The 3rd International Conference
Financial Stability and Financial Sector Supervision: Lessons from the Past Decade and Way Forward

(Summary of the Conference)

On Monday, December 17, 2007, the Third International Conference was held on the theme "*Financial Stability and Financial Sector Supervision: Lessons from the Past Decade and Way Forward*" at the Financial Research and Training Center. The conference was jointly hosted by the Financial Research and Training Center of the Financial Services Agency (FSA) of Japan, the International Monetary Fund (IMF) Regional Office for Asia and the Pacific, and the Keio University 21st Century Center of Excellence (COE) Program run jointly by the Graduate School of Economics and the Graduate school of Business and Commerce. Experts from financial supervisory organizations, international organizations and universities from Europe, the United States and Asia were invited to the conference. Conference participants discussed lessons to be learned from the experiences of the financial sector in response to the Asian financial crisis and its transformation. thereafter. Discussions did not only focus on the experiences of the financial sector to date, but also covered current developments and perspective going forward, in the face of changes in the international financial environment, including the progress of new financial technology and the adoption of the Basel II standards. The conference was attended by approximately 150 participants, including researchers from Japan and overseas, diplomatic officials from missions resident in Tokyo and persons from financial institutions.

Opening Remarks

Takafumi Sato, Commissioner, Financial Services Agency

In his opening remarks Commissioner of the FSA Takafumi Sato noted the significance of the international conference, given the experiences over the past ten years and current situation of Japan's financial administration. A summary of his remarks is as follows.

With the advancement of financial and IT technologies and the further progress of globalization, the financial environment is undergoing truly remarkable changes, including the emergence of new financial products and new actors in the provision of financial services. In addition, competition among the financial markets of each country is intensifying. Financial authorities in each country aim to respond to these changes in the financial environment, and create a vigorous financial system, by securing a robust and competitive environment for financial institutions and by promoting independent self-help efforts by those institutions.

As the quality of financial regulations is an important element in determining the competitiveness of the market to which the regulations are applied, in order to respond to changes in the financial environment and to strengthen the international competitiveness of the market, qualitative improvements in the form of better regulation can be seen as an important means of achieving this goal. The theme of the conference, "*Financial Stability and Financial Sector Supervision: Lessons from the Past Decade and Way Forward.*" is of particular significance and will allow participants to benefit from a look back over the ten years since the financial crisis, and discuss the lessons of the crisis and how they can be applied to further responses to the changing financial environment.

Session 1: Banking and Financial Sector Reform after the Crisis

Chair: Mr. William A. Ryback, Special Advisor, Financial Supervisory Service (FSS), Korea

The theme for Session 1 was “Banking and Financial Sector Reform after the Crisis” and reports were heard from Mr. Jonathan Fiechter (Deputy Direct, Monetary and Capital Market Department, IMF) and Mr. Krirk Vanikkul (Assistant Governor, Financial Institution and Policy Group, Bank of Thailand).

In his presentation Mr. Fiechter pointed out the priority challenges for East Asian countries in preparing for a financial crisis in the future. A summary of his remarks is as follows.

Following the financial crisis of 1997 in the financial sectors of the countries of East Asia, a variety of reforms have been implemented in the management of financial institutions and also at regulatory and supervisory bodies, and important improvements have been made. Accordingly, the potential for a crisis similar to the one in 1997 to reoccur is now thought to have receded. However, over the last ten years the financial sector has become increasingly complex, and this has raised the likelihood that if a new problem emerges in the future, it will occur in a previously unanticipated sector. As preparation for such an unknown crisis, one challenge for the future is to heighten the adaptability and flexibility of the financial system. Based on the experiences of East Asia ten years ago, four priority challenges can be identified: improving credit culture; improving supervisory capabilities; boosting the capital of financial institutions; and development of a liquidation framework for financial institutions that have become insolvent.

