

Comparative Analysis of Non-U.S. Bank Regulatory Reform and Banking Structure

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Introduction

In seeking to restructure the U.S. financial regulatory system to address the current financial crisis and prevent future banking woes, an examination of other countries' experiences may prove valuable. Some countries have fought their own devastating financial crises; others have discovered opportunities to open their markets to trade by reinventing their regulatory structure. Though there are numerous examples to choose among, this analysis reviews the collective experience of Sweden, Japan, the United Kingdom and Australia with observations as to what may or may not translate well to the U.S. financial system.

This paper begins with a review of two countries that have recently experienced a financial crisis similar in cause and consequence to what is occurring in the United States. Both Sweden and Japan were hit with significant banking crises in the early 1990s, caused in large part by the bursting of asset price bubbles in real estate and consumer debt. However, that is where the similarities end. The methods each country used to get a handle on its crisis, and the results, were very different. In that way, the two stories offer significant guidance to U.S. policymakers as they consider financial regulatory reform.

The analysis then turns to an examination of a report by the Financial Services Authority of the United Kingdom on the current financial crisis with recommendations for regulatory reforms. While the European and American views on market regulation differ philosophically, each now must deal with some of the same issues, and given the global nature of the current banking system, international cooperative regulation will be needed to reduce the potential for regulatory arbitrage.

Finally, the sweeping financial regulation reforms enacted in the late 1990s by Australia provide a different perspective on financial regulation: one geared toward growth and investment. In Australia, a new financial regulatory structure was created not out of the need to resolve a crisis, but rather from an examination of the country's financial system during a period of relative prosperity. Australia considered a well-regulated banking system an essential tool in attracting trade and investment. Likewise, the U.S. may benefit from Australia's experience by considering regulatory reforms designed to instill confidence in its financial system, in addition to preventing another credit crisis.

Sweden: Bank nationalization and creation of aggregator bank

The current financial crisis in the U.S., and the world, stems generally from a bubble in real estate prices and a large increase in consumer debt. Likewise, Sweden's crisis in the early 1990s resulted from a massive surge in speculative real estate and consumer debt.

A housing bubble, fueled by cheap credit, collapsed in 1990, with residential real estate prices falling by 25 percent in real terms by 1995 and nonperforming loans reaching 11 percent by 1993. In 1991, two of Sweden's largest banks, Första Sparbanken and Nordbanken, fell below their required capital levels amid rising loan defaults. The aggregate loan losses of the seven largest banks amounted to the equivalent of 12 percent of Sweden's annual GDP. The outstanding balance of nonperforming loans outgrew the banking sector's total equity capital, effectively rendering the entire financial system insolvent.ⁱ

To avoid a meltdown of the banking system, the Swedish government took up a three-pronged program: (1) recapitalization of banks; (2) establishment of an aggregator bank to buy up bad assets; and (3) nationalization of banks. The program was implemented using four guiding principles:

1. Transparencyⁱⁱ;
2. Politically and financially independent receivershipⁱⁱⁱ;
3. Maintenance of market discipline^{iv}; and
4. Restoration of credit flows^v.

In late 1992, the government guaranteed all bank creditors (but not shareholders), with no upper limit. As a condition of government support, government auditors reviewed the balance sheets of all the banks involved, with the goal of taking write-downs immediately and showing the true state of affairs.

The government guaranteed all of Nordbanken's liabilities and nationalized the bank, while arranging for a guarantee for Första Sparbanken. When a third large bank, Gota, had to be taken over shortly thereafter, the government decided to separate and quarantine the bad assets of the three institutions. This was done by merging Gota into Nordbanken, which only held onto "good" assets, and the "bad" assets were moved to two new entities, Securum and Retriva. These entities

were capitalized by the government and bought 21 percent of Nordbanken's assets and 45 percent of Gota's assets.

The asset management companies were charged with managing and liquidating the bad assets of these banks and taking on the assets of non-bank companies that were in default. According to the Federal Reserve Bank of Cleveland, the asset management companies returned \$1.8 billion out of their \$4.5 billion in initial capital to the government, for a net taxpayer loss of \$2.7 billion. Swedish legislators made sure that the companies were adequately capitalized and granted exemptions from regulatory rules that would have rushed their actions or limited their effectiveness, including a rule that required seized collateral to be liquidated within three years.

