The New Financial Regulatory Regimes: Japan, U.S., and Europe

On November 22, 2010, Columbia Business School's Center on Japanese Economy and Business (CJEB) held a symposium entitled, "The New Financial Regulatory Regimes: Japan, U.S., and Europe." The event, which was sponsored by CJEB's program on "The New Financial Architecture: Japan and the United States," featured Takatoshi Ito, professor at the Graduate School of Economics at The University of Tokyo; Lawrence Glosten, S. Sloan Colt Professor of Banking and International Finance at Columbia Business School; and Gillian Tett, U.S. Managing Editor at the Financial Times.

Professor Ito began by noting that the global financial crisis from 2007 to 2009 was caused primarily by lax financial supervision in the United States and some European countries. While other economists point to global imbalances and prolonged low interest rates in the United States, Ito believes these factors played only supporting roles.

Ito stated that, ideally, financial supervision should achieve several objectives: to keep financial institutions robust against shocks, to maintain financial systemic stability, and to prevent moral hazard among financial institutions despite possible bailouts. In the most recent crisis, the United States did not have a mechanism in place to take over large financial institutions, to protect systemic stability, or to punish shareholders and management. Current financial reforms are aimed at improving the government's micro- and macro-prudential abilities, through monitoring asset price increases, implementing counter cyclical rules, and watching out for bubbles. While Ito finds these objectives appropriate, he believes that two goals are missing: (1) a precise resolution mechanism for systematically important financial institutions (SIFIs) and (2) international coordination of resolution mechanisms, particularly in bankruptcy courts.

Turning to Japan, Ito observed that no Japanese financial institutions held significant amounts of toxic assets during the crisis due to both their implementation of Basel II and their inherently risk-averse behavior. While the Financial Supervisory Agency (FSA) and Bank of Japan may have acted appropriately during the crisis, there has been no discussion of financial reform since then. Japanese banks are still worried about several factors including the impact of Basel III and the limits of core capital available to global financial institutions.

Professor Glosten continued the discussion, focusing on the United States' Troubled Asset Relief Program (TARP) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Under TARP, Glosten explained that the government recognized both the collapse of Lehman and the subsequent behavior of banks as a market failure and dedicated $700 billion to resolve the issue. The government assumed that the auction for toxic assets would determine their price and hoped that the assets would trade better in the future. In the end, TARP resulted in a huge government transfer to the banking sector. The government also bought equity in AIG, GM and Chrysler. A projection made in October 2010 found that bank

capital programs which cost $250 billion will end up making a profit of $16 billion. While Glosten acknowledged a positive outcome in this case, he expressed a desire to better explore, ex-ante, the risks to which the U.S. government exposes itself through such financial regulatory measures.

Glosten also explained that, ex-post, while the government's involvement in AIG, GM and Chrysler limited major long-term costs to the U.S. economy, the Home Affordable Modification Program has fared worse with a 30-40% re-default ratio. Looking at Dodd-Frank today, Glosten is not confident that it will prevent asset bubbles in the future. More importantly, he does not believe that financial institutions will stop finding loopholes to get around leverage rules. In the end, Glosten expressed hope that Dodd-Frank will retain the better aspects of TARP.

Ms. Tett commented on both the current banking crisis facing Ireland and the challenges that Europe as a whole has faced over the last two years. She compared the situation to a hurricane hitting a house and revealing small cracks that no one had noticed before. Then, when the cracks began to grow and spread, soon even the foundation of the house began to look suspicious.

Among Europe's challenges, Tett first identified the unresolved ambiguity and contradiction of having a monetary union without a fiscal or political union. Second, she described how trying to impose a single monetary policy over multiple countries moving at different speeds has created a situation in which monetary union cannot exist peacefully and calmly. Third is the issue of how the European Central Bank (ECB) can run monetary policy and maintain financial stability without a mandate for bank supervision or control over what is happening at the micro-level with banks. Fourth is the lack of protection for the ECB if it were to go bust. Finally, there is ambiguity over what should happen in a monetary union if some members begin to seriously lag behind due to financial problems or if a member wants to exit the monetary union. Tett explained that, while some elements of the Eurozone financial system have worked well in the last five years, there is still the tendency to paper over the cracks in several countries and, overall, the outlook for the Eurozone is rather shaky.

Question and answer session:

David E. Weinstein, Carl S. Shoup Professor of the Japanese Economy at Columbia Business School, began the Q&A session by asking what is to be done in light of the many problems we see in financial systems. If the members of the panel had no restrictions on ability, what would they do?

