Prasarn Trairatvorakul: Trust as a pillar of the industry

Keynote speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at The Asian Banker Summit 2012 “Trust as a Pillar of the Industry”, Bangkok, 26 April 2012.

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Ladies and gentlemen,

It is an honor to join all of you today, and to welcome leaders of Asian banking community to Bangkok. The theme of this year conference, “Trust as a pillar of the industry”, highlights the fact that the global financial market stands at an important cross-road. The topic of trust inevitably arises after a crisis. The cross-road is about how to reform regulation, that is, how to re-regulate.

This is the juncture which we have reached today, with reforms proposals such as those by the Basel Committee, the Financial Stability Board, or Dodd-Frank Act in the US. All these are attempts to rebuild trust and confidence.

It is well known that Trust is the cornerstone of the financial industry. But it should also be added that, ***Trust alone is not enough. We also need to have a good dose of healthy skepticism***. The reason for this is that we must avoid, on the one hand, overly trusting market mechanism, or on the other hand, overly trusting in regulation. This is because of the rapid changes in the financial system and how risk is transmitted.

The last crisis showed how financial innovation and complexity of bank business model overtook risk management and regulation in the west. In Asia, economic and financial liberalization is a powerful driving force that is reshaping our financial landscape today. This could potentially open up the gap between risk and our ability to manage it.

So what should be our strategy to build trust, but avoid being blinded by our sense of security?

The strategy to deal with this is to have Trust that is counter balanced by well informed debate on risk management, supervision, and good governance. So, we need a good dose of well-informed skepticism, as well as financially literate public.

Let me turn to the progress on the global efforts to reform regulation. Where are we today?

In all of these reforms – be they Basel or FSB – the questions we ask are these. Have we done enough to rebuild “Trust” and secure financial soundness? Is the international standard right for the local context? Are there unintended consequences, i.e. the bad side-effects?

Getting it right, with the right balance, and right timing is very difficult. This is especially so when the dust has not settled, and the real economy is still vulnerable. Indeed, five years after the crisis erupted in the US, we are still seeing the spread of impact in Europe, and deleveraging of European banks.

From Thailand’s own bitter experience of the 1997 crisis, the combined impact of all the economic and financial sector reforms was hard to gauge beforehand. And certainly, the design of reform package did not anticipate the effect of the contagion spreading to the rest of Asia and our trading partners. ***The key lesson is that, even in our best effort to get the reform right, we may still fumble***.

So, how should Asia think about the impact of the global regulatory reform?

For Asia, although the banking system has been quite resilient to the crisis, these regulatory reforms carry high stake for us, especially for our future developments.

The reforms such as Basel III are, to a large extent, designed to correct major weaknesses in Basel II that allowed the crisis to emerge in western countries. These weaknesses were such as undercapitalization, over-leveraging, inadequate liquidity, and procyclicality of the banking system. ***So, in so far as Basel III would make these banks safer, it would contribute to stability of the global economy***.

However, the weaknesses that were targeted by Basel III did not cause damage in Asia. ***This is mainly because the banking model here tends to be simpler, understandable, and traceable***. The western system, on the other hand, is so complex that no one, not even the CEO, could understands the bank's structure and activities.

The value of this simpler model is that bankers know what is going on in their banks. Supervisors can keep very close eyes on their activities. As a result, banks in Asia were not as prone to the problem of massive over-leveraging, undercapitalization, or under pricing of risk of complex derivatives. So from this perspective, the ***significant improvement of Basel III over Basel II is in addressing the problem of procyclicality and adoption of macroprudential approach in our policy framework. This is a major contribution of Basel III going forward***.

The key emphasis of Basel III is to strengthen capital base. While this is important, I regard this as only a second line of defense. ***The first line of defense is a good risk management system, and strong governance***. Asia's simpler banking model, and reforms to strengthen bank risk management and risk-based supervision, help to foster a strong first line of defense.

But as I mentioned earlier, we would risk false sense of security if we believe we can depend just on our simpler banking model. With economic and financial liberalization, especially propelled by the regional economic integration such as ASEAN Economic Community or AEC, that simpler banking model is changing. I will return to this issue later.

For now, let me return to Basel III and the potential side-effects for Asia?

There are some concerns about unintended consequences from Basel III that bankers and regulators in Asia have voiced to the standard setters. I will, at this time, not comment on those issues which are not concluded such as liquidity rule.

