

## **Tarisa Watanagase: Setting a balanced regulatory reform agenda – the global challenge and an emerging market perspective**

Keynote address by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Symposium of SEANZA Forum of Banking Supervisors 2009 "Global Crisis: Challenges for Risk Management and Regulatory Framework", Phuket, 31 October 2009.

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Distinguished Colleagues,

Ladies and Gentlemen,

It is a great pleasure to join all of you here at the Symposium of SEANZA Forum of Banking Supervisors 2009. I am honoured to have the opportunity to share with you my thoughts on the global crisis, and challenges it poses for risk management and regulatory framework, particularly from emerging market perspectives.

Despite the recent indication of increasing stabilisation of the global financial markets, the extent of the impact of this crisis and prospect of sustainable recovery still face many uncertainties. This financial crisis has been the most severe in modern time. Not only in terms of width and depth of its impact globally, but more importantly, it has brought into question the very tenet of modern capitalism, the trust in market mechanism, and the rationale for regulation. In short, it ushers in a new paradigm in global financial landscape and regulation.

The forces unleashed by the crisis are very powerful, and will continue to drive fundamental changes going forward. We witnessed a widespread collapse of financial institutions worldwide, the apparent demise of certain business models, such as the investment bank, and retrenchment of critical markets such as mortgage securitisation market. In short, a reshaping of global financial landscape. Moreover, the extraordinary macroeconomic and prudential measures deployed to stabilise the market, while having been vital and successful, have left a legacy.

There has been a shift in global financial landscape, as rescue and intervention operations led to the redistribution of asset ownership, between state and private sector, and between nations, further complicating the intricate linkages within the global economic and financial system. These forces will, no doubt, have important bearing for systemic risk, cross-border supervisory coordination, and financial stability going forward.

These are the dynamics of structural change that unleash a new paradigm for financial market and regulation. At the core of this force is the public demand for greater assurance of stability, through stronger mandate for governance and accountability of financial institutions and regulators. The response to this has been a sweeping reform package championed by the leader of G20 that will reshape the global supervisory standards.

Ladies and gentlemen,

The key challenge for regulators in emerging markets such as the Bank of Thailand is to deploy strategies that help to ensure that emerging global standards remain aligned with risk-based principle, consistent with emerging markets' national contexts, and that our adoption of new reforms are based on those measures and reform agendas which are relevant and practical in our context.

Equally important, banks in emerging markets such as in Thailand also need to further strengthen risk management to handle changes in global landscape, uncertainty, and strengthened regulatory framework that emerges as a result of this crisis. I believe these are the key strategic policy agenda facing the leadership of banks and regulators alike, and I

believe a forum such as SEANZA will become even more important going forward in tackling such challenges together.

In this spirit, the key parts of my talk today will look at

- First, the key features of this new paradigm.
- Secondly, strategic agenda of emerging markets, such as Thailand in dealing with these challenges, that is, how to seek a balanced reform agenda.

My core message today is that, with a growing role of emerging markets and their interdependence with major financial markets and economies, the agenda for global regulatory reforms should pay adequate attention to economic and financial context of emerging markets. Regulators in emerging markets, such as ourselves, therefore have been and will endeavour to take more proactive role in helping to shape such reform agenda, at key forums such as the BIS, and in regional groupings such as EMEAP, SEACEN, and SEANZA.

In this regard, we welcome the BIS' strengthened initiative in this direction, with greater representation of emerging markets in various working groups. Through such means, we look to putting increased emphasis on ensuring that the policy option and implementation process are strengthened and fit the local context, while adhering to best risk-based supervision principles. This will have implication not only for local banks, but also for global banks' operations in emerging markets.

Thus, I would like to use this opportunity today to highlight key areas which require attention and leadership of top policy makers at supervisory agencies as well as banks, to ensure not only soundness of individual banks, but also guard against systemic risk as a whole.

