Masaaki Shirakawa: Reforming the framework of financial regulation and supervision – an international and Asian perspective

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Central Bank of Malaysia – Bank for International Settlements' High Level Seminar, Kuala Lumpur, 11 December 2009.

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1. Introduction

I am very much honored to have this opportunity to speak before such distinguished participants, including those from central banks, at this High Level Seminar co-organized by Bank Negara Malaysia and the Bank for International Settlements.

Today, I would like to offer my reflections on the lessons from the current global financial crisis. However, under this theme, many issues have already been raised and numerous discussions held. I myself have participated in many such discussions at many international forums and, I have to confess, I have been wondering about some piece missing in these discussions. Thinking about why this has been the case, I came to realize one of the reasons I feel this way is that such discussions have been mostly conducted under the designation of "global financial crisis", despite the fact that Asian financial systems, including that of Japan, have remained relatively stable. Sufficient consideration has not been extended to such aspects as regional diversity and differences in the structures of financial intermediation. In this regard, I would like to express my views on the lessons of the global financial crisis, from both an international and an Asian perspective, as the financial structure in Asia differs from those in the United States and Europe. I will first present some ideas as to why financial systems in the Asian region remained relatively stable under the current crisis, compared with those in the United States and Europe. Then, I would like to talk about how we should make use of the lessons we have learned from the current crisis, from such a perspective[1].

2. Relative stability of financial systems in the Asian region during the current crisis

To begin with, let us consider how we should assess the performance of the financial systems in the Asian region during the current crisis. A fair assessment, in my own view, would be as follows.

First, Asian financial systems obviously could not be immune to the global financial turmoil, and have indeed been seriously impacted.

Second, compared with what happened in the United States and Europe, financial systems in Asia remained relatively robust, and here I need to stress the word "relatively". For example, between the collapse of the Lehman Brothers in September last year and early 2009, the share price of Asian financial institutions plummeted by 30 to 40 percent, depending on jurisdiction. In most Asian economies, the prices have now recovered to pre-Lehman levels, and in some economies have even exceeded that level by more than 30 percent. The performance of financial shares matches that of average indices covering all sectors. On the other hand, the rebound in the U.S. and European banking sectors is clearly

[1] See Masaaki Shirakawa, "Preventing the Next Crisis: The Nexus between Financial Markets, Financial Institutions and Central Banks", speech at the London Stock Exchange (May 2009), and "International Policy Response to Financial Crisis", remarks at the Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming (August 2009), for discussions on reforming the framework of financial regulation and supervision based on the lessons from the current financial crisis.

weaker, recovering only to 70 to 80 percent of pre-Lehman levels, while indices of all sectors have recovered to roughly 90 percent. The difference of performances between Asian and U.S./European financial institutions is also reflected in their respective balance sheets. While the ratio of non-performing loans has recently shown a steep rise in the United States and Europe, it remains stable at a low level here in Asia. Bank lending growth has decelerated sharply in the United States and Europe and recently turned negative in some countries. In most Asian jurisdictions, it has also decelerated in recent periods but remained positive, and even accelerated in China.

Likewise, Japan's financial system has enjoyed relative robustness compared with the U.S. and European systems. Libor-OIS spread[2], which directly reflects the stress in a funding market, widened in the aftermath of the Lehman shock until the end of last year, as it did in the United States and Europe. However, in yen funding market, the spread remained relatively narrow, and is currently back to August 2007 levels.

Third, the impact of the current crisis in the Asian region has been smaller than that of the Asian financial crisis of 1997 to 1998. The Asian financial crisis led to sovereign debt crises, and some economies were compelled to seek financial support from the International Monetary Fund. The situation this time is not nearly as serious.

3. Backgrounds to the robustness of Asian financial system

This begs the question: How could Asian financial systems remain relatively robust this time? In my view, the main reason is that the memory of the previous severe financial crisis was still fresh in our minds, and the lessons learned from that crisis were put to good use, even if not perfectly.

There were a variety of factors behind the Asian financial crisis, and they were combined with each other in a complex way. The key factor that directly precipitated the crisis was the double mismatch of currency and maturity formation in the asset and liability structures of financial institutions, creating a downward feedback loop between currency risk and liquidity risk. With this bitter experience in mind, many Asian economies endeavored to increase the robustness of their financial systems.