Professor Ito replied that the serious implementation of Basel III and Dodd-Frank, as well as improved international coordination, are the most important next steps. As the crisis is fading in the United States, there is the risk that implementations will be watered down. He would make sure that the implementations remain vigorous and that the financial supervisory organizations are examined further.

Professor Glosten noted that while Dodd-Frank contains some mechanisms to prevent financial institutions from getting around leverage rules (e.g. the Volcker Act), it is not a cure-all but simply a move in the right direction. He asserted that proprietary trading should not be pooled into banks' profits.

Ms. Tett expects the IMF to propose a resolute program, and that it will be successful since the people in Europe have more confidence in the IMF than their own governments. For the Eurozone, she stated that a cross-border resolution regime and a system to let banks fail are crucial.

Alicia Ogawa, Senior Advisor at the Center for Japanese Economy and Business and adjunct associate professor at the School of International and Public Affairs, asked about the efficacy of "co-cos," convertible bonds that force bondholders to convert into equity when a bank's capital falls below a certain requirement.

Tett noted that Switzerland implemented co-cos because they could not find a resolution regime. While a resolution regime would be more effective and clearer than co-cos, she does not believe the system is close to developing one. People are still sweeping the issue under the carpet and looking for quick solutions.

Glosten stated that a rational economic person cannot figure out the price of co-cos and these pricing problems will lead to disinterest. While the solution of co-cos appears promising, there are significant difficulties in their implementation.

An audience member from Citigroup asked about banking crises in the United States and Japan, and the differences in the states of their financial systems post-crises.

Ito remarked that the Japanese crisis remained in the realm of commercial banking as it was primarily caused by non-performing loans (NPLs) in real estate and construction. Although people knew how to solve the problem, the government prolonged and enlarged the issue. In the United States, it was the shadow banking system that created "gold out of junk," making it a securities problem rather than a bank loan issue. In Japan, when commercial banks were able to rid themselves of NPLs in 2003, they were provided capital injection and were able to repay debts with profits. Now the obstacle Japanese banks face is low profitability. In the United States, the problem is much deeper. The government has made all the investment banks into commercial banks supervised by the Federal Reserve. They have forced shadow banking into the light and believe that will fix the problems. However, Ito is not so sure—even with the Volcker Act, he believes that investment banks may still find ways to work around restrictions. Furthermore, other financial institutions (e.g. hedge funds) could rise and become large enough to pose a systemic threat.

Merit E. Janow, Professor of International Economic Law & International Affairs at Columbia's School of International and Public Affairs, wondered if the panel had any observations on the

unintended consequences of regulatory reform, specifically reducing the flexibility of the Federal Reserve to respond to crises.

Professor Glosten said that the imposed rigidity on the Federal Reserve is intended and worries that this debate will become ideological (i.e. the government should never own equity). At the same time, he does not have complete confidence that the Fed will make the right decisions is every situation, so reducing flexibility is a valid approach. While Glosten believes that TARP has worked well, he does not think this can happen every time. Ultimately, the Fed's actions thus far must be viewed as a "many-year experiment."

Ito believes that if the United States can develop a good reservation mechanism, then restricting flexibility may not be a bad thing.

Tett asserted that the next crisis will come not from sub-prime loans but from a less predictable source. She believes that the global system needs someone who can connect the dots and anticipate crises. Currently, no one has the authority to look across the entire system and take corrective actions without being beaten back by the financial industry.

Another audience member commented on his concern that the financial system has developed to a point that is impossible to stabilize. He does not believe that there are clear advantages to the endless removal of control. Nor have resource improvements offset the loss of 12% of world growth due to the recent crisis.

Tett agreed that financial innovation is no longer about more efficiently serving customer needs. Instead it is about adding layers of complexity and "dancing around" the edge of the rules. As a result, it was difficult to send people to jail in response to the recent crisis because everything they had done to cause the crisis was not technically illegal. She explained that we are building an increasingly complex world and at every level there is growing fragmentation, making it extremely hard to know what everyone is doing. This interconnectivity means that one small group can do something wrong and its actions will reverberate across the entire system.

This event was co-sponsored by CJEB and the Sanford C. Bernstein & Co. Center for Leadership and Ethics and was moderated by Hugh Patrick, Director of CJEB and David E. Weinstein, Carl S. Shoup Professor of the Japanese Economy and Associate Director for Research at CJEB.