefore, Dr. Santos further argued that as banks enter new businesses, regardless of their organizational structure, they tend to become more complex. This, together with their increasing linkages to financial markets, raises new challenges both for the ways they are supervised and regulated. These challenges have led supervisory agencies in some countries, for example, to place teams of permanent supervisors in the most complex organizations. In addition, they have led to increased prominence for certain regulations, such as a bankruptcy procedures, as stressed by Professor Allen and Professor Herring.

63. Mr. Jose P. Aquino, Director, The Market Regulation Department, Securities Exchange Commission, Philippines, expressed his comments on the experience of the Philippines. In the Philippines, corporations generally rely on affiliated banks to finance their projects and obtain guarantees. Although the Philippines has a bank-based financial system, it was able to escape the worst effects of the Asian crisis primarily because corporations and banks generally had more manageable levels of exposure to foreign debt at the outset of the crisis. Furthermore, high capital adequacy ratios (more than 16% before the crisis) helped allay depositor fears and minimized incentives for foreign investors to withdraw their funds. The Securities Exchange Commission (SEC) played a critical balancing act during the crisis, which involved the adoption of foreclosure abatement proceedings to prevent a massive fallout on corporations most affected by the sudden rise in the value of the US dollar. The SEC was able to convince the banking community that massive foreclosures would neither do any good for the long-term health of their borrowers nor benefit domestic banks. Banks were thus encouraged to search for commercial solutions.

64. Mr. Aquino also expressed his views on the need to reform the bankruptcy law in the Philippines. He pointed out that the existing regulation code aims at regulating systemic risk. He further proposed that in the long run, there is a need to rely more heavily on financial markets for raising funds, to provide proper legal infrastructure (bankruptcy reform), to better monitor capital and liquidity requirements, to improve corporate governance, and to promote more diversified ownership of public companies.

65. In response to a concern about the position of the paper on the general inadequacy of bankruptcy laws in dealing with financial firms, Professor Herring mentioned the uniqueness of financial firms, whose assets are marked to the market, and the significance of speed in dealing with faltering firms. Ordinary bankruptcy procedures cause delays, which can quickly erode the value of assets. In response to a question
on who should be in charge of supervising financial firms, he pointed out that progress has been made in Europe in terms of ruling out arbitrariness by applying the laws of the country in which the company is headquartered.

66. In response to an opinion that it is difficult to prevent crises in an era of globalization and revolution in information technology, Professor Allen expressed his ideas on the possibility of preventing crises with tough regulations. In response to a question on the relationship between the financial sector and systemic risk, Professor Herring pointed out that traditionally, the banking sector failure was believed to cause systemic risk because of its knock-on effect on the real economy. The usual transmission channels are payment systems, declines in investment due to cumulative banking collapses, and declines in asset prices. When securities firms become complex, they inherit some of the problems that banks face, such as the bearing of systemic risk.

Three Financial Market Structures and the Costs-Benefits of Regulation and Enforcement

67. Professor Hideki Kanda, Professor, Tokyo University presented a paper on “Regulatory Differences in Bank and Capital Market Regulations.” He proposed to compare bank-based financial structures and capital market-based financial structures by emphasizing the cost of regulation and enforcement. He argued that the financial system cannot function successfully unless proper regulation and enforcement are ensured. However, due to the cost of regulation and enforcement, designing and maintaining effective regulations and enforcement is a crucial decision for any government. Even though we may have broad guidelines to tackle various problems, the question of who makes decisions according to what criteria becomes important when a problem actually arises. Further, without specific rules, enforcement is extremely difficult and the costs are high. In addition, given recent developments in the financial markets, it has become necessary to have extensive rules on specific issues.

68. In order to have effective enforcement, it is also necessary to have sound legal and judiciary infrastructure and good accounting standards. Bank regulation is justified by two facts. One is that it is impractical for dispersed depositors to monitor a bank effectively in an organized fashion because of the problem of collective action. Thus, regulators monitor banks on behalf of dispersed depositors. Second, banks often participate in payment systems that inevitably entail systemic risk, thus producing a negative externality.

