



**The 6th SEACEN/ABAC/ABA/PECC Public-Private Dialogue  
for the Asia-Pacific Region**

**15 – 16 June 2010**

**Manila, Philippines**

*The Role of the Financial Sector in Sustaining  
Economic Growth and Stability*

*Presentation by:*

*Ken Waller, Director, Australian APEC Study Centre and the  
Melbourne APEC Finance Centre at RMIT University*

*Session 6:*

*Strengthening Frameworks for Global Regulatory Cooperation*

**DEVELOPING A REGIONAL FRAMEWORK TO SUPPORT  
GLOBAL REGULATORY COOPERATION**



I am honoured to be invited to speak at this important dialogue.

I will talk to five points:

- The genesis of the crisis
- Financial architecture in responding to the global financial crisis
- Emerging US legislative responses and consequences for Asia
- European proposals on taxation and consequences for Asia
- Building an Asian architecture

At the outset, history is replete with financial crises. More will come. Hopefully, we get a breathing space to adjust the major imbalances now present in the global economy to put in place arrangements that will better prepare economies before the next crisis does occur.

Different reasons have been advanced on the cause of the crisis. A major cause was the failure in governance in both public policy agencies and in commercial financial institutions in major developed capital markets.

While deregulation, technological innovation, financial engineering and risk dispersion have contributed to spectacular growth in financial transactions and in supporting economic growth and risk taking, regulatory arrangements and regulatory knowledge were inadequate to capture the extent of leveraging in international capital markets.

The capital backing for financial transactions was seriously lacking, resulting in the need for massive bail outs of major institutions by governments.

Boards and management of some major investment banks and trading banks based their activities on inappropriate incentive systems, magnifying rewards for reckless risk taking and disclosure of a highly questionable nature.

Policy makers and regulators failed to exercise their authority to bring a halt to extreme leveraging, or they lacked the authority to do so.

The damage wrought by these failures has cost global development dearly.

While the recent World Economic Outlook by the IMF points to a number of significant positive developments as a consequence of actions taken by both developed and developing economies in fiscal and monetary policies to ameliorate the impact of the crisis, it also notes that financial conditions remain more difficult than before the crisis, especially in advanced economies.

The noteworthy development in global financial architecture in response to the crisis has been the efforts at global coordination by the G20, the Financial Stability Board, Basel Group of Banking Supervisors, and other groupings, in finding resolutions to the crisis and in developing reforms to financial system regulatory standards and practices to minimise the prospect of further crises.

The arrangements involve:

- new and higher capital charges for banking institutions
- investment banks to be brought under more intensive regulation
- stress testing and macro-prudential measures to strengthen financial institutions and reduce systemic risk
- the inclusion of systemically important non-financial institutions in an economy's financial regulatory systems
- compensation arrangements for banking executives aimed at rewarding prudent risk managers
- capital charges as a measure to safeguard against liquidity risk
- enhanced disclosure requirements to enforce market discipline
- capital charges to cover potential exposure to activities of non-bank subsidiaries of a banking group
- arrangements for closer cooperation between national regulators where institutions they supervise operate across borders

These measures will involve higher capital charges for banks and other financial intermediaries and require them to take greater precautions in their lending functions. This will slow credit growth, lead to higher risk premiums on borrowers and slow economic activity. These are some of the costs that societies must bear for the crisis.

The mix of policy and regulatory responses proposed by G20 and the financial standard setting bodies will have far reaching implications for Asian economies. They will certainly impact on the Asia Pacific region. I will come back to this matter later in my remarks.

Before looking at regional matters, I would like to talk briefly about developing responses in the US and Europe.

Following the salvaging of the US financial system and intensive review of US financial regulation, the US Senate has voted to vastly increase the scope and sophistication of regulation; to provide more resources and more authority to regulators and for the creation of an agency to protect consumers.

The Senate did not elect to break up conglomerates but it did agree to prohibit some speculative trading. It agreed with the Volker rule prohibiting banks from proprietary trading or investing on the side and it voted to put curbs on the trading of derivatives.

The proposed rules *do not*:

- Break up banks too big to fail, or impose limits on their size
- Caps on charges on credit card holders
- Reintroduce Chinese walls between trading and commercial banks which were removed in 1999
- Include taxes on financial transactions and on individual bonuses

The Senate reflects views of some in the US administration that the financial system is fundamentally sound and that the problem inherent in the global financial crisis was the lack

of governance and regulation. This contrasts with a view that “too big to fail” institutions should be broken up and prohibitions imposed on their activities.

