International Conference on
The Role of the Financial Sector in Promoting Economic Growth in Asia
(Summary of the Conference)

The Financial Research Center of the Financial Services Agency (FSA Institute) held an international conference titled "The Role of the Financial Sector in Promoting Economic Growth in Asia" on February 3, 2011. The conference was jointly hosted by the Asian Development Bank Institute (ADBI) and the Keio University Global Center of Excellence (GCOE) Program.

Session I: The Development of the Asian Financial and Capital Markets and Its Implications for Financial Regulations

In session I, the impact of the global financial crisis on the financial system was examined and the progress in undergoing discussions on financial regulatory reforms was reported.

Mr. Masamichi Kono (Vice Commissioner for International Affairs, FSA Japan) explained how the recent global financial crisis emerged and how it spread to European and U.S. financial institutions. In response to the emergence of the crisis, bank rescue plans and regulatory responses were taken to stabilize the financial system. By spring 2008 the crisis seemed to have been managed, but in 2010 it turned into sovereign risk issues. Standard-setting bodies such as the Financial Stability Board (FSB) are developing rules and standards in response to the crisis. Mr. Kono stated that there are still some gaps to be addressed, such as the shadow-banking issue. Regarding the FSB and other standard-setting bodies, there should be strong legitimate criticism about their arrangements, governance and transparency given the importance and influence of the rules they set. Rules set by the G20 and the FSB are applied globally so there must be wide support and understanding for their activities. It was pointed out that the situation of Asia is different from the United States and Europe, and therefore Asia's voice must be institutionalized in the process of designing the new regulatory framework.

Mr. Hunsuk Rhee (Deputy Director General, International Cooperation, Financial Services Commission, Republic of Korea) presented Korea's experience in addressing the global financial crisis. At first, Korea was hit by the shortage in foreign currency liquidity, which later turned into credit risk. To cope with the liquidity shortage, the government provided payment guarantee to foreign currency borrowings by Korean banks, and with other measures in place Korea exited from the crisis quickly. He added that one country's efforts are not enough to address risk, and emphasized that coordinated efforts are necessary. He expressed his view that there are pros and cons to universal implementation, but to avoid regulatory arbitrage, rules should be implemented in the same manner across all countries.

Dr. Shogo Ishii (Director, Regional Office for Asia and the Pacific, IMF) described the current global situation as a dichotomy. The global economy is recovering, but the financial system is still unstable. Sovereign risk and banking-sector credit risk are intertwined. The creditworthiness of banks declined as shown in an increase in the credit default swap (CDS) spreads. Recently, as sovereign risk has been increasing, countries' CDS spreads are also increasing.
So far credit growth has remained moderate in general in the Asian region, but asset price pressures are strengthening as seen in the rising trend in the property market in China. Asset reallocation by global investors could increase further capital flows, risking macroeconomic and financial stability. Capital inflows to Asia are likely to continue, and hence a challenge for Asia would be how to manage volatile liquidity to maintain stability in the economy and the financial system.

Mr. Pietro Ginefra (Chief Representative for Japan, Korea and South East Asia, Bank of Italy) commented on recent developments in Europe following the global financial crisis. The global financial crisis revealed a lack of adequate macro-prudential supervision and an absence of truly harmonized rules in Europe. Given the situation, Europe decided to establish the European Systemic Risk Board (ESRB), which is responsible for macro-prudential analysis in Europe, and the European System of Financial Supervisors (ESFS), which is responsible for micro-prudential supervision with national authority and cross-border colleges of supervisors. Since Europe has faced sovereign risk, he pointed out the need for double-checking the effects of bank bailouts on public debt stability. Bank bailouts are useful to stabilize financial markets in the beginning, but later they can cause sovereign risk issues through increased public debt, and therefore decisions on bailouts need to be made carefully.

Session II: The Current State of the Financial Sector and the Regulatory Framework in Asian Economies

Session II looked at the financial systems of China, India, Thailand and the Philippines closely. Presenters from each country explained the current situation and how their financial system dealt with the global financial crisis. The effects of global regulatory reforms, such as Basel III, on their financial systems were also explained.

