DEBATE

Jean-Claude Trichet, former President, ECB

Thank you very much indeed. I do not suggest that we lose time by applauding our speakers, but you deserve a virtual round of applause. Thank you very much. It is good that you were not complacent. You really identified the very hard job that remains to be done in terms of the technicalities of the reforms that are on their way, but which are far from being achieved, and in terms of the challenges of global governance in a totally interconnected world that does not have the same interconnectedness in government, perhaps for good reasons, as you said you are a sceptic yourself.

Let me add that it is true, as you say, that in the crisis we found the ways to respond and practice crisis management in exceptionally dramatic circumstances because the phenomenon was extremely rapid – contagion was extremely rapid – and the systemic risk was materialising at a speed of half-days and we had to take decisions within those half-days. The bankruptcy of Lehman Brothers was announced on Monday the 15th September 2008 and by the next Thursday all of the central banks of the largest economies in the world were publishing the first reaction, which was a liquidity reaction of extreme boldness, with generalised swap agreements and capacity to deliver any currency that was needed, mainly the USD, in a way which was extremely bold because we could do that in terms of the collateral in local currencies in the various national currencies. Without that I really think that the crisis would have been dramatically worse.

That being said, I have to say that on a more sustainable basis we transformed all the Basel machinery. The privilege of the 10 industrialised countries was enlarged to a grouping of countries and central banks representing almost 30 central banks. Of course the G7 passed the baton to the G20 and the emerging world came to be at the heart of these discussions, whereas before the seven or the 10 dominated. That is a very big change. Also, the principle of having the same rules and regulations and, as much as possible, the same supervisory concept for the entire planet is also something which is probably very good, even if it is extraordinarily difficult to implement.

However, I will stop there and I would suggest that those who want to speak for up to three minutes raise one hand and those who want to speak for up to one minute raise two hands so that we can have the most vivid exchange of views possible.

From the floor

I have a short question. You talked about the Basel machinery and John Lipsky and Mr Frieden spoke of Basel III. French bankers have complained to me that the Americans have imposed new rules that banks should keep proper forms regarding 8% and all the rules of Basel and that the French banks are suffering from that. They are complaining that the Americans do not apply to themselves the rules that they have imposed, probably through the G20, to the world. My question is very simple. Is what was told to me true or not true?

John Rielly, former President, Chicago Council on Foreign Relations

Anyone who has been reading the *Wall Street Journal* in the last year has noticed that at least once a week they have at least one article condemning Dodd-Frank. Dodd-Frank primarily addresses national regulations, not the kind of cross-border issues that Professor Frieden reckoned, but I would be interested in having the panel address at some point what impact Dodd-Frank has had abroad, such as in Europe and Asia, and whether it has been a largely positive or negative influence.

From the floor

I have a question for either Dr Lipsky or Professor Frieden. I was hoping you could walk me through something. My understanding is that over the last couple of years we have seen a tremendous capitulation, not only within the industry because also a particular business model, in the way banks are run now. The traditional arbitrage mechanism used by retail banks in particular to make money has been proven to be a systemic failure and I am curious to see if the regulation that we are seeing implemented now is actually trying to regulate banks back into being good companies rather than an industry. Regulation is typically user-focused, but are we actually looking at imposing regulation for a cohort of industry players who all in likelihood are either not going to be here in 20 years' time or are going to be manifestly different through vertical integration, particularly from technology companies such as Google, over the next decades. My question specifically is whether the regulation is specifically dealing with banks as a mechanism representative of the industry as a whole rather than regulation dealing with the industry and the users who are the beneficiaries of that industry.

From the floor

I have two specific questions. First to Professor Frieden, could you elaborate more on the political and economic aspects of the question? There were several papers from Mr Johnson, the former chief economist of the IMF, about the political influence of Wall Street on financial regulation in Congress. Would you say that the balance of power between politicians and financial bankers has significantly changed since the crisis?

My second question is to John Lipsky. You talked about the 'too big to fail' problem and the responsibility issue. There was a report from British Parliament's Independent Commission Banking Reform that had a proposal to hold individual banking managers more responsible for their past actions. Do you think that it would be efficient and just to impose criminal sanctions on individuals within banks? Thank you.

