Prudence Policy for Stable Economic Growth

Research Group on the Financial System*

The G-20 Summit held in Seoul in November 2010 adopted a financial regulatory reform package intended to prevent a recurrence of the recent financial crisis by strengthening capital adequacy rules and introducing new liquidity regulations.

Last year, the Japanese Bankers' Association Research Group on the Financial System formulated recommendations, "*Post-Financial Crisis Regulatory Reform Proposals*." This year our focus has been on following the discussions by the Basel Committee on Banking Supervision, G-20 Finance Ministers and Central Bank Governors and other international forums and on advancing last year's research to identify *Financial Regulation and Supervision to Encourage Stable Growth for the World Economy after the Financial Crisis*. This document contains recommendations based on the findings from this year's research together with an evaluation of the recently-adopted financial regulatory reform package. Our recommendations are made from the perspective of maintaining the soundness of the financial sector and identifying financial regulations and supervision that will encourage the flow of funds to growth sectors and contribute to stable economic growth.

There is no single, simple solution to the matter of financial regulation and supervision. Particularly today, as technology advances and financial systems evolve and become more complex, regulation and supervision must be a series of uninterrupted innovations to identify "better" approaches. The global regulatory framework agreed this time is not without flaws and side-effects only a step towards further improvements. Our research group hopes that our recommendations should contribute to improvements on regulations and supervisions of the global financial markets.

* The Research Group on the Financial System is a research body within the Japanese Bankers Association founded in February 1984. Its members are scholars of economics, finance, and public finance. The recommendations of the Research Group are independent of the views and opinions of the Japanese Bankers Association.

I. Evaluation of the financial regulatory reform package and remaining issues

<Evaluation>

The new financial regulatory reform package has two primary pillars: the strengthening of both the quality and quantity of banks' capital and the introduction of quantitative liquidity regulation. It also includes: 1) stronger capture of risk in calculating capital adequacy, 2) the introduction of leverage ratios to control the accumulation of excessive exposure, and 3) the introduction of capital buffers to reduce pro-cyclicality (amplified economic cycles). There are also plans for 4) additional measures for systemically important financial institutions (SIFIs).

With respect to the strengthening of capital adequacy rules, one of the pillars of the new package, though we appreciate the steps taken to mitigate any adverse impact on the real economy by providing for fairly long-term transition measures, banks will be forced to substantially raise their real capital levels.

The Research Group cannot support these measures. The measures are essentially a response to a financial crisis resulting from flaw in the financial supervisory regimes in the United States and the United Kingdom. Raising quality and quantity of capital is the core of these new measures. The regulatory package attempts to impose "one-size-fits-all" regulatory frameworks without considering differences among financial markets and the diversity of business models in each country.

The principal objective of capital regulation which was in force in the past two decades has been to *prevent financial crisis*. Large US financial institutions, however, had failed, regardless of their sufficient capital ratio well over the regulatory requirements at that time. This episode clearly illustrates the strengthening of capital requirements alone would not work to prevent crisis. Indeed, excessively stringent capital rules could further facilitate regulatory arbitrage through financial innovations and shadow banking system, which was the main background for the financial crisis in the U.S.

While the package provides long transitional period by introducing grandfathering measures, it will inevitably impede banks' function of providing a steady flow of funds for economic rehabilitation and growth. In countries where deposit based financial markets are primary source of funds, the costs of the new package in to form of reducing the growth rate of the global economy are likely to outweigh the benefits in lowering the probability of recurrence of extremely rare financial crisis. In retrospect, the capital adequacy rules adversely affected Japanese banks' lending capabilities in recession periods, impeding the reallocation of funds from inefficient to efficient sectors. Since the Japanese financial crisis in the 1990s, internal risk controls were overly emphasized, resulting in loss of vitality for financial institutions, robbing growth opportunity from the Japanese economy. This is an important lesson to be learnt.

