***Draft for discussion***

# Reforms to the Financial Sector in South Asian Countries to Promote Economic Growth with Financial System Stability

## The Future of Financial Sector Reforms

## 1. Introduction

South Asian countries began introducing far reaching reforms to the financial sector in their respective economies in the early 1980s. The nature and progress of these reforms vary from country to country. These initial reforms covered a number of areas, which included promoting competition in the financial sector, in particular, the banking sector; strengthening regulations; improving disclosure requirements and auditing and accounting standards; developing payment and settlement systems; and strengthening the legal framework. The reforms undertaken thus far have helped South Asian economies to significantly raise domestic savings, attract foreign capital, and raise economic growth rates. For instance, India, the largest South Asian economy, has successfully become a growth promoter of the world during the recent past as a result of financial reforms in the 1990s. Financial reforms had also been supporting greater economic integration of South Asia.

Financial crises often result in providing greater space for new reforms. In Asia, the case for strengthening the financial systems came to the forefront following the East Asian Crisis, leading to a further round of reforms in the 1990s. The current financial crisis, which began in the U.S. sub-prime mortgage market in 2007 and then became an unprecedented global financial and economic crisis within a span of one year, has already prompted a reassessment of financial sector policy making globally. In fact, the regulatory landscape is being reshaped to address many of the weaknesses in supervisory, regulatory and prudential frameworks.

Although in the case of South Asia, the financial sector did not have direct exposure to the complex financial products, which the beginnings of the current global crisis is associated with, the global crisis has already caused a considerable slowdown of

South Asian economies as a result of contagion effects of global shocks. The main channels through which these economies were affected were capital, remittances, credit and international trade. Outflows of capital, particularly towards the end of last year, a decline in receipts of foreign remittances, drying up of international credit markets and a contraction in exports have had serious implications for these economies. These developments call for a careful reassessment of the reforms that have already been implemented. It is also necessary that we examine further the additional reforms that are necessary, since an efficient, competitive and resilient financial sector is a key determinant of the ability of South Asian economies to move to a sustainable high growth path.

## 2. Strengths and flaws in the current financial architecture

**There are several strengths in the current financial structure that lessened the direct impact of the global financial crisis on South Asia.** Supported by previous financial reforms, several South Asian economies have already built up healthy reserves, shown improved export performance and enhanced risk-taking capabilities of financial institutions, which have contributed to mitigate the impact of the global crisis. At the same time, some reforms have not yielded required results. Therefore, we discuss below some of the reforms that are proven to be effective and reforms that have not been effective in achieving desired results.

**The banking reforms in many countries in the South Asian Region had started with the opening up of the financial sector for domestic and foreign competition.** With the liberalization of entry restrictions, many foreign banks have set up branches in South Asia and privately owned banks were established thereby increasing competition among banks. This has also resulted in a sharp reduction in the market shares of state owned banks. With the opening up of financial markets, the ownership pattern of financial institutions too has changed. Meanwhile, banks have also set up various fee-based activities by setting up entities to engage in merchant banking, leasing and stock-broking, and insurance, thus expanding the financial services they offer. In order to remain competitive, many banks in the region have invested in state-of-the-art technology and state banks too have invested in technology, contributing to increased efficiency of financial services.

**Expanding the availability of credit information was vital for the growth of the banking industry.** The non-availability of sufficient information about credit histories was a major factor that deprived many credit worthy borrowers of access to credit. **.** Hence, many countries in the region have established Credit Information Bureaus. In some countries, the information base has been expanded to cover other ancillary information such as utility payment histories also.

**In the recent past, banks have been required to obtain credit ratings from Credit Rating Agencies acceptable to the respective regulators, thus enhancing transparency and investor awareness of banks.** Further, there has also been a need to advise borrowers regarding banking products and to rehabilitate borrowers to increase credit quality. Accordingly, many countries in South Asia have set up Credit Councils, with the objective of increasing credit quality, promoting awareness of banking products and inculcating credit discipline among customers and potential customers.

