The Sixth International Conference
A Perspective of Asian Financial Sector under the Global Financial Crisis

(Summary of the Conference)

The direct impact of the subprime loan crisis on financial institutions was relatively small in Asian countries, including Japan, in comparison to the United States and Europe. In this conference held at the Financial Services Agency of Japan on January 21, 2010, it examined the ongoing discussion of policies and measures undertaken in the United States and Europe, and reviewed the state of the Asian financial sector in relation to such policy discussions. In the final panel discussion, policies taken in the Asian region were summarized, and panelists discussed and emphasized the need for regional cooperation to enhance Asian financial markets and the financial system, as well as the need for ensuring smooth financing for small and medium-sized enterprises (SMEs) given the importance of not only large companies but also SMEs in the Asian region.

Session 1 of the conference looked at the effects of the global financial crisis on Asia and the current situation of the Asian financial system. In the Asian region, the financial sector were relatively robust in comparison to those in the United States and Europe, although Asian countries were affected in terms of the economy as they encountered huge declines in exports to the United States and Europe. The Shortage of the U.S. dollar created liquidity problems to some Asian financial institutions. However, the international cooperation among the Federal Reserve and central banks of major countries successfully mitigated the impact in a very short period by establishing temporary reciprocal currency arrangements (central bank liquidity swap lines).

Asian financial crisis of 1997 led Asian financial regulators to develop many banking resolution measures, such as re-capitalization of banks, improvements in financial supervision, establishment of bankruptcy laws and deposit insurance schemes, all of which softened the impact of the current subprime loan crisis to the Asian economy. In 1997, sudden inflows of capital into Thailand, Indonesia, Korea and other Asian countries were followed by massive outflows of capital from the

region, and caused wide fluctuations of exchange rates, credit crunch, and a surge in interest rates. The economy was severely affected as firms were unable to borrow money for transactions and faced with the shortage of capital.
In the current global crisis however, Asia has been less vulnerable compared to the financial crisis of 1997 as many Asian countries had accumulated foreign reserves and maintained high savings ratio. Furthermore, financial markets in Asia are still dominated by banks and given that they are less sophisticated compared with U.S. and European financial institutions, exposures to securitized financial products had been small, which kept the Asian financial sector relatively undisturbed.

The fact that the Asian financial sector was less affected does not necessarily mean that there is no room for improvement in Asian financial regulation and supervision. Rather, the impact was small because bond markets and securitized markets in Asia have been less developed compared with U.S. and European markets. In Asia as a whole therefore, it would be necessary to build stable financial markets and the financial system and to discuss the future of the financial supervision to cope with unexpected turmoil.

Financial markets and the financial system in Asia are different from those in the United States and Europe. They can be characterized as follows. First, banks account for a large part of financial activities in the markets (i.e., bank-dominated financial system), securitized financial products are not developed and bond markets are still thin. Especially the secondary market of various financial products is not yet functioning well, thus incentives for holding Asian financial products are low as they cannot be traded smoothly. Second, there are still strong connections between firms and financial institutions. Corporate groups are often established among firms and financial institutions, and therefore connected lending is not unusual. And third, public-sector banks and publicly-owned firms still account for a substantial share of economic activity in such countries as China, Indonesia and Vietnam. Hence, there are cases where market mechanism is not working in financing activities involving such institutions.
Due to these characteristics, the allocation of resources and allocation of financial assets are not efficiently conducted in Asia. On the part of regulators too, they often place more importance on collateral values rather than the market value of

bank loans. It is desirable that improvement in bank supervision and bank regulations are made.

Following the current financial crisis, the Basel Committee on Banking Supervision and G-20 countries are working toward improvement in bank supervision. Discussions at the global forums were reported, explaining measures considered in the following issues: (i) strengthening the resilience of the banking sector; (ii) introduction of a leverage ratio; (iii) strengthening the risk coverage by, for example, putting higher risk weights for re-securitized products; (iv) mitigation of pro-cyclicality; (v) introduction of regulatory standards for liquidity; and (vi) strengthening capital requirements to improve the quality of bank capital.

