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Financial Regulation: Lessons from the Recent Financial Crises

BOKOR JÁNOS

Financial Regulation: Lessons from the Recent Financial Crises by Takeo Hoshi. (*Journal of Economic Literature*, Vol. XLIX, March 2011, pp. 120-128)

Takaeo Hoshi's paper examines the experiences and consequences drawn from two major recent crises: the 1990 Japanese crisis, and the 2007 global financial crisis which started in the United States. In the first two sections, the paper introduces the two crises and reviews their main characteristics. Then, it identifies important lessons learned for a better financial regulatory system in the future. In the third and fourth sections, the paper examines possible recommendations presented in the *Squam Lake Report*[1] and the *Dodd-Frank Act*[2] for the implementation of a properly functioning regulatory system in order to avoid and handle future crises.

The most important lessons of the two crises are more or less the same, although there are remarkable differences. In Japan, the traditional way to avoid bank failure was to ask a healthy bank to take over a troubled one. This mechanism worked quite well before the 1980s. Regulators were routinely able to convince healthy banks to acquire failing ones. This practice worked effectively under a strong regulatory system. Since the financial deregulation in the 1980s however, larger financial institutions have not been able to make a profit when acquired a failed bank. Therefore, the Japanese regulators have not had any tool to deal with the problem of insolvency in recent years.

The United States handled its crisis somewhat differently. Before 2007, it had a special bankruptcy regime for certain financial institutions. The experiences of economic cycles in the US economy provided some special resolution process to handle different types of crisis situations. However, these resolution processes were not applicable to non-depository financial institutions. The Federal Reserve's ad hoc rescue package to save Bear Stearns[3] from failure in March 2008 set certain expectations about how future insolvencies would be handled. These expectations may have dulled financial institutions' willingness to deal with the problem themselves. When Lehman Brothers developed similar problems in September 2008 which Bear Sterns had had half year earlier, the government refused to act according to market expectations. It did not put together any rescue package as it had in the case of Bear-Stearns. Lehman Brothers was forced to file for bankruptcy which led to chaos in the financial system. Therefore, for the government, no more options remained. It could no longer refuse to provide financial help for large troubled financial institutions. As a result of the implicit expectation of a government rescue, large financial institutions had less of an incentive to clean up their balance sheets on their own.

The conclusion of the paper stresses the lack of any resolution mechanism regarding future failures. This will inevitably lead to a delayed government response to a crisis. Thus, according to Hoshi, the first lesson from these two crises is the need for a strong, credible mechanism to resolve failed financial institutions without disrupting the functioning of the financial system. The second lesson is the importance of a systemic approach. Both cases reveal that the health of individual financial institutions is different from the stability of the financial system as whole.

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[1] Report of The Squam Lake Working group which first convened in fall 2008. The group have come together to offer guidance on The reform of financial regulation. It aspires to help guide reform of capital markets. The guidance is based on The group's collective academic, private sector experience.

[2] Originaly the Dodd-Frank Act aims the stability of the financial system. It protects the debt consumers and prevents the fall of the giantic financial institutions-which can be extremely harmful for the whole financial system.

[3] The Bear Stearns Companies, Inc. was an investment bank and brokerage until its collapse and sale to JP Morgan Chase in 2008.

The Squam Lake Report proposes recommendations for managing further crises and the Dodd - Frank Act constitutes regulations in the United States more or less based on the report's principles. The Squam Lake Report is laid out on a realistic basis. It does not aim to fully avoid future crises, but to reduce their frequency and their cost.[4] It addresses the two important lessons mentioned above. Its first principle reflects the systemic approach; it requires policymakers to consider how regulations affect not only individual financial firms but also the financial system as whole. The second principle demands regulations which force firms to bear the costs of failure they have hitherto been imposing on society. Furthermore, the report makes recommendations regarding capital ratio requirements. It argues that the required capital ratio should be higher for large banks, and also suggests higher capital requirement for banks which are more likely to create systemic problems. In addition, the report highlights areas where systemic risk magnified during the recent crises and argues for the need of an orderly resolution mechanism for large financial institutions.

The Dodd-Frank major regulatory reform started in June 2009. These reforms partially follow the recommendations of the Squam Lake Report. On the one hand, it creates a systemic regulator - The Financial Stability Oversight Council (FSOC)[5]. It monitors and, if necessary, responds to systemic risks. It outlines measures regarding the whole system (systemic approach) and collects data and information relevant to systemic risks. On the other hand, the Dodd-Frank Act does not put forward any capital requirement regulation unlike the Squam Lake Report. Instead, it introduces new regulations to reform derivative markets. In harmony with the Squam Lake Report, which tries to force companies to bear the costs they impose on society, the Dodd-Frank Act proposes recommendations to reduce the 'too big to fail" problem. By this measure, the Dodd-Frank Act has proved to be a good starting point for implementing principles and recommendations drawn up in the Squam Lake Report.

Conclusion

Takeo Hoshi's paper carefully introduces the lessons which can be learnt from the crisis in Japan and the United States. He outlines what kind of basic principles should be considered to create an effective regulatory system, which should ease the consequences of these crises in the future. He also introduces the Squam Lake Report, which lays down the basic principles for further regulations, and the Dodd-Frank Act, which more or less effectively, implements these principles in the United States.

The financial events of the last one and the half decade emphasize those shortages of the financial regulatory systems which are somehow connected to systemic interpretation and problem solving. At the same time, the national governments and the economic integration organizations provided rescue packages in several cases for those institutions and states who were in need. The problem was not the lack of funds in many cases, but the lack of harmonization, continuity for the effective spending of the financial aid. This is why recognising the need for the regulatory system reform was so crucial for the crisis management in the recent years.

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see@southeast-europe.org
www.southeast-europe.org

[4] Economic cycles in the United States made it evident that cycles are natural attendents of the capitalist system. therefore the efforts are made regarding to these cycles have not to aim to fully avoid them, but to reduce their costs.
[5] The FSOC was signed into law On The basis of The first title of The Dodd-Frank Act by President Barack Obama on July 21, 2010.