The Basel Committee on Banking Supervision has released estimates claiming that stronger capital and liquidity regulations would substantially reduce the probability of a financial crisis with net positive benefits over the long term. The Committee has used this estimate as a economic rationale for stiffer regulation. Financial crises are, however, the result of a complex interaction of a number of different factors over time. It is hard to believe that this type of very simple estimate model based on number of hypothetical numbers could serve as a realistic rationale for strengthening capital and liquidity regulations. If the regulatory reform package was indeed able to reduce the probability of financial crisis, rendering net benefits both to individual and international economy, it should be greeted favorably by equity markets. However, no such signs are apparent.

The rationale presented by the Basel Committee on Banking Supervision for strengthening regulation is overly simplified and extremely self-serving. A plethora of deliberate assumptions and hypothetical numbers are employed in an attempt to justify stronger regulations. Impacts on variety of economic conditions in variety of countries with variety of business models were treated as if there are no differences. This model approach is not scientifically justifiable as a rationale for such important regulatory reform by the reputable global regulatory body. We afraid that it could lead to a loss of confidence in international supervisory authorities.

<Issues>

A measure under consideration to address the "Too Big to Fail" problem is strengthening regulations by imposing additional capital surcharges and contingent capital requirements on systemically important financial institutions (SIFIs).

The Basel Committee on Banking Supervision and other groups argue that SIFIs must have greater loss-absorption capacity than ordinary financial institutions to create a framework that will allow bankruptcies to be handled without taxpayer’s support. The Research Group touched upon this issue in last year's recommendations and argued that it should be addressed by improving financial institution transparency and providing more appropriate supervision.

The definition of "systemically important" is to be made primarily on the standards of *size*, *substitutability* and *interconnectedness*. In reality, however, identifying SIFIs would be difficult based solely on these standards. Should a line be drawn at any of the SIFI identification standards, globally-active financial institutions could contract their sizes and networks in order to avoid the designation. Additionally, the SIFIs designation could be viewed as an indication that a financial institution is "Too Big to Fail," which could impact depositors’ choice of banks. Thus, the criteria could actually exacerbate moral hazards.

The Research Group offers specific recommendations below based on the evaluation and perspectives outlined above.

II. Recommendations

1. Achieve both prudence and stable economic growth by regulations that reflect the unique characteristics of individual countries.
   - ✧ Ensuring resilience in the financial sector is the foundation for sound economic growth. Regulations should avoid an impediment to economic growth.
   - ✧ A level playing field is only possible when there is a correct acknowledgment of varieties in jurisdictions, including their economic circumstances. "One-size-fits-all" regulations that ignore such differences will have substantial adverse side-effects.
   - ✧ The actual imposition of regulations on SIFIs should be left to the discretion of the authorities in each country who are best situated to understand the business conditions of individual financial institutions and the economic conditions of their jurisdiction.

The financial regulatory reform package would contribute to the strengthening of the resilience of the financial sector in the U.S. and the U.K., but not necessarily to the other countries. Additional regulations on SIFIs and the introduction of a new package of regulations extending beyond capital adequacy rules will have unintended consequences. In some cases, these could impede the flow of growth funds to industries and destabilize financial systems.

This is particularly the case in Japan and other countries where the primary banking model is commercial banking based on deposits. In these countries, sound economic growth has the highest priority, which ensures the resilience of the financial sector, as well as smooth supply of funds so that banks are able to support that growth. It is critical that global regulations take different characteristics of individual countries into account. Global, one-size-fits-all regulation seems to be fair and looks rational. Nevertheless, individual countries differ in economic activities and circumstances as well as in existing regulations and the functioning of their supervisory regimes, legal systems, and tax systems, etc. A level playing field can only be assured when these differences are correctly taken into account. One-size-fits-all regulation that fails to address these differences will have significant adverse side effects to the global economy.

Indeed, many of the side effects are already apparent. In Japan, global, one-size-fits-all capital adequacy rules reduced banks' risk capacity and constrained growth; in the U.S., the rules set the backdrop for expansion of the market for securitized instruments that triggered the most recent financial crisis.

