

Deepening Asia's Financial System

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Financial regulation & reform

- Lessons from the global crisis for Asia
- Progress in financial deepening and integration
- Preventing crises
- Crisis management/resolution
- Deepening and strengthening regional bond markets
- Conclusions and areas for regional cooperation

Lessons from GFC: Innovation, complexity and role of global firms

- **National level problems**

- Excessive leverage
- Inadequate capital, especially systemically important FIs
- Gaps in regulatory oversight and coordination
- Lack of understanding of system-wide risks
- Excessive reliance on self-regulation (moral hazard)
- Excessive reliance on credit ratings for capital requirements
- Lack of understanding of risks involved in innovative financial products
- Procyclicality of regulation
- Lack of comprehensive framework to deal with complex, systemically critical institutions—moral hazard and the issue of “too big to fail” or “too interconnected to fail”

Lessons from GFC: Innovation, complexity and role of global firms (2)

- **Global level problems**

- Inadequate macroprudential supervision/regulation
- Inadequate framework for surveillance, regulation and resolution of large and complex international financial institutions
 - Issue of home regulator vs. host regulator

- **Implications for Asia**

- Financial development brings new risks
- Need for macroprudential supervision/regulation
- Unfinished work in developing capital markets
- Increased regional cooperation can contribute

Progress in financial deepening

Measures of Financial Sector Size

Ratio to GDP	Median ratio by income class 2007				Asia ex Japan*	
	High	Upper	Lower	Low	2000	2008
		Middle	Middle			
Central bank assets	0.01	0.01	0.04	0.02	0.06	0.03
Bank deposits	0.87	0.43	0.39	0.20	0.92	1.15
Deposit money bank assets	1.14	0.55	0.31	0.15	0.97	1.06
Liquid liabilities	0.90	0.45	0.43	0.27	1.06	1.35
Private credit by deposit money banks	1.01	0.47	0.31	0.14	0.82	0.84
Stock market capitalization	1.05	0.42	0.30	0.26	1.04	1.11
Private bond market capitalization	0.36	0.16	0.03	0.00	0.16	0.19

Beck and Demirguc-Kunt (2009) and ADBI estimates.

*Simple average

Progress in financial efficiency and integration

Measures of Financial Sector Efficiency and Integration

	Median ratio by income class 2007				Asia ex Japan*	
	Upper		Lower		2001	2008
	High	Middle	Middle	Low		
Net interest margin	0.06	0.06	0.06	0.02	0.03	0.03
Cost to income ratio	0.60	0.58	0.57	0.50	0.62	0.51
Loan to deposit ratio	1.00	0.80	0.85	0.60	0.84	0.75
Return on assets (%)	1.5	1.9	1.6	2.0	0.2	0.9
Return on equity (%)	16.0	15.0	15.0	21.0	4.7	10.7
International bonds/GDP	0.41	0.19	0.07	0.03	0.11	0.11

Source: Beck and Demirguc-Kunt (2009) and Bankscope database.

*Simple average.

Progress in financial stability and governance

Measures of financial stability and governance

	1998	2003	2008
Non-performing loans (% of total)	19.38	9.79	2.77
Capital adequacy ratio	10.38	12.91	13.70
Regulatory Quality	0.53	0.51	0.61
Rule of Law	0.51	0.40	0.49

Source: CEIC, Bankscope, World Bank.

Preventing crises

- Rationalize/unify regulatory structure
 - Most Asian economies already relatively centralized, unlike US
 - Need to check for regulatory gaps
 - Comprehensive oversight of complex financial institutions
- Improve microprudential framework
 - Strengthen capital requirements, especially of systemically important institutions (Basel III?)
 - Extend the range of surveillance and regulation to other non-banks and innovative product areas

Preventing crises (2)

- Macroprudential regulation and supervision that monitors and acts on economy-wide systemic risk
 - Establish powerful Systemic Stability Regulator with both surveillance and regulatory tools: including all major players, including those with fiscal responsibility
 - Prudential measures: leverage ratios, foreign currency exposure, etc. (many already in place)
 - Identify risks in public, corporate and household sectors also
- Issues to resolve
 - Should the central bank be responsible for financial stability?
 - Should same institution be responsible for ex ante crisis avoidance (supervision) and ex post correction of problems?

Preventing crises (3)

- Reduce pro-cyclicality of regulations
 - Countercyclical capital ratios
 - Countercyclical provisioning
 - Issues related to fair-value accounting
- Harmonize international framework for surveillance and regulation
 - Large international firms
 - Innovative financial products and investor groups
 - Credit rating agencies—role needs to be downgraded
- Special rules for credit default swaps (CDS)

Crisis management/resolution

- **Stabilization and containment**
 - Identification of systemic crisis
 - Clear delineation of responsibilities
 - Consistent policy package, including liquidity support
- **Asset writedowns and absorption**
 - Need for capability to assess quickly losses and solvency of banks and other institutions
 - Consistent framework for NPL removal

Crisis management/resolution (2)

- Bank recapitalization and resolution
 - Consistent framework for intervention and recapitalization
 - Special resolution framework for financial institutions: “Living will”?, debt-for-equity swap schemes
 - Develop rules for coordination of resolution of international institutions
- Issues related to deposit insurance
 - Eliminate gaps in access, coverage, capitalization, scope
 - Issues of coordination
 - Exit strategy

Deepening and strengthening regional bond markets

- Encourage foreign participation (multilateral institutions, MNCs)
- Improve government debt management
 - Provide well-distributed yield curve
- Provide adequate financial infrastructure
 - Currency hedging and swap facilities

Deepening and strengthening regional bond markets (2)

- Encourage rating agencies (global and regional)
- Improve financial regulation and liberalize further
- Cooperate regionally to harmonize markets
 - Tax rules, issuance standards, regulations
- Develop market for ACU-denominated bonds

Conclusions and areas for regional cooperation

- Asia survived crisis reasonably well
 - More progress needed on governance, regulation
 - Strong macroprudential framework needed
 - Bond markets require further initiatives, especially corporate bonds
- Further progress needed at regional level
 - Asian Financial Stability Dialogue (AFSD)
 - Liquidity provision—Chiang Mai Initiative (CMIM)
 - Independent Surveillance Unit (AMF)
 - Development of ACU-based bond market
 - Harmonization of tax rules, regulations, etc.

Thank You