Jean-Claude Trichet, former President, ECB

We have a lot of questions to answer, so it is best we respond to them quickly. One of the major problems we have is that undoubtedly we do not have the same financial structure on both sides of the Atlantic, in Japan and in other countries, including the emerging countries. Let me give you two or three figures. The commercial banks in Europe are financing 80% of the economy and the markets 20%. In the US the banks are financing 20% of the economy and the markets 80%. That is the reason why, while bank runs are very well known historically, the evaporation of liquidity from the market is the equivalent of a bank run. That has a dramatic impact in the US because the economy is largely financed through the markets. Also, the markets do not have the same structure. For instance, the repo are not the same. They have tight repo in the US and we have traditional repo in Europe and securities lending is generalised and not it is not necessarily so in Europe.

You have all these differences and I think that European banks are saying they are playing a much more important role than in other advanced economies and exactly the same rules are being put on all of us, which is true. The same rules will apply in terms of liquidity and are applied in terms of capital requirements. That is part of the issue and I think it is a real one. We have to accept that. There were global negotiations which were a compromise between some who wanted to go much further in terms of capital requirements and pressure and regulation and being tougher and tougher and those who were arguing that it would be too tough because it would dramatically hamper the financing of the economy. The results of the negotiations were the global compromise in extraordinarily difficult circumstances. John, what remarks do you have in response to the series of questions you received?

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

I think your answer on Basel III was definitive. As regards Dodd-Frank, the jury is still out and it is going to be out for quite a while. Many detailed regulations are still not complete even though the legislation was passed some time ago. Therefore, the actual effect on the ground is not yet clear. As I indicated earlier, with proposals like the Volcker Rule, the devil is in the details, many of which have yet to be clarified. I suspect, for reasons that are understandable, when we look back we will find that Dodd-Frank will provide at least some examples of legal and regulatory overreach. In some cases, regulations are being applied although the implications for the workings of the system are not completely clear and/or are not necessarily directly responsive to the problems that were made evident by the crisis. Of course, it is understandable why this happened and to some extent, the sector simply is going to have to live with it.

Financial sector reforms are going to have international implications and maybe some of my colleagues here can speak to these more authoritatively than I can, but it will be hard to say whether Dodd-Frank overall will have been good or bad in its effects for several years to come. To be honest, I think that in many ways, the impact has not been as positive as it might have been. Substantial uncertainty that has been extended for rather a long time about many operational aspects of the institutions, including the very structure of the institutions themselves. Are they going to be broken up in different ways? What is the Volcker Rule -- or its counter-parties -- really going to mean for the workings of the financial system?

Has regulatory reform focused on institutions that essentially are dinosaurs? Is that the question?

From the floor

That is pretty close. Are we regulating banks or banking and is it important to distinguish between the two now?

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

Are we doing one or the other? The answer is "Yes". We probably are doing both. A word of caution: I can recall attending presentations in the 1990s by experts claiming that banks were dead, or at least zombies: Consumers want to be able to do all their banking on the Internet, so the story went, and therefore whoever comes up with the "killer app" is going to win all the business -- and that could be Microsoft or Google just as well as it could be a major bank. Maybe there will prove to be truth to that. So far, it has been even less true than might have been expected, but online commerce continues to grow at a very rapid pace. So perhaps more changes of this kind are on the way.

Jeffry Frieden, Professor of government, Harvard University

I would just echo that. First of all, the regulatory reforms or initiatives are not only about banks and in fact they are not even only about banking. They are about financial services generally. I would be loathe to project what finance is going to look like 20 years from now, but they cover things like derivatives trading, exchange trading and so forth. I think that is the wave of the future to some extent. A lot of the future is on exchange trading and on markets and I think the regulators are aware of that.

There were questions about the political economy. On Dodd-Frank, first of all, John says the jury is still out. I would say the crime is still being committed. Dodd-Frank, like all regulation attempting to reform an entire sector or regulatory structure, is all in the implementation and that is actually where a lot of the political comes in. Simon Johnson and his predecessor, Raghuram Rajan, have been very clear about this, which is that the problem from a political economy standpoint is really that the only people who care about the micro details of regulatory implementation are the banks and the institutions that are being subjected to these regulations.

In some areas you have consumers who lobby. In trade policy, for example, if you try to impose tariffs the users of steel, such as the big auto companies, will lobby against that. When you are talking about consumer finance or anything that is very dispersed there is not a lot on the other side. Legislators are more aware of the risks of financial crisis now, not surprisingly, than they were five years ago. Barney Frank was my congressman, for example, but there are others who are alert to these issues. I do think that there is a risk that to some extent the implementation of Dodd-Frank will be – I hesitate to say hijacked – but will be unduly influenced by the financial institutions themselves in ways which will dilute some of its effects. That is always a risk with regulation. That is the political economy of anything.

