NEAT Conference on East Asian Financial Cooperation

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Panel V: Financial Cooperation at Other Aspects

"Reforming Financial Regulatory Frameworks in East Asia: Some Implications for Financial Cooperation"

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1. Important structural changes are taking place in financial systems in the region[2]

- ***Financial systems have become more diversified***

  Although banks continue to be the biggest sector in most financial systems in East Asia, there has been progress in diversifying financial markets after the 1997 Asian financial crisis, due to the focus of policymakers in the region to develop especially the equity and bond markets. East Asia's equity market has tripled since 1997. Bond markets have also seen sizable growth over the past six or seven years, although much of the growth in bond markets was due to government issuances. But overall, compared to countries in other regions with broadly comparable per capita incomes, those in East Asia have relatively large banking, equity, and even bond markets.

Table 1 **Structure of financial systems in East Asia** (in percent of GDP)

	Bank assets		Equity market capitalization		Bonds outstanding	
	1997	2005	1997	2005	1997	2005
China	124.6	163.1	11.2	17.8	12.9	24.4
Indonesia	31.1	49.8	12.2	28.9	1.9	19.6
Rep. of Korea	37.9	93.5	8.1	91.2	25.2	76.2
Malaysia	100.9	159.4	93.2	138.0	57.0	88.0
Philippines	56.1	63.2	37.7	40.4	22.4	36.7
Singapore	122.0	185.4	110.8	220.4	26.0	68.2
Thailand	79.7	103.6	15.1	70.1	7.1	40.8

Source: Ghosh (2006): Table 1.1, p. 27.

- ***Significant consolidation and diversification have taken place in the banking sector in the region***

Table 2 **Measures of consolidation and diversification of banking sector activities in selected East Asian economies**

	Median size of assets (US$bil)		Median market share of assets (%)		Income diversification index	
	1998	2004	1998	2004	1998	2004
Indonesia	0.2	0.8	0.4	0.7	0.46	0.45
Rep. of Korea	16.7	61.9	4.0	5.8	0.65	0.61
Malaysia	1.9	7.4	1.3	2.7	0.53	0.64
Philippines	0.4	1.3	0.8	2.4	0.57	0.65
Singapore	2.2	0.8	0.8	0.2	0.40	0.41
Thailand	4.4	13.4	3.9	6.9	0.41	0.61

Source: Ghosh (2006): Table 4.4, p. 82.

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[2] This section draws on Ghosh (2006).

Consolidation is indicated by the large rise in the median size of banks, especially in Korea, Malaysia and Thailand. Banks in the region have also significantly broadened their range of services. Traditional demarcations among banking, insurance, and securities markets are being eroded by technological innovations, deregulation, and liberalization. Indeed, there has been a significant increase in financial conglomeration worldwide, including in East Asia. Although it is difficult to systematically measure the range of services being provided by, income statements allow us to measure the extent of fee- versus non-fee based services. The income diversification index[3] presented in the last column indicates that there has been significant diversification of banking activities especially in Malaysia, the Philippines, and Thailand.

However, empirical results indicate that larger banks and banks that are undertaking a broader range of activities are not yet enjoying economies of scale and scope. That is, banks' operating income would be much higher if they were broken up into financial intermediaries specializing in individual activities, rather than if they were engaged in multiple activities. This could be attributed to some lag in seeing the benefits of consolidation, since it is a learning process.

As we have been discussing in the earlier panels, several regional initiatives have already been successfully launched to harness the potential of regional cooperation and minimize the risks of contagion. In particular, regional cooperation has provided significant impetus toward achieving more diversified financial markets. However, many of the still needed policy measures will have to be undertaken at the domestic level. The necessary deepening and diversification of markets largely depend on actions at the domestic level. Also, the benefits of the regional initiatives themselves depend on the complementary development of domestic markets.

This is because despite significant efforts at the official level, East Asia is still lagging in terms of financial market integration. In particular the capital markets are relatively shallow and contain significant barriers due to a host of reasons, many of which are entrenched, including large national differences in market practices, institutional development and regulatory standards, laws and processes." The bottom-line is that "the single most important obstacle to market integration is the huge differences in initial conditions within East Asia" (Sheng and Teng 2007: 14).

2. These structural changes are giving rise to a number of supervisory concerns and recommendations for reform

- ***Adoption of international standards or "best practices"***

Various initiatives have already been undertaken by governments in the region to strengthen the financial sector's regulatory foundations, such as strengthening prudential regulation/supervision, corporate governance and disclosure standards. And we are continuing to do that. That being said, it bears pointing out that there is still significant regulatory forbearance especially in some countries in the region, including the Philippines.

According to Walter (2002), a core element of the IMF packages for the crisis economies in Asia has been to facilitate a move from a "relational-patrimonial" system of financial regulation towards a western-style "rules-based" system of prudential regulation and supervision. That is, close relationships between banks and bank regulators are common in our region, and regulation is deemed as more relationship-based than rules-based. However, Walter argues that formal convergence upon standards and codes is the easy part. The main problem with this reform strategy is that it underestimates the likelihood of implementation failure. He demonstrates the important role of regulatory failures at the level of implementation by focusing on the specific area of regulatory forbearance relating to bank capital adequacy in Indonesia, Korea and Thailand. The Philippines can also be added to this list. Thus, while there has been formal convergence towards western regulatory standards, divergence continues in practice given strong pressures for regulatory forbearance in countries with unresolved financial and corporate sector problems.

[3] Income diversification index = 1 – abs[(net interest income – other operating income)/total operating income]. A score of one denotes perfect diversity; that is, interest income and other sources of operating income are exactly equal. A score of zero, on the other hand, denotes specialization in one line of activity. The index will be reduced by imbalances of income.