Mr. Luo Ping (Director General of Training Department, China Banking Regulatory Commission) explained recent developments in China's financial sector.
The key issue for China is how to keep focused on the domestic policy agenda while adopting new global standards. Basel III is another important milestone for capital regulation. However, Basel III is only part of an effective regulatory framework. While phasing in Basel III, China also needs to implement the idea of forward-looking provisioning policy, particularly to address the deterioration of credit quality following huge credit expansion in order to arrest the downturn of the economic activities indirectly affected by the financial crisis. In addition, activity restriction will be another effective tool to prevent banks from getting too complex for bankers to manage and for the regulators to supervise. China will focus on the domestic policy as a priority, while adopting new global standards. Until capital markets in China become mature enough to help finance a significant part of the funding demand, indirect intermediation by banks will continue to be dominant in China's financial situation. Therefore, the challenge remains with respect to how to keep the right balance between enhanced regulation and promoting financial innovation.

Dr. Abhijit Sen Gupta (Associate Professor, Jawaharlal Nehru University, India) presented the impact of the global financial crisis on India's financial system.
Despite a low exposure to the non-performing assets involved in the sub-prime crisis and a gradual approach towards liberalization of the financial sector, certain parts of the Indian financial sector were significantly affected by the global financial crisis. The consequent tightening of the liquidity and the slump in global and domestic demand had a strong adverse effect on the industrial sector, a large part of which is covered by small and medium-sized enterprises (SMEs). Therefore, there was a significant decline in employment and output in some parts of the SME sector. Indian policymakers reacted in a proactive manner, and introduced measures to counter the adverse effect of the financial crisis but the subsequent recovery has not been uniform. With regard to Basel III, the Indian financial sector will be impacted by its introduction. While

financial institutions in India are in a comfortable position to meet some of the proposed Basel III standards, the implementation of some of the other standards would be a challenge.

Mr. Bandid Nijathaworn (former Deputy Governor, Bank of Thailand) discussed regulatory reforms carried out in Thailand's financial system.
Financial-sector development in Thailand in the last ten years has been a story of restructuring, adjustment, and renewal. The reform of the regulatory and supervisory framework put in place following the Asian financial crisis was important in rebuilding and strengthening the financial sector, and it brought about a sounder and more resilient financial system. Such strength has enabled the economy to successfully weather the impact of the global financial crisis and helped place the economy on a recovery path. Key to these reforms was the consolidation of the banking sector, initiatives to deepen and broaden the capital market, the reform of the regulatory and supervisory standards under Basel II and IAS 39, and the reform of the legal framework in the financial sector. To further strengthen the financial sector, the reform efforts are continuing under the broad agenda of the Financial Master Plan Phase II, which focuses on improving the financial system's level of efficiency through greater competition, reducing the system cost by addressing the problem of non-performing loans, expanding access to financial services, and strengthening the risk management capacities of banks through complex financial markets and infrastructure in the current global financial crisis.

Mr. Diwa C. Guinigundo (Deputy Governor, Central Bank of the Philippines) presented the financial system of the Philippines.
The Philippine's financial system remained strong after crises in the 1980s and 1990s and even in the recent global financial crisis. Important banking reforms, particularly in the areas of supervision, corporate governance, risk management, and asset clean-up, have strengthened the banking system, boosting its overall performance with higher asset growth, enhanced asset quality, improved profitability and better capitalization. There were also some improvements in other areas of the financial system: the debt market has continued to develop, deposit insurance has been strengthened, and supervisory coordination enhanced. These same reforms served financial institutions well as they were able to stand global financial turbulence. Regulatory authorities are embarking on reforms to further strengthen the financial system with respect to emerging risks and to sharpen macro-prudential tools.

Session III: Challenges for the Asian Financial and Capital Markets and the "Growth Strategy"

In Session III, presenters identified the challenges for Asia's financial markets and provided solutions for such challenges.

Mr. Shigesuke Kashiwagi (Senior Managing Director, Government Affairs and Risk Advisory Group, Nomura Holdings, Inc.) emphasized the importance of fostering Asia's capital markets for further economic growth.

The Asian economy has grown significantly in the last decade. Despite the rapid growth in capital markets, indirect financing accounts for a substantial part of corporate financing, especially in countries such as China, India, and Malaysia. There will be a significant reduction in banks' lending capacity in Asia due to implementation of Basel III rules. Hence, capital markets will increasingly become important for financing in Asia. To this end, the governments of Asian economies are planning to develop capital markets in Asia through regional cooperation, including the Asian Bond Markets Initiative (ABMI). In addition, for further progress, Asia should make financial services into an "industry"; it should create a pan-Asian financial services industry.