Let me now turn to the first part of my talk: Key Features of New Paradigm

What is driving the changing global financial landscape?

The failure of several financial giants, and with many still in retrenchment, led to market space being taken up by surviving global banks, some have become state-owned via rescue programme. Their systemic importance has risen further along with their market power, and regulation must rise up to the challenge. The interdependence of the financial sustainability of these financial giants and sovereign risks have become increasingly linked, while perception of state guaranty of such institutions may distort local or even global markets, creating un-level playing-field.

The demand for accountability for public bail-out money puts pressure on managing such banks, which have now become "public institutions". Thus, the intervening authorities face a strong risk of having to micro-manage the institutions, and with this the associated risks, not least reputational and legal. Timely exit is important for the reason cited. Exit policy however could also be complicated, for example if recovery value of bailed-out fund is under pressure from weak market conditions. Most importantly, it is important to observe that, the precedence set by the actions regulators took in such intervention could have a long-term implication. We may very well be setting a new expectation, standard and text-book for bank resolution, and it may not be the standard we want to set going forward. Moral hazard and time inconsistency are always difficult subjects.

For financial institutions in the SEANZA region, many regional financial institutions, thus far unaffected directly by the crisis, are also moving into new markets, such as expanding regionally. Indeed, there is some indication of search for yield, as managed funds start to flow overseas to markets which have attractive risk-return prospects, for example due to prospect of faster recovery, or due to some distortion created from implicit risk-guaranty on certain asset classes as a consequence of rescue package. In some countries, certain asset classes such as real estate may be benefiting from ample liquidity, giving rise to concern on asset bubble.

All these spell potential for increased volatility and demand increased vigilance on management of risks, not only for those arising from country risk and market risk exposures, but also to exposures from counterparty and liquidity risks arising, for example, from hedging positions in OTC markets. Some of these risks, such as country risk, may have hitherto been marginal for regulators in emerging markets, but going forward things may change quickly. Moreover, with credit-play still a very risky and expensive business, with lending subdued by low demand for loans, treasury return could be a potential profit centre, especially with various liquidity support in interbank markets globally. This potential trend, of course, would also depend on accounting standard and a regulation on fair valuations, which itself is still under much debate.

Thus, strengthening of risk management and supervision is important. Indeed, the importance of this is highlighted by the rebound in many regional stock markets as well as upward pressure on the currencies. I have also observed from some reports that, within the many financial centres, the recent return generated by FX traders have been strong, while hedge funds, thought to have seen end of days, are starting to come back to life. We may be heading in for a sporadic period of increased risk-appetite.

At the same time, many corporate borrowers, particularly the large conglomerates which used to fund from global market, may switch to domestic market, due to retrenchment of international debt market, as well as still heightened risk-aversion and retrenchment of global banks. This would be at the same time as increasing issuance of local sovereign debt to finance stimulus package. In the early stage of recovery, risk of crowding-out may not yet be high, but even at this stage, the investment portfolio of local financial firms may shift significantly, and may likely see increasing concentration risk due to increased exposure to major conglomerate which used to source overseas funds. But as momentum of recovery gathers pace, competition for funds and risk of crowding-out rises.

Therefore, even abstracting from challenges of reshaping regulatory framework, managing the risks from the current market environment is demanding. Uncertainty and risk remains high, and I believe there are four key risk factors we need to focus on.

First, sustainability of nascent “green shoot” global recovery remains a subject of financial market speculation, and will continue to drive trading position and volatility.

The sign of recovery in global economy appears to be revealed as “green shoots” after a deep recession. This recovery is credited to a wide range of public intervention in major economies, which has boosted the subdued private demand as well as reduced uncertainty especially in the financial markets. However, the sustainability of the nascent recovery is yet to be confirmed, as the financial systems in major economies have not been fully repaired.

Secondly, the timing and speed of the unwinding process of public stimulus packages have yet to be settled, the so-called “exit policy.”

