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RESPONDING TO THE CHALLENGES OF THE GLOBAL FINANCIAL CRISIS

**SESSION 4: LESSONS FROM THE CRISIS: THE ROLE OF INTERNATIONAL REGULATORY
AND SUPERVISORY COOPERATION AND PROMOTING MARKET INTEGRITY.**

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I thank the organizers for inviting me to speak at this public-private dialogue on an issue as important as the one under consideration. On a personal note it is a great pleasure to rejoin this series of dialogues.

The Economist journal of 18th July asks the question what remains of the efficient – markets hypothesis which underpinned many of the financial industry models for years, after the crash. It is a sobering question and one which G20 Leaders, global policy makers, financial system regulators and bankers are grappling with as they/we attempt to reshape the global financial system and its regulation.

The size of this challenge is underpinned by a comment in the World Bank's recent "Prospects for the Global Economy" – June 2009 – which noted that "conditions continue to be tight and markets nervous. Interbank spreads remain above historic levels, and the IMF estimates that only a third of all financial sector losses have been booked at this stage".

Given the massive public financial support (and the private losses) already provided to major components of the global banking and investment banking system – particularly in the US, the UK and Europe, and the highly accommodative monetary policies and the massive fiscal deficits that are now being incurred in many countries to resuscitate growth, it is reasonable to conclude (assuming the IMF estimate is correct), that more, and perhaps much more, will be needed to get to a juncture which resembles a state of global financial system stability.

I think it is clear to all that that state will be markedly different to the one that existed prior to the onset of the sub-prime crisis and the collapse of global liquidity and credit markets. While the actions of G20 and policy makers generally have averted a massive global recession, we still face the prospect of much slower growth over the period ahead, rising unemployment, increases in global poverty and a series slow down in international trade and investment flows.

Importantly, for participants in this dialogue, bankers and supervisors, are confronting an environment in which regulatory oversight of financial institutions and markets is becoming more sharply constraining, where more capital will be needed to support the activities of financial institutions and where public intervention in the operation of major financial intermediaries will become the norm, both in the pursuit of systemic stability and consumer protection.

In major economies and in many if not all economies, these developments will have some inherent conflicts. Asset values have already been written down in very significant proportions, investment and wealth creation have been eroded and this at a time when major financial intermediaries are required to recapitalize on a major scale. This conjunction of circumstances suggest that real economic activity – that which is financed by financial intermediaries and that which creates employment – could be subdued for a lengthy period ahead.

What I am here suggesting is no more than that which will be evident to you all in this region's banking sector – that banking intermediation is and will continue to be on a lower trajectory for some period ahead than that which we have all become used to over decade since the Asian financial crisis.

It is this matter that I would like to focus on.

As a starting point, I refer to the UK Chancellor of the Exchequer's response to Lord Turner's report on "Reforming Financial Markets" in July, when the Chancellor noted, in accepting the major recommendations of the Turner report that the (UK) Government's objectives are to:

- strengthen financial regulation
- reduce the impact of financial firm failure and prevent contagion
- boost consumer trust and confidence in financial markets
- improve competition and efficiency in financial markets
- strengthen regulators and the international regulatory framework

To achieve these objectives, the Chancellor proposed key areas of reform as:

- corporate governance of banking institutions
- changes to capital requirements
- reduction of leverage
- more intensive regulation
- enhanced powers to deal with banks that are seen to be failing

These are some of the many matters that are under consideration in the working groups established by the G20 and being developed by the Financial Stability Board, the BCBS and related forums.

My point is to ask the question should these be the main points of attention for banks and supervisors *in this region at this juncture* in the global economic crisis? They are all clearly vital matters in redesigning the prudential and supervisory order, but we should also be seriously focused on providing credit to grow businesses and trade in the economies of the region and between economies of the region.

In the context of seriously slowing economic activity it would be a great pity if attention is overly focused on buttressing the capital of banks and other financial institutions and redesigning financial architecture at the expense of supporting risk-taking and real economic growth activities, particularly when most banks in this region are well capitalized and liquid.

A concern that should be noted is the sharp decline in trade flows within this region when intra-trade flows are becoming the predominant pattern of trade for regional entrepreneurs. Is the private financial system providing credits and entering and accepting letters of credit and guarantees to facilitate intra-regional trade and investment flows and are national export and insurance corporations finding innovative ways to support the growth of commercial activities – how do we resuscitate real economic activity?

In raising these questions, the role of the G20, the Financial Stability Forum and other groups in their response to the global financial crisis is not in doubt. The fault lines in the international financial system have been seriously exposed and need remedying. The decisiveness of the G20 in tackling the myriad issues confronting both the financial and the real economy is to be commended.

The region should also contribute its views on how regional and global financial relationships and governance systems should be amended and reformed. And they should be views that reflect the interests of the region.

How this should be done is a matter for serious discussion in regional groupings and is beyond the theme of this session. But I would suggest that regulators and bankers in the region do determine from their assessments of risks borne by regional banks, whether additional capital is needed to support banking intermediation, what level of leveraging is regarded as within prudent tolerance levels of the regional banking systems and what information host economy regulators in the region do require of home economy jurisdictions and of banks' head offices.

These and other prudential matters should be determined from within the region and be reflected in the emerging reforms emanating from the Financial Stability Forum and related bodies.

While the G20 and Financial Stability Forum call for global responses to global financial problems – and there is much to commend a global approach – this should not be at the expense of serious regional assessment of what prudential measures are specifically relevant to this region.

In providing a banking perspective on the issues identified for this Session, I will draw heavily on the response of the International Banking Federation when it gave its support to the G20 and the work of the Financial Stability Forum. The Federation sought to avoid piecemeal regional or purely national responses without international coordination for problems that are global in nature. It supported coordinated international responses that are consistently applied. But that kind of support did not rule out regional assessments of what prudential standards are most relevant to the region's banking systems.