Mr. Kashiwagi presented six solutions for achieving further development of Asia's financial system and markets. First, regulators should cooperate for harmonization and standardization of national rules. Second, standardization of hard infrastructure will contribute to more efficient market transactions. Third, regulators should engage in global regulatory reform discussions and carefully consider possible impacts that the new regulations, such as liquidity rules, would have on the region's capital market activities as they would raise the cost of market making. Fourth, development of reliable and efficient settlement systems will increase the resilience of the financial markets. Settlement systems are one of the most important infrastructures, especially for growing economies which need smooth money flows and market activities. Fifth, each country, city, or region should seek a core competitive skill set to make a pan-Asian financial services industry. And sixth, a consistent and predictable regulatory/supervisory approach is a crucial element for the private sector in making investment decisions and committing their resources.

Mr. Chikahisa Sumi (Deputy Commissioner for International Affairs and Competitiveness, FSA) presented Japan's growth strategy for financial markets and financial industry. Mr. Sumi briefly explained "The Action Plan for the New Growth Strategy," published by the FSA in December 2010, which summarizes necessary measures for the financial sector to promote economic growth. The action plan placed a focus on the importance of the growing Asia.

Mr. Sumi then described the situation of the Japanese financial system. Subprime loan products had limited direct impact on the Japanese financial sector, partly because Japanese financial institutions had implemented Basel II before the crisis. According to Basel II, unrated securitization exposures are deducted from capital unless a bank can appropriately capture the risk profile of their underlying assets. Therefore, banks were reluctant to purchase subprime products. The small exposure to toxic assets generally limited the losses from these assets for Asian financial institutions.

On the other hand, Japanese financial institutions were damaged by the subprime problem indirectly through contraction of external demand and valuation losses of equity holdings. Therefore, policy measures taken in Japan against the global financial crisis focused on maintaining financial intermediary functions, and were different from measures taken in the United States and Europe. These measures include capital injection to 11 regional financial institutions.

For Asian economic development, Asian countries need to make further investment in infrastructure. To this end, these countries need capital for investment. However, capital flows into Asia are not always stable; capital comes in quickly but can leave quickly. Therefore, these countries need to promote regional cooperation such as Chiang Mai Initiative (CMI) and ABMI in order to attract long-term funds.

Ms. Belinda Gibson (Deputy Chairman, Australian Securities and Investments Commission) emphasized the importance of regulatory cooperation. At international and regional levels, cooperation and coordination are critical to reduce arbitrage risks. Regulators must keep all regulatory provisions within a zone, especially in credit ratings. Information on capital inflows is not transparent to regulators. Information sharing between regulators would be useful.

Mr. Jiro Seguchi (President and Representative Director, Merrill Lynch Japan Securities Co., Ltd., Country Executive for Japan, Co-Head of Asia Pacific Corporate and Investment Banking, Bank of America Group) identified the challenge for Asia and discussed what the banking sector can do to address that challenge.

The challenge for Asia is how to make the current economic growth sustainable. There are two roles on the part of the banking sector in this regard. First, banks in Asia should have in place infrastructure and capacity to utilize excess capital within Asia. Specifically, banks need to implement stringent risk management in order to effectively utilize capital. And second, they should build infrastructure so that stable, long-term capital can be introduced to the region. On the part of regulators, they should work to establish robust and consistent standards across Asia. Consistent rules on governance structure will be crucial for financial institutions in making appropriate decisions in the changing financial situation. Transparency and disclosure are also important for efficient capital markets.

Session IV: Panel Discussion

The chairman of this session, Prof. Yoshino, summarized the discussions made in sessions I, II and III. The financial environment in Asia is different from those in the United States and Europe. For example, SMEs account for a significant part of the economy in Asia, and the financial system is bank-oriented, as bank lending is the most important financing means for many businesses. In some countries, access to credit remains difficult. Such unique features of Asia's financial system need to be taken into account when considering the roles the financial sector plays in promoting economic growth.

Discussions by panelists then took place. The summary of the discussions are as follows.

The situation of Asia's financial system is different from that of the global financial system. Asia's financial structure is dominated by the banking sector and banks are not as efficient and transparent as those in the United States or Europe. Hence, global discussions on regulatory reforms under the G20 and the FSB seem to focus on issues different from what Asia is facing. Asia should promote its voice to be heard in the global discussions.

Promoting access to finance and consumer education is important for continuing economic growth in the Asian region. The lack of financial products and the difficulty SMEs face to receiving credit from banks are issues that need to be dealt with to achieve further economic growth and to enable the fruit of economic growth to be distributed to a wider population. In relation to promoting access to finance, there is an issue that micro credit is not under the supervision of financial regulators or central banks.

Under the globalization of the financial markets, much more progress in the financial sector will be needed to strengthen regulation and supervision in Asia.