

# **Financial Regulatory Reforms: Not far enough or Overkill?**

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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.

# 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

# 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)

# Asian Perspectives

## 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**