First, financial institutions themselves took measures to improve risk management. Mismatches were reduced, although further effort seems necessary. Moreover, most Asian financial institutions adopted a cautious approach towards the complex securitization products in their investment decisions, as memories of the Asian financial crisis were still fresh in their minds. This led to the comparatively lower credit costs this time.

Second, the Asian regulatory and supervisory authorities made efforts to enhance the resilience of their financial systems. They used a variety of measures to enhance the robustness as well as the transparency of the financial systems, including attracting foreign capital and facilitating mergers. Moreover, with the enactment of laws and regulations concerning deposit insurance and prompt corrective action, the financial systems were provided with safety-nets to ensure stability in times of crisis.

Third, following on from the previous point, liquidity backstops were put in place in preparation for turmoil in the financial and foreign exchange markets. Central banks have been equipped with market operation tools and standing facilities to ensure liquidity in domestic funding markets. A regional network of currency swap arrangements was expanded under the Chiang Mai initiatives to ensure liquidity in foreign currency markets.

[2] Libor-OIS spread is the difference between the Libor and the overnight index swap rate, which could be considered as an indicator of counterparty credit risk and liquidity premium.

Enhanced foreign reserves, flexible foreign exchange mechanisms, and stringent fiscal discipline also contributed to reducing concerns over sovereign risk.

4. Learning from past crisis experience

And yet, even if we learn all the lessons past crises have to teach us, can we guarantee the resilience of the Asian financial system in the future as well? I must say, I refrain myself from being optimistic in this respect.

I have my doubts because, first, it is difficult for any of us to truly learn from the experience of others. Since the bursting of the bubble and the subsequent financial crisis in Japan, there has been much discussion of the so-called "lost decade" by academics and policymakers abroad. However, I must say that the implications of our experience, such as the severity of liquidity crisis and balance sheet adjustments, have not been fully taken to heart[3]. Even if the lessons of a crisis are correctly understood by outside observers, it is often difficult for those to implement necessary measures in their jurisdictions without actually experiencing a crisis. For instance, it was only by facing so many failed financial institutions after the bursting of the bubble that Japan learned the importance of an infrastructure whereby failed institutions can be resolved in an orderly manner. We had to overcome so many difficulties before we finally introduced the resolution regimes we are equipped with today. After the outbreak of the current financial crisis, I was rather surprised to learn that resolution regimes were not yet fully introduced in many European countries. Thus, I realized again how difficult it is to learn from the experience of others and to translate that into one's own action. The financial systems in Asian economies were relatively stable during the current crisis, but we need to recognize that by feeling less pain, we in the Asian region may have missed something that we were supposed to learn during this new experience.

Second, memories fade with time and as generations pass. I mentioned earlier that Asian financial institutions, including Japan's, were cautious in investing in complex securitization products, but there is no guarantee that they will remain prudent in the future. History provides us with so many examples of one success leading to complacency: the bubble economy of Japan in the late 1980s, the East Asian Miracle of the early 1990s, and the Great Moderation of the mid-2000s, to name just a few.

Third, since crises emerge in different guises depending on the stage of development and the structure of the economy, the way we respond to a crisis should also evolve. In order to maintain financial stability, the mechanism of financial institutions' governance and the safety-net of the economy, or indeed of society in general, are of crucial importance. However, there is no governance mechanism or safety-net arrangement that is appropriate for all societies at all times. The Asian crisis taught us the downside of free capital flows if a country is not equipped with the appropriate bank supervision and regulation. In the arguments over the so-called crony capitalism, the Asian financial system was once criticized for its opacity, which was considered to be the result of favoritism based on family and local ties. It is beyond my ability to judge whether such criticism was justified or not, but it is quite possible that at some stage of economic and social development, factors, such as long-term customer relationships and mutual assistance, do have a role to play in the governance mechanism. The exact form of governance mechanism still varies across societies even in the age of globalization. In reviewing policies and systems, including financial regulation and supervision, it is very important that each jurisdiction strives to find an answer that best fits its own financial and economic structures.