Thirdly, the difference in speed of recovery between major economies and emerging economies may also have important implications for cross-border capital flows, and financial market volatility, particularly exchange rate. The unstable differentials caused by rocky recovery paces, can give rise to large and volatile capital flows, which may have a tendency to be short-term and foot-loose.

And fourth, uncertainty regarding global regulatory reform. In the immediate aftermath of the crisis, it is natural to observe the growing sentiment towards re-regulation, coupled with nationalisation of problem banks, the trend towards re-regulation has picked up momentum. Therefore, it is important to ensure that we do not swing from unquestioned faith in the market to unquestioned faith in the regulation. A balanced approach is needed. Just as market failures cause inefficiencies and instability, regulations too can be a two-edge sword, it could correct market failures and distortions, or it can be the cause itself if not well designed. The task of such design to avoid regulatory gap and arbitrage is all the more difficult, given the shifting financial landscape, shifting regulatory landscape as countries

embark on their own reform agenda at different speed. This is why a forum such as the BIS is all the more critical.

The key lesson that we should learn from this and past crises is that the financial system is always vulnerable to the unobserved and unmeasured. It is not that our tenet of risk-based supervision is flawed, but rather we overestimate our ability to understand and manage such risks. In response to the calls for strengthening of regulation, G20 leaders and finance ministers have committed to strengthening of regulation. The comprehensive regulatory reform package being proposed is aimed to address the key weaknesses such as excessive leverage, under capitalisation and underestimation of risk, weakness in standards of risk management for liquidity risk for complex products and markets, and macro-prudential measures.

The range of policy proposals that have been supported by G20 leaders and finance ministers, the Financial Stability Board, the Basel Committee on Banking Supervision, and international accounting standards setters, include calls for strengthening of micro- and macro-prudential regulations that aim at capturing risks of individual institutions and risk arising from interconnectedness of the financial system, as well as more robust governance framework.

The shift in policy paradigm from this crisis has been the increasing recognition of the concept of macro-prudential policy in dealing with the problem of systemic risk posed by the interconnectedness within the financial system, as well as between the financial system and the real economy.

The key macro-prudential policies are, for example, a proposal on build-up of capital buffer and the introduction of a simple leverage ratio as a supplement measure to the BIS ratio. We look forward to the BCBS' proposals on these measures by the end of this year.

While vital, this is a tall order, and demanding on supervisory capacity, especially in emerging markets.

Let me highlight some of these challenges.

The standards being discussed are complex, with still many unresolved issues on technical aspect such as calibration. Among the new guidelines, some key coefficients may be based on data of developed markets, and therefore might not be representative of emerging market conditions. Both calibration and actual implementation will require adequate data, which is often a constraint in emerging markets. This data constraint could also become an issue for some developed markets, given a structural break in data due to the financial crisis and market dislocation.

On top of these, there is the issue of level playing-field, as the structure of bank asset and liability in emerging and developed countries may be significantly different. We have found several policies that may have impact on level playing-field, between countries and business models of banks. An example is the application of a simple leverage ratio, which does not take into account inherent risk, because this would tend to penalise banks in developing countries that generally hold less risky assets compared to developed countries.

In addition, macro-prudential measures, such as leverage ratio, could likely have a macroeconomic impact, possibly similar to use of liquidity reserve requirement as per classic monetary policy tool, and thus coordination with macroeconomic policy is vital. For central banks with dual role, this is less of a challenge, but for separated regulators, the issue of organisation structure once again comes into play.

Turning to the Bank of Thailand's involvement on these regulatory debates through various international forums – such as the bi-monthly BIS Governor Meetings, the Standard Implementation Group of BCBS, of which we are a member – we have proposed that developing countries be invited to participate in the formulation of new standards right at the beginning, rather than to be included at the later stage of implementation. Recently, a

number of countries, including Thailand was invited to take part in the newly created Basel Consultative Group, or the BCG, which met for the first time during 28 to 29 October this year.

