Financial Regulatory Reforms After GFC: Analysis from Asian Perspectives

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Causes of Global Financial Crisis

• Pre-crisis views: self-regulation, market discipline, and financial innovation

• Global financial crisis revealed 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
Lessons of Global Financial Crisis

• Market discipline failed to constrain excessive risk-taking behavior of financial institutions.
• Regulatory policies, including capital, liquidity, and disclosure requirements, failed to mitigate risk management weaknesses.
• Systemic importance of non-banks was recognized.
• Importance of relationships between banks and non-banks was underappreciated.
• Potential cost of innovation is high.
• Too much reliance on credit rating agencies.
• Compensation structures / asymmetric incentives.
• Corporate governance failure – ignorant and negligent boards.
Diverse Financial Reform Process after GFC

• FSB: Basel III compliance; raising capital requirement; getting more OTC derivatives centrally cleared on platforms; and improving the resolvability of SIFI’s, etc.

• The US, the EU and Japan: Work together on clearing platforms for OTC derivatives

• Switzerland: Focus on holding more capital than required and is dealing with resolvability in a unique way—a capital rebate if its banks can demonstrate resolvability.

• Canada, the U.S. and Switzerland (to be implemented next year): Leverage ratio, not based on risk weighted assets that runs alongside the Basel risk-weighted approach.

• The US Dodd-Frank bill: To ban proprietary trading and certain swap transactions must be separated and (by law) will not be bailed out in the event of a problem.
G20 Regulatory Reform Framework

FSB, BIS & SSBs
- Develop, coordinates, and monitors implementation of global financial regulations
  - SSBs: BCBS, IOSCO, IASB...

IMF, WB, MDBs
- Expand mandates & resources
- Analyze economic situation
- Support low capacity countries

Global Forum, FATF, FSB
- Develop peer review process & countermeasures for NCJs
- Develop capacity building program
Spectrum of the Reform Agenda

- **Prudential Regulation**
  - Strengthen capital (minimum capital, quality and consistency), leverage and liquidity requirements
  - Counter-cyclicality: capital buffer & expected loss model for provisioning

- **Systemic Risk**
  - Identify systemically important financial institutions (SIFIs) and reduce moral hazard posed by SIFIs

- **Regulatory Scope**
  - Hedge fund registration
  - CCP clearing of OTC derivatives; CRA regulation/supervision

- **Risk Mgmt & Compensation**
  - Improved internal risk management system
  - Risk-based compensation system, stronger disclosure & monitoring

- **Accounting**
  - Single set of high quality global accounting standards

- **Non-Cooperative Jurisdictions**
  - Measures to deal with tax havens, money laundering & terrorist financing
  - Peer review for non-cooperative jurisdictions (NCJs)
Financial Regulatory Reforms under G20

• G20 agreements reached so far:
  – Requirements for greater quantity and quality of capital
  – Liquidity requirements
  – Leverage ratio
  – Standards for OTC derivatives markets (by 2012)
  – 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
# Recent Progress & EMDEs Perspectives

- BASEL III Implementation
- D-SIBs
- Resolution Regime
- Shadow Banking Regulation
- OTC Derivatives
- Reducing Reliance on CRA Ratings
- FSB Governance Issues
(I) BASEL III Implementation

Progress in Liquidity Regulation

- Short-term: Liquidity Coverage Ratio (LCR)
  
  \[
  \text{LCR} = \frac{\text{Stock of high quality liquid assets}}{\text{total net cash outflows}} > 100\%
  \]
  
  * Ratio to indicate whether a financial institution can stand first 30 calendar days of a crisis for the management or supervisors to take actions.

- Long-term: Net Stable Funding Ratio (NSFR)
  
  \[
  \text{NSFR} = \frac{\text{Available Stable Funding}}{\text{Stable funding required by supervisors}} > 100\%
  \]
  
  * Fixed, long-term (1yr<) loans and investments must be backed up by long-term liabilities (1yr<)

EMDE Perspectives

- Expansion of the scope of high quality liquid assets, revised calculation for total net cash outflows, alternative to high quality liquid assets
  
  - EMDEs seem to focus on decreasing the burden of introducing the BASEL III regulation by expanding the scope of HQLAs and decreasing the III requirement. Korea already accumulated sufficient liquidity that satisfies the BASEL

- Meanwhile, as the introduction of BASEL III has been delayed in the US and EU (including UK), skepticism towards timely introduction of BASEL III is likely to spread in EMDEs as well.
  
  - Korea is well prepared to introduce the BASEL III from 2013 and the postponement will have minimal practical benefits.
(II) D-SIBs

Progress in D-SIBs

- The BCBS finalized a framework for dealing with domestic systemically important banks which was approved at the G20 Finance Ministers Meeting in November 2012.
  - Supervisory authorities of each nation assess the systemic importance of banks by considering their ① size ② interconnectedness ③ Substitutability/financial institution infrastructure and ④ complexity
  - The D-SIB surcharge should be fully covered by Common Equity Tier 1 and the level of surcharge will be decided by national supervisory authorities according to the review of systemic importance.