In addition, due to the current sub-prime issue in the United States, doubts have been raised concerning the quality of the risk management and risk models of a number of European and US financial institutions, and authorities in those countries are advancing deliberations in the above-mentioned four priority sectors. Although the impact of the sub-prime issue on the financial sector in East Asian countries has thus for been relatively small, it is essential to take advantage of the economic conditions and address the challenges of infrastructure development of financial sector systems, before the outbreak of a new problem in the next economic downturn.

In his presentation Mr. Vanikkul reported on the experiences of Thailand in banking and financial sector reform following the crisis. A summary of his remarks is as follows.

Since the Thai financial crisis financial system reforms can be classified into three stages in terms of chronology and content. The first stage was from 1997 to 2001, when an initial response was made to the crisis and measures were implemented to protect savings and boost bank capital. The second stage was from 2001 to 2004, when non-performing loans were transferred from banks to the Thai Asset Management Corporation (TAMC) and disposed of in a concentrated manner, while reform measures were implemented, such as the strengthening of provision standards for bank loans and the enhancing of risk management. The third stage was from 2004 to the present, and included two financial system master plans, in which actions aimed at increasing efficiency in the financial sector and its competitiveness was taken. In addition, progress has been made in the introduction of the Basel II standards.

The lessons from the 1997 crisis are as follows. Firstly, it is the most important to enhance capital and to guard against loss, to underscore a bank’s strength. Secondly, awareness of risk and implementation of risk management measures are important. Risk assessments and associated remedial actions are beneficial for supporting capital and reserves. Thirdly, in Thailand it has been necessary to enhance the number of experts and improve transparency of information disclosure, as well as develop a legal basis for prompt corrective measures.

In response to the presentations from Mr. Fiechter and Mr. Vanikkul, Dr. Anwar Nasution (Chairman, Supreme Audit Board of Indonesia) provided comments based on the experiences of Indonesia. A summary of his remarks is as follows.

The crisis that occurred in 1997 was a dual one in that banking and currency crises occurred simultaneously. It has been pointed out that the factors causing these crises were “a combination of fixed exchange rate policy (with capital liberalization) and high domestic interest rates” from a macro perspective, and “excessive corporate investment and borrowing, excessive financing and insufficient reserves at banks, as well as lax banking supervision,” from a micro perspective. Following the crisis the fixed exchange rate was replaced by a floating system, and inflation targets were introduced into financial policy. A variety of financial system reforms were implemented, including injection of capital into insolvent banks; lowering the reliance of companies on short-term financing; strengthening financial infrastructure, including development of the banking supervisory structure; consolidation of financial institutions; consolidation of legal system, such as bankruptcy procedures; improve debter credit information; and the lifting of the pay-off ban in the deposit insurance system. In addition, currently work is being progressed relating to the introduction of the Basel II standards.

While on the one hand these system reforms were advanced, there are also aspects whereby it cannot be said that “the Indonesian economy has steadily changed over the 10 years after the crisis.” In other words, government influence remains strong on nationalized banks and governance challenges, including management transparency and accountability have yet to be addressed. Over the course of ten years some cases have been witnessed in which the shareholders and managers who withdrew from the market following the crisis have returned, and this is also viewed as due to backtracking on reforms. The question for assessment should not be one of what kinds of policies have been implemented, but whether they were implemented steadily, in other words effectively.

In addition, Prof. Mariko Fujii (Professor, Research Center for Advanced Science and Technology, The University of Tokyo, and Special Research Fellow of the Financial Research and Training Center, FSA) provided comments in response to Mr. Fiechter and Mr. Vanikkul’s presentations, based on efforts to avoid financial crisis and response measures at the time of a crisis. A summary of her remarks is as follows.

