Keio University

FINANCIAL STABILITY AND FINANCIAL SECTOR SUPERVISION:
LESSONS FROM THE PAST DECADE AND WAY FORWARD
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PANEL DISCUSSION: CHALLENGES GOING FORWARD

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Financial Stability and Financial Sector Supervision: Lessons from the Past Decade and Way Forward

Session 3: *Panel Discussion: Challenges going Forward*

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DBS

Key Points

- Risk management in Asia has improved, but whether it has kept pace with the rate at which the complexity of financial markets and products have been accelerating is another matter;
- The practical dimension of supervision and up-tiering risk management;
- Globalization of financial markets and integration of the real economies has totally outpaced the building of global institutions;
- The real risk of the current crisis comes from the trade off between the repair of balance sheets of some major financial institutions versus the burden of inflation and hence political stress on emerging economies.
- There is too much at stake and inherent dangers of using rating agencies as quasi-regulatory agents in Basle II - issues of track record, and also conflict of interest as they are listed companies.

Risk Management Improvements in Asia Adequate?

- There is no doubt that risk management in banks and supervision have improved since the 1997 crisis. However, the way products enter the scene and how global capital moves have become far more complex. It is still unclear if the improvements in risk management that we see in the region is adequate because we have not seen it stress-tested yet;

- The financial systems in Asia have held up well up till now not because of the improvements in risk management or supervision. The fact is that after the crisis banks cut back on lending sharply, and corporates de-leveraged. The conservatism and the fear of borrowing prevailed until just recently. Bank lending has therefore not spiked to dangerous levels for countries;

- The real test may come during this crisis, but it may come in a different form of shock.

Practical Considerations

- The scope and complexity of markets and products make it extremely challenging to supervise financial institutions' activities. The option is then to get banks and financial institutions to self manage and up-tier their risk management;

- This sounds reasonable and good. Rules and new approaches can be re-drawn and introduced overnight, however, the reality of implementation is an entire different matter;

- There is a severe shortage of people with the experience and skills to upgrade risk management in the way that is needed to cope with global risks and stress-testing. Putting the burden of risk management on banks themselves when there are not enough supply of risk managers also entails danger;

- Building risk management competency is not a one cycle event. Many risk managers have not seen a full-cycle.

Institutional Vacuum

- **It is not only a matter of individual supervisory authorities "putting their own house in order", which is largely what is happening at present;**

- **The most obvious fact today is the fact of globalization. We have a world that sees global capital moving across borders freely, we see that intellectual property (which I take to replace land as the main resource) being mobile, people moving more freely between countries. But there is a serious vacuum in that we do not see international institutions that have grown at the same pace as globalization. This applies also to the area of supervision;**

- **In the medium term, there needs to be some better way of pulling together or building some institutional framework that strengthens supervision on a global scale.**

Political Stress on Emerging Economies

- **The Fed will be forced to bring down interest rates to stabilize financial markets – in a sense, markets are forcing the hand of the Fed. Lower interest rates will also shore up US growth and help repair the balance sheets of major banks that have been hurt. But lower interest rates would lead to higher inflation. Indeed, it is an implicit tax being paid to repair the damaged in the financial markets.**

- **Inflation hurts the lowest segment of the population the most. The poorest segments are in emerging economies, and it is in these countries that have more vulnerable political institutions. Furthermore, within individual countries globalization forces have been widening the income gap in individual countries. The stress on political systems could possibly lead to unexpected political outcomes. This is something that cannot be ruled out.**

Rating Agencies and Basle II

- **Basle II revolves around the calculation of risk-weighted assets, from which regulatory capital requirements are derived. The calculation of credit risk weightings are directly related and derived from the credit ratings assigned. The option that will be viable to most banks will be to rely on ratings by rating agencies;**

- **In effect, as Asia Risk magazine (Nov 2007) puts it, regulators in endorsing the use of rating agencies' credit ratings for banking capital allocation purposes under Basle II are in effect turning them into quasi-regulatory entities;**

- **Rating agencies are listed companies, with primary obligations to their shareholders, and in an area where so much is at stake – get the ratings wrong and the capital allocation will be incorrectly calibrated – this is a dangerous path to go down.**