69. Professor Kanda argued that one of the major problems with a bank-based financial structure is that banks often continue to lend until they fail. This is mainly because deposit insurance schemes protect depositors in the case of a possible bank failure, and because the central bank and/or government usually extend help through various rescue measures if a bank fails to protect its payment system and/or the jurisdiction’s economy. This typical moral hazard problem is not easy to solve.

70. Another problem is that especially today, banks face not only credit risk, but also, market risk and other risks as well. They tend to have financial assets, such as bonds, that are subject to market risk, and even loans are often securitized and thus produce market risk. While banks bear these risks, depositors usually bear only the credit risk of the banks with which they deal. Since deposit insurance schemes often protect depositors, however, depositors hardly bear any risks at all. This means that risks are not diversified or spread out among many investors, but are instead taken concentrationally by the banks. This form of risk taking leaves banks vulnerable especially today, when risks exist more widely and across country borders. Banks, as intermediaries, are centralized risk takers.

71. Bank regulation is basically designed to respond to these problems. Its most important objective is to ensure proper risk management by banks. From a policymaker’s perspective, a bank-based financial structure may look relatively easy to regulate, because there is a clear focal point for the regulator to examine: banks. Unless banks fail, there is considered to be no problem. However, experiences show that maintaining bank solvency is not an easy task in the long run and that the cost of regulation is thus very high.

72. Historically speaking, Professor Kanda continued, there has been a change in the paradigm of bank regulation over time. Bank regulation in earlier times could be characterized by direct regulation, while modern regulation is indirect in nature. Older regulations focused on regulating risks directly by prohibiting competition among banks as well as investment in risky assets. Modern regulations focus on capital adequacy and capital regulation, and also rely on internal control and accounting systems by banks themselves.

73. Furthermore, the outcomes of bank failures may differ depending on the legal, regulatory, and political environments. Deposit insurance schemes play an important role not only as providers of insurance but also as suppliers of financial assistance and purchasers of bad assets. The purpose of post-insolvency intervention by bank regulators should be clearly recognized: it is usually done to prevent confusion and to protect the payment system—not to rescue the individual banks in question.

74. Thus, the overview of bank regulation shows where the cost of bank regulation primarily lies. First, there is the cost of providing proper deposit insurance. Second, it attempts to prevent bank failure by requiring banks to be sound. Third, bank failure causes enormous cost to the economy. Capital market regulation is more complex in nature than bank regulation. This stems from the historical aim of securities regulation: the protection of public investors against manipulative and deceptive activities by securities brokers. In general, the capital market-based financial structure is superior to the bank-based financial market structure.
However, the question of how to regulate capital markets is not an easy one. Indeed, the benefits of capital market regulation have not been well established in the empirical literature by academics. The experience of the United States, where capital markets are more advanced, suggests, however, the need for three strong sets of regulation: (1) strong investor protection; (2) a strong enforcement agency; and (3) strong regulation of intermediary institutions. Investor protection is ensured by transparency, fairness, and legal methods. Enforcement is ensured by prudential regulation, such as effective auditing and accounting standards. Institutional investors, who are subject to typical agency problems, are regulated by fiduciary regulations. From a policymaker’s perspective, preparing and maintaining these sets of regulations is quite costly. This is a major consideration when moving towards a market-based financial structure.

Professor Kanda pointed out the existence of an intermediate financial market structure, in which long-term credit banks, as exemplified by Japan, issue bank notes on behalf of borrowers and use the proceeds for long-term lending. Although this system was quite successful in Japan, from the regulatory standpoint it requires strong regulations. This is because under it, the soundness of long-term credit banks is a key issue, and if one long-term credit bank fails, it can lead to a greater disaster than when one (ordinary) bank fails under the simple banking system.