[3] See Masaaki Shirakawa, "Way Out of Economic and Financial Crisis: Lessons and Policy Actions", speech at Japan Society in New York (April 2009) for discussion on the so-called "lost decade".

5. Towards better financial regulation and supervision

Vigorous discussions are currently being held in a variety of international forums, including the Financial Stability Board and the Basel Committee, with a view to reforming the framework of financial regulation and supervision. Although the Asian financial system remains relatively stable, it cannot be guaranteed immunity from global financial crises, and has actually been significantly impacted by the current crisis. A robust global financial system is a public good that benefits the whole world. This cannot be over-emphasized. In order to prevent another financial crisis, each country should be well aware of this common objective in the first place. Efforts should then be made to organize an internationally consistent regulatory and supervisory framework.

In making such efforts, we must be very cautious that the reforming of the financial regulatory and supervisory framework is conducted in a well-balanced manner. When we talk about regulation and supervision, we should not confine the discussion within the sphere of regulation and supervision itself. We should rather keep our eyes on its wider context. When we embark on regulatory and supervisory reform, I believe, it is very important to strike the right balance in a number of dimensions as follows.

Balance between macroeconomic policy and financial regulation and supervision

First, balance is needed between macroeconomic policy, particularly monetary policy on the one hand, and financial regulation and supervision on the other. In recent years, there has been a growing tendency among academics and central bankers to draw a clear line between the role of monetary policy and that of supervision and regulation: namely, monetary policy should aim at price stability, and regulation and supervision should aim at financial system stability. However, what we actually witnessed during the credit booming period was an unwelcome combination of asset prices increase, rapid credit expansion, and subdued inflation. As a result, debate has been often framed in terms of a trade-off between price stability and financial system stability. However, the true trade-off is not between price stability and financial system stability, but it exists intertemporally between economic stability of the present and that in the future. Although ensuring the soundness of individual financial institutions through regulation and supervision is surely important, the sound management efforts at a micro level may not be sufficient to guarantee the financial system stability. From a macro-perspective, however, if we maintain a monetary policy that accommodates excessive leverage and maturity mismatches over the longer term, someone will eventually take excessive risk, and this will lead to an erosion of financial system stability. That is why monetary policy, too, should be conducted with a macro-prudential perspective, aiming at sustainable price stability in the longer term. At the same time, we must avoid strengthening regulatory framework becomes an impediment to macroeconomic stability. In this sense, we must carefully assess the condition of global economy to determine the timing for implementing the strengthened capital standards. For this, as declared in the Statement of the G20 Pittsburgh Summit in September, it is necessary for us to take an approach that strengthening of the capital standards should be implemented as economic recovery is assured.

Balance between regulation and self-discipline

Second, balance is needed between regulation applied to financial institutions on the one hand, and management and self-discipline by financial institutions themselves on the other. Financial markets are ever-changing and business models differ across institutions. Given the limited resources of supervisors and regulators, it is impossible to supervise or regulate every inch of the activities of financial institutions. Moreover, given the limited liability of shareholders, the myopic behavior of shareholders and managers cannot be restrained simply by enhancing minimum capital ratio standards or through other regulations. Before the emergence of the subprime loan problem, most financial institutions were well-capitalized in terms of the regulatory definition of capital. Of course, we can say this is owing to the deficiency of the current capital regulation. That is, risks are not adequately captured in the calculation of the capital ratios. At the same time, however, this seems to suggest how intrinsically difficult it is to capture risk correctly in a timely manner. After all, the first line of defense of a financial institution is its managers whose task is to properly identify and manage risks to ensure the financial soundness of their institutions.

On a related issue, the mechanism and factors that govern the self-discipline exercised by managers varies from country to country. A typical example is the compensation scheme for managers. If you check the disclosure journals of U.S. and Japanese financial institutions, you will notice a huge difference between the two countries in terms of the level of compensation for managers. In its recent report, the Financial Stability Board describes a number of attributes required of a desirable scheme and level of compensation. For my part, I would just like to emphasize that managers' appropriate judgment on strategic issues is crucially important.

