
Event Report

Why Was the Financial Crisis Less Enduring in Japan and Other Countries...This Time Around?

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On December 4, 2009, the Center on Japanese Economy and Business and the Sanford C. Bernstein & Co. Center for Leadership and Ethics at Columbia Business School co-hosted the panel “Why Was the Financial Crisis Less Enduring in Japan and Other Countries...This Time Around?” Moderated by Ronald Gilson, the Marc and Eva Stern Professor of Law and Business at Columbia Law School, the panel featured Takatoshi Ito, visiting professor at Columbia University and professor of economics at the University of Tokyo; Floyd Norris, chief financial correspondent of The New York Times; Jacques Longeraey, executive vice president and chief risk officer at State Street Global Advisors; and Thierry Porte, operating partner at J.C. Flowers & Co., LLC, and former president and CEO of Shinsei Bank, Limited.

While American and European financial institutions have suffered considerably from the recent financial crisis, the largest banking groups in Japan have successfully endured. Professor Takatoshi Ito highlights two diverging hypotheses that justify such an outcome: (1) Japan was so advanced that it was able to avoid risk, or (2) Japan was so backward that it avoided risk. Thierry Porte of J.C. Flowers states that Japan has actually exhibited traits of being both ahead of and behind the curve. For instance, Japan was the first major country to adopt the Basel II Accord, which established an international standard for rigorous risk and capital management requirements. However, Japan has not been a major innovator in the trading of financial assets.

Mr. Porte attributes Japan’s relative success to the fact that the trauma of Japan’s previous banking crisis was still fresh in the minds of its people. From the mid-1990s to around 2003, Japan’s financial sector scaled back international activities and carefully managed risk. This was

a stark contrast to the preceding period of the 1980s through the early 1990s, when “Japanese banks participated in every global financial extravaganza,” including the rise of junk bonds and derivative instruments. Interestingly, the Norinchukin Bank did not share the history of trauma experienced by its peers during Japan’s Lost Decade. Following that period, the bank used its liquidity to amass a sizeable portfolio of risky alternative investments while the rest of the industry became increasingly conservative. The Norinchukin Bank subsequently assumed large financial losses in 2008, demonstrating the consequences for those few institutions that did not appreciate lessons learned from the Lost Decade. As it turns out, the placement of large numbers of executives with first-hand experience in banking crises was key to the country’s relative success.

Mr. Porte also underscores the increased transparency measures undertaken in the wake of its previous crisis as a differentiating factor. Japan undertook major reforms, including the establishment of the Financial Services Agency in 1998. In the early 1990s, standards regarding nonperforming loan disclosure were quite lax. A decade later, Japan had implemented a significant set of disclosure rules coupled with a robust inspection system.

In rationalizing why the U.S. was among the hardest hit by the recent financial crisis, Jacques Longerstaey of State Street Global Advisors highlights the transition from an issuer/holder model to a financial-market-intermediary model in the U.S. In recent times, a large number of U.S. banks became underwriters and lost their sense of fiduciary responsibility. This behavior was supported by a regulatory regime of weak underwriting standards. Floyd Norris of *The New York Times* adds that the property bubble in the United States undoubtedly exacerbated the recent crisis.

Mr. Norris shares other lessons learned from countries that fared relatively well in the recent financial crisis. Quite simply, countries with better regulation were better able to ride out the storm. Canada and Spain, for example, performed relatively well because their regulators were significantly more stringent than those of the United States, and the countries aggressively pushed for the accumulation of capital in good times. Another lesson is that allowing the overall financial sector and its accumulated debt to become excessive exposes a country to meaningful risk. For instance, before the three largest banks in Iceland crashed, their combined debt was more than six times the nation’s gross domestic product. Finally, international openness translated to risk vulnerability. Although Germany’s property bubble was less severe than that of the United States, German banks bought U.S. toxic assets and exposed themselves to the ensuing losses.

Japan’s banking sector is by no means out of the woods. After all, these banks did experience meaningful losses and must now build equity capital. Nonetheless, as the panelists assert, the recent memory of Japan’s banking crisis and its subsequent financial regulation reform have enabled Japan’s banking sector to emerge in a better position than its American and European counterparts. Strong underwriting standards and a heightened sense of fiduciary responsibility are crucial to avoid repeating the mistakes of the past. Furthermore, the role of better financial sector regulation and risk management, particularly in open economies, cannot be emphasized enough in helping to stave off future crises.

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