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Financial Regulatory Reform in East Asia: The Need for National, Regional, and Global Actions

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Weak regulatory and supervision of financial institutions were at the heart of the Asian Financial Crisis of 1997-1998. They were also at the heart of the Sub-prime mortgage crisis which became the on-going full-blown global economic crisis. The theory, models, and prudential indicators were all at fault. There was also an insufficient appreciation of systemic risks and the need for a robust system of macro-prudential regulation together with the micro-prudential one.

The on-going crisis has clearly highlighted that regulatory reforms should be coordinated globally and be international. First, the cross-border operation of many financial institutions and the strong contagion effects of the present crisis calls for multilateral actions. Second, multilateral rules would provide a level playing field and prevent regulatory arbitrage – that is, businesses running away from tightly to lightly regulated jurisdictions. Third, international regulation would reduce the influence of politicians over regulators and give the latter a certain amount of independence. **This means that regulatory reforms should be addressed at 3 levels - the national, regional and the global level.**

Reforms implemented by Asian countries after the Asian financial crisis at the **national level** and lack of sophistication of Asian financial markets, had enhanced the region's resilience to the present shock. But, of course, countries should not be complacent. Regulatory gaps have been exposed and global standards/codes and best practices are in the process of being revised and Asian countries should pro-actively implement them when they are available. Unfortunately, this has to be done without jeopardizing the on-going recovery. As suggested by Kawai and Pomerleano (2009), countries should also establish "systemic stability regulator" similar to the Financial System Stability Committee (KSSK) in Indonesia headed by the Finance Minister with the central bank governor and other regulators as a member.

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At the **global level**, the G20 appears to have reached a broad agreement on the need to tighten regulations, but partly reflecting the complexity of the issues views still appear to differ on several issues such as compensation packages and how to deal with institutions that are too-big-to-fail. It was easy to get a consensus on deregulation but difficult to get a consensus the other way around. The Leaders have agreed to develop internationally-agreed rules to improve quantity and quality of bank capital by end-2010 and implement them by 2012. The various standard setting bodies are at work and revised standards are to evolve over the next few years. In the area of macro-prudential monitoring, the recently strengthened FSB and IMF are to work jointly.

However, the political will for quick and coordinated reform seems to be lacking. Senator and candidate Obama had placed a lot of emphasis on regulatory reforms, but President Obama has not been very successful.

In terms of institutions, at the present level of political will it is not possible to establish a supreme international body with full-fledged regulatory and supervisory power over all financial institutions. Political will to establish such an institution is not there as countries would like a certain amount of autonomy over regulations.

The G20's approach has, therefore, been to extend the mandates and improve the governance of existing bodies like the FSB, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions and encourage a voluntary process of closer coordination among national regulators based on agreed multilateral frameworks. On the monitoring of implementation of the new standards by countries the IMF, World Band through their FSAPs and ROSCs has been given the tasks. The G20's approach is, therefore, more an institution-based one rather than a rules-based one with sanctions. This may not be enough. For example, the staffing and competencies at the FSB may not be adequate.

At some point in the near future, it may make sense to consider Barry Eichengreen's proposal to establish a World Financial Organization (WFO) because unless this is done cracks that have appeared in regulatory frameworks across the world may remain and so will the vulnerability to a new crisis. He had made this proposal at the time of the AFC and repeated it now once again.

Barry's idea is to establish a World Financial Organization (WFO) analogous to the already-existing World Trade Organization (WTO). In the same way that the WTO establishes principles for trade policy without specifying outcomes, the WFO would establish principles for prudential supervision (capital and liquidity requirements, limits on portfolio concentrations and connected lending, adequacy of risk measurement systems and internal controls) without attempting to prescribe the structure of regulation in detail. The WFO would define obligations for its members; the latter would be obliged to meet international standards for supervision and regulation for their financial markets. Membership would be mandatory for all countries seeking access to foreign markets. The WFO would appoint independent panel of experts to determine whether countries were in compliance of those obligations failing which the authorities would be able to impose sanctions against countries that fail to comply. Eichengreen reiterates that the WFO would not dictate regulatory conditions on countries.

At the **regional level**, the global economic crisis has enhanced the case for establishing the Asian Financial Stability Board (AFSB) to work with the FSB and eventually the WFO when established. The AFSB would be responsible for both micro-prudential as well as macro-prudential supervision[2]. The AFSB could promote financial stability in the region by developing and implementing early warning systems of banking crises. With ADB support, the ASEAN Secretariat and ASEAN+3 have already done some work in this area. The AFSB could also focus on long-term financial market development and integration issues in the region. It could work closely with the global standard-setting bodies in identifying best practices in financial regulation. The AFSB could also work closely with national regulators in providing training and capacity building to regulators in the region.

The AFSB and the eventually-to-be-established AMF could work together in promoting macroeconomic and financial stability in the region[3]. According to the latest information,

[2] Europe is in the process of setting up the European Systemic Risk Board as a macro-prudential monitor and the European System of Financial Supervisors for macro-prudential coordination.

[3] Some have suggested that given the difficulties in reforming IMF governance, the future IFA should comprise the IMF supported by regional reserve funds such as the AMF and the Latin American Reserve Fund established in 1980.

the CMIM – the $120 billion crisis fund - is to be operational from March 24, 2010. The additional steps required in moving from the CMIM to the AMF are (i) setting up an independent professional secretariat for analytical works and developing independent conditionality and (ii) delinking the CMIM from the IMF – this can be done after the professional secretariat is established. A decision has been taken to establish the secretariat, in the mean time such a service is being provided by the ADB and the ASEAN Secretariat

How about membership of the CMI/AMF and the AFSB? In addition, to **deepening** East Asian economic integration through the establishment of the CMIM/AMF, AFSB, ABMI, PAIF etc, it is necessary to **broaden** it by inviting India to contribute to and join the various regional financial integration efforts including the CMIM/AMF. This is for, at least, two reasons. First, nowadays people speak almost with once voice about the economic dynamism of China and India or “Chindia”. The re-emergence of these giants has implications for all Asian countries. China has become the largest trading partner of India. Second, by bringing in India, the Asian 6 members of the G20 – Australia, China, India, Indonesia, Korea, and Japan - could further leverage and strengthen their participation at the G20 which has replaced G8 as the premier fora for global policy coordination. Regional policy coordination could be conducted at the expanded ASEAN+3 and the views carried forward to the G20 by the ASEAN Chair who in the past has been invited to participate in the G20 Summits. Some have suggested that the East Asia group is the appropriate fora. This is not proper as the East Asia Summit focuses more on cultural and other issues. It is the ASEAN+3 that has the ERPD for policy coordination and the ESW models for monitoring economic and financial vulnerability.

In terms of trade and connectivity, market-led integration of South Asia with East Asia is increasing. The establishment of the G20 as a premier institution for global policy coordination has enhanced the case for South Asia and East Asia to cooperate in the areas of finance and macroeconomic policy as well.

Let me conclude, with a final thought. Financial sector in the US is now starting to recover. But full recovery in Western financial markets will still take a long time and they can’t meet the financing requirements of Asian countries. The crisis has, therefore, provided an excellent opportunity for Asian countries to develop local currency capital markets including bond markets by establishing a regional credit guarantee and settlement mechanism.

References

M Kawai and M. Pomerleano, Bolstering Financial Stability Regulation, Ft.com/economistsforum, 28 August, 2009.