Before the global financial crisis, it was understood that if each financial institution were sound, then the financial system as a whole would be sound. Financial regulators focused on the safety and soundness of each financial institution, namely, the micro-prudential policies. The crisis, however, showed that micro-prudential policies alone were not adequate. There is now a consensus among financial regulators that macro-prudential policies are necessary. Participants in Session 2 discussed and explained the concept of micro-prudential policies and macro-prudential policies. The objective of micro-prudential policies is to ensure the safety and soundness of each individual institution and that of macro-prudential policies is to stabilize financial system as a whole. Micro-prudential policies are closely connected with the preparedness of other policies such as a deposit insurance scheme, a bridge banking system in the event of bank liquidation, bank closure policies, injection of public money, and capital requirements. Micro-prudential policies aim to ensure protection of investors (and consumers) such as bond investors, insurance holders, pension claimers, depositors.

Macro-prudential policies aim to mitigate systemic risk. Systemic risk has two dimensions, namely time dimension (i.e., pro-cyclicality) and cross-sectional dimension (i.e., micro-systemic risk). Since risk management by the private sector alone may, in some cases, have macro-systemic externalities, it is appropriate to regulate individual financial institutions.

While discussions at the global forums suggested the move toward extending the

coverage of regulation, there was a cautious view about strengthening and expanding regulation, describing the situation as "a regulatory tsunami." This was because the global financial crisis started in the United Kingdom where, according to the IMF's Global Financial Stability Report published in March 2003, the financial institutions were highly developed and the financial markets sophisticated, supported by a financial stability policy framework.

The role of monetary policy is also important for the stability of the financial system. This is because excessive liquidity (i.e., a significant increase in the money stock) has been one of the factors behind the subprime loan problem.
Central banks play a "lender of last resort" function. They can provide liquidity to individual banks experiencing liquidity shortage and maturity mismatch. The provision of ample liquidity by central banks to financial markets also restores the stability of the overall financial system.
Since financial institutions are interconnected, a shock such as a failure of one financial institution can, if the size of such an institution is very large, lead to systemic risk in the entire financial market. Such financial institutions are described as systemically important financial institutions (SIFIs). From Japanese experience, however, it is not so easy to define whether one financial institution is systematically important or not, since environment surrounding the financial sector changes from time to time.

In Session 3, participants discussed lessons Asian countries have learnt from the global financial crisis and identified further challenges for the Asian financial sector. They are the following: (i) deepen understanding of expected risks associated with each financial product and financial activities by financial institutions, corporations, and investors including households; (ii) review the role of unified financial regulators and supervisors which monitor overall financial activities including banks, insurance companies, investment banks, and securities companies; (iii) strengthen prudential regulation and inspection of each individual financial institution to prevent spill over of individual risk to market-wide macro instability; (iv) strengthen ex-post policy responses toward problem financial institutions, such as guarantee of deposits through the deposit insurance scheme, injection of public funds and government support to maintain capital adequacy;

and (v) further promote Asian regional financial cooperation such as the Chiang Mai Initiative (CMI) and Asian Financial Stability Forum.

In the final panel discussion, the important role of SMEs in the Asian region were discussed which are somewhat different from those in the United States and the United Kingdom. SMEs are always the first one to suffer whenever a crisis hits countries in Asia. Singapore has introduced a credit guarantee system for SMEs that borrow from banks, and other countries provide interest rate subsidy to SMEs in emergency situation. Based on the current experience, the short-term and long-term policies toward SMEs in Asian region need to be analyzed further and the micro-credit mechanism must be adequately provided.

In this international conference, discussion and analysis on how the subprime loan crisis influenced the Asian region was made and the micro- and macro-financial aspects of the policies considered by the Basel Committee, G-20 and IMF were examined. The conference revealed that the effects of the global financial crisis on Asia were different from those on the United States and Europe. Given that SMEs account for a large part of economic activity in Asia, challenges specific to Asia were identified such as improvement in SME financing and development of broader and deeper financial markets. It was also pointed out that a micro-credit mechanism is an issue that needs to be discussed further in depth in Asia in relation to SME financing.
Collection of data on SMEs will reduce information asymmetry in SME lending and would reduce non-performing loans (NPLs) on the part of lenders. Japan's experience on building SME data base and carrying analysis of such data could be provided to other Asian countries to reduce NPLs. Furthermore, it would be desirable that Japanese regulators communicate their experiences in the 1990s on bank resolution measures and public fund injection given that such information would offer useful and valuable lessons to U.S. and European financial regulators.