After experiencing the 1997 crisis and the subsequent reforms, a consensus being formed among those involved in the financial sector concerning efforts to avoid financial crisis. It is generally viewed that the banking sector needs to strengthen its capital base and it is also necessary for management techniques to become more sophisticated, including in terms of risk management. Improvements in corporate governance in the corporate sector are also required, including improvements in transparency. In addition, as a regulatory framework, capital regulation based on risk, including the introduction of the Basel II standards and the strengthening of the supervisory structure, including human resources, remain as challenges. In order to avoid financial crisis, it is also important to implement macroeconomic policies which sustain stability, including appropriate exchange rate and fiscal policies.

As effective crisis response measures, the lessons common to each country of the 1997 crisis can be said to be the importance of swift action to maintain market stability, and the need for uniform policy packages in order to regain the confidence of the market and investors. However, specific policy is carried out based on the realities in each country and the situation in each is not necessary uniform. In addition, one of the challenges for the future has been pointed out as "capital base regulations have the potential to magnify the amplitude of credit-cycle", and therefore close investigation into the relationship between risk-based regulatory indices and economic cycles should be implemented.

In the free discussion part of the session, the issue of the "role of financial supervision from the perspective of risk management and crisis response" was discussed. The following is a summary of the discussion.

If a crisis breaks out caused by non-performing loans of individual financial institutions, supervisory authorities should take the necessary measures, including closing the insolvent institutions, as quickly as possible. However, the crisis in 1997 also featured macroeconomic problems such as imbalances in international payments and the financial sector as a whole was facing a crisis. Weak financial supervision contributed to the crisis, but it cannot be said to have been the cause of the crisis. The problems of distortions in banks' lending activities and the emergence of an asset bubble would make it difficult to resolve a crisis purely through strengthening financial supervision, such as the introduction of Basel II standards. In terms of a response to a future crisis further analysis of the relationship between macro (national and international economy) and micro (financial institutions' actions) indicators is required.

Session 2: Bank and Financial Sector Supervision and Examination

Chair: Mr. Nobuyoshi Chihara, Deputy Commissioner for International Affairs, FSA, Japan

The theme for Session 2 was “Bank and Financial Sector Supervision and Examination” and reports were heard from Mr. Hirofumi Gomi (Former Commissioner, FSA), Dr. Jan-Yung Lee (Assistant Governor, FSS, Korea), Ms. Nor Shamsia Yunus (Assistant Governor, Bank Negara Malaysia), and Mr. Nestor A. Espenilla (Deputy Governor, The Bangko Sentral ng Pilipinas (BSP)).

In his presentation Mr. Gomi discussed the issues of non-performing loans and financial revitalization in Japan. A summary of his remarks is as follows.

Loans by banks should be examined from the perspective of what value is being added to capital and how cash flow is generated and collected, and the collection of collateral disposition should act as a supplementary action. However, in the latter half of the 1980s, during the bubble period, loans rapidly expanded that were dependent on collateral, based on the assumption that asset prices would continue to rise. In the late 1990s at the time of the outbreak of the financial crisis the government prioritized crisis response measures over fundamental policy, and financial protection for deposits, the creation of insolvency legislation, and intensive examination of banks were implemented. Drastic reforms to revive the financial sector focused on special examination of credit risk management by banks from 2001, and these efforts resulted in the non-performing loan problem being normalized in the fiscal year ending March 2007.

One of the lessons learned from these experiences is the important role played at governance at banks under conditions of economic stagnation. Even if afflicted by problems of non-performing loans, etc., if a structure is in place to accurately gauge the situation and implement response measures, it is possible to gain the trust and confidence of the market. Also, in today’s banks not only should loan examination capacity be strong, there is also a strong need for knowledge with regard to knowhow on corporate restructuring and also verification of the effectiveness of restructuring plans.

Dr. Lee spoke about Korea’s experience of financial system reforms since the financial crisis. A summary of his remarks is as follows.

One of the factors for the financial crisis in Korea was structural weaknesses in the financial sector. These have been identified as inefficient regulations and political intervention in the supervision administration. Following the crisis the pre-crisis structure of fragmented supervisory organizations for banks, securities, insurance and non-banks was integrated and through the enactment of legislation the independence of supervisory organizations was guaranteed. However, in terms of systemic operational factors, many constraints still remain, and at the time of the credit card crisis in 2003 a response was delayed due to differences in understanding of the crisis by the financial supervisory authorities and other government departments.

