Law, Finance and Economic Performance: Implications of Recent Developments for Japan[1]

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The dominant paradigm amongst law and finance academics and the most influential policy prescription is that investor protection is key to financial development and economic growth. This policy has risen to the fore in international agencies such as the OECD and the World Bank as well as amongst governments around the world.

The basis for this assertion is that investor protection is critical to the willingness of minority investors to participate in the financing of corporations. In the absence of adequate protection, minority investors are exposed to self-interest of large shareholders and markets are dominated by these large shareholdings. Participation by outside investors is then discouraged, and the development of financial systems is stunted. Furthermore, investment in some companies and industries is particularly dependent on external finance. The growth of these firms and industries is therefore impeded and economic development suffers.

The policy prescription is therefore straightforward. Strengthen investor protection and financial development will follow. This will promote external finance, which will accelerate economic growth.

This emphasis on investor protection takes several different forms. It stresses the importance of bank regulation and the protection of depositors through prudential supervision. It points to sound regulation of non-bank financial institutions, such as pension funds, life assurance firms and mutual funds. It takes the form of creditor protection and the establishment of insolvency procedures that preserve creditor rights and priorities. And it concerns the rights of shareholders to vote on corporate policies, to dismiss management and to litigate against injustices.

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This is in the spirit of the prevailing economic paradigm of the day – if there is a problem, regulate it. If firms are not environmentally conscious enough, regulate them. If they pay their directors too much, regulate them. If they fail to pursue social agenda, then introduce legislation that requires them to pursue more enlightened policies. We are living in an age in which regulation is viewed as a panacea for any economic ill. Whereas the 1980s and 1990s were the decades of privatisation, this century is beginning with the decade of regulation. We are replacing the tentacles of government with the claws of regulators.

The justification is, of course, that in the process of withdrawing the boundaries of the state, market failures are revealed that require correction through regulation. At least, the claws of regulators can maintain a degree of detachment from the political considerations that guide the tentacles of government.

It is not difficult to see failures in financial markets that justify regulation. At the very least, they are prone to imperfect information that makes investors exposed to mis-selling, incorrect prices and poor execution of transactions. More seriously, investors are at risk of fraud, which pervades financial markets more than any other because of the ease of perpetrating it, the difficulty of detecting and the frequent impossibility of prosecuting for it successfully even when disclosed. Furthermore, regulation can readily be justified by threats to financial systems as well to individual investors. Systemic risks in financial markets provide the same rationale for regulation that "the commanding heights of the economy" provided for public ownership in previous decades.

No sound economist could dispute the importance of regulation in financial markets. Only cranks and business men could argue against it. The pre-eminence of investor protection pervades most current financial market policy proposals. For example, the response in the US to financial irregularities is to introduce legislation that strengthens accounting standards, increases directors' fiduciary responsibilities, imposes larger penalties for corporate governance failures and encourages whistleblowing by insiders. Conflicts of interest are to be discouraged by raising barriers between different institutional activities, such as analysis and broking.

In Europe, there are proposals to introduce a range of new regulatory standards to promote financial market integration. Minimum standards of conduct of business and capital requirements are to be raised to enhance investor protection and ensure that firms operating in different jurisdictions provide acceptable levels of investor protection. In the field of investment management, the European Commission is seeking to extend the principles laid down in the Second Basel Accord to asset management firms. These involve the imposition of capital requirements that reflect the underlying risks of investment business

Nowhere is this policy more evident than in the context of European corporate governance and takeovers. The absence of a market for corporate control has been regarded as serious deficiency of European capital markets and a reflection of the antiquated systems of ownership and control that pervade European corporate systems. The absence of a level playing field has been viewed as an impediment to the restructuring of European enterprises. The European Commission believes that the breakdown of barriers to a market in corporate control is a fundamental requirement for the establishment of an integrated European financial market.

It is difficult to dispute the objectives that lie behind these proposals. Enhancing corporate governance, imposing greater standards of care, facilitating international movement and trade in financial services, encouraging a level playing field in takeovers are like motherhood and apple pie. They improve financial efficiency, they diminish risks for investors, they enhance managerial oversight and monitoring and they increase competition. The political as well as economic appeal of enhancing regulatory standards is overwhelming.