Balance between regulation and supervision

Third, balance is needed between regulation and supervision. There is a non-negligible difference among countries in terms of financial and economic structures, as well as in terms of the business models of financial institutions. A minimum set of common rules is needed to be applied to internationally active financial institutions. At the same time, however, it is also important to leave a certain amount of room for local regulators and supervisors to adapt to the local situation. For example, the appropriate method of liquidity management can differ according to the business model of a particular financial institution. When considering liquidity regulation, the first item that comes to many people's mind as qualified liquid assets would be government bonds. However, in some Asian jurisdictions, outstanding amounts of government bonds issued are small, as a result of fiscal discipline. For such jurisdictions, a uniform liquidity regulation could even be harmful.

In Japan, supervisory authorities are monitoring the liquidity positions of financial institutions in a more detailed manner on a routine basis. Thus, at the time of the Lehman shock, the Bank of Japan was in a position to know on a daily basis the funding activities of financial institutions, including foreign banks and securities firms. This type of information was particularly valuable when the Bank of Japan conducted open market operations in such a stressed situation. This is one of the reasons why Japan's financial system was able to remain relatively stable at that time. Of course, not all countries can afford to conduct such monitoring on a regular basis. Thus, the best way of addressing these issues may be more or less different across jurisdictions, and it might be difficult to always establish an internationally uniform hard-wired standard.

As I mentioned earlier, I strongly believe in the necessity of internationally common rules. That said, it is hard to draw a clear line between those areas where internationally common rules should be applied, and those where domestic rules should be applied. The same holds for determining whether supervision or regulation should play the main role in a particular area. I would like to emphasize the importance of both; that is, internationally common rules on the one hand, and due respect for the differences among countries and institutions on the other.

Balance between preventing crisis and containing ripple effects

Fourth, balance is needed between policies aimed at preventing crisis and those aimed at containing the ripple effects of a crisis that has already occurred. Even if all the efforts I have mentioned were made, including macroeconomic policies, regulation, supervision, and self-discipline, there will always remain the possibility of financial institution failure. Recognizing this harsh reality, we have to redouble our efforts to construct a financial infrastructure that is resilient to shocks. Challenges abound in this sphere, but I would like to stress the crucial role of the smooth transfer of liquidity across currencies, time zones, and jurisdictional boundaries. It is the lack of liquidity, rather than the lack of capital, that directly causes failures of financial institutions. Therefore, we should endeavor to prevent the crisis contagion triggered by concerns over a lack of liquidity. In this regard, for example, currency swap arrangements and cross-border collateral arrangements could both be effective liquidity supplement tools. Enhancing the infrastructure of financial transactions, including the shortening of settlement periods, is also an important issue.

6. Concluding remarks

As I have argued, striking the right balance in a variety of dimensions is important for realizing financial system stability. I would like to conclude my remarks with a few words mentioning that in order to attain the kinds of balance I have outlined, it is crucial for the relevant organizations and personnel themselves to have a balanced and broad perspective on the issues at hand.

The Japanese financial crisis was a result of the bursting of the bubble that emerged in the late 1980s. During this bubble era, I was working in the monetary policy area. For several years after the bursting of the bubble, I was involved in the resolution of failing financial institutions and in developing the necessary framework to carry out such resolutions. In the late 1990s, I moved over to work on international financial markets, and in the several years just before and after the Asian financial crisis, I was involved in the work carried out by the Committee on Global Financial Systems hosted by the Bank for International Settlements. After that, I returned to the monetary policy area until the mid-2000s, covering a period identified with a number of keywords, including the bursting of the IT bubble, deflation, and the Yen carry trade.

Looking back, I believe the knowledge and intuition that I gained through this experience has been extremely valuable in making policy decisions in the face of the recent crisis. Such personal experience has led me to emphasize the importance for people involved in the world of financial stability to have as broad a perspective as possible, rather than confining themselves in a silo, and for staff to experience a variety of jobs in rotation. It is also quite important for the management of central banks and regulators to foster such an institutional culture.

International human networks are also a vital element in developing a broader perspective. The recent crisis has reminded us of the significance of international networks and cooperation. From such a viewpoint, I would like to express my gratitude once again to Bank Negara Malaysia and the Bank for International Settlements for organizing this fruitful event, which has made a most valuable contribution to widening our perspectives.

Thank you very much for your attention.