We appreciate the allowance of the new package with larger discretion of each country with their own responsibilities in enforcing the new package in specific aspects, such as countercyclical capital buffers. The focus of the package is, however, on capital adequacy rules. Without such flexibilities in its enforcement, the potential for regulatory arbitrage and other adverse side effects could be real threats in the future.

When considering the introduction of further regulation on SIFIs, authorities must be fully aware of the cumulative impact of financial regulatory reform as a whole. They are expected to respond flexibly in light of the different financial systems and different financial institution roles in different countries. Only in this way will both prudence and stable economic growth be achieved. More specifically, regulatory administration must be left to the discretion of authorities in the countries, those who are best suited to understand the business conditions of individual financial institutions and the economic conditions of their country. Consequently, each government is the only one with the capacity and responsibility in dealing with crisis once happened. Why not let them handle regulations by themselves with larger discretions and responsibilities? With respect to stronger regulations on SIFIs, we note that each financial institution has unique features, and across-the-board regulations should be avoided. Policymakers must carefully and correctly assess the impact which any such regulation will have on the economy. We are concerned about the potential for stronger regulations to produce unnecessary contractions in financial institutions that could distort financial innovation.

2. The emphasis should be on macro-prudence perspectives and supervision suited to the circumstances of the financial markets of individual jurisdictions.

- ✧ Rebuilding systems and organizations should be firstly prioritized so that the financial sector supervision is once again effective in the U.S. and the Europe.
- ✧ A proper balance between macro and micro perspectives is critical to ensure multifaceted supervision of the entire scope of increasingly sophisticated and complex financial systems.
- ✧ Supervision should contribute to financial institution portfolios that are more resilient to domestic and international macroeconomic environments.
- ✧ Authorities in different jurisdictions should further strengthen their cooperation and coordination to improve both depth and speed of their response.

The recent financial crisis stemmed from a variety of issues not directly related to capital adequacy. For example, inappropriate behavior, such as excessive risk-taking in creating securitized instruments, and inappropriate reviews of loan structuring. The real problems were inadequacies in financial institutions' basic risk management practices and behavior contrary to management discipline. Addressing such problems must include a candid review of existing regulatory and supervisory regimes that overlooked or were unable to identify inappropriate practices. Rebuilding these regimes to function effectively should be prioritized. In the U.S., where the financial crisis erupted, the recently-enacted Dodd-Frank Wall Street Reform and Consumer Protection Act attempts to strengthen the supervisory regime, at least in its regulatory structural form. The Act establishes, for example, a Financial Stability Oversight Council comprised of the Secretary of the Treasury, Federal Reserve Board Chairman and Federal Deposit Insurance Corporation Chair. The Act does little or nothing, however, to change the complex matrix of sector, federal and state regulations, and it remains to be seen whether the new regime will function effectively.

The biggest factors in the US financial crisis were unique to the country's financial system, such as arbitrary consolidation standards and the lending practices to unqualified borrowers. In that sense, we must calmly reconsider whether these problems should be generalized and used as a basis to strengthen international regulation even in countries where such problems never existed.

Another factor in the financial crisis was the failure of supervisory authorities to understand that institutions were incorporating enormous risks into securitized and other complex instruments. Using varied channels financial, commodities were disseminated throughout the world, leading to large risks accumulated within the whole global financial markets where initiating financial institutions are the part of it. Micro-prudence focusing the soundness of individual financial institutions is inadequate for capturing larger trends mentioned above. Macro-prudential perspectives are needed that monitor risks across economic and sectoral boundaries throughout the financial system. Effective programs are needed to improve the transparency of the entire financial sector—not only banks, but also insurance companies and nonbank financial companies—monitoring asset price trends, GDP, and other macroeconomic metrics, i.e., appropriate risk analysis before they trigger a financial crisis. Clearly, implementing appropriate macro-prudence policies without micro information is impossible. Multi-faceted supervision on the financial system should play a crucial role, with a balance of both macro and micro perspectives.

