Policy Statement from the T-5

THE DEVELOPMENT OF CAPITAL MARKETS AND THEIR GOVERNANCE

—A Shift to Markets in Diverse National Contexts—

The Brookings Institution Washington, DC

ifo Institut für Wirtschaftsforschung

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The Royal Institute of International Affairs

Think Tank T-5

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The Development of Capital Markets and Their Governance

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Policy Statement from the T-5 Members of the Tokyo Club Foundation for Global Studies

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Representatives of the above five research organizations, which comprise the T-5 members of the Tokyo Club Foundation for Global Studies, met in Tokyo in December 2002 to examine and discuss recent developments in financial markets — particularly capital markets — and their governance in today's world. This statement presents a consensus view on the important principles that should guide policies toward the financial and capital markets in order to ensure that they contribute to economic growth in Europe, Japan, the United States, and elsewhere around the world. The statement is based in part on research papers presented at the T-5 conference and on discussions during and after that conference.[1] The Tokyo Club Foundation for Global Studies is disseminating this statement with the intention of affecting the ongoing debate on the governance of financial markets.

[1] The papers will be published in 2003 in the Tokyo Club Papers series. They are also available at *http://www.tcf.or.jp*.
The views in this policy statement are those of the individuals involved in its preparation and they are not necessarily sanctioned by the participants' institutions.

A Shift to Markets in Diverse National Contexts

It is difficult to exaggerate the importance of finance to the effective functioning of a market economy. Financial institutions, primarily banks, "intermediate" between savers and investors, channeling funds from the former to the latter. Financial markets, primarily capital markets, do the same thing, but they facilitate the transfer of funds more directly. In effect, financial institutions and markets are analogous to the circulatory system in the human body. When circulation is healthy, funds flow rapidly and efficiently to the sectors of the economy that can make the most profitable use of them. In this way, financial institutions and markets are key to ensuring growth of the economy. But if the financial circulatory system somehow becomes "clogged" — with weak or insolvent financial institutions or poorly performing capital markets — then growth will be impeded or even halted.

Each of the three major areas of the world economy — Europe, Japan, and the United States — has learned this lesson over the past two decades. All three economies have suffered major bank failures. To contain the damage to the rest of their economies, governments in all three regions have injected funds into the banking system, protecting depositors in order to avoid wider financial panics. In both the United States and the Scandinavian countries, in particular, governments also facilitated the transfer of poorly performing assets out of weak or insolvent banks, and their banking systems returned to health relatively quickly. This process proceeded more slowly in Japan, where banking troubles have continued to deepen while the real sector of the economy has stagnated.

In this report we look beyond the well-known but difficult problems associated with the failure of financial institutions to address some of the longer-term trends that are affecting the financial sectors in each of the three regions. We focus on these three regions not only because they are the homes of our respective institutions, but also because collectively they account for more than half of the world's total output of goods and services. If the world economy is to grow at a healthy rate, the economies in these regions must provide much of the impetus for that growth.

The key long-run financial trend we examine is the gradual movement away from banks and other institutional means of attracting and mobilizing savings toward financial markets. In essence, markets in all three regions have been gradually, but inexorably, replacing institutions as the centerpiece of finance. Why this is happening, whether it is a cause for concern or celebration, what should be done to alter or fine-tune the process, and how to make capital market rules more compatible from one country to another are the subjects of the following sections of this report.

1. From Banks to Markets

The movement from institutions to markets has proceeded most rapidly and penetrated most deeply in the United States. With the Single Market project and the adoption of the euro, capital markets are also rapidly evolving in Europe. The Eurobond market now is thriving, while equities trading in Frankfurt, Paris, London, and other continental markets has attracted investors from inside and outside Europe. The transition to markets is less advanced in Japan, where, as in Europe, banks have long been the central source of finance, even for large companies, and where public financial institutions mobilize and channel a large share of savings. But markets are slowly becoming more important relative to institutions in Japan as well. At the same time, banks continue to play an indispensable — though somewhat more limited — role in all three regions.

Several factors account for this transition. One is the ongoing process of globalization, by which we mean the increased movement of goods, services, capital, people, and, above all, knowledge across national borders. Cross-border capital flows increase the need for financial markets, especially markets for currencies. In addition, investors seeking to diversify their portfolios beyond their home markets find it easier to do if efficient markets in equities, bonds, and other financial instruments are available to permit these investments.