Comparing the three financial market structures (bank-based, capital market-based, and intermediate), it is hard to identify one which is superior. However, it seems that when the size of an economy is small, a bank-based financial structure is better, due to the smaller costs involved in regulation. While it is difficult to precisely assess the costs of regulation and its enforcement in the banking system, it seems that capital market regulation is more costly than bank regulation, since it must reach a wider range of matters. Particularly in terms of disclosure and anti-fraud regulation, the effectiveness of regulation depends very much on other legal infrastructure, such as the existence of a strong enforcement agency and a well-functioning and reliable judicial system in which private litigation is effectively enforced.

However, as the economy grows, a capital market-based financial structure seems to become more appropriate since the benefits from a capital market-based financial structure offsets costs involved in capital market regulation. In reality, both financial market structures coexist and their costs and benefits must be considered in aggregate rather than separately for each system. This makes prescriptions more complex and more ambiguous. In addition, the globalization of financial markets adds to the complexity, by providing the opportunity to borrow from markets outside the jurisdiction of regulators in a particular country. Thus, Professor Kanda concluded that each country must choose the policies and system that fit it best.

Professor Herring expressed appreciation for Professor Kanda’s paper and gave his own comments. He agreed with Professor Kanda’s proposition that bond markets should complement banks, since they offer capital at lower cost and give the opportunity to borrowers to diversify their borrowing. He then pointed out that both banks and investment banks are likely to focus on the same customers, while the regulations required are totally different.

He then pointed out that problems such as systemic risk and information asymmetry are common to both banks and capital markets. Although systemic risk is traditionally associated with banks, in modern times the failure of a securities firm can lead to an implosion of market prices. Information asymmetry also exists between retail customers and financial firms. Professor Herring argued that while both banks and capital markets are needed in a modern economy, the benefits—such as cheaper capital, higher quality investment decisions, encouraging long-term investments and venture capital, market-determined prices, etc.—provided by the capital markets exceeds the costs involved in designing a regulatory regime and ensuring enforcement. Further, capital markets reduce the vulnerability of the economy to banking crisis. Meanwhile, Professor Herring agreed that it is important to undertake a cost-benefit analysis when designing a regulatory regime and pointed to the case of the UK where it is already in place.

Professor Herring also cited the case of Israel, which has successfully outsourced financial regulation and has more than 100 firms listed in NASDAQ. He argued that even a small country might want to invest in the infrastructure to foster the development of capital markets because of the potential benefits. He also argued that the intermediate financial market structure, within which long-term credit banks operate, requires a proper exit strategy. Furthermore, he said that he had doubts regarding the contribution that long-term credit banks could make to the transition process from a bank-based financial structure to a capital market-based structure. Instead, he proposed that an economy with a bank-based financial structure should be required to invest in the infrastructure needed for the transition.

Mr. Yeo Kwon Yoon, Director, Banking Supervision Policy Division, Financial Supervisory Commission, Republic of Korea, expressed his appreciation for Professor Kanda’s views and expressed his own comments. Mr. Yoon agreed that the cost benefit analysis proposed by Professor Kanda would be essential for the Republic of Korea (henceforth, Korea). He also agreed that capital market regulation is more costly than bank regulation and that the banking system is probably better in countries whose economies are small. He pointed out that in Korea, the issue of costs associated with the choice of a financial structure is very important, because the Financial Supervisory Service, the execution body of the Financial Supervisory Commission, is funded by allotments and fees obtained from private entities.

He pointed out that the Korean financial structure was bank-based in spite of efforts before the crisis to develop domestic capital markets. Domestic banks, however, were un-
able to cope with the double mismatches as well as an explosion in non-performing loans; they were plunged into the crisis. Following the crisis, the Korean government has undertaken a series of measures to develop the capital market. The Securities Act was amended to improve corporate governance, strengthen minority shareholders rights, and introduce audit committees and compliance officers. The bond price evaluation system for investment trust funds was changed from a book value system to a marked-to-market system. Disclosure, accounting and audit systems have been improved by adopting international standards. Furthermore, supervision of the capital market has been significantly strengthened.

84. Mr. Yoon pointed out that in spite of these government efforts, investors remain reluctant to invest in the capital market and continue to prefer bank deposits. This is due to the lack of confidence in the market, poor corporate earnings and interest rate volatility. Therefore, there is a need, in addition to establishing infrastructure, to develop investor confidence.

