Report on Session 3

Session 3 addressed the financial reform and its impact on economic growth.

Mr. Robert Ophèle, the then Director General of Operations and a member of Executive Committee of the Banque de France -- currently Deputy Governor -- focused on the relationship between the regulatory environment for financial activities and economic growth. The question is how we could avoid having a financial sector which would amplify the current economic downturn. Mr. Ophèle pointed out that there are two especially worrying aspects in the current crisis: the negative feedback loops between sovereign debt and the banking sector as well as possible shortage of funding in US Dollars. The financial reform agenda's explicit objective is to prevent any recurrence of intense episodes of financial turbulence and instability. But the outcome seems to be the exact opposite, and we could even wonder if these reforms are not at the very root of the financial crisis.

Mr. Ophèle first explored the idea that the recent changes in the regulatory environment could actually have weakened the financial system and could therefore become one of the main trigger of a crisis. The current regulatory changes could indeed induce a reduction of the amount of credit available for the private sector, increase cost of credit and, more worrying, it could distort the efficient allocation of credit in favor of the most promising growth sectors by penalizing SMEs.

But the new financial regulations, Basel III and G-SIFIs surcharges, require more core capital for banks. It is based on the idea that a more stringent regulation will not have any large negative impact on growth because it essentially reduces the frequency of crisis, hence improving the long term performance of the economy.

One might argue that the current economic slowdown could justify a delay in the implementation of Basel III. On the contrary, in order to shore up confidence in banks, their capital planning must not be delayed and be proactive.

Moving to the second point, Mr. Ophèle said, the current crisis clearly shows the limit of the envisaged liquidity regulation. It could occasion unintended consequences, to use the wording of Basel Committee: it increases negative feedback loops between sovereign debt and the banking sector without providing the banks with liquidity. Fortunately, we have the necessary backstops, i.e., central banks playing their role of lender of the last resort. The Euro-system with its fixed rate full allotment procedure and its USD liquidity providing facility based on a swap arrangement with the Federal Reserve provides liquidity on a "need to fund" basis while other central banks have chosen to flood the market with liquidity through their quantitative easing policy. But the outcome is broadly similar. The central bank facility would cure, if not prevent, liquidity crisis.

Lastly, Mr. Ophèle emphasized the importance of supervision. The supervision is aimed at checking the adequacy of capital buffers and that of liquidity buffers in line with the effective risk profile of the institution in question and with the overall level of risk in the system. It should be based on frequent on-site examination and the requirements should be regularly updated to take into account innovations and changes in the corporate policy.

Mr. Junichi Ujiie is Senior Advisor to the Board of Nomura Holdings – formerly, its Chairman. In his opinion, the financial regulatory reform agenda has two pillars: First, tighter prudential regulations to avoid defaults of financial institutions. The second pillar is to present resolution mechanism for failing financial institutions. He said applying global solutions requires very careful consideration as individual countries approach regulations differently.

He began his remarks about the first pillar of tighter prudential regulations. There is increasing demand for capital among financial institutions because of Basel III and G-SIFI regulations. These reforms will put pressure on expectations for bank profitability, which may make major suppliers of capital, such as insurance companies, reluctant to supply capital. Therefore, banks will have to obtain capital at a higher cost and/or unload their risk assets.

Since a recovery led by the private sector is the key to any sustainable growth, the financial sector should raise its ability to channel risk money into the economy. Especially for an economic recovery with job growth, small and medium enterprises that are higher in credit risks should not be penalized in the process of balance sheet deleveraging.

Moving to the second pillar of regulatory reform, or orderly resolutions, Mr. Ujiie said the proposed scheme for orderly resolutions could increase the costs of financial intermediation and create obstacles to the supply of risk money.

The current scheme for orderly resolutions is focused on eliminating the possibility of injecting taxpayer money. We should be careful about the feasibility and efficiency of resolution schemes that do not include scope for injecting some taxpayer money, given the undoubted reality that financial stability is a public good.

It is right to say that we need to put an end to financial institutions being considered too big to fail. However, it is also correct to say that the financial system remains too important to fail. When multiple financial institutions are hit by any factors and are sitting on huge holes in their balance sheets, the efforts for the orderly resolution of individual financial institutions without using any public funds could lead to disorder in the financial system. Mr. Ujiie said that he believes that Japan has made a reasonable choice not to hesitate to use taxpayer money if the benefits outweigh the costs.

Lastly, Mr. Ujiie talked about the uniformity of international regulations. He pointed out that the direction of international regulations has been reversed to create a framework which is uniform across banks and countries. Experiences in a number of countries set forth a widely held view that the injection of public funds should not be too little, too late.

In his view, it's a matter of moving quickly to a new direction in the debate over international regulations. The wide swing in theories and ideas behind the current changes in regulations has significant intended and unintended consequences and the fact that many details are far from being finalized yet hinders the activity of private institutions.

Mr. Ujiie argued that the diversity of economic systems among countries may necessitate the diversity in the financial regulations. The capital markets are divergent among countries. For example, Japan's financial system is bank-centered, while it is market-oriented in the US. The appropriate set of financial regulation to enhance economic growth of each country should be divergent among countries.

Any change in bank regulations will have a bigger impact on economic growth in Asia than in the West. Asian banks rely on sticky deposits and not on the markets for funding. Mr. Ujiie advocates that capital market activities should be promoted rather than restricted in Asia to sustain economic growth. These are the reasons why we need to be careful about pursuing globally uniform financial regulations.

Then, Mr. K. Kobayashi, Research Director of the Canon Institute for Global Studies and Professor of Hitotsubashi University, who was the moderator of this session, asked two questions to Mr. Ophèle. He first asked him what will be the impact of the tighter capital requirement of Basel III. Secondly, he asked him whether the financial regulations should be uniform across countries.

In answering to the question, Mr. Ophèle argued that there is a possibility that while a tighter regulation may cause the credit crunch for SMEs, there is also a research that indicates there is no adverse effect of the tight capital requirement on economic growth. Consensus at the Basel committee is that the stringent regulation contributes to a steady and sustainable economic growth through preventing the recurrence of financial crises. The regulatory reform concerning settlement among financial institutions, such as establishing the centralized settlement system, is expected to be effective to circumvent liquidity shortage and to prevent future crises. What should be emphasized is that monitoring and supervision by competent supervisors are more important than the rule-making in financial regulation.

As for the second question, Mr. Ophèle argued that the financial regulation should be coordinated among countries to prevent giving adverse incentives to financial institutions. Financial system is global public goods, for which we need internationally coordinated regulation.

To conclude this roundtable, Mr. Kobayashi asked a final question to both speakers: what can financial regulators do to resolve the excess debt in the non-financial sector?

Mr. Ujiie answered that financial regulations that allows banks to put money on the zombie firms undermine economic growth substantially. Financial regulation should accelerate the cleaning-up of the non-performing debt in the non-financial sector. The regulator should not allow banks to keep lending to non-viable firms. On the other hand, Mr. Ophèle argued that the supervisor has the strong regulatory power to make banks write off their bad loans. The competence of supervisors in the regulatory agencies is the key. The regulators have to prevent banks from distributing dividends to their shareholders by delaying the write-offs of bad assets. If this is to be widely witnessed across borders, an internationally coordinated macro-prudential policy may be necessary.