# Governance & Development: Views from G20 Countries

**Session 4** **Presentation**

## Progress and Implications of Reforming the Global Financial System

**JAE HA PARK**

September 17-19, 2012

India Habitat Centre, New Delhi

# Progress and Implications of Reforming the Global Financial System

**Jae Ha Park**

**Deputy Dean**
**Asian Development Bank Institute**

**Governance and Development: Views from G20 Countries**
ICRIER, Delhi, India, 17-19 September 2013



# Causes and Lessons of the Global Financial Crisis (GFC)

## Causes of the GFC

- The GFC revealed a number of flaws in financial regulation and supervision
  - inadequacy of the macroprudential supervision
  - shadow banking
  - “too-big-to-fail” problems
  - insufficient capital and liquidity standards
  - inadequate transparency on derivative products
  - procyclicality



## Lessons Learned from GFC

- A number of lessons can be learned from the experience of the GFC
  - 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, particularly in the US and Europe
  - corporate governance failed, including uninformed and negligent boards

## Lessons Learned from GFC

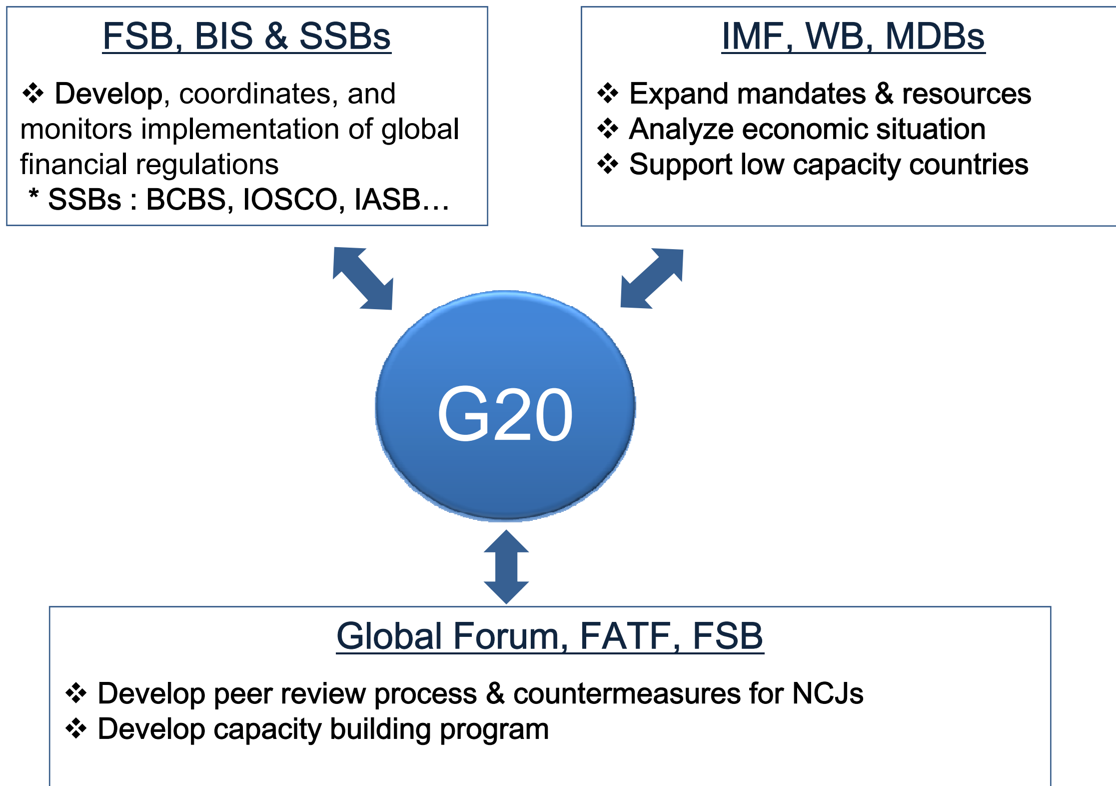
- under appreciation of the importance of the relationships between banks and non-banks
- overreliance on credit rating agencies
- the potential high cost of innovation
- compensation structures/asymmetric incentives
- the systemic importance of non-banks

- For emerging markets, particularly in Asia, these lessons highlight the importance of having sound financial systems to promote long-term and balanced development, as well as to absorb various types of shocks.



# Financial Regulatory Reforms after the Global Financial Crisis

# Financial Regulatory Reforms after GFC




# Financial Reform Process after GFC

- Diverse financial reform measures have been taken by various organizations and countries to make financial systems more resilient and better able to serve the needs of the real economy.
  - strengthening prudential regulation
  - reducing systemic risk
  - increasing regulatory scope
  - improving internal risk management and compensation systems
  - developing global accounting standards and
  - improving measures to deal with non-cooperative jurisdictions (such as tax havens, money laundering and terrorist financing).