In today's borderless financial markets, regulators must adapt with better coordination among domestic monetary and fiscal authorities as well. Improvements in both the extent and speed of coordination and cooperation among countries are needed in order to prevent regulatory arbitrage on a global scale.

From a macro-prudential perspective, appropriate management of the monetary policy is the key. One primary cause of the housing bubbles in the U.S. was its wrong monetary policy, the prolonging of low interest rates after the collapse of the IT bubble, according to some analyses. It should be acknowledged that monetary policy must balance price stability and financial system stability; this might be difficult. In light of this, traditional monetary policy must be appropriately combined with the new policy tool of macro-prudence policy.

In Japan, the Financial Services Agency supervises financial institutions in all categories. The Bank of Japan manages monetary policy from a macro perspective and measures overall risk in the financial system through its day-to-day monetary regulation and administration of the payment and settlement system. The two authorities work in close coordination, but the Ministry of Finance must participate in further advancement of macro-prudence policy. Each body's role and responsibility must be clear, and all must work together in both day-to-day policy administration and in response in times of crisis. The creation of a forum for detailed coordination among the three may also be desirable in order to highlight Japan’s stance towards strengthening macro-prudence both domestically and internationally.

The global financial crisis was partly due to large variances in interest rates, prices, and foreign exchange rates in Japan, the U.S. and the Europe. These disparities caused significant distortions in the international flow of funds. Specifically, large scale funds flow the U.S. from Japan, as well as to the Europe from Japan and the U.S.. As money flowed into economies, asset prices, most clearly, real estate prices surged. These distortions in the international flow of funds could not be corrected by the stronger capital and liquidity regulation package on financial institutions.

A more effective solution is better supervision based on macro-prudence perspectives. Once regulators and central banks provide useful information on deviations between current economic circumstances and the undistorted long-term state based on metrics of the macroeconomic and international financial environments, it would help to create an environment in which financial institutions do not overreact to distortions in the international financial environment. Individual financial institutions must also take steps to ensure that their portfolios are more resilient to changes in domestic and international macroeconomic environments. These concrete and pragmatic efforts on the part of regulatory authorities to enhance their financial market health would contribute to prevent another global financial crisis.

3. Regulation should be reviewed and reassessed to better address pro-cyclicality problem.

- ✧ Strengthening the health of the financial sector will require voluntary efforts on the part of financial institutions themselves, but also the reliable implementation of policies to encourage stable economic growth by individual governments.
- ✧ The imposition of multiple rules and regulations produces cumulative effects that could lead to unintended adverse economic consequences.
- ✧ If regulations are found to have unintended economic consequences, stable economic growth must be prioritized. Candid reviews and reassessments of regulations in order to better address pro-cyclicality problem are critical.

As noted at the beginning of this document, we commend the new financial regulatory reform package for providing long-term transitional grandfathering measures that give financial institutions time to prepare and mitigate adverse impacts on the real economy.

Nonetheless, the new regulations essentially represent a substantial increase in capital adequacy. In order for necessary benefits to continue to accrue, both voluntary efforts on the part of financial institutions and stable economic growth are indispensable. For this purpose, each government should appropriately enforce the new regulatory package in a way suitable for the economic circumstances of each country.

The new package also introduces new regulatory concepts and tools: i.e., liquidity regulation and countercyclical capital buffers. Our view is that any package of regulations should focus on more flexible enforcement of capital adequacy rules because the rules themselves are clearly inadequate to prevent a crisis.

Individual regulations might have some positive effects. Nevertheless, a combined effect of these multiple regulations could lead to cumulative effects with unintended adverse consequences on the complex real economy. Regulators and supervisors must carefully monitor impacts of new rules once they are actually implemented. Authorities must be courageous enough to always revise their regulations, if any signs of unintended economic consequences appear in the process of implementation. Since a stable economic growth is the first priority, avoiding regulatory pro-cyclicality should be a key concern for all regulatory authorities.

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