But these policies come at a price. There are, of course, many objections that are raised against regulation. Firstly, as I have just described, regulators have the advantage relative to public sector enterprises of enjoying a degree of independence from government. But to the extent that they are protected from the vagaries of government, they are exposed to the charge of unaccountability. While in principle accountable to parliaments, their relation to their political masters is similar to that of management of a publicly listed company to their shareholders. *De jure,* the shareholders are owners, *de facto,* their property rights are restricted to the

appointment and replacement of the board of directors. Just as company law deliberately creates the concept of a legal entity that is distinct from its owners, so regulatory agencies should have an existence that is separate from government.

A second objection that practitioners in particular raise against regulation is cost. The direct costs derive from those of the regulatory agency itself. In addition, there are indirect costs that firms incur in complying with regulatory standards. It is difficult to provide accurate measures of the latter but there are a number of studies that have attempted to do this. One study reports that for each £1 of direct costs there are £4 of indirect costs in the UK and another reports that there are substantial variations both across countries and financial sectors. However, while market participants complain vociferously about the introduction of new regulations, the volume of complaints tends to diminish rapidly over time. One obvious explanation is that the marginal costs of compliance are small in relation to the fixed costs of setting them up and firms become accustomed to the regulatory standards that they are forced to adopt. A less encouraging interpretation is that regulation is a barrier to entry of new firms and therefore a convenient method of protecting the rents of incumbent firms.

A third concern is moral hazard. In performing their function of protecting investors, regulators are often expected to offer compensation in the event of failure. Public compensation schemes are a particularly important aspect of financial regulation in Europe and the Far East – what I have elsewhere termed "public contracting". If correctly priced, compensation schemes do not necessarily create moral hazard problems. However, insurance is notoriously difficult to price and, in any event, subsidized insurance is a convenient way of encouraging entry. Moral hazard is a particular concern in relation to banking where concerns about systemic risks result in interventions to protect institutions from failure through lender of last resort, bail-outs and recapitalizations. Anticipating these interventions in the event of failure, banks are willing to bear excessively large risks.

Accountability, direct and compliance costs, and moral hazard are conventional objections to regulation and financial services are just one example of where they are relevant. However, there is a fourth aspect that I want to emphasize today that is, I believe, particularly applicable to the financial sector. A primary function of a

financial system is to channel resources from savers to firms. We rely on financial intermediaries to do this for similar reasons that we rely on managers to run firms for us – they can do it cheaper and frequently better. It is expensive for us to obtain the information and expertise that is required to evaluate the comparative merits of different investments. In particular, there are substantial economies of scale and scope associated with portfolio diversification and the pooling of investors' savings in collective investments. As noted before, regulation is justified by the risks of fraud, negligence and incompetence to which this delegation exposes investors.

But the costs of regulation are not only borne by savers and financial institutions but also by the users of capital, namely firms. The significance of financial systems in promoting growth and investment is by now well established. But what is not so well appreciated is the role that different institutions play in that process. We are only just beginning to understand the different function performed by stock markets and banks let alone bond versus bank finance in the investment behaviour of firms. What we do know is that there is considerable variety in the forms of finance that firms employ, despite the fact that the best established theory in finance, the Modigliani and Miller theorem, suggests that, *ceteris paribus*, firms should be indifferent to different forms of finance.

We observe this variety across countries, across time, and across activities within countries. I can only briefly illustrate this point. One of the most pronounced differences in corporate sectors across countries concerns the ownership and control of firms. Levels of concentration of ownership differ pronouncedly from the highly dispersed systems of the UK and US to the highly concentrated of Continental Europe, Japan and the Far East. Principal-agent theories tell us that the corporate governance problems associated with dispersed ownership are quite different from those of concentrated ownership. As guardians of investors' savings, the role that financial institutions should perform in monitoring their corporate investments should therefore vary appreciably across countries.

Nowhere is this more in evidence than in the differences between developed and emerging economies. The financial and corporate governance needs of enterprises in developing and transition economies are quite different from those in developed

economies. For example, the significance of bank versus market finance is quite different across economies.

Similarly, within particular economies, the financing and governance requirements of small firms are quite different from those of large and those of high tech industries quite different from those of more traditional manufacturing and service firms. For example, venture capital emerged to meet a specific financing and governance requirement of start-up and developing corporations. Venture capital funds work in very different ways from other mutual funds, and banks and business angels work in quite different ways from venture capital funds. Furthermore, the funding of venture capital firms in Japan is quite different from that in the UK and US - primarily through banks rather than pension funds and life assurance firms as in the UK and US.