**There has also been a significant change in the conduct of monetary policy over the years.** The main focus of monetary policy has shifted to achieving a sustainable path of low inflation. In monetary management, central banks now rely primarily on market oriented instruments. Accordingly, Open Market Operations have become the main instrument used to manage market liquidity while encouraging good liquidity management by financial institutions. In moving towards amore market oriented monetary management system, steps have also been taken to enhance the transparency, predictability and credibility of monetary policy. In this regard, countries have set up mechanisms to provide information on the monetary policy framework, monetary projections, and changes in the monetary policy stance.

**An efficient and secure payment and settlement system is key to the effective functioning of the financial system.** Hence, payment and settlement systems have been upgraded and modernised in many counties. Facilitating the payment and settlement of large value and time critical transactions, the central banks in Sri Lanka, India and Pakistan have implemented Real Time Gross Settlement Systems which attract the majority of high value and time critical inter-bank payments. Electronic fund transfer mechanisms have also been put in place, enabling the implementation of modern retail payment systems. To further modernise and increase the efficiency of payment systems, a cheque imaging and truncation system has been introduced with the long-term objective of moving towards electronic cheque transactions. The SARRC payments initiative is another step taken by central banks in the region to reform national payment systems and regional payment and settlement systems collectively.

**Enhancing access to finance is crucial for increasing opportunities available to small and medium enterprises (SMEs) and low-income groups and therefore, for fostering economic growth.** Many countries have taken measures to expand and strengthen the development finance delivery systems in their respective countries in addition to taking steps to create a conducive environment for the establishment of financial institutions in rural and remote areas. Introduction of credit guarantee schemes with a view to encouraging bankers to grant facilities in relation to poverty alleviation microfinance projects has also helped expand the outreach at a relatively low cost. SMEs in Sri Lanka are unduly constrained in terms of access to credit on commercial terms. In this regard, credit secured on movable assets is severely underutilized, in large part due to accompanying high risks and transaction costs. Accordingly, a Secured Transaction Registry will be set up with the objective of facilitating the extension of credit secured on movables and intangible collateral.

**Several new regulatory measures have been introduced to strengthen the regulatory and supervisory framework.** Central banks have moved away from compliance-based supervision to risk-focused supervision. Considering the fiduciary responsibility of the Boards towards their stakeholders, and in the interest of wider financial system stability, central banks have issued directions on corporate governance requiring banks to streamline their governance practices.

**The implementation of the Basel II framework is another enhancement to the regulatory structure.** It has contributed to improving the financial industry's risk management mechanisms. With the adoption of Basel II, most of the leading banks have taken steps to set up independent risk management units and compliance divisions to monitor bank-wide risks. Major banks are now focusing on implementing advanced approaches under the Basel II framework and have set up data warehouses and sophisticated IT systems, which will contribute to better risk management and compliance. Similarly, the adoption of Basel II will enhance disclosures, presentation, and measurement practices in relation to financial instruments.

**Although in many countries, the financial sector has expanded with improvements in the institutional structure, developments in money and capital markets, facilities and products offered, there are several weaknesses in the current financial architecture as shown by several indicators.** In particular, low financial deepening, high intermediation costs, a low level of access to finance, and under developed bond and derivative markets clearly show that some reforms have not been effective.

**In many of the South Asian countries, a large share of the banking sector is still state-owned and requires to be better managed.** South Asian countries have a much higher proportion of state-owned banks than the rest of the world, ranging from 20% of total banking assets to 70%. Although, in the current uncertain environment, the stability of the financial sector owes much to the high degree of state ownership given the generally high degree of public confidence in state-owned entities in times of turbulence, state-owned banks throughout the region are found to be less competitive and have tended to be less profitable and efficient when compared with privately and foreign-owned banks. This is largely attributable to higher operating expenses due to overstaffing and higher loan-loss expenses, reflecting the generally poorer asset quality arising from directed or priority sector lending and politically influenced credit decisions.