Furthermore, implementation failure more than the blocking of key reform legislation is the key obstacle to the upgrading of financial sector governance in much of East Asia today.

Recent structural changes in financial systems in the region, particularly the consolidation and diversification of banks, pose additional challenges for risk monitoring, regulation, and supervision. Thus, the importance of strengthening risk management in financial institutions across the financial segments needs to be continuously highlighted. It is each economy's responsibility to "use international rules and standards to raise and enforce domestic market standards, codes, and rules of the game" (Sheng and Teng 2007: 27).

Clearly, what we also need to take into account is that rules could work differently in different settings. Using the terminology of Douglass North – institutions being the rules of the game - institutional imitation may not be enough; some degree of adaptation may be needed to make sure imported institutions work the way they are supposed to. We could also need some institutional innovation, i.e., coming up with "unique" institutions. That is why local knowledge is vital, because good institutions are heavily dependent on local context. Without local knowledge, it would be difficult to understand how existing institutions actually work, much more how to reform them.

Of course, for markets to integrate, they need common standards for greater efficiency. It may be an instructive exercise for the region to assess these "international standards" from our perspective, and perhaps evolve our own.

- ***Reform of financial regulatory frameworks***

The evolution of common standards, which is essential to financial market integration, also has a domestic dimension. In particular, the development of a common standard in the financial sector would require the coordination of the all regulations and laws by the different jurisdictions: the ministry of finance, the central bank the securities regulators, and other financial regulators. It is the failure to coordinate interests that often stands in the way of common standards (Sheng and Teng 2007).

Some countries have even gone beyond the coordination of the all regulations and laws by the different regulators. The architecture of financial supervision and any need for change also became an important issue to be addressed. Thus, strengthening the supervisory mechanism under the IMF programs for Indonesia, Korea and Thailand also required the establishment of integrated prudential regulators. However, to date, only Korea has managed to undertake such a reform.

Most countries that adopted the integrated financial regulatory framework were motivated by the need for more effective and consistent supervision of financial conglomerates. And these are mostly developed economies. In most developing countries in Asia, though, financial conglomeration is at an early stage. That makes it an important issue to discuss in terms of being able to shape future policy, including any effort to reform financial regulatory structures. And there is enough experience in the region from which we can extract valuable lessons.

The bottom-line is that it will take time to change the structure of financial regulation. Intermediate steps can be taken, e.g. existing regulators ought to set up immediately a forum for the exchange of information and the notification of incipient problems. Laws and regulations should be modified to mandate the free flow of information across regulatory bodies with appropriate safeguards. In the longer term, the structure of financial regulation can then be adapted to the new supervisory issues that arise from financial conglomeration.

While it is true that much of the focus of policymakers needs to be on domestic policy measures, there are potentially significant synergies that can be derived from undertaking regional measures together with the domestic measures. Thus, strengthening and reforming financial regulatory frameworks is one area where regional cooperation can have a significant impact, particularly in terms of experience sharing, mutual support and monitoring performance. Regional study networks can also have a significant impact.

3. Some implications for East Asian financial cooperation

In our last report, one of the recommendations that we proposed was to "establish an East Asian Finance Association to promote financial cooperation and exchange." The proposed East Asian Finance Association would be made up of representatives from the central banks, financial supervision institutions, and private financial institutions of the economies in the region, who would discuss and exchange views on major issues concerning the development of East Asian financial integration. One of the tasks to be assigned to the Association would be to "promote cooperation among financial supervision institutions." I think this particular task and goal deserves to be in a class of its own. That is, the creation of some explicit and exclusive mechanism for financial regulators to discuss various financial supervisory issues, share experiences, and monitor performance. This is not an area that we have explicitly, exclusively and comprehensively addressed on a regional level. Under the current ASEAN framework for cooperation in finance, financial supervisory issues are being discussed rather piecemeal and not comprehensively. Other regional groupings, such as the EMEAP and the SEACEN only involve central banks. But if the trend towards financial conglomeration continues and countries respond by moving toward integrated financial supervision, then not only central banks and finance ministers need to be involved. In fact, the latter's role in financial regulation and supervision would be diminished.

ASEAN Cooperation in Finance:

1. ASEAN Finance Ministers Meeting (AFMM)
    - 1.2 ASEAN Insurance Regulators Meeting (AIRM)
    - 1.3 ASEAN Central Bank Forum
    - 1.4 ASEAN Finance and Central Bank Deputies Meeting (AFDM)
        - 1.4.1 ASEAN Directors General on Customs
            - 1.4.1.1 Experts Committee on Customs Matters
        - 1.4.2 Working Group of the AFDM
            - 1.4.2.1 Working Committee on Capital Market Development
            - 1.4.2.2 Working Committee on Financial Sector Liberalization
            - 1.4.2.3 Working Committee on Tax and Public Finance
2. ASEAN+3 Finance Ministers Meeting (AFMM+3)
    - 2.1 ASEAN+3 Finance and Central Bank Deputies Meeting (AFDM+3)
        - 1.5.1 Working group on Bilateral Swap arrangement
        - 1.5.2 Study group on Regional Cooperation

Finally, more than changing the rules and regulatory structures in the financial sector, policymakers in the region also need to have a change in mindsets, and/or develop a common mindset. That is, a supervisory philosophy that favors and promotes a high quality regulatory environment (low corruption, transparency etc) and that supports private property rights, information transparency and market discipline (Corbett 2007). Ultimately, developing our financial systems and deepening the reform process will rest on a clear understanding and appreciation of, and strong commitment to, strong regulatory framework as being in the national interest.

Some references:

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Walter, A. (2002). Financial Liberalization and Prudential Regulation in East Asia: Still Perverse?, Working Paper Series No. 36, Institute of Defense and Strategic Studies.