# Financial Reform Process after GFC

- Among the various organizations that were the locus of coordination, the Financial Stability Board (FSB) took several measures including
  - Basel III compliance
  - raising the capital requirement for banks
  - getting more over-the-counter derivatives centrally cleared on platforms
  - improving the resolvability of systemically important financial institutions, etc.



# Other Regulatory Initiatives

- Other regulatory issues are being debated, including
  - strengthened oversight of shadow banking
  - credit rating agencies
  - development of macroprudential frameworks and tools
  - convergence to strengthened international accounting standards; and
  - strengthened adherence to international supervisory and regulatory standards.

# Implications of New Rules on Asian EMEs



# Implications of the New Rules

- It is widely expected that financial reforms efforts will bring about substantial benefits by
  - reducing the risk of financial crises,
  - enhancing the resilience of banks and other financial institutions in case crises do arise,
  - reducing economic volatility and increasing transparency
- However, they will also apply to a great extent to emerging economies, including those in Asia, even those economies that did not experience financial crises, and have financial systems considerably different from those in advanced economies.

# Implications of the Higher Capital Requirements Rules on Asian EMEs

- For EMEs, new definition of capital is not expected to represent a significant change in practice. In these economies, there are few alternatives to equity; common equity has always been the major component of capital (IMF GFSR 2012).
- Asian banks, in particular, are generally well capitalized, with overall capital adequacy levels well above the 10.5% target for 2019. NPL ratios are also generally low, reflecting the passage of time since the Asian financial crisis.
- However, the new rules could prompt Asian banks to raise capital ratios to maintain a safe margin above the minimum requirements, which could have negative impacts on loan growth.



# Asia's Financial Soundness Indicators

| Country | Capital Ratio | | NPLs | |
|---|---|---|---|---|
| | 2000 | 2011 | 2000 | 2011 |
| PRC* | 13.5 | 12.7 | 29.8 | 1.0 |
| Hong Kong, China | 17.8 | 15.8 | 6.1 | 0.7 |
| India | 11.1 | 13.1 | 12.7 | 2.7 |
| Indonesia | 21.6 | 16.1 | 18.8 | 2.1 |
| Japan | 12.2 | 14.2 | 6.1 | 2.4 |
| Republic of Korea | 10.5 | 14.0 | 6.6 | 0.5 |
| Malaysia | 12.5 | 17.7 | 15.4 | 2.7 |
| Philippines | 16.2 | 17.1 | 16.6 | 2.6 |
| Singapore | 19.6 | 16.0 | 3.4 | 1.1 |
| Taipei,China* | 11.9 | 11.9 | 4.4 | 0.4 |
| Thailand | 11.9 | 12.3 | 17.7 | 4.1 |
| Viet Nam | N/A | 11.6 | N/A | 1.6 |

Notes: Capital ratio means the Ratio of Bank Regulatory Capital to Risk-Weighted Assets, %. NPL = Ratio of non performing loans to weighted risk assets, %

* PRC's NPL ratio, Taipei,China's Capital Ratio and NPL Ratio for 2000 and 2001 data.

Sources: Financial Soundness Indicators, IMF, available at: http://fsi.imf.org/, accessed 13.02.2013; Bankscope (for Taipei,China, Thailand (2010-2011), and Viet Nam (2007-2011)).

# Implication of the Liquidity Standards on Asian EMEs

- Potential issues of the liquidity standards for emerging economies include
  - the scarcity of high quality liquid assets in emerging market economies (EMEs) may inhibit local capital raising and constrain liquidity in local markets.
  - liquidity ratios may constrain bank lending in economies where bank lending is the main source of credit.
  - the calculation of required ratio can be complex.



# Implication of other requirements on Asian EMEs

- A number of other new requirements originating from the FSB and the Basel Committee on Banking Supervision (BCBS) may have potentially negative impacts on Asian EMEs
  - Policy measures for globally systemically important financial institutions may constrain lending growth in host countries.
  - Additional capital requirements and margin requirements for uncleared over-the-counter derivatives may limit financing opportunities.
  - New rules may put domestic central clearing parties at a disadvantage relative to those in advanced economies.

# Recommendations for Financial Regulatory Reforms to help EMEs



# Recommendations for Financial Regulatory Reforms to help EMEs

- International bodies should take into account EME-specific considerations and concerns in designing new international financial standards and policies.
- The international community should continue to promote the development of supervisory capacity in EMEs, particularly through technical assistance.

# Recommendations for Financial Regulatory Reforms to help EMEs

- FSB (2011) emphasizes on:
  - strengthening supervisory independence, resources and capacity
  - adjusting prudential frameworks to reflect the growth in, and the risks arising from, small-scale, non-bank lending and deposit-taking institutions
  - strengthening the management of foreign exchange risks
  - promoting the development of a domestic investor base
  - taking measures at both national and regional levels to deepen capital market liquidity; and
  - ensuring the robustness of the infrastructure for clearing and settlement systems



# Recommendations for Financial Regulatory Reforms to Help EMEs

- Identifying potential major systemic risks to Asian economic and financial stability emanating from the GFC and eurozone crisis.
- To sustain Asia's growth, regulators in the region need to:
  - improve investor-friendly financial regulations
  - ensure predictable and transparent enforcement of financial regulations
  - improve financial infrastructure and corporate governance
- All these strategies taken at the national and regional level may complement the strengthening of Asia's financial system to make it more resilient to any potential crisis risks arising regionally or globally.