**The non-availability of an appropriate regulatory environment is a major constraint for the development of non-bank institutions and markets.** In many countries in South Asia, stock markets have developed and expanded. However, bond markets are not developed, restricting the array of financial instruments available to diverse investors. With regard to bond markets, a liquid corporate bond market could help prevent the build up of asset price bubbles. Foreign access to local bond markets is also limited mainly due to macroeconomic concerns. Meanwhile, high government borrowings from the non-bank sector crowd out investments, while deficiencies in respect of disclosure standards, credit rights, as well as investor protection have hampered the development of liquid bond markets.

**The non-availability of an institutional investor base has constrained activity in money and capital markets. An** institutional investor base is needed to provide funds for long-term investment requirements. **In this regard,** pension funds and insurance companies should be promoted as they play an important role in mobilising long-term funds.

**Underdeveloped derivative and securitization markets constrain the expansion of financial markets and therefore financial deepening**. Many investors/borrowers are exposed to market, liquidity and credit risks. In this regard, the non-availability of developed financial markets with requisite products such as credit derivatives has not permitted the allocation of risks such as credit risk and interest rate risk amongst market participants in accordance with their preferences.

## 3. Lessons for future financial sector reforms that can be drawn following the global financial crisis

- ***Need for greater co-ordination and consistency between economic y policies and the regulatory framework for financial system stability***: One of the major causes of the financial crisis is the macroeconomic imbalances. The prudent management of fiscal and monetary policies and allowing appropriate adjustments in the exchange rate are important to prevent the build up of crisis triggering factors such as a sharp depreciation of the exchange rate or a significant increase in inflation, which are likely to result in a deterioration of the trade and current account balances and therefore the balance of payments and the reserves position of the country. A stable macroeconomic environment, particularly credible and prudent monetary policy along with supporting fiscal management are found to be the prerequisites for the development and stability of the financial sector.

- ***Need for further strengthening the banking sector by allowing mergers and acquisitions:*** A rationalization of regulatory standards to permit consolidation of small weak banks through mergers, acquisitions and closures needs to be considered to promote a healthy consolidation of the banking system in order to eliminate weak banks.

- ***Bringing the unregulated shadow banking system together with the significant build-up of off-balance sheet leverage under the scrutiny of the prevailing regulatory regime:*** In most of the Asian countries, the shadow banking system has not been subject to the rigorous prudential regulatory requirements applicable to the licensed financial institutions. Further, the growing use of structured investments allows excessive build-up of off-balance sheet leverage.

- ***Development of non-bank financial institutions:*** Specific measures need to be taken to develop non-bank financial institutions as they provide vital financial services, and have the potential to expand their role in areas where banks are unlikely to be competitive.

- ***Need for developing capital markets to raise long-term funds and share the risk of raising capital:*** A developed bond market plays an important role in improving the efficiency of financial markets and promoting sustainable economic growth. By expanding the range of opportunities available to financing large-scale projects, contributing to better allocation of capital, providing a non-inflationary source of finance for the government and facilitating public debt management, , a developed bond market could contribute significantly to the progress of a country. There is a need to strengthen the institutional infrastructure and remove impediments, which will foster the efficient functioning and sustained growth of the bond market, particularly the corporate bond market. In this regard, particular emphasis needs to be placed on the institutional infrastructure; establishing rating agencies, trading platforms, and clearing and settlement systems; and the regulatory environment..

- ***Promoting long-term funding sources and derivative/futures markets:*** Policies to develop a diversified institutional investor base will ensure sustainable demand for bonds. In particular, pension funds and mutual funds not only create demand for fixed income securities but also contribute to increasing financial innovation and enhancing corporate governance and competition in the bond market. Strengthening the disclosure standards, credit rights and investor protection too will help remove impediments to the smooth functioning of the bond markets.