In addition, various efforts are being made to develop the financial regulatory environment, with a view to making Korea a financial hub in Northeast Asia. In order to adapt to environmental changes, such as the globalization of finance and the progress of financial innovation, supervision is transferring to a risk-based and principles-based approach. In addition, at present, when international uncertainty is heightening over financial transactions, it is hoped that the authorities of each country will cooperate with each other to realize a uniform system of regulatory supervision that transcends national borders.

Ms. Yunus spoke on the theme of Malaysia's financial regulatory system and supervision. A summary of her remarks is as follows.

Malaysia's response to the financial crisis was to establish an organization for the acquisition of non-performing loans (Danaharta) and proceed with the disposal of such loans, as well as making efforts to strengthen financial institutions, through M&A and capital injections in the financial sector. Subsequently a master plan towards mid- to long-term growth was formulated and the domestic bond market was promoted. Through the expansion of the bond market, cross-border capital flows increased and activities by foreign banks also increased, with financial innovation, including derivatives also being promoted.

In order to respond to the increasingly complex financial environment, the previous top-down financial regulations have been relaxed to become more flexible, and a transfer from a rules-based approach to a principles-based approach has been implemented. Islamic financing is developing in Malaysia and care will be necessary to avoid arbitrage from emerging between standard financial regulations and Islamic financing regulations. In addition, the improvement of supervisory capacity is also an important challenge, and human resource development in terms of risk management specialists is also called for.

Mr. Espenilla spoke about financial regulatory systems and supervision in the Philippines. A summary of his remarks is as follows.

It has been pointed out that the Asian financial crisis of 1997 was caused by macroeconomic policy, but in the Philippines it is recognized that weaknesses in financial supervision also contributed. For this reason post-crisis reforms were implemented that set a target of improving the quality of financial supervision. Financial supervisory organizations in the Philippines were fragmented, with separate supervision of banks, securities and insurance, and so a Financial Sector Forum was established to enable information exchange through regular meetings among these supervisory bodies. In addition, a system was constructed to enable the active sharing of information with international organizations also.

Furthermore, efforts were made to improve capacity among the staff at financial supervisory authorities, and with technical support from the IMF and other organizations, a supervision and examination manual was compiled and training implemented. Revised legislation was also enacted for the legal protection of supervisors and examiners. Under the current legal structure there are also limitations to reforms, but over the last ten years the financial regulatory and supervisory structures in the Philippines have made steady progress.

In response to these reports, Mr. W. Jason George (Senior Financial Sector Specialist, Representative Office for Asia and the Pacific, Bank for International Settlements (BIS)) provided his comments. A summary of his remarks is as follows.

After the financial crisis of 1997 the countries of East Asia have steady strengthened the financial sectors in their countries. In particular, with regard to risk management, the reform policies implemented in each country have also been adapted to the core principles of the Basel II standards, representing a significant step forward. However, there is room to reconsider a total transfer to a principles-based approach in supervision. There are financial transactions that are more suited to a rules-based approach and in the current environment in which new financial technologies are not yet accurately understood by financial institutions and authorities, principles-based supervision alone has the potential to expose unexpected weaknesses.

In addition, although in terms of the sub-prime loan problem the losses incurred by Asian financial institutions have been relatively small, it should be recognized that this outcome is not purely due to advanced risk management. As there is no situation in the financial sector that is totally devoid of risk, now is not the time to be complacent, but action should be taken that always bears in mind the lessons of a decade ago.

In addition, in the free discussion part of the session the “form of supervisory organizations” was discussed. The following is a summary of the discussion.