Technological changes that have reduced the cost of producing, transmitting, and storing information also facilitate the growth of markets. Historically, institutions have had easier access than individuals or even than large institutional investors to information about borrowers or issuers of equity. But the proliferation of information about users of capital — perhaps best symbolized by the ease of acquiring it on the Internet — has leveled the playing field. Now, ordinary investors have access to much the same information as do institutions, allowing markets to grow in relative importance.

Third, many financial instruments that were once held only by institutions are now 'securitized.' Illiquid loans of various types including mortgages, automobile and other consumer loans, and business loans are used to back new securities that are issued and traded in markets.

Privatization of formerly state-owned enterprises has also facilitated the growth of capital markets. In many instances privatization has led to publicly held companies that rank among the highest valued listings on national stock exchanges. Moreover, in a number of European countries and in Japan, governments have resorted to financial markets to manage growing public debt and obtain more favorable conditions.

One of the more revolutionary financial developments of the last decade has been the growth of a formal venture capital market. From a few billion dollars a year, the US venture capital market mushroomed to $100 billion in 2000, before falling back in the wake of the bursting of the bubble in technology stocks. Nonetheless, the venture capital market in all three regions today is far larger than it was in the mid-1990s.

Venture capital is important because it facilitates the rise of new companies. As successful new companies mature, venture capitalists take them public, through initial public offerings (IPOs). These IPOs would not be possible without the presence of exchanges on which the new shares are traded. In turn, as more new companies issue stock, exchanges become deeper and more attractive.

We have experience with both bank-centered and market-centered systems. The core of more bank-centered financial systems, as exist in Germany and Japan, consists of a small number of powerful banks which maintain close relationships with their loan customers, often participating directly as shareholders. In more market-oriented systems, as exist in the US and UK, bond and equity markets are at the center, and relationships between financial institutions and their customers are maintained at arm's length. The shift from institutions to markets as the locus for most financial transactions is further along in some countries than in others.

In any event, it is wrong to say that there is a contest between institutional and market-based finance. Even in such countries as the United States, where financial markets are best developed, institutions, banks in particular, continue to have a role. For the foreseeable future, banks will attract a significant share of household savings and will also serve as important providers of credit to consumers and small businesses unable to access the capital markets at a reasonable cost.

The way financial information gets transmitted to the economic system differs between systems that are more bank-centered and those that are more market-centered. In market-centered systems, there is greater effort to insure that information is widely available to market participants and its consequences are diffused throughout the market. In bank-centered systems, where borrowing firms and banks have direct, long-term relationships, the information channel is narrower and more specific. Through close monitoring of firms, banks can avoid the problem of information asymmetry that may exist with anonymous, arm's length market transactions. This makes banks suited to financing small and medium-sized enterprises, which make only limited amounts of information public.

Bank- and market-centered systems also differ in the way they discipline firms. In financial systems that are oriented around capital markets, markets judge corporate performance swiftly and market reactions guide corporate decisions. Falling stock prices may trigger a takeover by new investors who can force a change of management. In bank-centered systems, on the other hand, a firm's major creditors judge management performance and may work to restructure a firm in financial distress in order to protect their own interests.

Is the current trend of financial systems to become more market-centered a good thing? The question has three dimensions. The first is whether systems with greater market orientation are better at financing the expansion of industries that depend on external funds, at facilitating the formation of new establishments, and at allocating capital efficiently across industries. The second is whether market-centered systems are better able to adapt to changes in the prevailing environment. And the third is whether market-centered systems are better at controlling systemic risks.

There is no solid evidence about which type of financial system is more efficient. Empirical evidence seems to show that legal system efficiency and overall financial development are more important for industry growth, formation of new businesses, and efficient capital allocation than whether the financial system is bank-centered or market-centered.

With globalization and rapid technological change, however, the market-centered financial systems have an advantage over bank-centered systems in their adaptability to the fast-changing nature of return and risk in the global marketplace. For example, a world of rapid-fire innovation requires that high-risk, high-return businesses have quick access to funding. Capital markets are better suited to providing such financing through a combination of venture capital and emerging stock markets. This is why a number of European countries have promoted the emergence of venture capital through specific public funding schemes.

Moreover, markets provide a means of spreading financial risks on a broad global scale. International financial disruptions have exacerbated the consequences for the real economy in countries where financial structures are more rigid and in ones that depend disproportionately on particular financing channels that have experienced disruption, such as cross-border bank lending. While capital markets pass financial risk quickly to diverse investors, banks tend to carry the risk themselves for a long time. As the expanding volume of international transactions and intensive financial innovation in global markets increase the complexity of financial risk, government's ability to control systemic financial risk diminishes. Portfolio diversification and flexibly adjusting capital markets under adequate regulatory oversight are better ways to protect investors from fast-changing, complex risks.