- ***Improving access to finance:*** Micro finance has been found to be an important instrument in poverty reduction through promoting economic activities as micro finance provides relatively easy and flexible financing options. However, the presence of a large number of unregulated finance businesses can cause instability in the financial system due to frequent failures of unauthorised financial institutions, disputes between those institutions and their customers, and the resulting continued uncertainty as well as public perception that most of those institutions are not solvent. The introduction of an appropriate regulatory mechanism for MFIs will strengthen the environment within which MFIs operate and will thus foster public confidence in the financial system. In view of the fact that some MFIs have already been operating under the existing regulations, the Central Bank of Sri Lanka has adopted a two tier approach for the regulation of MFIs. The existing regulatory and legal framework is used to the extent possible while setting up a comprehensive legal, regulatory and supervisory framework for categories of institutions whose micro finance business is not currently regulated and/or supervised by any institution.

- ***Strengthening the regulatory and supervisory framework and better corporation between regulators:*** Lack of coordination among different regulatory agencies within countries and amongst countries had been a risk factor that had contributed to the global financial turmoil. Therefore, there is a need for regulators in the region to form regional alliances to establish a mechanism that can effectively monitor cross-border financial activities that could threaten financial stability.

- ***Consolidated supervision to limit regulatory arbitrage that can arise from fragmented supervision:*** Lack of consolidated supervision is another risk factor that had contributed to the recent global financial market crisis. As with some developed financial markets, regulators' responsibilities vary widely within the Asian region as well. In some jurisdictions, there are integrated regulators with prudential supervisory responsibilities for the full range of financial activities while in other jurisdictions the regulators have responsibility for supervising diversified financial groups at the holding company level. But, in certain countries, there is no integrated regulator with responsibility for the entire financial system or such regulators have a mandate to supervise holding companies which are not themselves licensed institutions. In order to ensure financial system stability, it is necessary for regulators to adopt a "group-wide approach" to the supervision of licensed institutions so as to take account of the possible effect of all risks within the group on licensed financial institutions, wherever they reside within the group.

- ***Need for a well-established resolution framework:*** As witnessed in the recent past, bank failures cause significant direct and indirect costs to economies resulting in enormous economic and business hardships to all segments of the society. At a broader level, bank failures jeopardize the maintenance of financial system stability and public confidence in the financial system. Therefore, Bank Regulators and Supervisors across Asia have to be prepared to take timely measures to avoid bank failures and to cushion the impact of failing or failed banks. Dealing with weak banks would present serious difficulties unless contingency plans are in place and there is a good understanding of the tools available for handling such weak banks and nonbank financial institutions. Appropriate measures have to be put in place with a view to facilitating the identification of weak banks, taking appropriate corrective measures to turn around weak banks and setting out an appropriate exit strategy. Successful identification of an impending bank failure is a challenging task but if undetected, losses could increase further. Therefore, suitable methods, which could be used to form the basis of identification of weak banks, need to be formulated and established.

- ***Improving Governance:*** The adoption of sound corporate governance standards and practices is an important means of ensuring that licensed banking institutions are managed in a safe and sound manner. The financial institutions that have strong governance and compliance processes will be more capable of winning public confidence, attracting investors, improving corporate reputation and efficiency, as well as contributing to promote financial system stability. In order to steer the banking sector in this direction, principle-based rules on corporate governance need to be prepared. These rules should place significant emphasis on the role of boards of directors and their responsibility to maintain proper stewardship of the institutions, as well as to ensure that the policies and procedures adopted by the banking institutions are sound and prudent and are adhered to at all levels of the organization at all times.

- ***The need for strengthening disclosure requirements and monitoring compliance with standards :*** Financial crises repeatedly show the lapses in financial reporting, non-compliance with accounting standards and adopting creative accounting methods to boost profits and hide material risks. Effective or sufficient internal controls and processes are fundamental to making sure that accounting standards are met. There is an urgent need for supervisors and regulators to improve disclosure standards and make sure that there is a mechanism in place to ensure that standards are complied with and monitored.