In East Asia, some supervisory organizations remain within the central banks, which differ from the U.K. model where the central bank and supervisory organization are separate and is believed to be better model. In East Asia, the Central Bank model’s main merit is the ability to acquire data directly from the financial market and such a system also makes it possible to make more effective use of limited human resources, particularly in emerging countries that lack an accumulated pool of human resource talent.

Accordingly the more advanced form of supervisory organization like in the U.K. is not necessarily desirable for every country and each country should adopt a model suitable to its situation.

Session 3: Panel Discussion: Challenges going Forward

Chair: Prof. Takatoshi Ito, Professor, Graduate School of Economics and Graduate School of Public Policy (GraSPP), The University of Tokyo

The theme for Session 3 was "Challenges going Forward" and was held in the form of a panel discussion. Prior to the discussion, reports were provided by Mr. Masamichi Kono (Deputy Director General, FSA, Japan), Mr. Simon L. Topping (Executive Director, Banking Policy, Hong Kong Monetary Authority (HKMA)), Dr. Wong Yit Fan (Managing Director and Head of Country Risk Management, DBS Bank Ltd., Singapore), and Mr. Peter Tebbutt (Senior Director Financial Institutions, Asia, Fitch Ratings).

Mr. Kono gave a report on the challenges of financial supervision in a period of financial stability. A summary of his remarks is as follows.

Ten years have passed since the Asian financial crisis and also the Japanese financial crisis, and through various post-crisis reforms the financial sector is currently stable. If we review the modalities for financial regulation at this time of calm we find that market participants are calling for "better regulation." Both principles-based regulation and supervision and rules-based regulation and supervision have their advantages and disadvantages. Better regulations means not having to make an either-or choice, but aiming to achieve an optimal combination of the two approaches. This is what the FSA is currently engaged in doing.

In addition, as a response to the recent turmoil in the international financial markets, a Task Force (Financial Market Strategy Team) has been organized under the Minister of Financial Services, and is engaged in analyzing the situation and providing policy recommendations. However, given the progress of economic globalization and financial innovation, turmoil in the financial markets is not a problem exclusive to the financial markets, it also has an impact on foreign exchange and commodity markets, as well as on macroeconomic policy such as fiscal policy, including financial and taxation policies. Accordingly in working to adress the financial market turmoil, it is essential that not only the financial supervisory sector takes action, but that other government and private sector actors also cooperate to share information and coordinate policies and measures.

Mr. Topping gave a report on appropriate supervision styles and preparations for a future crisis. A summary of his remarks is as follows.

Reports have been provided from the countries of Asia that through post-crisis reforms supervision style is transforming to more emphasis on risk and principles-based approach. However, there is a need for caution in these activities. In other words, it does not mean that implementing these supervision styles is in itself of significance. If the criteria for financial transactions are made clear through rules, such as understanding how capital is used at the point of investment or at the loan destination, and understanding whether changes in market conditions will have an impact on risk positions, even a rules-based approach will not hinder free financial activities.

In addition, through the economic expansion of recent years there are concerns among market actors as to whether preparations are in place for an economic downturn. There are those who think that even if the US economy takes a downturn due to the sub-prime loan problem, Asia will not be unduly affected thanks to the economic growth in China and other countries, but the overall picture is not an optimistic one in the midst of a globalized economy. Even if the economic cycle is extended, it is definitely not the case that economic cycles will disappear entirely. It is necessary to prepare for any coming economic downturn, and financial institutions need to confirm that they have made sufficient preparations, such as implementing stress tests and stockpiling financial reserves.

Dr. Wong gave a report on the current status of risk management as viewed from a private sector financial institution. A summary of his remarks is as follows.

Somebody has already pointed out that although the losses of Asia's financial institutions through the sub-prime loan problem have been relatively small, this is not due entirely to advanced risk management. However, neither can it be said that it was merely luck coincidence. Since the Asian financial crisis corporate capital requirements have decreased rapidly and banks have also adopted a conservative approach. From this background it can be inferred that the impact on Asian financial institutions of the sub-prime loan problem was not particularly large.

