An Asian Perspective on Global Financial Reform

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Outline

1. Lessons from the GFC for financial regulation
2. Major global and regional regulatory initiatives and possible Asia impacts
3. Studies of impacts of Basel III
4. Our empirical estimates
5. Messages and implications

1. Lessons from the Global Financial Crisis for financial regulation

Four claimed policy mistakes behind the global financial crisis (GFC)

(1) Failure of macroeconomic policy, particularly monetary policy, to contain the buildup of financial vulnerabilities and systemic risk

(2) Flaws in financial regulation and supervision:

- Inadequacy of macroprudential approach
- Shadow banking, outside of regulatory perimeter
- “Too-big-to-fail” problems
- Insufficient capital adequacy and liquidity standards
- Inadequate transparency on derivative products
- Procyclicality

GFC-related policy mistakes/problems

(3) Weak global financial architecture

- IMF and FSF unable to forcefully identify risks and issue strong warnings

(4) Global payments imbalance

- The arguments by Greenspan (“conundrum”) and Bernanke (“savings glut”) suggest that East Asia supplied ample liquidity to the US and kept the US long-term interest rate too low

- However, we believe the importance of the fourth cause is less:
  - The current account deficit was concentrated in the US while there were many surplus countries
  - The financial crisis concentrated in the US & Europe
  - Not all countries had housing bubbles or crises (eg, Australia and Canada managed well)

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Post-GFC crisis/turbulence in US and Europe

- Zero-interest rate policy and quantitative easing (QE) by the US Fed
- Sovereign debt problem (US) and sovereign debt & banking crisis (eurozone)
  - US government lost AAA-rating
  - Europe: Ongoing debt crises in Greece, Ireland, Italy, Portugal and Spain, affecting the European banking system
  - Growth likely to remain sluggish in coming years
  - QE3 in the US
- Implications for Asia—trade and financial channels
  - Export weakness to US and Europe highlights importance of rebalancing growth toward domestic and regional demand
  - Continued low interest rates, the debt problem and sluggish growth in the US and the sovereign debt & banking crisis in Europe point to the need to maintain financial stability through defenses against large-scale and volatile capital flows

Asian Financial Systems

Asian strengths

- Asian financial systems relatively unscathed from the GFC and the ongoing Eurozone crisis, reflecting sound balance sheets, prudent risk management, and modest exposure to toxic assets
- Asia already has sizable non-banking financial firms
- Large foreign exchange reserves provided a cushion against volatile capital flows in most cases
- Asian regulatory frameworks were more “conservative,” with less regulatory capture and less ideology about virtues of free financial markets
- Asian regulators already had many macroprudential policies (administrative guidance to limit bank-credit growth, real estate loan caps, etc) and willingness to use them

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Asian Financial Systems

Asian weaknesses

- Asian financial systems still relatively bank-dominant, with smaller bond markets and modest role for securitization, derivative products, etc.
- Low degrees of regional financial integration in portfolio investment, still depends on London/NY
- Limited regulatory capacity to address procyclicality, exposure to activities of large global financial firms, growing non-bank financial activities, and rising financial complexity over time
- Shortfalls in governance, accounting standards, etc.
- Vulnerable to volatile capital flows and "double mismatches"

Development of Asian corporate sector funding

% of GDP	Private credit by deposit money banks			Stock market capitalization			Private bond market capitalization			Total		
	1990	2000	2010	1990	2000	2010	1990	2000	2010	1990	2000	2010
PRC	74.3	106.4	120.0	--	48.5	81.0	2.9	7.0	21.3	77.3	161.9	222.4
Hong Kong	--	150.9	168.1	108.5	368.6	1207.9	0.2	17.2	14.4	108.7	536.7	1390.4
India	24.2	26.4	49.7	12.2	32.2	93.5	0.3	0.5	5.7	36.6	59.1	148.8
Indonesia	38.1	17.8	24.1	7.1	16.3	51.0	--	1.4	1.5	45.1	35.5	76.6
Japan	168.2	195.3	102.8	95.5	67.6	74.6	39.8	47.4	36.3	303.4	310.4	213.6
Korea	47.2	69.7	98.4	42.1	32.2	107.4	28.3	51.5	63.0	117.5	153.4	268.7
Malaysia	77.0	123.1	109.3	110.4	124.7	172.6	18.8	32.9	43.5	206.2	280.7	325.4
Philippines	17.0	38.2	29.4	13.4	32.0	78.8	--	0.2	1.1	30.4	70.5	109.3
Singapore	78.2	96.7	96.1	93.1	164.8	166.2	14.6	16.9	11.4	185.9	278.5	273.7
Taipei,China	--	116.5	124.5	60.5	80.4	175.0	14.7	24.4	21.8	75.2	221.3	321.4
Thailand	72.3	116.3	91.7	28.0	24.0	87.1	6.5	11.8	17.9	106.8	152.0	196.7
Viet Nam	--	30.4	109.7	--	--	19.7	--	--	--	--	30.4	129.3

Sources: IFS Dec 2011 CD, CEIC Data Company, BIS Quarterly Review June 2011, WDI.