EMDE Perspectives

- Prior to full introduction of D-SIB regulations by 2016, financial authorities of each nation need to conduct thorough case studies of other nations and analysis on the possible ramifications of the regulation to the domestic market.
  - Various opinions on the selection criteria and surcharge level should be considered by conducting pilot testing of selection and surcharges during 2013-2015

- Introduction of D-SIB regulation can increase the internal reserves as banks will be required to have more capital due to the BASEL III minimum capital requirement (which will be introduced from 2013; Revision of the regulation on banking business supervision is now in progress)
  - The size of surcharge on banks subject to regulation can be predicted more accurately; This will also help banks to methodically respond to regulation in advance.
(III) Resolution Regime

Progress in SIFI Resolution

- ReSG and CBCM of FSB has been preparing guidance for implementation of Key Attributes that should be included in resolution plans.
  - The guidance includes ① nature of the stress scenarios and triggers for recovery actions,
    ② Development of resolution strategy and operational resolution plan, and ③ the identification of the critical functions that would need to be maintained
- In Tokyo Plenary, FSB members discussed about the thematic peer review (now in process, will end by early 2013) that evaluates implementation of Key Attributes to monitor resolution regime of each jurisdiction and to upgrade the resolution regime to be more effective.

EMDE Perspectives

- In Korea, resolution authorities (FSC, FSS, KDIC) exercise most of the powers listed in the Key Attributes
  - However, there is no legal ground yet for items such as Statutory Bail-in, Temporary Stay on Early Termination Rights and Acceleration Rights, so Korea will discuss whether to introduce such items with Interested parties and legal experts.
- Most EMDEs do not own G-SIFIs, so they will have to co-operate as host states.
  - Co-operating with home authorities and financial institutions, EMDEs will participate as members of Crisis Management Group, sign Institution-specific Cross-border Cooperation Agreement, conduct Resolvability Assessment, come up with Recovery and Resolution Planning, and enable wider Access to Information and Information Sharing.
(IV) Shadow Banking Regulation

Progress in Shadow Banking

- FSB conducted Monitoring Exercise on Shadow Banking in 2011 and based on the findings, 5 Work Streams were formed to give recommendations for the areas that can bring about systemic risks.
  - (i) Banks’ interactions with shadow banking entities (indirect regulation): BCBS / (ii) MMF: IOSCO / (iii) Other shadow banking entities: Separate WS / (iv) Securitisation: IOSCO / (v) Securities lending and repos: Separate WS

- Initial recommendations on supervision of shadow banking were announced at the G20 Finance Ministers Meeting in November 2011 and at Los Cabos Summit in June 2012, the G20 leaders reiterated their support to made the final policy measures by the next summit (Sep 2013)

EMDE Perspectives

- Generally speaking, countries agree on the need of regulation but will come up with specific regulatory measures that are suitable for their financial system and market by closely monitoring the progress of each Work Stream.

- In case of EMDEs, since their Shadow Banking markets (E.g: MMF, Securities lending & Repo) are not really active and mature compared to advanced countries, they have to consider the growth potential and virtuous functions such as provision of capital and transfer of credit risks.
  - EMDEs need to consider that imposing regulations such as Variable/Floating NAV and recourse to insurance can undermine the high liquidity and profitability of MMF
  - EMDEs should undergo thorough review before introducing relevant regulation for the Securities lending & Repo market since the RP market can complement the call market while the Securities lending market should be developed to foster Global IBs.
(V) OTC Derivatives

Progress in OTC derivatives

- In Cannes Summit, leaders agreed to implement recommendations for OTC Derivatives Market Reforms by the end of 2012 and this was reiterated in the Los Cabos Summit.
  - Encouraged the implementation of recommendations such as standardization of OTC derivatives, central clearing, reporting to the Trade Repository, trade via the Exchange or electronic trading platform etc. (Cannes);
  - Urged to create standard for higher capital requirement imposed on non-centrally cleared OTC derivatives (Los Cabos).

- At 2012 G20 Finance Ministers Meeting in November, FSB ODWG (OTC Derivatives Working Group)’s fourth progress report on implementation was presented.
  - Countries were asked to make changes in their legal and regulatory framework and to address cross-border issues, regulatory mismatch and conflict by the end of 2012.

- In February 2013 G20 Finance Ministers and Central Bank Governors meeting, the G20 has reaffirmed its commitment to achieve OTC derivatives implementation goals and in April 2013 FSB published fifth progress report on implementation.

EMDE Perspectives

- EMDEs should continue to reform and find balance between the G20 mandate and practical difficulties in establishing infrastructures for OTC Derivatives such as CCP.
  - In Korea, TR function is already carried out by BOK’s FX network, FSC&FSS’s comprehensive information system for OTC derivatives; CCP is technically ready for use.