By identifying and pricing bad assets and forcing write-downs of those assets immediately, Sweden achieved a level of transparency that has eluded Japan in the wake of its financial crisis. In addition, extending political and financial independence to the asset management companies, offering incentives to bank owners to inject capital into banks, and injecting government capital into banks where necessary prevented a rise of "zombie" banks and "evergreening," issues that plagued Japan by inhibiting its recovery throughout the 1990s and beyond.^{vi}

Japan: Ad hoc approach to recapitalization supported "zombie" banks

In the 1980s, the Japanese real estate and stock markets were negatively impacted by a speculative bubble. Financial liberalization throughout the 1980s and the desire to support the United States dollar in the latter part of the decade led to an expansion in credit. During most of the 1980s, asset prices rose steadily, eventually reaching very high levels. For example, the Nikkei 225 index reached a peak of 38,916 in December 1989. At that time, the Bank of Japan became concerned about inflation and, therefore, tightened monetary policy, leading to a sharp increase in interest rates in early 1990. The Nikkei index fell sharply, to a level of 20,222 on October 1, 1990^{vii}. Other asset bubbles burst as well, including real estate prices. Over the following years, higher rates of default and retrenchment in the financial system led to failures of three large banks and one of the largest four securities firms. Japan's economic growth stalled and has still not returned to its prior level of growth. Using the average growth rate of GDP of 4 percent from 1976-1991, the difference between trend GDP and actual GDP from 1992-1998 is about 68 percent of GDP.

Japan's economic slowdown has largely been explained by the emergence of "zombie" banks.^{viii} The increase in zombies depressed the investment and employment growth of healthy firms and widened the productivity gap between zombies and healthy firms. That firms were allowed to become zombies seemed to be more a problem of regulators than gaps in regulation. Most large Japanese banks were only able to comply with Basel capital standards because regulators failed to thoroughly inspect banks' balance sheets and loan transactions. The banks often engaged in sham loan restructuring that kept credit flowing to otherwise insolvent borrowers, or zombies. This process, whereby undercapitalized banks choose not to address problem loans because doing so would force asset write-downs, possibly prompting technical insolvency, is what has become known as "evergreening."

Evergreening negated the usual result of free-market competition because the zombies were able to continue operating, rather than being forced to shut-down or reduce workforce and lose market share. In response to this initial crisis, the Japanese government embarked on an ad hoc program to recapitalize the banks. Unfortunately, the banks were not recapitalized to a point where there no longer was any incentive to "evergreen" bad loans.

The existence of zombie banks also damaged the market by reducing output and thus lowering the profits of healthy banks which were then discouraged from investing in new products and entering into new markets. Without the restoration of credit flows, solvent banks were unable to find lending opportunities. In this context, efforts to stimulate the economy through government spending programs were muted at best, and otherwise, entirely ineffective.

Some of the lessons offered by Japan's experience are as follows^{ix}:

- Capital injections into banks are a beginning, not a comprehensive program;
- Debt relief and rehabilitation of viable but debt-ridden firms and the liquidation of nonviable firms are crucially important to wipe out the payment uncertainty from the economy and restore market confidence;
- Stringent and conservative evaluation of toxic assets should be the premise behind bank-capital injections and debt restructuring;
- To stop the vicious cycle of debt deflation, the government should establish asset management companies, public entities that purchase and hold the bad assets;
- Large fiscal stimulus packages will not work without a serious policy effort to make banks dispose of their non-performing loans.

A regulatory structure that may be useful in addressing the risks raised by the Swedish and Japanese experiences, while also adhering to the

guiding principles in avoiding financial crises, is the Integrated Approach. An integrated regulatory structure generally has a unified focus on regulation and supervision by drawing regulatory jurisdiction under a single entity responsible for all sectors of the financial industry. However, some observers have noted that this may create the risk of a single point of regulatory failure.^x The United Kingdom, one of the countries that employ the Integrated Approach, has attempted to address that risk in a recent analysis of the current financial crisis.

United Kingdom: A Blueprint for Financial Regulatory Reform

In the United Kingdom, the Financial Services Authority recently released a report, known as the “Turner Review,” identifying causes of the financial crisis and recommending financial regulatory reforms.^{xi}

The Turner Review identified numerous key areas requiring regulatory attention. The following summarizes those proposed reforms that seem to reflect the guidelines and lessons from Sweden and Japan:

1. Capital adequacy, accounting and liquidity
 - The nature of the role of banks in the economy is such that regulation should focus on systemic, as opposed to idiosyncratic, risk;
 - Seven key measures required: (i) increasing the quantity and quality of bank capital; (ii) significant increases in trading book capital, and need for fundamental review; (iii) avoiding procyclicality in Basel II implementation; (iv) creating counter-cyclical capital buffers; (v) offsetting procyclicality in published accounts; (vi) a gross leverage ratio backstop; and (vii) containing liquidity risks both in individual banks and at the systemic level.
2. Institutional and geographic coverage of regulation
 - Ensuring that bank-related activities do not migrate outside the regulator perimeter in order to escape capital and liquidity requirements (examples include AIG and special investment vehicles);
 - Hedge funds are not bank-like (comparatively low leverage at 2-3 times assets, and no dealing with retail customers), however hedge fund activity in the aggregate has important procyclical impact;
 - Regulators must be able to gather information on hedge funds and should have power to apply capital and liquidity rules to hedge funds as needed;

- To regulate hedge funds, geographic coverage becomes an issue because many are legally domiciled and located in the U.K., U.S. or Switzerland.
3. Bank Resolution
 - The Northern Rock failure highlighted U.K.'s lack of special bankruptcy-type regime to ensure orderly resolution of failing bank. Banking Act 2009 has closed the gap. Under the Act, FSA determines the need for bank resolution, and provides the U.K. authorities (i.e. FSA, Bank of England, and Treasury) with wide-ranging powers to ensure orderly resolution.
 4. CDS Market Infrastructure
 - Large growth of over-the-counter (OTC) derivatives in last 10-15 years includes credit default swaps (CDS), which have grown to more than \$60 trillion of gross nominal value by the end of 2007; however, the net exposure (risk) outstanding in 2008 was \$3.7 trillion;
 - Sheer size and OTC nature creates danger that failure of one party could disrupt the entire market;
 5. Macro-prudential analysis
 - This is complementary to examining systemic risk: Bank of England and FSA focused too much on inflation targets and individual institutions and did not recognize economic warning signs running up to the financial crisis;
 - The review recommends formalizing the relationship between the Bank of England and FSA, either to make Bank of England the final arbiter of judgments relating to the economic cycle, with the FSA responsible for regulatory adjustments, or to create a joint committee, which would have a final decision maker.
 6. FSA Supervisory Approach
 - A new philosophy of financial regulation was launched under the Supervisory Enhancement Programme (SEP), enacted in the aftermath of Northern Rock in April 2008;
 - Intensive supervision: A significant increase in the resources devoted to the supervision of high impact firms and in particular to high impact and complex banks, with an increase in the frequency of comprehensive risk reviews from a maximum of three to a maximum of two years, and less for firms facing particularly risky issues;
 - A shift in supervisory style from focusing on systems and processes, to focusing on key business outcomes and risks and on the sustainability of business models and strategies;
 - An increase in resources devoted to sector and firm comparative analysis, enabling the FSA to better identify firms which are outliers in terms of risks and business strategies and

to identify emerging sector wide trends which may create systemic risk;

- A much more intensive analysis of information relating to key risks, including more detailed information requirements.

Many of the recommendations for reform made in the Turner Review revolve around better defining the roles of the regulatory agencies, most notably the central bank and the FSA. The goal is to redefine the roles of the agencies so that they focus on the guiding principles that emerged from crises like those of Japan and Sweden and the current global financial crises. One may argue that the U.K. is taking steps in the direction of the “Twin Peaks” Approach, adopted by both Australia and the Netherlands.

Australia: "Twin Peaks" model

While examining the experiences of countries like Sweden, Japan and the U.K. in fighting their own financial crises is relevant to the current situation in the United States, important regulatory reform has also been achieved during periods of economic growth. An analysis of financial regulatory reform must also take into account this type of change because reform taken in good times tends to be more encompassing and seeks different goals than regulatory reform that is targeted to resolve a crisis and prevent recurrences.

In a paper on the Australian bank regulatory system in September 2006, the Australian Securities and Investments Commission noted several advantages to a well-regulated financial system:

- “companies can get on with doing business confident that the same rules apply to everybody. They can seek capital in Australian markets at rates that are broadly competitive with leading world markets and without paying a significant market risk premium;”
- “financial services businesses can operate profitably and efficiently, while treating customers honestly and fairly. Being in a well-regulated market also helps them do business across borders;”
- “financial markets are well respected and attractive internationally, and are clean, fair and reliable;”
- “all participants can understand their obligations;”

- “investors and consumers can participate confidently in the financial system, using reliable and trustworthy information to make decisions, with access to suitable remedies if things go wrong; and”
- “the community is confident that markets, corporations and the businesses involved in them operate efficiently and honestly and contribute to improving Australia’s economic performance. Firm action is taken against fraud, dishonesty and misconduct. The regulatory system is respected.”^{xii}

Following a period of financial deregulation that began in the early 1980s, the Australian government commissioned a study of the financial regulatory structure in 1996, entitled the "Wallis" Inquiry. Generally, the inquiry was charged with examining the results of deregulation and determining the best structure for regulatory efficiency with an emphasis on addressing technological changes in the banking industry.