2. Improving the Performance and Security of Capital Markets

Despite the advantages of market-centered systems in today's financial world, the recent spate of accounting scandals in the US as well as in Europe illustrates some of the dangers of allowing the run of unfettered markets. Trust in companies, in capital markets, and in the capitalist system more broadly has plummeted from an all-time high in the US and in other rich countries. Vigorous prosecution of alleged wrongdoing and speedy reforms in corporate disclosure and corporate governance, especially in the US, could ultimately persuade investors that it is safe to go back into the market. In this process, the previous bias toward self-regulation by the private sector has been corrected and governments have started to play a greater role in creating and enforcing capital market rules.

Two specific features of the present crisis deserve highlighting. First, both the bubble in equity prices and the deficiencies in corporate governance and regulation of capital markets were exacerbated by the rapid pace of innovation that spurred growth during the 1990s. Two cases of corporate scandal in the US, Enron and WorldCom, originated in sectors of rapid deregulation and significant innovation. In Europe, cases of deficient corporate governance and fraudulent behavior were more common in high-tech sectors. Frankfurt's Neuer Markt, which was established to spur venture capital and innovation, was beset by scandals in 2001-02. In France, two of the most prominent cases of corporate governance failure, Vivendi and France Telecom, also belong to innovative and deregulated sectors. These various cases suggest that special care should be taken in applying capital market regulations and governance principles to firms in innovative industrial and service sectors, where performance is more difficult to measure and where investment therefore involves greater uncertainty.

The second point involves the interaction between financial market regulation and reform, on the one hand, and corporate governance, on the other. Despite the expansion of capital markets since the 1980s, capitalist countries are not converging towards a uniform market-centered system. But this does not lessen the need for all countries to adopt relevant systems of stockholder protection. For instance, the European Commission is working at new guidelines for corporate governance and the OECD recently launched a consultative process to update the set of corporate governance principles it issued in 1999. As the OECD and European Commission examples suggest, sound principles of corporate governance are compatible with a variety of systems that involve different combinations of market- and bank-based financial structures.

Recent scandals and corporate governance failures have not changed the fundamental principles of sound capital market regulation, which relate to information disclosure, protection of shareholders, and enforcement of rules. The Enron scandal and the massive insider stock sales during the economic boom do, however, underscore the need for adaptive regulation and consistently strong enforcement.

We endorse the following basic principles to regulate financial markets and promote sound corporate governance:

—The information system should guarantee that companies disclose adequate information to investors and other market participants. A strong system should exhibit transparency, timeliness, and credibility. Accounting, which is a major component of such a system and belongs to the soft infrastructure of capitalism, needs to be improved. Beyond accounting, the development of capital markets depends on a complex chain of financial and economic information, which passes among auditors, financial analysts, financial institutions, and others. Regulation should be designed so as to minimize conflicts of interest for those actors in the information chain. They should act at arm's length and banks should avoid owning the shares of their loan clients. Also, as France has decided, accounting firms should stop doing consulting work for audit clients. There should be strict control of activities that cause conflicts of interest between divisions in a financial conglomerate.

—The corporate governance framework should also ensure the equitable treatment of all shareholders. The development of capital markets hinges on the guarantees and trust that such a system provides. These guarantees relate in particular to the trading of shares, the representation of shareholders, and the working of markets for corporate control.

—Strong systems of oversight and supervision are necessary to ensure transparency in the provision of relevant information and investor protection. Accounting rules, in particular, should be consistently enforced. Efforts to strengthen financial authorities in a number of countries should be continued and the authorities should be given broad oversight and sufficient enforcement power and resources to accomplish their mission.

3. Specific Need to Maintain a Sound Banking System

The long-term trend toward greater reliance on financial markets has been particularly problematic for countries with predominately bank-oriented financial systems, such as Japan and Germany. While the financial systems in these countries must undergo fundamental structural changes, their economies stand to benefit significantly if they do not unduly delay the change. At the same time, as the shift toward capital market financing has put mounting pressure on bank profits, countries with bank-centered financial systems have become prone to experience difficulties in their banking systems. Because a sound banking system is a prerequisite for the healthy development of a capital market, these countries are challenged in realizing the necessary development of capital markets.

Japan, where a banking crisis that followed an asset price bubble resulted in the current economic malaise and capital market fragility, dramatically illustrates this point. While the equity market reacted quickly to the overshooting of asset prices during the late 1980s and early 1990s, the heavy burden of non-performing loans (NPLs) caught the banking system in a stalemate, which further dampened the equity market. Non-government analysts estimate that the NPLs amount to one-quarter of Japan's annual GDP.[2] It is not possible for Japan to grow its way out of this situation. And the longer the corrective operation is delayed, the greater the cost of adjustment will be.