On the first question about the international front, there is a similar story here as well, which is that the international politics of harmonisation is that typically everyone can agree that harmonisation is a good thing but no one agrees where the harmonisation should take place. You can say we should have common capital adequacy standards, but everyone wants the common standard to be their own standard so they do not have to do any adjusting. The compliant typically comes from firms being asked to do more adjusting and, not surprisingly, as was also the case in Basel I and Basel II, the Anglo-American firms have had a little bit more influence and therefore they have been doing less adjusting, despite Jamie Dimon's claim that Basel III was anti-American, than some of the European firms. However, I do not think that is because it is ineffective. I think that is because any harmonisation is going to require adjustments by the various parties. If you believe that harmonisation is a good thing then you have to recognise that some are going to be hurt more than others by harmonisation. If you want to avoid that then do not harmonise.

Jean-Claude Trichet, former President, ECB

We should also add in this regard that it is a game which is more complex because you also have the market. The Basel rules allow a staggering of the capital requirements in order to permit the global economy to be financed as much as possible in the recovery period, but the markets are not waiting. They are not used to waiting and they immediately asked to have the level of capital requirements at the global level which was only supposed to culminate in 2018/2019. Again, when there is anxiety in the market it will always ask for more. It is what we have observed. It also perhaps explains part of the complaints that some of us have heard.

Benoît Coeuré, Member of the Executive Board, ECB

Very shortly on harmonisation, I certainly acknowledge that there are enormous political economy challenges to having something closer to a global regulation. Because we do not have a global government we are not going to have it. Nevertheless, I see grounds for hope in one new aspect, which is that there is now an international agreement that taxpayers will come last when we wind up banks. These rules are being implemented in various ways throughout the world under the aegis of the Financial Stability Board. That is reason for hope because the biggest hurdle for harmonisation has been that whenever taxpayer money is involved finance ministers talk first to their parliaments, and rightly so. That is absolutely what they have to do and what they should do. If you have an agreement that taxpayers will come last then it will become a bit easier to coordinate bank supervision and maybe even to coordinate when you wind up a large cross-border institution.

Jean-Claude Trichet, former President, ECB

Jeff and John were both very clear that resolution was one of the most important things. Let me add to what you have just said, Benoît. The problem of distinguishing the difference between a going concern and a gone concern also causes me some anxiety because it is of course perfect to put taxpayers last if you have a gone concern. You liquidate the bank in that case and you make the private sector pay what is needed. It might nevertheless be necessary for the taxpayer to be somewhat involved to avoid systemic contagion, but that should be very modest involvement. However, if you have a going concern, such as a bank which is in difficulty but is can continue working, to say that the taxpayer comes last might mean that all of the creditors will have to pay a price, perhaps a big one, and then the bank's credit might be totally destroyed. I would therefore prefer by far in such cases to have a lot of bailing in ex-ante with a lot of the new instruments that now appear to be perfectly workable, but I feel a little bit uneasy.

Jeffry Frieden, Professor of government, Harvard University

Again, as is so often the case, this is really a political economy issue. Once you establish the principle that the taxpayer comes last then of course the regulators and the institutions themselves have every incentive to declare that every financial institution in trouble is illiquid but not insolvent and to exercise regulatory forbearance and all sorts of mechanisms to avoid going to the taxpayer, and that can get you down an ever deeper hole.

Jean-Claude Trichet, former President, ECB

The discussion between the speakers is excellent, but I have to make sure that all of your questions are answered. Do we have any other questions?

From the floor

This is not necessarily an issue on the international scene, but it is a pretty large issue in the United States. There is a possible student loan crisis or bubble. How do you see that unfolding if it were to happen?

From the floor

I have one question that goes back to capital requirements. Could you elaborate a little bit on the capital charge for government bonds and your opinion on that? Secondly, on the Basel III rules, do you not think at some point that we have gone too far in creating so-called 'shadow banking'? For examples, it is proposed to have insurance companies invest in some risk, which used to be held by banks. What do you think about that?

From the floor

Do you think the Volcker Rule will lead to a better market or do you think the market will remain the same as it is now and do you think it will make banks more risk-adverse or risk-taking in terms of opening the credit market up?

From the floor

I just wanted to say that we did not have an answer to the young gentleman's question, which was very interesting, about the personal responsibility of the CEOs whose actions led to this situation. Thank you.

From the floor

Basically would it be efficient and just to send more people to jail if they fail?