85. In response to a question regarding the necessity of having the government bond market in place before the development of the corporate bond market, Dr. Yoshitomi argued that although it is ultimately necessary to establish the government bond market, some countries may find it difficult to do so when their budget is in surplus. In response to a concern raised on the impact of capital market development on the position of SMEs, Professor Herring responded by pointing out the experience of the US, where securities firms have actively lent to small-scale industries, although there is a reluctance to accommodate medium-scale industries.

**Dinner Speech: Integrated Theory of Financial Regulation**

86. Mr. Anthony Francis Neoh, Chief Advisor, China Securities Regulatory Commission, gave a presentation entitled, “*Is There a Unified Theory in Financial Regulation?*” Mr. Neoh presented an outline of the historical development of financial products. The development of financial products occurred over a period of time in response to various needs. In Medieval Europe, elders regulated the markets and the state played no part. The futures market also developed in very early times and was restricted to serving the needs of traders; speculation did not exist. Risk-sharing was also common among sea-faring nations, long before insurance was established. The concept of transferable instruments also existed in very early times. The use of paper money dates back to the Song dynasty in China. The state issued the coinage and the money merchants guaranteed the deposits on pain of death penalty (perhaps the most effective kind of prudential regulation known to date).

87. Today, there are banks, insurance companies, securities firms, pensions administrators, custodians, trustees, market operators, clearance and settlement systems operators, professional advisors, etc. They are all regulated in one way or another by the state or by self regulation. By reviewing the statutes of the world, Mr. Neoh pointed out that it is found that the legal definitions for banks and insurance businesses tend to be relatively simple and defined on highly traditional lines—namely, banks being deposit taking and lending institutions and insurance firms guaranteeing a payout in terms of the happening of a contingency. Yet, these institutions are much more complex, engaging in a wide range of activities and hedging their risks in complex ways. The reasons for the failures, for example, by Barings and Lloyd could be found in the fact that these institutions were run on the basis of their traditional legal definitions without regard to the complex changes which have taken place since these definitions were constructed. Also, the failures are related to the fact that these institutions and regulators did not overview the institutions’ overall risk exposure.

88. Mr. Neoh listed three objectives of financial regulation—(1) financial stability, (2) consumer protection, and (3) market integrity—that should be considered in developing a unified theory. With respect to the first objective, Mr. Neoh stressed that we need to be very clear that those who are players in the market should not be the umpires of the markets. Also, we should be clear as to the functions of a lender of last resort. Perhaps, he suggests, the best solution should be that this is socialized by way of public insurance schemes, run with minimum moral hazard. Lender of last resort should only provide liquidity rather than replenishing wasted capital, except in an extreme case, in which maximum political oversight should be exercised. There is convergence of these principles in the General Principles for Banking Supervision by the Basel Committee for Banking Supervision and the 30 Objectives and Principles of IOSCO.

89. Another consideration in this regard would be to look toward a general system of financial product regulation. Basic common standards may be required for product definition, product authorization, disclosure, intermediary authorization, market and clearing settlement authorization and market abuse. Further, harmonization may be required in accounting standards, corporate governance standards, insolvency treatment, systems of private laws, and effective enforcement systems for civil and criminal cases.

90. In addition, common principles of prudential supervision may have to be established. Both the international groups of banking and securities regulators are investigating the way risk should be managed and have issued joint papers on derivative disclosures, internal risk management, and the use of statistical models in dealing with market risk. They both agree that financial supervision should focus on credit, market, operational and legal risk. They also agree that internationally active financial groupings must be looked at as a whole. Even the Basle Committee in their latest version of the Capital Accord goes towards a more dynamic standard and emphasizes quality of supervision. In the end, financial risks deal with the overall soundness of a financial institution operating in the total financial environment.
All of this points to the need for an overview of the financial markets in order to attain the three goals of financial regulation. Whether one goes for a super-regulator or functional or institutional regulators, one should make sure that someone has to overview. Whether this be the central bank or some other agency, Mr. Neoh argued, depends on the linkage between monetary policy and market regulation. If there cannot be a clear ability for the central bank to deal with conflicts of interest, the central bank cannot be a regulator. These are some of the considerations that need to be considered in developing a unified theory of financial regulation.