The requirements for resolving the bad debt problem are well understood from the experience of preceding banking crises. The necessary change requires decisive governmental initiatives.

The following principles for the cleanup of the banking system are fundamental to initiate a phase of sustainable growth and to overcome the deflationary trend in Japan:

—The Financial Services Agency (FSA) has to introduce stringent rules for the evaluation of loans. Changes in accounting rules that have already been carried out did improve banks' loan classification behavior. Further changes are necessary to ensure true and correct balance sheets and to improve their informative value. Asset valuation, particularly rules for the impairment of fixed assets, will be an important topic.

—Banks must write-off their NPLs according to the stricter loan classification to restore the health of their balance sheets.

—Distressed assets (foreclosed collateral) have to be put back on the market. Then, actual price formation through transactions will begin to remove uncertainty from the markets, particularly in the real estate sector. This will facilitate the bottoming out of asset markets.

—The exit of non-viable banks and the recapitalization of the banking system will be necessary. Even though banks' tier 1 core capital gives the impression that they have sufficient equity to cover loans and meet the BIS capital adequacy ratio of 8%, their real capital position is weaker, as about half of major banks' equity is deferred tax assets. Banks will need an infusion of public money to restore their capital. It must be provided under strict conditionality.

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[2] "Japan's banking crisis," House Editorial, *Washington Times*, 11 September 2002.

In total, the cleanup will provoke a noteworthy consolidation of the banking sector. Moreover, the write-off of NPLs and the sale of distressed assets into markets will affect the non-financial economy in a similar way. Further delay in a cleanup operation, however, will increase the burden of NPLs and continue to impede the development of capital markets in Japan.

Looking beyond the resolution of Japan's bad-debt problem, the following principles should be applied to maintain healthy banking systems worldwide:

—A market for securitized bank assets should be developed in order to provide greater liquidity in the banking system.

—Banks should reduce or eliminate their holding of shares of industrial corporations in order to limit the risk of a banking crisis. Moreover, for banks, the advantage of maintaining close, long-standing relationships with borrowers has diminished in the past two decades and their likelihood of making clear-cut credit decisions and pursuing rational lending policies is greater if they do not have a shareholding interest in borrowing firms.

—Public financial institutions should be limited to areas where market failures are apparent because they tend to be even less flexible than private banks and are likely to distort the allocation of financial resources.

4. Competition of Rules Rather than Global Harmonization

The globalization of capital markets along with the continuing coexistence of a variety of country-specific financial systems points to a need for more compatible rules. With each system introducing rules to improve the performance of its own capital markets, the problem of incompatibility arises. Inconsistency among these rules may detract from the benefits of global capital markets and increase the difficulty of controlling risk. If rules were compatible, then transactions in primary and secondary capital markets would carry lower cost and risk and the allocation of capital across countries would be more efficient. Thus, on the surface, it would seem that harmonization of capital market rules is necessary to allow participants to enjoy the full benefit of global capital markets.

In fact, convergence of capital market rules has proceeded to some extent. The process is taking place through two routes: competitive market forces and international negotiations. Under the pressure of competition in the global capital market, national regulatory regimes are increasingly accommodating common elements, which generally reflect a market-centered orientation usually emanating from the United States. For example, many countries including Japan have modified their laws on corporate governance to be more compatible with those of a market-centered system.

At the same time, there are attempts to harmonize rules under the umbrella of international institutions. In the area of accounting, for example, in 2005 EU Member States are to adopt the International Accounting Standards (IAS) promulgated by the International Accounting Standards Board (IASB). Japan and other countries are also moving to adopt the IAS. Currently, two of the world's main accounting standards setters — the Financial Accounting Standards Board (FASB) and the IASB — are working to harmonize their standards. Convergence of capital market rules in the EU is generally occurring through a mix of both competition and harmonization efforts. The EU is attempting to create a fully liberalized, single financial market that accommodates the existence of country-specific laws and corporate governance structures by obliging mutual recognition of national laws conditioned with minimum standards under common principles.[3]

The consequences of global harmonization seem particularly relevant to rules on corporate disclosure and corporate governance. Differences in accounting standards that make it difficult to compare the financial performance of firms in different countries impede cross-border investment in securities. The recent scandals revealed the weaknesses in the US rules, which have become a *de facto* standard for capital markets around the world. The US Generally Accepted Accounting Principles (GAAP), for example, do not require companies to expense stock options, apparently because of political pressure against doing so. These imperfections in the global standard may be taken to indicate that harmonization under international institutions is a preferred approach.