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2. Major global and regional regulatory initiatives and possible Asia impacts

- G20 guidelines (Basel III and related)
- Dodd-Frank legislation in US
- Vickers Report in UK
- Recent European Union measures
- All essentially based on experience of North Atlantic countries
- Not necessarily directly relevant to experience of Asian economies
- Making financial regulation consistent with promotion of economic growth and financial development remains an important goal in Asia

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G20 and Basel III

- G20 issues already finalized
  - Requirements for greater quantity and quality of capital
  - Liquidity requirements
  - Leverage ratio
  - Standards for OTC derivatives markets
  - Identification, surveillance, regulation and resolution of systemically important financial institutions (SIFIs), especially global ones (G-SIFIs)
- G20 issues expected to be finalized soon
  - Strengthened oversight of shadow banking
  - Compensation and credit rating agencies
  - Development of macroprudential frameworks and tools
  - Convergence to strengthened international accounting standards
  - Strengthened adherence to international supervisory and regulatory standards

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Basel III Capital Requirements Schedule

Phase-in arrangements (shading indicates transition periods) (all dates are as of 1 January)

	2013	2014	2015	2016	2017	2018	2019
Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conversation Buffer				0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.750%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)		20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer	8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital Instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital	Phased out over 10 year horizon beginning 2013						

Source: BCBS (2010)

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Potential problems with Basel III capital requirements

- Higher capital ratios may restrict growth of lending and economic output
- Trade finance: 100% credit conversion factor (CCF) applied to off-balance sheet items (including trade finance exposures) for Basel III leverage ratio purposes will increase the cost and reduce the demand for trade finance
- Credit-to-GDP guide for activating the Basel III countercyclical capital buffer may be too mechanistic for EMEs
- Constraints on ability to issue convertible bonds in EMEs
- Triggers for debt-to-equity conversions may differ between home and host country

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Basel III Leverage and Liquidity Requirements Schedule

Phase-in arrangements (shading indicates transition periods) (all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 - 1 Jan 2017					Migration to Pillar 1
Liquidity coverage ratio	Observation period begins				Introduce minimum standard			
Net stable funding ratio		Observation period begins						Introduce minimum standard

Source: BCBS (2010)

Recent developments:
Liquidity Coverage Ratio (LCR) has been revised to ease impact by widening HQLA (high quality liquidity assets) to include certain equities and securitisation products: more tradable assets included (Jan. 2013)

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Potential problems with Basel III liquidity requirements

- Scarcity of high quality liquid assets (HQLA) in EMEs may inhibit local capital raising and constrain liquidity in local markets
- Liquidity ratios may constrain bank lending in economies where bank lending is the main source of credit
- Calculation of required ratio can be complex

Other Basel III Requirements

- Policy measures for G-SIFIs
  - May constrain lending in host countries
  - Concerns about cross-border resolution frameworks
- OTC derivatives market: additional capital requirements and margin requirements for uncleared derivatives:
  - fx swaps related to for. curr. bond issuance and trade finance
  - mandatory two-way initial margin on a gross basis
  - Domestic CCPs may be put at disadvantage
- Shadow Banking: Securities lending and repos
  - Minimum haircuts
  - Cash collateral reinvestment
  - Requirement on re-hypothecation
  - Minimum regulatory standards for collateral valuation and management

Other non-Basel requirements

- US Dodd-Frank legislation
  - "Volcker" Rule (41)
    - Possible impacts liquidity of government, corporate securities and derivatives markets in other countries that may hinder bank liquidity and financial market development
    - Related regulatory requirements
  - CFTC requirement that OTC derivatives be traded on electronic trading platforms and that dealers of such 'swaps' be regulated
    - Would subject non-US entities to double regulation
    - Mandatory two-way initial margin on a gross basis
  - Minimum regulatory standards for collateral valuation and management
- Europe financial transactions tax (FTT)

Implications for emerging Asian economies

- Need to avoid the “one size fits all” approach
  - Most Asian banks can meet more stringent capital, liquidity, and leverage requirements under Basel III
  - But regulations to address weaknesses in Western banks should not be applied to Asia, as complex derivatives products are less developed in the region and many Asian banks have large retail funding bases
  - Asian regulators need to review macroprudential policy best practices
- Need to strengthen regulatory capacity
  - Data requirements for Basel III implementation may impose considerable burden on some economies
- Need for global and regional cooperation on global and regional SIFIs

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5. Messages and Implications

- Reforms of Asian financial systems since the Asian financial crisis served them well during the GFC & EZFC
- Basel III and related reforms were designed from the perspective of the experience of developed economies during the global financial crisis, and are not necessarily applicable to EMEs
- The need for tighter financial regulation and supervision must be balanced with needs for financial development, deepening and integration as well as financial inclusion, to support sustainable growth in the region

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Thank you
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