What this points to is a considerable variety in the needs of firms across countries, time and activities. The heterogeneity of financial institutions and financial systems is a reflection of those needs. But still more significantly, those needs change in unpredictable ways. We would have been hard pressed to predict the remarkable growth in venture capital thirty years ago. We would have seriously understated the significance of derivatives in corporate activities. We are still only beginning to appreciate the relevance of securitization to corporate finance.

In the context of the importance of diversity and innovation in corporate finance, the concern that regulation raises is its inevitable tendency to homogenize. Financial regulation focuses on fit and proper, conduct of business and financial solvency requirements. It imposes limitations on who is allowed to operate, how they operate and how much capital they are required to hold. To avoid accusations of arbitrary or unfair conduct, regulators have to operate according to well-defined, pre-specified rules. Only a very modest amount of variation can be permitted before regulation becomes unworkable or unenforceable. An illustration of this is conduct of business rules that require firms, for example, to segregate clients' assets and invest them in particular institutions.

Such rules impact on some institutions more than on others. One example of this is the suggestion in Basel Two of imposing capital requirements on investment

management firms to provide protection against operational risk. This in particular discourages the entry of small, independent asset management firms. Not only does this diminish competition and variety but more seriously it discourages institutional innovation. A good example of this was the prudent man rule for pensions funds whose relaxation in the United States during the 1970s was instrumental in the growth of venture capital during the 1980s and 1990s.

The central argument then is that, possibly the most serious risk of financial regulation is not the cost that it imposes on investors and financial institutions but its effect on corporations and the rest of the economy. Regulation threatens diversity and innovation in financial institutions and systems. This is a particular concern in relation to regulation at an international level. There is a natural inclination for regulators to favour harmonization. Not only is it tidier and avoids "runs to the bottom" but it also allows best practice from one regime to be imposed elsewhere.

And therein lies the heart of the problem. There is a presumption not only in harmonization but in regulation more generally of best practice. There are best ways of executing transactions, of holding clients' monies, of separating investment from commercial banking. Adopting these best practices enriches financial systems. But there is another view and that is best practice varies across countries, time and activities. What is suited to one economy is quite different from another. What is suited to one firm is quite different from another.

According to this view, regulation should not be picking winners. It should encourage the market to identify winners and push out the frontier of best practice. It should be minimizing interference in the operation of financial institutions. It should not be substituting for markets but promoting them.

Financial market reforms over the past six years in Japan have been clearly designed to do this. Critical to the promotion of markets is the provision of information. The one failure that we know pervades financial markets is asymmetries of information and the one element that we know has traditionally been particularly deficient in Japanese financial markets is transparency. Investors need to know the basis on which they are investing. They need to know the systems of protection and execution

that firms employ and the levels of capital that they hold. They need to be able to price the risks that they incur. But they should not have the nature of those risks prescribed in some regulatory office.

US financial regulation has traditionally placed greater emphasis on "private contracting" than the public contracting system of European financial markets and the Far East. Private contracting emphasizes disclosure, private insurance and auditing rather than conduct of business rules and compensation funds. It promotes rather than substitutes for markets. Recent experience has demonstrated the potential vulnerability of private contracting. It relies not only on *caveat emptor* but also on the accuracy of information and the integrity of auditors. It is particularly vulnerable to the failures that we have witnessed over the past year. Superficially at least, public contracting offers greater investor protection. But an alternative policy is to strengthen disclosure, auditing and private insurance rather than impose the uniformity of public contracting.

In sum, I have not disputed the necessity for financial regulation or belittled its significance in the context of systemic risks. On the contrary, I have acknowledged the magnitude of failures that can afflict financial markets. In particular, in the case of Japan, banking reform and restructuring of non-performing loans are prerequisites for wider financial sector development. However, I have warned against the current trend to see salvation in regulation, encouraged by a line of academic thought that links tough investor protection directly with strong economic performance. Not only do I believe that this association is incorrect but I also think that it can be positively damaging in a context that sees any regulation as better than none and counts the number of regulatory rules as being a positive indicator of regulatory standards.

Instead, I have suggested that we should think very carefully about the real sources of market failure in financial markets and target regulation very specifically at these to promote rather than substitute for the operation of markets. I have argued that one set of policies that is critical to this is information disclosure and transparency and I have advocated devoting particular attention to their implementation.