Session 2: Country Studies

The Case of China: The Period of 1870-1930

Professor William Goetzmann, Professor, Yale University presented a paper on “China and the World Financial Markets: Modern Lessons from International Borrowing 1870-1930.” Professor Goetzmann pointed out that early in the 20th century, China was one of the hottest emerging markets for global investment. It began to borrow from foreign investors in 1861, and continued to do so until 1938. Like many other nations in this period, it used foreign capital for military defense activities and railroad construction. What made the external financing of China interesting in this era was the role that investment played in colonial designs on Chinese sovereignty, and the dangers of disequilibrium in the development of financial markets. In other words, foreign investment financed growth in the Chinese economy, but the protections given to foreign investors nearly tore the nation apart. While such protections may have seemed reasonable from a foreign perspective, they were viewed as an affront to Chinese sovereignty and an impediment to the domestic corporate sector. This view led to a backlash against the foreign ownership of Chinese capital and foreign encroachment on Chinese sovereignty.

In opening his presentation, Professor Goetzmann stated that he would focus on the factors that led to the reliance on foreign capital and the economic motives behind the onerous terms demanded by foreign investors. If we look back a century ago, we can find many similarities with the situation today, such as the internationalization of product markets and of capital markets. It is important to look at history in order to understand globalization as a process that takes place over a period of time. There are some fundamental economic structures and motivations, such as the desire to reduce risk and to protect capital, that underpin the capital markets of today as well as those of a century ago.

Professor Goetzmann went on to argue that China’s reliance on foreign capital was attributable to two financial factors: (1) a mismatch between the international investor opportunity set and the Chinese investment opportunity set, and (2) the relative newness of legal protection and governance structures for enterprises in China. On the first factor, Europe had the most liquid and well-developed capital markets in the world, while capital markets in China were underdeveloped. This disparity provided a fundamental comparative advantage for European investors in funding the infrastructure projects necessary for China’s economic development, since they could lower the cost of capital through diversification. As for the second factor, by the late 19th century, many European countries had developed laws and norms for the definition and governance of business enterprises, as well as the legal protection of the rights of securities holders. The first steps in this direction were taken in China only in the early 20th century—and even then only to a small extent. Thus, virtually all rail and mining firms operating in China were incorporated in Europe, not China.

Furthermore, foreign investors obtained guarantees from the Chinese government, including direct control over the collection of revenues, the right of property seizure in case of default, the right to source their own materials, and exclusivity against domestic or foreign competition. On the other hand, while international investors were ready to lend money, they demanded extraordinary privileges. Professor Goetzmann argued that foreign ownership of domestic enterprises and the favorable terms given to foreign loans led to a backlash, which was quite significant in the political history of China, as seen for instance in the revolution of 1911.

In order to demonstrate that (foreign) investors that are able to diversity their portfolios have a lower cost of capital, Professor Goetzmann presented an analytical framework based on the CAPM model. Suppose that there are two separate capital markets: Market 1 (China) and Market 2 (Europe), and that investors holding shares in Market 1 cannot hold shares in Market 2 and vice versa. Consider a new project, which will provide a random cash flow and needs financing. The project owner must decide which market will give the best terms, and will choose the market with the lowest cost of capital for the project (the expected rate of return). We will assume that the CAPM holds and the coefficient of risk aversion for the representative investor and the riskless interest rate are the same in both markets. In such a framework, the required rate of return on the projects in Market 1 will be larger than that in Market 2, when the covariance of projects in Market 1 is greater than in Market 2. This suggests that the cost of capital in Market 1 will be higher, and thus the owner will find it cheaper to obtain external financing. When investors in Market 2 can diversify their portfolios and thus reduce the risk of investment, they will be willing to pay for the same asset. If this were true, one would expect to find reluctance by Chinese investors to invest their capital in domestic projects on the same terms provided to foreign investors.