The Wallis Inquiry put forth three regulatory options:

1. A mega-regulator;
2. A lead regulator;
3. “Twin peaks” regulation.

Under the mega-regulator regime, a single regulator would undertake market regulation, consumer protection and prudential regulation. The advantages were deemed to be regulatory consistency, in-depth supervision of diverse financial groups and diminished regulatory arbitrage. The arguments against the mega-regulator model included concerns about placing too much power in one regulatory agency and an inflexible, “one-size-fits-all” approach to regulation.

The lead regulator model would invest in a single agency responsible for assessing the risk profile and capital adequacy of the entire operation of a diversified group. Such a structure would ensure a coordinated approach to financial groups and retain the specialist expertise of existing regulatory agencies. Concerns about the lead regulatory model included possible fragmentation of regulatory arrangements, competition or conflict between regulators, and confusion for the regulated population.

The Twin Peaks regulatory model would consist of two financial regulators in conjunction with the central bank, Reserve Bank of Australia (RBA), and the competition regulator, Australian Competition and Consumer Commission (ACCC). This structure had the advantage of creating two highly specialized agencies with clearly defined and understandable regulatory roles. The two agencies would be divided along functional

lines. However, the potential for regulatory overlap and duplication, conflict between different regulatory perspectives and objectives, and the possibility of important regulatory issues falling through the cracks were arguments against adopting the “twin peaks” model.

The Wallis Inquiry considered the three structural options in light of four principles of market regulation (which seem to echo, from a perspective of prevention, the four guiding principles in the Swedish study and the lessons of Japan’s failure to resolve its banking crisis):

1. Market misconduct;
2. Information asymmetry;
3. Anti-competitive behavior; and
4. Systemic instability.

The Twin Peaks model was chosen. Under the parameters of the model, two agencies were created: the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). The Twin Peaks model is “regulation by objective.” ASIC was given the power to regulate market integrity and supervise consumer protection with the objectives of promoting market fairness and consumer confidence. APRA was provided the power to regulate asymmetric information problems by setting and enforcing standards of prudential behavior on all institutions making promises in the areas of deposit taking, insurance and superannuation. Thus, the two agencies split the regulation function between conduct of business regulation and safety and soundness supervision.^{xiii}

Additionally, the RBA was assigned the task of overseeing systemic stability, mostly through monetary policy, while the ACCC regulates anti-competitive behavior. The Wallis Inquiry offered three reasons to keep the central bank separate from the prudential regulator:

1. Combination of deposit taking, insurance and superannuation regulation is unlikely to be carried out efficiently and flexibly by a central bank whose primary operational relationships are with banks alone and whose operational skills and culture have long been focused on banking;
2. Separation will clarify that, while the central bank may still provide support to maintain financial stability, there is no implied or automatic guarantee of any financial institution or its promises in the event of insolvency; and
3. Separation enables both the RBA and APRA to focus clearly on their primary objectives and will clarify the lines of accountability for the regulatory task.

The Twin Peaks Approach has gained some admirers. It has been adopted by the Netherlands^{xiv}, and is under debate by France, Italy, Spain and the United States.^{xv} One of its advantages is that the model uses many of the benefits and efficiencies of the Integrated Approach, while addressing the inherent conflicts that tend to arise between the safety and soundness function and the objectives of consumer protection and transparency.

Conclusion

The lessons of the financial crisis battles waged by Sweden and Japan, the United Kingdom's analysis and recommendations for regulatory reform in light of the current financial crisis, and the experience of Australia in creating a new financial regulatory regime in prosperous times offer the United States many options in considering its own financial regulatory reform.

The contrast between the continuing struggle of Japan to restore its financial system and Sweden's success in overcoming the failure of some of its largest financial institutions appears to hinge on the ability of the government to adequately identify and evaluate a bank's bad assets and then move quickly to both capitalize the bank adequately and separate the bad assets by moving them to a new independent management entity. To effectively accomplish such actions, the regulatory agency charged with that mission must, at least, have the authority to: (1) gather information from financial institutions on a regular basis to identify potential risks and acquire intimate knowledge of the institutions' balance sheets; (2) govern financial institutions as a systemic risk regulator; (3) assume financial institutions' operations in a crisis and create independent management entities for "bad" assets; and (4) provide funding for the management entities so that they may remain independent.