Indeed, the Federation argued that debate on the future of the international regulatory system should not be kept to a small coterie but should encompass all relevant financial centres, including new and emerging financial centres in order to achieve global consistency and cooperation in the future.

It went on to say that to ensure an open and inclusive debate on the new globally coordinated regulatory framework takes place, there should be a fundamental review of the membership of the international organizations – BCBS, IOSCO, the Financial Action Task Force and the Financial Stability Forum (now an expanded Board).

I agree with that sentiment; the question for this region is, are the mechanisms in place in the region to make an effective contribution to the regulatory arrangements which reflect the region's assessment of its own prudential interests.

In response to some of the other matters raised by the G20 Working Group and identified for this session, the Federation offered a range of observations.

As regards regulatory responsiveness to financial innovation, the Federation argued that regulatory responses must recognize the benefits of innovation in financial services. It acknowledged excesses which must be addressed but noted that innovation has brought significant benefit and economic advantages for individuals and firms and that the new regulatory framework must be capable of quickly adapting to market innovation or shifts in policy objectives to reduce the possibility of systemic risks emerging.

In supporting measures that will enhance a regulatory system that ensures financial stability, provides reliable and consistent outcomes and evolves to remain relevant to continuous market innovation, the Federation supported:

- enhanced transparency to promote healthy markets by giving confidence in the accounting and valuation practices that entities use by means of high quality, meaningful disclosure
- the FSB's recommendations that the IASB should strengthen its standards to achieve better disclosure, in particular on valuation methodologies and the uncertainties associated with valuations and that there be better disclosure of off-balance sheet structures and risks associated with them

Most importantly, the Federation believed that most useful disclosure for users comes when the management of a bank determines how to present information that best reflects its business model and mix. Information requests by national and regional authorities should be coordinated to avoid duplication and this may require more effective cross-border regulation and information sharing.

On the question of the prudential framework, the Federation argued that the genesis of the global financial collapse occurred in a pre-Basel II environment. Banks have only been operating under the Basel II risk sensitive regime in Japan since the end of March 2007 and in Canada and the US since the beginning of 2008; US banks are not expected to adopt Basel II for at least two more years.

Banks support the underlying principle of Basel II that capital requirements should be commensurate with risk and that banks should be incentivised to improve risk measurement, management and mitigation. Nonetheless, banks agree to the need for a thorough review of the prudential framework to identify areas which must be strengthened.

Greater regulatory focus should be on consultative arrangements under Pillar 2 rather than a reworking of Pillar 1 capital models. Regulators should engage in a more proactive dialogue with banks about the range of risks they face, based on a more rigorous review of Pillar 2 stress tests and peer group analysis, in the context, where necessary, of a bank's supervisory college.

The crisis has highlighted the important need for international and national regulators to cooperate more effectively in the supervision of cross-border banks and financial institutions. Effective cooperation involves tailoring the needs of individual groups and their families of supervisors, with the home supervisor taking a strong lead in designing the modus operandi and facilitating the exchange of information and the coordination and delegation of regulatory responsibilities. Banks support the critical objectives of supervisory colleges, namely to:

- facilitate the exchange and sharing of information, views and assessments among supervisors
- enable supervisors to develop a common understanding of the risk profile of the institutions as the starting point for risk based supervision
- achieve coordination of supervisory reviews and risk assessment, establishing supervisory plans, arranging any division of tasks and onsite visits
- coordinate decisions taken by individual authorities

It is worth noting that at the inaugural meeting of the Financial Stability Board, June 26/27th, the Board established a range of internal structures to complete its mandate to assess vulnerabilities affecting the financial system; to identify and oversee action needed to address them; to promote coordination of information exchange among authorities responsible for financial stability and to complete many other equally important tasks required of it by G20. In short, to provide effective responses to some of the issues identified on the agenda for this dialogue.

No one in this dialogue would underestimate the complexity of the work program nor its importance and the challenges it poses to national and regional authorities, regulators and international standard setting bodies and national and international financial institutions.

But at the heart of the financial systems we are all concerned about are the activities of private intermediaries and risk-takers, investors, consumers – bank customers. The balance between public policy concerns and the interests of market players is being redrawn in the reform processes now going on in response to the global financial crisis.

A crisis in which governance failures in both the public and private sectors occurred on a massive scale and which required and has received remarkable public policy responses – as well as highly constructive responses from banks and other financial institutions.

In supporting the actions of the G20 and the Financial Stability Board, the International Banking Federation called for a more holistic approach in identifying the build-up of systemic risk as well as the integration of macro-economic policy with institution-specific supervision.

Importantly, it noted that culture must be set at the top. Banks play a key role in promoting growth of the real economy and enhancing financial stability. The board and senior management have a key role in setting the overall culture of a bank and establishing the key ethical values to which it subscribes, as a means of ensuring that its employees act in accordance with these values.

Perhaps the deep and critical lesson we should ponder in the aftermath of the sub-prime crisis is how far any government's social policies can and should be implanted, if at all, in financial market systems with complex institutions and techniques for risk diffusion across many borders. If we have learned one lesson from the crisis it is that the pursuit of social policy objectives which involve the finance system should not be undertaken at the expense of rigorous prudential risk and governance standards that have to underpin modern finance – and in fact, finance through the ages.

I started with a note from the Economist journal. Let me finish with a challenge from that same article. In noting a task for the finance industry and for macro economists the Economist observed that there is a common interest to work out what central bankers should do about bubbles – now that it is plain that they do occur and can cause great damage when they burst.

We are all in this together, bankers, regulators, policy makers, tax payers, consumers and the community at large. We will have much to engage in, in these kinds of dialogues for many years to come.

Thank you.