With respect to investor protection, he stressed that colonialism was one of the major determinants of the origin of the country’s legal system. Colonialism can be thought of as an export mechanism for the legal framework of one country to another despite all of its known faults. One may be able to
interpret the colonial world as one form of political-economic equilibrium in which investor-friendly legal systems across the world allow for increased efficiency in capital allocation and the emergence of private enterprises. The foreign control of Chinese government revenues and the extra-territorial rights extended to foreign railroad concessionaries bore a close resemblance to a process of legal imperialism designed to protect the rights of investors. While presumably these benefits would have accrued to all investors in Chinese railroads and all holders of Chinese bonds, the fact that most investors were foreign means that the benefits of the protection accrued disproportionately to foreigners. China’s reforms of the commercial code in 1904 and 1905 were aimed at facilitating the development of domestic corporations and limiting the ability of foreign investors to gain control. Nevertheless, weak corporate governance made it difficult for China to protect minority shareholder rights.

Professor Goetzmann noted that the most remarkable feature of Chinese bonds in those days was the stability of the yields of government bonds until 1918, compared with those on Indian, Japanese and Russian bonds. This happened during an era of major political events in China. Under such circumstances, one would have expected a large movement in the price of Chinese bonds. Contrary to this expectation, however, the yield on bonds was remarkably stable; they never moved outside of a narrow trading bank between 5.5–6% during 1899-1913, and from 6% to 7% during 1913-1918. This indicates the presence of investor confidence in spite of political events. This stability may have been associated with the distinctive characteristics of the Chinese loans. In particular, their enhanced security features helped lower investors’ risk of investment.

In recent years, Chinese capital markets have developed rapidly as Chinese financial regulators have modernized the legal framework for investment. Professor Goetzmann stressed that one approach that might prevent unequal treatment between foreign and domestic interests would be to concentrate efforts on protecting minority shareholder rights for domestic shares, and testing the institutional structures for such things as contests for corporate control, public accounting and disclosure and insider trading laws in the context of the domestic share market. He also added that the current dual-listing structure of the Chinese equity market is an effective means to mobilize, and in some sense to nurture, domestic commitment to Chinese capital markets. He stated that the international community should support future efforts to protect this re-emergence of Chinese investing by accepting a gradual process of experimentation with market regulation and share dissemination, as well as a gradual reduction in the differences between foreign and domestic shares.

Dr. Michael Chui, The Bank of England, expressed his appreciation of the views of Professor Goetzmann, and proposed to highlight some of the constraints that China might face in adopting the recommendations of the paper. The Chinese banking system today is very different from that of a century ago. Further, today’s markets are characterized by exchange rate risks. Dr. Chui also pointed out that in addition to the reasons suggested by Professor Goetzmann for the price stability of Chinese bonds in the early period, the existence of a unified government and guarantees for the loans might have been another reason. The lower expected return in the international market could have also reflected the enforcement capacity of international investors through military means. On the other hand, domestic investors faced more risk of investment and thus expected higher returns.

Some of the similarities between the historic China and China today are that there is a lack of investment, excess saving, weak corporate governance and underdeveloped financial intermediaries. One of the major differences, however, is the presence of large banks today. Dr. Chui also pointed out that China was able to avoid the East Asian crisis of 1997-1999 largely because of the existence of capital controls. He also pointed out that in spite of China’s large capital market, it is segregated due to capital controls.

Professor Shirai appreciated the views of the paper and presented her own comments. She pointed out that the advantages enjoyed by foreign investors due to their diversified portfolio and expertise led to a lowering of the cost of capital and a consequent increase in their willingness to finance defense and railroad activities in the Chinese market. However, domestic investors were not willing to invest in them because underdeveloped domestic capital markets raised their cost of capital, and at the same time there were alternative domestic projects with higher return alternatives.