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

I would like to say a few things on this topic. First, regarding Dodd-Frank and the industry trying to influence it, I think, again, the devil of the legislation is in the details, including regulations that have not yet been written and applied. We will see what really happens, but I think it is safe to say that it has added a lot of complexity and a lot of uncertainty in areas that are not clearly central to the goal of making the system work better. We understand why that has happened, but nonetheless, that is where we are.

The issue of possible student loan bubbles is intriguing. I do not know if everybody is familiar with the situation in the United States. It has been very easy to get federally-guaranteed student loans to attend university. At the same time, university education has become extremely costly, as tuition has increased by a multiple of the general inflation rate for many years. It makes one wonder whether that rapid price hike has been encouraged by public policy that made it very easy for students to get themselves deep in debt to pay for rapidly-increasing tuitions. I don't have an answer for this, but there certainly has been a tendency recently for students to find out that the increase in their earning power has not been commensurate with the debts they have accumulated in order to finance their education. There is a similarity of this situation to the subprime crisis: Many borrowers got themselves in over their heads financially. This creates moral hazard problems, but at least hopefully the universities, who have very happily kept raising tuition, will help to come up with policy solutions, along with ways to avoid future problems.

On zero weighting, it seems to me that this is an area where transparency is more effective than officialdom arbitrarily trying to differentiate the risk weighting for different sovereigns, but we will see. That idea will get tested in the upcoming European stress test because if you get this combination of zero weighting in the stress test but total transparency in terms of holdings it will be very interesting to see from the market reaction if that is an effective way to deal with this challenge.

Benoît Coeuré, Member of the Executive Board, ECB

In any case, total transparency is necessary. It is a demand of the market. It is necessary.

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

I agree. That is exactly right.

Benoît Coeuré, Member of the Executive Board, ECB

We will, however, have the second session on banking union, which may give me an opportunity to elaborate further on sovereign exposures.

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

Yes. Regarding personal liability, I find this whole business a bit puzzling. If someone has broken a law and committed fraud then they should be criminally liable. If they have been guilty of bad judgement and made mistakes in circumstances in which no criminal intent is indicated, I am not clear what issue of criminal law is at stake. I am not a lawyer and I am not an expert in this matter. I suppose that the concept of criminal negligence could be relevant. Where you draw the line on criminality, I do not know, but it seems obvious that many people have concluded that bankers got away with doing terrible things and somebody should have gone to jail. This sounds more like an issue for political science, so over to you, Jeffrey.

Jeffry Frieden, Professor of government, Harvard University

I am glad that sounds like political science to you. The student loan bubble is reminiscent of the subprime bubble in the sense that just as mortgages were a way for banks to speculate on housing, student loans are a way for banks to speculate on government loan policy. It does have a lot of that flavour. I think it will eventually require substantial government bailouts in one form or another, either of the students or of the financial institutions.

On personal responsibility, one thing to note is that American banks have been hit with extraordinarily large fines, much, much larger than anything that has been assessed in Europe. Whether that is sufficient to exercise any subsequent discipline or to have a deterrent effect I do not know, and I agree with John that personal liability should apply where the law has been broken. The one area where I think it would be in the interest of the firms to actually act is if they could demonstrate actions by individual loan officers or others that were irresponsible, if not illegal, and try to claw back some of the earnings themselves.

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

That has happened, and clawbacks have been applied.

Jeffry Frieden, Professor of government, Harvard University

That has happened in some cases. It may not have happened enough and it is typically not in the interests of the firms to publicise that. There was a question about Basel III and shadow banking. I am not sure I quite understood the import of the question, but I think the general view in the US, a view I agree with, is that there is not a problem with the shadow banking system as a system. There is not a problem with the instruments themselves, but there is a problem with the capital requirements associated with the institutions that are ultimately responsible for those operations. The problem that emerged in 2007/2008 was that you had essentially, although this is exaggerating a little bit, virtually nothing held in reserve against some very, very substantial liabilities. That is something that I believe is being addressed. I do not think therefore that the problem is the shadow banking itself. It is a problem of how the shadow banking system is integrated into the broader financial system in a way which does not lead to regulatory arbitrage that leaves the taxpayers exposed again.

On the Volcker Rule, I think the general consensus is that the Volcker Rule, no matter how it is interpreted – and no one really knows how it is going to be interpreted because the definition of proprietary trading is very ambiguous – is unlikely to have a substantial impact on financial operations. It may affect some institutions. It may affect the character of some trading, but it will not be a major factor.