The Senate legislation does not simply rely on improved regulatory performance; it also creates margins for error and provides incentives to behave. Regulators get more resources, more information and more power. The approach allows much larger margins of error to regulators and creates incentives for banks to take fewer risks.

The Consumer Agency will be able to move to protect consumers when the industry moves.

The advocates of the Senate approach are of the view that improving regulation makes more sense than restraining the financial sector which is critical to the US economy.

Advocates also note that the US is faced with fierce competition from foreign banks which do not themselves face similar restrictions.

Despite the emerging legislation, it is a clear intention that US financial institutions will be allowed to continue to provide important services: creating liquidity, financing governments, corporations and individuals and providing financial advice and products.

The regulatory changes likely to be judged of most importance are those to trading in derivatives. The Senate proposes that firms separate off their derivatives businesses and place them in subsidiaries requiring substantially more capital. However, this could be shelved or watered down before final passage.

A likely compromise would be to allow banks to offer derivatives to clients to hedge risk but that trading would be shifted to clearing houses or onto exchanges and banks required to put up more collateral to cushion against losses

Turning to Europe, the European Union’s Financial Services Commissioner has recently proposed that banks be taxed on the size of their balance sheets, on how much they owe other institutions or on how much profit they make. The idea is that the funds so raised

would be used to finance “resolution” funds designed to manage future lender – failures and to limit contagion.

This is but one of the plethora of proposals aimed at reducing risks in banking and in taming the excesses that some major internationally operating banks indulged in and which contributed to the crisis. Those excesses exacted a toll on taxpayers as governments, particularly in Europe and the US, used fiscal resources to bail out financial institutions.

In attempts to placate taxpayers, affected governments are seeking to recover the costs they incurred in bail-outs and to take preventative measures to curtail future excesses and risk taking.

Some measures proposed by the Basel Group of Financial Supervisors focus on greater disclosure of an institution’s risk exposure and appetite. They are likely to contribute to enhanced financial stability.

Other proposals of a taxation nature may do little to curb risk, may weaken prudent management in banking systems and add to the costs of banking.

In this latter category could be included the suggestion for a transactions tax.

Similarly, it is unclear what a levy raised on the level of a bank’s assets would do to limit excessive risk taking that could not be achieved by orthodox capital charges, assessed on the risk that particular asset classes carry, and which are already inherent in the Basel II framework applying to internationally operating banks.

Recommendations arising from G20 and the Financial Stability Board on the way in which governments and banking supervisors will reform banking supervision in the aftermath of the crisis will be of great relevance to APEC economies. Invariably recommendations will involve higher regulatory costs. For this reason, Asian economies will need to assess the value of specific prudential recommendations of standard setting bodies and determine the costs and benefits in adopting them.

As well, Asian economies can be expected to exercise great care in responding to proposals from the European Union for an international agreement on bank taxation with the purported objective of reining in excessive risk taking by banks.

The key policy issue in the current debate on new imposts on banks is the one of determining precisely what is the intended outcome of any specific tax or levy on the finance sector. A tax on the assets of banks would seem to have more to do with raising general revenue than of curbing excessive risk taking.

The EU argues that a tax on bank assets should be internationally agreed but utilised for national purposes. International agreement would ameliorate EU concerns that any tax it raised on its banks would not disadvantage those banks in an internationally competitive market place. There is some support in the EU for the view that any tax should be based on the systemic risk that a bank poses for an economy – but there would be major problems in agreeing on an international basis how this would apply.

Asian policy makers and supervisors will need to consider whether they would see any reason to implement the kinds of taxes now being proposed to guard against future systemic failure.

Regrettably, some of the taxation measures under discussion in the EC may do little to renew confidence in financial systems or to protect society from risk. They will almost certainly raise the costs of doing business.

Risk taking is what banking and financial systems are about. Ultimately, responsibility for managing risk in a prudentially sound manner resides with the boards and managers of risk taking institutions. Well constructed incentives to perform this function effectively and reliably is a critical matter for the institutions themselves and for financial system supervisors and governments.

Incentives should take into account acceptable levels of risk and the management of risk, sound governance practices and clear rewards for prudence and probity and, penalties when

standards are not met. Reforms proposed by international standard setting bodies which have these objectives as their goal will serve Asia and the global community well.