- In addition, there can be regulatory arbitrage if countries do not all complete the OTC Derivatives Market Reforms by the set due date (end of 2012).
  - Hence, countries must be committed to comply with the due date but at the same time closely monitor the implementation date of other countries and when necessary, consider the change of the date by coordinating with other countries.
(VI) Reducing Reliance on CRA Ratings

Progress in Reducing Reliance on CRA Ratings

- In 2011 G20 Seoul Summit, countries agreed on major principles to reduce mechanistic reliance on CRA ratings.
- In 2012 G20 Los Cabos Summit, countries agreed on additional reform measures to enhance transparency of and competition among credit rating agencies.
- In November 2012 G20 Finance Ministers Meeting, the roadmap for taking forward work to accelerate implementation of the FSB Principles was announced.

EMDE Perspectives

- Still at an initial stage in discussing about alternative approaches to reliance on CRA ratings; it is difficult to prevent the market from using the existing market infrastructure.
- Therefore, basic principle of reducing reliance on CRA Ratings must be kept but the specific dates and measures will have to be decided after considering the regulatory framework and market practice.
  - Considering the costs and human resources, establishment of internal credit rating infrastructure is rather difficult for small and medium sized financial institutions; Practical alternative approaches are necessary.
  - Needs to reflect unique characteristics (bank exposure, securitization exposure, special finance exposure etc.) of different investment assets.
(VII) FSB Governance Issues

Progress in Improving the FSB Governance Structure

- As different number of seats are given at the FSB depending on member countries, Korea felt that it may be difficult to reflect the views of countries in the fair manner, so Korea submitted recommendations to improve the FSB governance structure in early June and circulate these to the G20.

  - In case of the FSB Plenary, 3 seats are given to the G7 and BRICs, 2 seats for Korea, Australia, Mexico etc., and one seat each for Argentina, Indonesia, Turkey etc.
  - At Los Cabos Summit in June, G20 leaders agreed to continue to review the representation of the FSB governance.

- At 2012 G20 Finance Ministers Meeting in November, Korea called for the FSB to review and report about its representation that differentiate the seats according to member countries.

EMDE Perspectives

- FSB seats are allocated according to the size of the economy and financial market activities, but there is no specific guideline with legitimate ground, so the credibility and transparency of the representation of the FSB can be undermined.
  - EMDEs should come together to urge the FSB to improve its representation so that EMDEs can have stronger voices in discussions of global financial regulations.
Overall Progress and Issues

- Although many reform measures are proposed and discussed, they are not fully implemented yet almost 4 years after the global financial crisis.
- Among those proposed regulations, international consistency is critical factor for efficient implementation.
  - Without international consistency, issues will continue to arise about regulatory arbitrage and business migration from more to less controlled jurisdictions.
- Argument on the adequacy and appropriateness of the micro-prudential and macro-prudential regulations for ensuring systemic stability
  - Sufficient for ensuring systemic stability?
  - Too tight and overburdening for development of financial industry?
Debate over Financial Regulatory Reforms

• Conflicting views over reforming financial regulation
  – Need to further strengthen financial regulation to prevent financial crisis
  – Too tight and strong regulation would strangle financial industries and weak economic growth

• Should remember lessons of the GFC
  – Loose and soft-touch regulation has already failed, incurring huge cost to the global economy.
  – Financial regulation should be tight and strong enough to maintain financial stability

• In addition, repeated occurrence of scandals related to financial transactions in the recent years
  – (e.g.) Barclays’ attempt to manipulate LIBOR, J.P. Morgan’s huge loss from derivatives, HSBC’s money laundering, Standard Chartered’s breaching US rules
Debate over Financial Regulatory Reforms

• Should not believe pre-crisis views of self-regulation, market discipline, financial innovation, etc.

• Need to continue efforts to strengthen adequate financial regulation to limit malpractices and misbehavior in the financial industries
  – Should establish mechanism for limiting reckless behavior in the financial industries, ensuring a stable and growth-supporting financial system
  – Stable financial system and industry is critical for long-term, sustainable economic growth

• Are the current proposals for financial regulatory reforms too stringent to overkill the financial sector?
⇒ I don’t think so.
Asian Perspectives

Strength of Asian Financial Systems

• Asian financial systems were 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 some macroprudential policies (administrative guidance to limit bank-credit growth, real estate loan caps, etc)
Weakness of Asian Financial Systems

• 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

• Vulnerable to volatile capital flows and “double mismatches”
Challenge to balance financial regulation with development

- Asian financial systems were resilient to the GFC and EZC, but this partly reflected immature financial systems that need to develop further to accommodate sustainable economic growth, while promoting financial stability.
- Much of the G20 debate on financial regulation mainly reflects the viewpoints and problems of the US and Europe, not necessarily so relevant for emerging economies.
- Developing Asian economies are promoting financial inclusion to support farmers, SMEs, etc.
- Asia's regulatory capacity can improve.
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 macro-prudential 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
Thank you