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

Just to clarify what I said about the Volcker Rule earlier, in addition to the point that we will find out more when we see the final instrument: One expert has stated, the Volcker Rule is a concept but not a policy. In other words, there are many ways that it could be applied. We can all agree on the idea that publicly-guaranteed firms should not engage in proprietary trading. The question remains, however, of defining proprietary trading.

The point that I think is often underemphasized, that I mentioned earlier, is that a financial institution -- especially a large financial institution -- will create a market risk profile that will be somewhat random because of the timing of deals closing and so forth. This aspect is just not susceptible to control on a day to day basis. However, market risk exposure is susceptible to measurement.

It therefore is possible for an institution to have a very good idea of its market risk at any particular point in time. It seems to me it would be irresponsible for the management of such an institution to say, 'Our market risk profile is a result of whatever business happens and we are not going to try to modify it.' A common response to this is, 'Well, you mean hedging.' But this isn't quite right, either. The idea isn't to neutralize all market risk. The goal is to create a market risk profile that seems to be more appropriate than an essentially semi-random result of operations. Thus, both the principle underlying the Volcker Rule and the notion that market risk needs to be managed seem reasonable. So the challenge is to write regulations that allow management to be prudent without transgressing some reasonable limits.

Jean-Claude Trichet, former President, ECB

Thank you very much indeed. I would say we are both at a conceptual and philosophical level and a highly technical level, which of course is the interest of such an issue. As regards the Volcker Rule, the main problem I saw when discussing it with banks was that they would say that proprietary trading is okay. There is no problem there. However, what about market-making for our clients when we have commercial clients? It seems to me that the last crystallisation of the Volcker Rule in the US considers that market-making could be permitted for commercial banks, and I understand that is more or less what has been done in France, which is the first country to apply these rules because Liikanen, Volcker and Vickers have not yet been applied, but the French are very pumped up in issuing laws, so we have a law and the law says that market-making might be possible, and it has been criticised precisely for that, but I think it is common sense.

Regarding the last point on the banks, I totally share the views expressed. Either it is criminal according to the law or it is extremely poor management with an extremely bad risk culture creating problems for society as a whole. These are two different things. Normally in the second case where there is an impact on society as a whole you lose your job and you lose a lot of money, because the shareholders lose a lot of money so you are punished in your own personal wealth, and often highly punished. I think this is the right way to go about it. If you have committed a criminal act you go to jail, full stop, and there are people who are in jail. I would guard against scapegoating.

If you scapegoat the banks – and clearly the commercial banks have been scapegoated, if I may – then what about the non-banks? They have enormous responsibility for what has happened. What about pure speculation, such as hedge funds and so forth? They of course accelerated the crisis in some cases and are partly responsible for the bubble. What about the rating agencies that were creating a false sentiment of tranquillity? One can go on. You see that the problem we have is the total absence of resilience in an entire system. It is the entire system that proved to be extraordinarily fragile and it is the entire system that we have to make much more resilient and we are discussing how to do that, which goes further than what we have already said because you also have the accounting rules that are part of the procyclicality of the system and the rating agencies and so forth. Let us avoid scapegoating therefore because you would be scapegoating one part of the system and de-scalping the others, which should not be done. The responsibility is very widely shared. However, I think we had a very good interaction.

From the floor

I want to ask a question about the dependence on rules as opposed to thinking about principles. When we did corporate governance, for example, we looked at principles and the rules flow from the principles. We will always find lawyers – and I was a tax lawyer – who try to get out of the rules. If there is a rule that is what we spend our time doing. Finally, at least in Canada, the frustration of the government was that we have to go beyond that. We have to start looking at intention. In the cases, for example, that we are talking about there are several examples that come to mind where the principle of transparency was obviously set aside, as it was at Lehman Brothers and as it was in the doctoring of the national accounts in Greece. Had a principle been applied instead of the rules, the rules being simply examples of the principle, then that could not have happened. Some would say, 'Yes, you know what you were doing.' In other words, we are talking about criminality there because you really do have a strict application, but here it seems to me that we have got away from principles and we are becoming too dependent on rules. Dodd-Frank and Sarbanes-Oxley are examples of that. This will go on forever, but if you basically adopt something based on principles – principles of transparency, judicial principles and so on – I hope that we can simplify the system and make it more effective.

Jean-Claude Trichet, former President, ECB

This conversation about a rules-based system and a principle-based system is very, very stimulating, particularly because it opposes the UK and the US. Thank you.