# Financial Regulatory Reforms affecting Long Term Finance



# What is Long Term Investment Finance?

Long-term finance is defined as maturities of financing in excess of five years, including sources of financing that have no specific maturity (e.g., equities).

Long-term investment is spending on the tangible and intangible assets that can expand the productive capacity of an economy.

Long-term financing is critical for investment and necessary to fuel longer-term global growth.

Long-term financing can be considered as the process by which the financial system provides the funding to pay for investments that stretch over an extended time period.

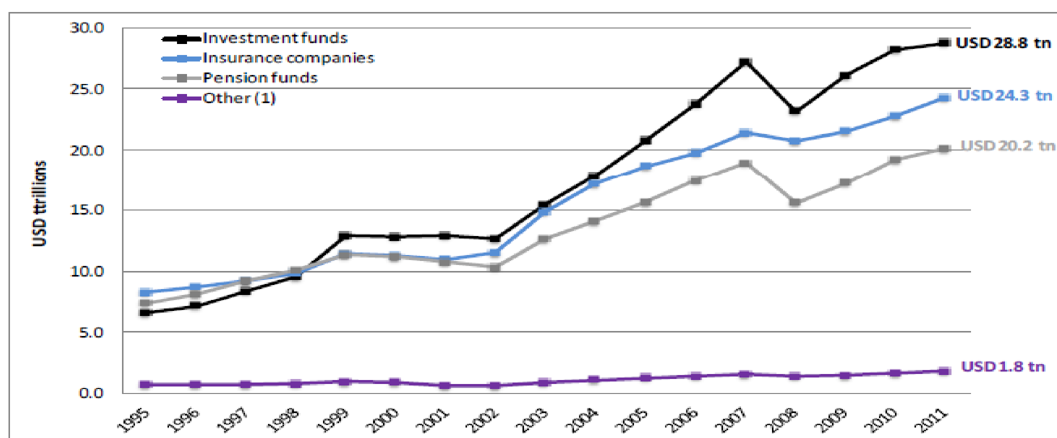
# What is Long Term Investment Finance?

- Long-term investments tend to be *less liquid*, have *maturities that extend beyond the business cycle*, and are *more exposed to changes in credit quality and inflation expectations* rather than short-term market volatility.
  - public and private infrastructure
  - equipment and software
  - education and research and development
  - new housing and real estate development
  - construction of oil, gas, and energy facilities, etc.



# Institutional Investors

- Institutional investors – such as insurance companies, mutual funds, endowments and pension funds – are suitable providers of long-term investment capital and funding in the financial system.
- Traditionally, banks have been a key player in the financial system, transforming savings into long-term capital to finance private sector investment.
- Recently pension funds, insurance companies, and mutual funds are becoming increasingly important players in financial markets.




Total assets by type of institutional investors in the OECD, 1995-2011
*(in trillions USD) (OECD 2013)*

# Financial Regulatory Reforms which may affect Long Term Finance

- New banking regulations (Basel III) could affect negatively the ability of banks to provide long-term financing.
- Over-the-counter derivatives reforms are likely to influence the supply of long-term finance for commercial end-users.
- The on-going shadow banking reforms aim to promote prudent financial intermediation and thereby contribute to more sustainable non-bank financing, including for long-term investments.
- Move to market-consistent valuations and risk-based solvency standards may indirectly affect the ability of pension funds and insurers to act as long-term investors.



# Reforms and Long-Term Financing Gap

- Emerging long-term financing gap is particularly acute in the infrastructure sector. It could slow the world economy for years to come and abort attempts by emerging and developing economies to set themselves on a high-growth path.

- However, there is little tangible evidence to suggest that global financial regulatory reforms have significantly affected to current long-term financing concerns.

- It is too early to assess the impact of global regulatory reform on the availability of long-term investment financing.

## How to Develop Long Term Finance in the Asian EMEs

- From a longer-term perspective, promoting the development of domestic contractual savings and the capacity of domestic financial systems to intermediate them will foster more and less volatile long-term finance, particularly in EMEs.



## Conclusion

## Conclusion

- Despite the various debates on financial regulations, the lessons of the GFC should not be forgotten.
- Reform efforts need to continue to strengthen financial regulations so as to limit malpractices and misbehavior in the financial industry.
- Special needs and economic situations of EMEs must be considered when new rules and regulations are introduced. In particular, role of FSB regional consultative group need to be strengthened.
- Monitoring the effect of regulatory reforms on an on-going basis will facilitate the identification of any factors that may disproportionally impact the provision of long-term finance so that they can be addressed.



## Thank you