One of the most important and immediate consequences would be impact on trade finance which is a critical issue for emerging economies and Asia. This is because our economies and financial structure is more dependent on it, compared to some western economies.

Let me elaborate. International trade is a major driver of GDP as our export is part of the global and increasingly integrated regional supply chain. However, many of our exporters are SMEs not large conglomerate. These local SMEs rely on bank financing, as our financial system remains more bank-based than market-based. Supplier of trade financing is still banks in western countries, especially European banks. The deleveraging of European banks can reduce the supply of trade financing and impact growth and development.

To address this, it is important that Basel Committee recognizes that trade financing has relatively large impact on Asia, compared to the western economies for which Basel III is mainly geared. Treatment of trade financing in leverage ratio framework will create incentive for banks to shift away from trade financing towards other types of financial transactions, including derivatives which have lower impact on leverage ratio, but can earn higher return. This is because they are assigned lower credit conversion factor even though trade financing is less complex, more familiar, has low liquidity risk as they are self-liquidating, and most importantly, it clearly serves real sector.

We believe these rationales argue for a more appropriate treatment of trade financing to ensure that the Basel III framework is appropriate for Asia. The current effort of FSB to survey unintended consequences of reforms on emerging market is welcomed.

Before ending this note on Basel III, let me touch on Thailand's own take on these developments.

For Thailand, we aim to adopt the Basel III framework in accordance with Basel Committee timeline.

After industry consultation, we believe that Thai banks will be well placed to implement the Basel III framework as their capital positions are well above the minimum requirements of 8.5%. The Basel III framework will help strengthen the bank's capital and risk management.

One of the major improvements of Basel III from Basel II is consideration on cyclicality, with requirement for conservation and countercyclical buffer. However, we believe that prudential measures, such as conservative provisioning designed to be countercyclical, should also be given due credit for achieving the same aim when implementing Basel III buffers. This would help avoid the double requirement on capital maintenance. Of course, we strongly support a better treatment of trade financing, to ensure that Basel III is supportive of stable economic growth.

On the last note, let me turn to a key trend in Asia, "regional economic and financial integration". Asia faces a challenge of steering a balance between liberalization and strengthening regulation.

ASEAN Economic Integration under AEC, which sets the landmark date of 2015, has progressed substantially on the free flow of goods and services, as well as direct investment. Financial sector integration is also set to speed up. The plan is to improve efficient and safe payments system in the region to facilitate trade and retail clients, as well as support payments and settlements of securities in our capital markets.

The road for AEC goods and services to flow has been built, we are now making it better. Payments should be easier, cheaper, faster, safer, and embrace e-technology to do this. Banking sector integration will work towards allowing entry of ASEAN banks into other member countries. Currently we are discussing the prudential criteria for Qualified ASEAN Banks. We expect to reach conclusion by the end of this year, and for implementation to begin in 2014.

So, given that the road is built, the financial intermediary or the carrier is set to operate cross-border services more widely. The capital account liberalization is also being speeded up with removal of capital control, that is equivalent of having less customs and immigration check-point at our borders. The capital market integration will act as catalyst to speed up the developments by expanding products and competition, and flow of financial assets.

The AEC will also serve to better integrate ASEAN into the other regional economies and supply chain, that is to integrate ASEAN plus 6.

Thailand is prepared for this, and our plans are being implemented on track. These are Financial Sector Master Plan phase II for banking sector, the capital market development plan, the Payment Road Map. Our capital account liberalization plan is undergoing industrial hearing.

These forces will shape the demand for financial services and supporting infrastructure going forward. The key outcome would be demand for broader set of financial products and services to serve regional cross-border trade and investment. The economic growth and growth of wealth in Asia will require better wealth management services.

So, we have come full circle. The simple banking model that has served Asia well so far will not be adequate to serve our growing future needs. So our banks will have more products, more complex risk profile, more interconnected with global capital market, more reliance on IT infrastructure. The regulations being discussed at Basel and FSB will become increasingly relevant to us.

To go forward, we need to create a trust in risk management system and supervision, not just in our country but also our neighbors in Asia. Having a global standard is a help in fostering this trust, if we and our neighbors adopt the same standard. The challenge also is that we also need to make the standard appropriate for us. To do this, both banks and regulators across the region need to work together.

This symbiotic relationship is how we get the Trust and healthy dose of skepticism to keep our financial system safe and efficient.

Thank you.