Asian policy makers and financial system supervisors would be wise not to let the taxation proposals from Europe get in the way of good banking and financial principles when they consider the region's responses to reforms following the global financial crisis.

In a broader sense, Asian regional economies should review the relevance and potential impact of major proposed regulatory reforms, including taxation proposals, on the region. Asian economies should develop an architecture to do this as well as provide a mechanism that would contribute to a better understanding of changing financial conditions that will determine systemic stability in the Asian region.

Developing such a mechanism is made more urgent by recent events in Greece and in other European countries which reflect the massive public deficits that have accrued, through lax fiscal policies and through public support for financial bail-outs. These developments have placed the Euro under considerable pressure and which will impact on other exchange rate relativities. It is far from clear how these pressures will play out over coming months and years. But there is a fair chance that fundamental relationships in the global financial system will alter.

These changes will impact on the APEC region, and in particular, the Asian economies of the region. At present, Asia is a stabilising influence in an otherwise unstable global system. Asian economies are exhibiting strong foreign exchange reserves, strong economic growth and resilient financial systems.

For these reasons, it is now the time for Asian economies to become rule makers or at least be a major voice in rule making in global financial bodies. The architecture to bring that positioning into play ought to be determined by regional financial policy makers, businesses and regulators. The architecture should be guided by some principles which are fundamental to the region's stability, namely, open markets and commitment to open trade and

investment flows, sound financial regulation, structural reform and to regional economic integration.

A new regional mechanism would complement the work of the IMF and international standard setting bodies by developing Asian regional perspectives on major financial developments that impact on the region, and on regulatory reforms most appropriate for the region. A regional mechanism may and should reflect differences in approaches in governance and these would be influenced by the way financial institutions in the region have evolved.

Managing future crises imposes responsibilities on economies of the region and regional forums. There is now an urgent need for a mechanism that coordinates regional policies and management approaches.

Issues that a new Asian mechanism or architecture should consider with the objective of minimising turbulence in finance systems, could include:

- minimising the impact on regional economies of changes in investor sentiment to any rise in concerns of sovereign debt in major western economies
- ways in which trade credit and investment flows can be maintained if global liquidity becomes more constrained than it is presently
- sustaining demand and investment in regional economies if recovery in advanced economies is protracted
- assessing the appropriateness of compensation systems and governance arrangements proposed by the Basel Group of Banking Supervisors and others, to institutional practices and standards in the region and to consider whether some differentiation is relevant
- measures to ameliorate any break out in trade and financial system protection
- the relevance of proposed capital charges to regional financial institutions

- exchange rate relativities as a consequence of protracted weaknesses in the Euro and the US\$

These are substantive policy issues that could and should be the subject of enhanced cooperation within the region. By starting work now on such matters, confidence in the region could evolve to place regional economies as equal and substantial partners with major western economies and other regional groupings in the formulation and determination of public policies in financial and regulatory affairs that impact globally and regionally.

The global financial crisis continues to pose threats to growth and development and demonstrates some serious weaknesses in governance and risk management in major economies and in major global financial institutions. The crisis has impacted on the Asian region, but it has not thrown regional development seriously off course.

Concerns early in the crisis that serious liquidity constraints would impede credit and trade credit in particular, were cause for concern in the Asian region. That concern has eased as the impact of the crisis lessens. But serious challenges remain – essentially in the major developed economies. How these are handled will be of major consequence for developed and developing economies in the Asian region.

Any further crisis in Europe for example, following the Greek crisis could have serious repercussions for the Euro and international financial and economic stability. International coordination has worked well in response to the global financial crisis. It is to be hoped that European support for Greece and other vulnerable countries in the monetary union will hold and will stabilise that region's economies and build confidence in the region and in the global system.

However, outcomes in Europe and indeed in the global economic system are far from certain.

It is against that background of uncertainty that Asian economies should develop an effective regional mechanism to determine ways of handling developments in international and regional monetary policy and regulatory affairs of vital interest to the region.

Regional economies need to establish an architecture to safeguard financial stability in the region and to make a fundamental assessment of the long-term costs and benefits of regulatory reforms now being proposed by international standard setting bodies, having in mind the institutional and financial structures of regional economies and inter-relationships with global financial markets.

Such a regional mechanism should also focus on major longer term issues that confront the region and which will inevitably have major repercussions for budgets and fiscal policies in regional economies and the development of the region's financial markets and systems.

THANK YOU.