Now, let me turn your attention to the second part of my talk. The Bank of Thailand's view on strategy to achieve "a balanced reform agenda". Going forward, it will be useful to focus on three key areas.

First, we need to balance between emerging market issues and developed economy issues in the global reform agenda.

Development of key policy proposals such as building-up capital and reserves buffer should recognise constraint of emerging markets in terms of data and institutional capacity. Therefore, prudent but practical standards for SA banks that are the core in emerging economies in addition to IRB banks should receive high priority. At the same time, with rapid development of local financial markets, IRB challenges will become our issues tomorrow, and a balanced approach means emerging markets need to set strategy to build data and capacity.

In this regard, we believe the BIS can play a vital role in increasing resource to policy research, standard development, and supervisor capacity building for SA banks. The BIS regional office has played a strong leadership role, and we strongly support this trend.

A similar issue arises in terms of the principles stipulated in Pillar 2 of Basel II. It is desirable that banks have good risk management system with an ICAAP that covers all significant risks. However, this entails cost to both banks and supervisors, in terms of a much more detailed and comprehensive process, with methodological guidelines as well as a more challenging on how to achieve an effective implementation. We then believe it is important to balance and align complexity and timeliness of supervision with complexity and risk faced by emerging market.

Second, we also need to balance between supervision, on the one hand, and market discipline and good governance in the following key areas.

On the issue of bank capital regime, appropriate implementation of macro-prudential measures such as leverage ratio as supplement to Basel II risk-weight asset system is important. However, the key question is how to integrate appropriately additional non risk-based measures, with the existing risk-based regulatory framework, as it might weaken or lessen clarity of risk monitoring, and consequently risk management. We believe further work are needed in terms of refining the framework such as setting definition and coverage, including treatment of off-balance sheet items, as well as the trigger-point for enhanced surveillance or to take supervisory action.

On the issue of valuation and leverage. The use of fair value, when significant uncertainty exists, may reflect current market expectation, and yet, lead to volatile balance sheet and difficulty in marking-to-market during market stress or breakdown. The BOT supports the IASB's solution on reclassification of financial assets in "rare circumstance" as it offers more discipline than currently. However, this, in turn, raises some concern on how to justify "rare circumstance". Again, implementation is a challenge, and no doubt you would have valuable discussions here.

As for the efforts to mitigate procyclicality, various models have been proposed for the build-up of reserves and capital buffer. Each model has its pros and cons. On the capital side, there are proposals to increase capital charge for securitisation product and market risk, as well as harmonising the definition of capital. We agree that the banks' capital buffers need to be improved both quantitatively and qualitatively. However, timing of implementation of guideline on definition of capital is quite crucial, and must be carefully considered. On the provisioning side, the current discussion is on which approach to be used as an alternative to the incurred loss model. The Bank of Thailand supports the principle of expected loss and dynamic provisioning, although it will be technically challenging to implement. As a regulator,

we need to weight the balance on pros and cons of various models proposed as well as consider if it fits the national context.

Turning now to the third dimension where a balanced approach is required. The balance in relationship and responsibility of home and host regulators, and a balanced voice of emerging markets on cross-border systemic risk. This is all the more important now, as regulatory reform across countries can create regulatory gaps and un-level playing-field, that could cause instability down the road. The principle of so-called “insignificant host”, as viewed from home supervisor’s perspective, may contradict with the agreed principle of the need for the host to oversee systemically important institutions. Thus, a host supervisor should receive better information and even be included in supervisory colleges by home supervisor, if the global bank branch operations are systemically important to the host economy.

Colleagues, ladies and gentlemen,

This is a challenging time, with new paradigm, and therefore leadership by all of us is required to ensure that we set a balanced agenda in our reforms going forward. I believe SEANZA forum would become all the more valuable in the future in cementing our network and friendship.

Thank you for your attention.