Professor Shirai also pointed out that the lack of investor protection, weak corporate governance and underdevelopment of capital markets were the reasons behind the need for the Chinese government to guarantee protection to international investors. Furthermore, she questioned the sequencing that the Chinese government took-capital market liberalization before developing sound domestic financial markets. She proposed that a country should strengthen its domestic banking sector before proceeding with capital account liberalization. She also argued that the current process of deregulation policies followed by PRC has not been well sequenced. She argued that interest rate deregulation should have preceded the operation of interbank markets and the initiation of open market operations.

She also stressed that the change from the gold standard to modern currency has added to the complications of today’s market behavior. During the earlier period, the Chinese currency was fixed to the value of gold, and therefore, there was no serious currency mismatch. On the other hand, the Chinese government now issues a domestic currency, which is more or less pegged to the US dollar. Since the current currency is issued under a less stringent fixed exchange rate regime, foreign borrowing can create a serious currency mismatch.
105. Mr. Neoh added his comments by proposing that future research could focus on the spread between different countries, particularly the US. He also added that political perspectives could be added to the analysis.

**Institutional Differences and their Impact on Capital Market Development: The Cases of Japan and the United States**

106. Dr. Ayako Yasuda, Assistant Professor, Wharton School, University of Pennsylvania, presented a paper entitled “Comparing Recent Deregulatory Experiences in Bond Markets: US and Japan.” Professor Yasuda pointed out that financial systems in both the US and Japan have been subject to similar deregulations. Therefore, her presentation focused on whether existing institutional differences in banking systems would affect bank competition in capital markets and whether the deregulation of capital markets would lead to the disappearance of institutional differences and the convergence of systems toward a market-based, Anglo-American one. In particular, she said she would test two hypotheses. The first is that the positive effect of bank relationships on underwriter demand is stronger in Japan and in the US, based on the certification hypothesis—which predicts that a pre-existing banking relationship positively affects a firm’s demand for underwriting services from a bank. The second hypothesis is that Japanese firms are more constrained by the betrayal cost of switching from existing relationships with their banks than are American firms, given that American firms have relied more heavily on capital markets, while Japanese firms have relied more heavily on bank borrowing.

107. Dr. Yasuda discussed the building blocks necessary for testing her hypothesis. By estimating the value of bank relationships, it can be hypothesized that Japanese firms are concerned with the long-run value of bank relationships. Since the relationship costs are not explicit, the betrayal cost of switching from an existing main bank relationship can be estimated. It can be hypothesized that the existence of betrayal cost lowers the relative demand for underwriting by rival commercial banks. There is also a long-standing policy question on whether there is a net certification or conflict of interest in commercial banks underwriting securities.

108. Her findings were that like the US results, a previous loan relationship could positively affect a Japanese firm’s demand for a given bank’s underwriting service. She also found that issuers with lower credit ratings gave more value to bank relationships, which is qualitatively similar to the US results. Moreover, a surprising result was that the value of bank relationships in Japan is not greater than that of the US. The other result was that there is the presence of betrayal costs in Japan, but not in the US.

109. The implications of these results are that bank relationships turn out to have the same net positive effect on firm’s demand for underwriting in Japan and the US, though the economic motivations behind them are different. In the US, the deal specific or net certification effect is the main benefit, while in Japan the long-run effect of not betraying an existing relationship has a significant impact on the firm’s decision. Further, deal specific or net certification effects are smaller or even can be negative in Japan. Japanese firms still prefer to have bank relationships, despite the potential conflicts of interest, in order to preserve the long-run value of the pre-existing relationships. These comparative results are important in evaluating the effects of market deregulation. In the context of Japan, they suggest that the institutions that supported the main bank system do not automatically disappear when capital markets develop. It may be costly to develop new relationships in a post-deregulation environment, but it may still be inexpensive enough to maintain such a relationship or at least some aspects of such a relationship. Therefore, the institutional history underlying existing bank relationships needs to be accounted for when comparing policy alternatives and forecasting the consequences of policy changes.