However, we believe that harmonization of global capital market rules under international institutions is neither realistic nor desirable, at least for the foreseeable future. It is not realistic for at least three reasons. First, the US, which is by far the most important and influential capital market player, is unlikely to accept a set of rules laid down by an international body. Second, philosophical differences among competing systems make it difficult to bridge the gaps through negotiation. In the case of accounting standards, for example, the US GAAP are very detailed while IAS are basically a collection of principles. Third, the experience of the EU is a lesson in the difficulty of achieving a unified set of rules. The EU resorted to mutual recognition of national rules conditioned with minimum standards after it found it impossible to realize the initial objective of harmonizing rules among all Member States.

More importantly, we believe that harmonization is not even necessarily desirable. First, a regulatory system under a single international institution is likely to be inflexible and slow in adapting to changes in global capital markets. Like a private-sector monopoly, an international institution with a monopoly on standard setting has no incentive to move quickly. The size and composition of such an institution alone slow down decision-making. The BIS (Bank for International Settlements) is an example of such a supra-national regulatory board that is having increasing difficulty keeping up with changes — in the banking sector in this case. In comparison, the multiple public- and private-sector institutions in the US reacted swiftly to address the flaws in the corporate disclosure and governance systems revealed by the Enron and other recent scandals.

Moreover, even if rules were harmonized, their enforcement would vary from jurisdiction to jurisdiction since nations are unlikely to agree to cede enforcement of capital market rules to an international supervisory body. We believe bringing consistency to enforcement of capital market rules is more critical than harmonizing the rules themselves.

[3] The ambitious pan-European "Financial Services Action Plan" was launched in 1999 to take Europe a decisive step closer to a single market in financial services.

As an alternative to global harmonization under a single rule-setting body we advocate a system that allows for competing sets of rules for capital markets, including *competition in standards* for corporate disclosure. With several systems of rules in place, each system would seek to adopt specific rules that proved successful in other systems in order to remain competitive. Such a system of competition among standards would be more flexible in the face of change and more investor-friendly than a single set of rules overseen by a single international body.

As in the private sector, competition should stimulate all standards setters to keep pace with market developments, thereby avoiding the foot-dragging problem that has troubled national monopolies such as the FASB and that very likely would plague international rule-setting bodies like the IASB if they had a worldwide monopoly. More importantly, competition is the only system that we believe is capable of diluting the role of political influence in rule setting. This is because, in a competitive environment, rule setters must please investors as well as issuing and reporting firms and their auditors in order for the rules to have relevance in the marketplace.

In summary, we believe the following principles should be applied to establish greater compatibility in the rules under which capital markets operate around the world:

—Competition of rules is preferable to harmonization of rules by a single international institution in global capital markets. At present, in the absence of viable competition, the US dominates global capital market rule setting through *de facto* standards. Efforts by organizations such as the IASB enhance competition by enlisting other countries to participate in establishing international rules. The EU is now playing an important role in this respect. Active participation by Japan and other Asian countries is desirable in order to have more genuine competition and a broader representation of interests.

—The basis for increasing compatibility of capital market rules should be mutual recognition of rules with common minimum standards together with increased consultation among independent rule-setting bodies. In the case of accounting standards, the US should give up its current requirement that foreign companies using IAS reconcile their accounts with US GAAP. International institutions such as the International Organization of Securities Commissions (IOSCO) and IASB should take the lead in setting minimum standards.

—The private sector should play a more active role in setting rules for capital markets, as it can respond more flexibly than government bureaucracies can to fast-changing markets. International cooperation or competition among exchanges is needed to ensure that the level of enforcement is consistent from one country to the next. One approach to creating more competition among exchanges is to permit investors in participating countries to trade on foreign stock exchanges directly from within their home country.

—Rather than focusing efforts on harmonizing rules among individual national systems, greater emphasis should be put on harmonizing the standards of enforcement through international cooperation in the public and private sectors.

—International rule-setting bodies, with all their limitations, should become more viable competitors by improving their objectivity and flexibility and increasing their independence from national governments.

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Tokyo Club Foundation for Global Studies

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President	Shozo Hashimoto

Aim of the Foundation

The world economy is currently beset with severe imbalances, a situation which has produced serious economic friction between countries. These imbalances and their repercussions could seriously arrest the stability and prosperity of the international community.

It is the aim of the Foundation to gather wisdom from the world's leading research organizations and scholars to produce creative proposals for solving these global problems, and then to make its findings available to the international public.

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