During the approximately ten years since the Asian financial crisis it can be said that the risk management of Asian financial institutions has improved. However, it is a current reality that many institutions are not implementing sufficient stress tests. The implementation of the Basel II standards requires that financial institutions have advanced risk management capacity, but in Asian countries the number of human resources with a detailed knowledge of risk management is extremely small in comparison to demand. Accordingly, although it may be said that there has been a transition in supervisory style, it should be recognized that it would be difficult to realize a situation in which all financial institutions were implementing risk management in a meaningful way. In addition, since the transition to more emphasis on risk approaches the economic cycle has yet to come full turn, and from this perspective the absolute lack of experience of risk management can be said to be a constraint.

Mr. Tebbutt gave a report on information provision and self-regulation from the perspective of a ratings agency. A summary of his remarks is as follows.

The US sub-prime loan problem is a small matter when viewed from the financial market as a whole, and only a number of institutions have had their ratings dropped as a result of this problem. However, the link to the current market turmoil is the tremendous credit crunch the sub-prime loan has caused. Behind this credit crunch is the unease that the problem is "too complex to understand." Methods of eliminating such unease have been suggested as "decreasing complexity" and "making information available." The complexity of assembled goods is said to decrease over the passage of time. As for the disclosure of information, this could be achieved by public-sector organizations requesting information from financial institutions. The role of public-sector organizations is expected to be in their active efforts to realize information disclosure.

The crisis in the Asian financial sector brought about dramatic changes. From the perspective of regulatory frameworks, more emphasis on risk supervision was introduced and staff capacity was also improved. In terms of the management of financial institutions, the number of nationalized banks and family-operated banks has decreased. However, in terms of environmental aspects such as legal system weaknesses, the potential for political intervention, and also a lack of economic and industrial diversity, Asian financial institutions are still operating under higher conditions of risk than other regions. In order also to boost market confidence in Asian financial institutions efforts should be made by regulatory authorities to strengthen capital adequacy ratio regulations.

In the panel discussion the role of public sector organizations in information disclosure was discussed. The following is a summary of the discussion.

From such perspectives as the transparency of market transactions, although progress has been made in terms of information disclosure by financial institutions, off-balance SIV (Structured Investment Vehicle) and conduits hardly received a mention until the emergence of the sub-prime loan problem. Public sector organizations are expected to recognize potential problems in advance and request information from financial institutions on areas of concern, and these findings should be disclosed widely.

The session was concluded with the point being made that a future crisis would come “in a different manner to crises in the past” and therefore in the current period of relative financial calm, not only should the lessons of the past be filed away, they should also provide a means of learning from the past and be utilized also in the future.

Closing Summary and Remarks

Mr. Akira Ariyoshi, Director, Regional Office for Asia and the Pacific, IMF

In his closing remarks Mr. Akira Ariyoshi summarized the proceedings of the conference. A summary of his remarks is as follows.

It is evident that the financial sector in Asia has made tremendous progress since the crisis of 1997 and through the reforms that followed the crisis. In particular, the improvement of systems for financial supervision is one aspect deserving of praise. The consensus among Asian countries that was affirmed at this conference is that as supervisory style moves from a rule-based approach to one based on principles (although not in all cases), the issue of HR development, focusing particularly on risk management in the financial sector, has become the most pressing issue facing countries.

However, with the issue of the US sub-prime loans looming before our very eyes, there is still room for doubt as to whether the countries of Asia, under their present structure could respond effectively to potential problems or crises. While it is easy to say that the importance of a risk management system is rising, the implementation of such a system is a tremendous challenge given human resource constraints. Ten years on from the Asian financial crisis and in an environment which has benefitted from the results of certain reforms that were implemented back then, we are now in danger of falling into a rut of self-satisfaction. In order to develop the financial sector and prepare a system that can respond to a future crisis, through this conference it was possible for participants to share a common recognition of the increasing importance of cooperation among the relevant institutions and organizations in each country.