110. In response to a question on the definition of bank relationships in the two countries, Dr. Yasuda described it as the presence of a significant known relationship prior to the commercial bank’s entry into the capital market, in both countries. In response to a question on the size of firms used in the sample, she responded by stating that only firms that have issued corporate bonds were included, indicating the exclusion of SMEs. In response to a question on the sample period, she stated that only the period after which commercial banks were allowed to underwrite domestic corporate bonds was considered. Furthermore, euro bonds were excluded to maintain consistency in the data. In response to a question on top lenders, she answered that multiple top lenders were allowed for. She added that an indirect approach was followed in order to measure the betrayal cost. In response to a question on the differences in bond market size between Japan and the US, she mentioned that junk bond markets were excluded in the US, which helped lower the difference in the size of the bond market.

**India’s Financial and Capital Market Development**

111. Dr. R.H. Patil, Director, National Stock Exchange of India Limited, presented a paper on “Broadening and Deepening the Bond Market in India.” He explained the long history of capital market development in India. At the time of independence in 1947, only traditional private commercial banks existed, and provided primarily short-term financing. In the 1950s, with the objective of supporting an import substitution development strategy, the government encouraged the establishment of development financial institutions that would provide long-term finance to projects in industry. The Reserve Bank of India and the government nurtured these institutions through various financial incentives and supportive measures. In the 1970s, many of the large private banks were nationalized. Since long-term credits were subsidized, an inverted yield curve was created. Although the banking sec-
tor developed many inefficiencies over time, it was able to extend its branch network and successfully mobilize financial resources. This system continued until the early 1990s, when financial sector liberalization was implemented.

112. Since 1991, development financial institutions have no longer had the comfort of the protective policy climate in which they operated. They no longer have access to concessionary sources of finance such as government guaranteed bonds or budgetary support. They have to compete with commercial banks, whose cost of funds is way below that of development financial institutions. Also, the branch network of commercial banks is more extensive than that of development financial institutions, since the Reserve Bank of India gave the latter limited access to deposits. Furthermore, competition has lowered the profitability of development financial institutions, thereby cutting off long-term project lending. Recent developments in India indicate that the development of bond markets is becoming increasingly important. Dr. Patil also stressed the need to move away from a bank-based financial structure to bond market-based one. He also stressed the need to shorten the span of the intermediate financial market structure, as described by Professor Shirai, in order to avoid the emergence of inefficiencies.

113. Dr. Patil pointed out some of the advantages of the capital market, such as a decline in the cost of capital and incidents of bad debts in the system. He argued that regulators play an important role in designing the financial market structure and maintaining its efficiency. He also pointed out that the Indian financial system is not well developed and diversified. While the bond market is still in the preliminary stage of its development, developments in the stock market are likely to provide a necessary infrastructure for the its development.

Closing Remarks

114. Professor Allen and Dr. Yoshitomi in their concluding remarks, thanked the participants for their presentations and discussions. Dr. Yoshitomi stated that the mission of the ADB Institute is to explore a post-crisis paradigm for Asia. A paradigm refers to an economic system that is composed of combined functions of entities (namely, markets, governments and institutions.) He proposed the need to develop a new regime for each of the four markets (namely, financial market, foreign exchange market, labor market and product market.)

115. Dr. Yoshitomi pointed out the ADB Institute will focus on India and China in its future studies on the linkages between financial liberalization and capital account liberalization and their proper sequencing, based on the experience of NIEs and ASEAN countries. He also pointed out that the discussions in this seminar focused on the potential advantages of various financial market structures and desirable paradigms for the current stage of economic development in Asia. Although there are differences in terms of development states among countries of Asia, he viewed the discussions as having revealed three different kinds of regimes in general: Stage I, Stage II, and Stage III. In Stage I banks remain very dominant, while in Stage III, the capital market is well developed even though banks remain important entities, particularly in terms of lending to SMEs. Stage II facilitates a transition from Stage I to Stage III. He also stressed that a regulatory regime to prevent banks from becoming too dominant in Stage II is necessary in order to facilitate a smooth transition from Stage I to Stage III. Finally, Dr. Yoshitomi concluded by assuring the continuation of future collaborative research with Wharton School.