Much of the Turner Review covers the issues raised by Sweden and Japan, but the proposed reforms may prove difficult to implement in the U.S. The FSA's analysis points out several key areas of financial supervision that need to be addressed by the U.K. to cover regulatory gaps and identify systemic risks in the future, along with specific reforms to reorganize the relationship between the FSA and the central bank. However, the U.S. employs an amalgam of federal agencies to oversee the financial industry, whereas, in the U.K., the FSA has full responsibility. Although some U.S. proposals have floated the idea of making the Federal Reserve a single entity responsible for governing the financial system, it is also the central bank, and thus would have nearly unlimited authority. Australia's financial regulatory structure may provide a

reasonable compromise, but in the U.S., implementing such a structure would require practically an entire overhaul of the regulatory system, which would present a political obstacle perhaps too difficult to overcome.

The United States has long been a leader in financial innovation and regulation. Thus, any solution to the current financial crisis must uniquely cater to the country's present needs and future growth potential. However, since any permanent solution will require some level of international cooperation, an understanding of other countries' experiences and proposals is beneficial. Those experiences suggest that, in constructing a regulatory structure to deal with the present crisis and position the U.S. financial market for stable growth in the future, policymakers should balance considerations of both the guidelines and pitfalls that have emerged from past financial crises and the goal of creating a well-regulated financial system designed to attract trade and investment. □

ⁱ O. Emre Ergungor, On The Resolution of Financial Crises: The Swedish Experience, Policy Discussion Paper No. 21 (June 2007), Federal Reserve Bank of Cleveland, <http://clevelandfed.org/research/policydis/pdp21.pdf>.

ⁱⁱ Transparency in this context means recognizing expected losses early on in the process to preserve confidence in financial markets.

ⁱⁱⁱ Relief from political pressure, which increases as banks are closed and borrowers are pushed into bankruptcy, is essential to ensure that decisions are based on economic, and not political, standards; financial independence is key to political independence because the government could still influence the decision makers if it must approve funding each time it is needed.

^{iv} Maintaining market discipline is really a matter of avoiding moral hazard; if all participants are provided blanket guarantees against losses, then risk-taking and ignorance of trouble signs are encouraged.

^v Even if banks are restored to health, borrowers need to be put in a position to be able to repay their debt.

^{vi} Douglas W. Diamond, Should Banks be Recapitalized?, Federal Reserve Bank of Richmond Economic Quarterly (2001), <http://faculty.chicagobooth.edu/douglas.diamond/research/recap.pdf>.

^{vii} In an indication of how the poor handling of the banking crisis continues to haunt Japan's equity markets, note that the Nikkei 225 index closed at 8,236.08 on March 20, 2009.

^{viii} Richard J. Caballero, Takeo Hoshi, and Anil K. Kashyap, Zombie Lending and Depressed Restructuring in Japan (January 2008), <http://faculty.chicagobooth.edu/anil.kashyap/research/Zombiejan2008fulldocument.pdf>.

^{ix} Takeo Hoshi and Anil K. Kashyap, Will The U.S. Bank Recapitalization Succeed? Lessons from Japan, NBER Working Paper No. 14401 (Revised December 2008), http://faculty.chicagobooth.edu/anil.kashyap/research/will_us_bank_recapitalization_succeeded2.pdf.

^x Group of Thirty, THE STRUCTURE OF FINANCIAL SUPERVISION Approaches and Challenges in a Global Marketplace (2008), http://www.group30.org/pubs/GRP30_FRS_ExecSumm.pdf.

^{xi} Financial Services Authority, The Turner Review A regulatory response to the global banking crisis (March 2009), http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

^{xii} Jeremy Cooper, The integration of financial regulatory authorities — the Australian experience, Australian Securities and Investments Commission (September 2006),

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^{xiii} THE STRUCTURE OF FINANCIAL SUPERVISION Approaches and Challenges in a Global Marketplace (2008), at 10.

^{xiv} The Netherlands version of the Twin Peaks Approach has a different structure than that of Australia. The Dutch Central Bank is responsible for safety and soundness oversight and the newly created Authority for Financial Markets is charged with responsibility for supervision of conduct of business issues.

^{xv} The U.S. Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (March 2008), <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

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