- ***Developing a regional alliance to facilitate intra-trade, excess fund investments by banks, and investments in sovereign bonds raised by regional economies:*** Already, several cooperative bodies and mechanisms have been established in many regions, to facilitate and promote intra-trade and excess fund investments. A mechanism that promotes the domestic bond market is essential as a developed bond market is necessary for sustainable development in South Asia.

- ***Disclosure of information:*** Information disclosure plays a key role in building market credibility and attracting foreign capital. Developing proper disclosure standards based on consolidated accounts and well established auditing and accounting standards will help markets and supervisors. In this regard, the adoption of IAS standards and promoting the listing of companies will also have a positive impact on information disclosure.

- ***Improve financial literacy and awareness about the characteristics of new financial products among investors:*** Enhanced understanding of the capital markets on the part of both issuers as well as investors will allow them to make educated decisions therefore would contribute enormously to the long-term development of the financial markets.

**4. How can regulators challenge the pro-cyclical risk taking behaviour of banks to a greater extent?**

A number of pro-cyclical features embedded in the market structure have induced banks to take excessive risks. Also it is alleged that the Basel II framework has reinforced the pro-cyclicality of the financial system by increasing risk sensitivity in financial regulation. However, some counter-cyclical measures were taken by several countries in the region to contain the pro-cyclical risk taking behaviour of banks, prompted by the large expansion in private sector credit and the overheating of economies during 2005-2007. In addition, some countries introduced provisions even on performing loans and increased risk weights to high-risk categories of loans in the computation of capital adequacy.

Following are some of the counter-cyclical mechanisms that would create negative feedback loops at the micro-level as well as the macro-level, to reduce excessive risk taking.

- ***Counter cyclical capital buffers and stronger quality of capital:*** A sound capital buffer is critical for banks' resilience to shocks and to promote financial stability. It hasbeen found that there is inadequate capture of risks by the Basel II framework in relation to complex credit products, while the minimum capital requirement and the quality of capital did not provide adequate buffer during the crisis. In this regard, creating counter-cyclical capital buffers by widening the coverage of capital requirements, taking into account asset-backed securities, off-balance sheet risk exposures and trading account activities; and improving the quality of Tier I capital, are some of the measures that are being considered.

- ***Fixing leverage ratios:*** Introducing a simple fixed minimum leverage ratio for capital will contain the size of bank assets and hence, would reduce risk taking by banks.

- ***Forward-looking provisioning:*** Dynamic provisioning which is aimed at capturing the rising risk of default over time is a countercyclical regulatory measure that mitigates risks from rapid loan growth.

- ***Requiring a meaningful share of the underlying assets to be retained on the balance sheets:*** Regulators could ask financial institutions to retain a meaningful share of the underlying assets on their balance sheets in order to alleviate the problems associated with the "originate-to-distribute" business model, including moral hazard and fraudulent loan under writing.

- ***Need for formulating specific guidelines for determining fair value measurement when there is no orderly market place:*** Fair value accounting has been identified as a factor that exacerbated the global financial market crisis, amplifying the market fluctuations. Even though the fair value approach is capable of showing the real time value of financial instruments, the danger is that it also magnifies the changes in their values, thus increasing the volatility of returns of banking and other financial institutions. In view of the foregoing, a guided adoption of fair value accounting, is necessary to avoid volatility in earnings of financial institutions, especially in non-active markets.

- ***Addressing the over-reliance on credit rating and enhancing internal rating capability***: The role played by external rating agencies had some pro-cyclical effect on the global financial crisis simply because of the similarities in assessments made by all major rating houses and also due to the very fact that the public and financial institutions had used them as the yardstick for operations and performance assessments. In view of the foregoing, regulators could encourage banking institutions to exercise their own judgment to assess risks, and not rely solely on risk assessments provided by the rating agencies. Hence, regulators need to encourage financial institutions to enhance internal rating capability to rely less on external ratings.

- ***Implementation of Pillar 2 of Basel II, as it provides a right balance of economic capital, commensurate with all other risks:*** As we are aware, the Basel II framework allows financial institutions to apply the internal rating-based approach in pricing and assessing risks associated with complex products. Risk weights for the purpose of capital adequacy calculation are derived from internal modelling. Currently, risk weights are generally low and lead to a high capital adequacy ratio (CAR) during economic upswings, and a low CAR during a cyclical downturn, everything else equal. As a result, financial institutions tend to have high leverage ratios during good times and have to deleverage during bad times. This amplifies bubble buildup during upswings and leads to a credit squeeze and asset dumping during downturns, thus increasing cyclical volatilities, reflecting a strong pro-cyclicality. In this regard, Pillar 2 of Basel II including the implementation of ICAAP provides a right balance of economic capital, which is commensurate with all other risks not covered under Pillar 1. It enables banks to compare the capital requirements with available capital to gauge whether the degree of leverage is appropriate given the amount of risk undertaken and the institution's desired risk appetite.

- ***The need for addressing the systemic risk in the context of banks outsourcing the development of internal control systems and the technical models:*** Experiences of some countries suggest that many financial institutions have outsourced the development of their internal control systems and the technical models used by the bankers and traders. Most of this work has been undertaken by a handful of quantitative analysts who are consulted throughout the industry. Such models tend to produce similar directional results at the same time when certain conditions prevail adding to the pro-cyclicity. It may therefore be appropriate to give issuers of structured products more incentives to better assess their risks.

## 5. Conclusion

***The presence of a sound and stable financial system is crucial for achieving sustainable economic growth and prosperity.*** Given the continuously evolving financial landscape and global integration of financial markets, it is of utmost importance that financial sector reforms are pursued to increase efficiency, competition and resilience of the financial sector, and to take the South Asian economies to a high growth path.

***Prudent monetary policy, supported by fiscal policy and appropriate adjustments in the exchange rate, is necessary to contain inflationary pressures on a sustainable basis and thereby provide a conducive environment for the development of the financial sector and for promoting financial sector stability.*** Further, several policy initiatives and targeted reforms are needed to strengthen the institutional infrastructure and remove any impediments to fostering the efficient functioning of the financial markets. In this context, in South Asia, to remove inefficiencies in product, labour and capital markets, structural issues may need to be addressed. Therefore, in removing bottlenecks in infrastructure and inputs markets to support the development of the financial sector, the co-operation of stakeholders from other sectors is also needed..

## Table 1

## Selected Economic Indicators for South Asian Countries -2007

| | **Afganistan** | **Bangladesh** | **Buthan** | **India** | **Maldives** | **Nepal** | **Pakistan** | **Sri Lanka** |
|---|---|---|---|---|---|---|---|---|
| GDP per capita ($) | 350.1 | 486.8 | 1664.8 | 1028.7 | 3470.5 | 390.8 | 910 | 1616.1 |
| GDP Growth | 11.5 | 6.4 | 17.0 | 9.0 | 7.6 | 2.6 | 6.8 | 6.8 |
| Inflation | 13.0 | 7.2 | 5.2 | 4.7 | 7.4 | 6.4 | 7.8 | 15.8 |
| Fiscal balance | (1.8) | (3.2) | (3.4) | (5.4) | (7.8) | (2.0) | (4.3) | (7.7) |
| Current Account Balance | 0.9 | 1.4 | 10.5 | (1.5) | (40.1) | (0.1) | (4.8) | (4.2) |
| Gross International Reserves (month of imports) | 3.6 | 3.3 | 12.9 | 15.0 | 3.1 | 8.9 | 4.5 | 2.9 |
| M2/GDP | 21.6 | 45.3 | 59.2 | 85.2 | 73.8 | 54.4 | 50.6 | 39.2 |
| Bank Deposits/GDP | 10.9 | 39.5 | 46.0 | 68.0 | 64.9 | 29.9 | 79.4 | 65.3 |

(Extracted from ADB review on South Asia's Financial Sector)