Prasarn Trairatvorakul: Financial crises and the future of global and Asian banking

Statement by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the Sasin Bangkok Forum 2012 Plenary Session "Financial crises and the future of global and Asian banking", Bangkok, 9 July 2012.

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Theme: "Strategy for Known-Unknown". The critical success factors are 3 Cs: Coordination of regulators, Commitment forged by Inclusiveness, and Communal responsibility to restore market mechanism as a pillar of governance and financial discipline.

Good morning. It is an honor to join all of you today. I would like to thank Sasin for organizing this forum and for inviting me. Over the past three decades, Sasin has played an important role in grooming business and policy leaders who have been instrumental in building Thailand's open and competitive economy. Today, we are facing another critical juncture for Thailand and the global economy. This forum has brought together the world's leaders in public policy, businesses, as well as academia, and is therefore a rare opportunity for dialogue on our strategy going forward.

Ladies and gentlemen,

This brings me to the topic of my remark today. The future of banking industry at the global level and in Asia is being shaped by three major forces, namely, the fragile global economy, global financial regulatory reforms, and the rise of Asia which faces its own developmental challenges. These forces are interrelated and complex, no one can claim to fully understand the final outcome. So is this the new paradigm of known-unknown? That is, we know what the major drivers of change are, but we cannot forecast outcome. ***So the key strategic challenge is how to deal with Known-Unknown.***

For the short-term, the key priority is dealing with the fragile and volatile global economy. Stability is the priority for banks and regulators. ***The strategic policy question is how to get the right balance between risk and return, stability and growth.*** Weaker banks will retrench, leaving rooms for the few stronger banks to take up market share. In Asia, we have seen banks from the Asia-Pacific, notably Japanese, Chinese, and Australian banks moved into market space where European and U.S. banks have retracted. ASEAN banks are also shifting strategy to play a greater role to support their conglomerates in the regional expansion. If this regional banking trend continues, what are the implications for banks, regulators, and central banks? While the region has so far remained relatively resilient to the first round impact of European bank deleveraging, there is significant concern about the second round impact through the slowdown in global trade and economy that will impact growth.

Another known-unknown in the short-term is the impact of interaction of various traditional and non-traditional policy measures, such as monetary policy, prudential policy including macroprudential. As a result of this crisis, the acceptable policy space has been significantly widened, for example, macroprudential policy now includes sectoral measures such as those to prevent property bubbles or to control adverse impact of capital flows. While these measures have merits in safeguarding financial stability, they could have complex and cross-border impact.

Even on the ***monetary policy front***, unconventional measures are becoming more conventional. Central banks in the major economies have increasingly used unconventional monetary easing. Though necessary to stabilize their economies at this juncture, these policies have side effects of large and volatile capital inflows into Asia. This further complicates safeguarding of financial stability in other countries including Asia, and could, in turn, trigger some countries to resort to macroprudential measures themselves.

Thus, in terms of policy space, we are dealing with a new paradigm of expanded policy tools, with new transmission mechanism, and requiring their own policy framework and governance. So we need to recognize the need for ***crossborder coordination as well as flexibility in execution given emerging uncertainty***.

Turning to the more medium-term structural issues, major regulatory reforms especially Basel III, Financial Stability Board reforms, and Dodd-Frank Act are still a known-unknown. We do know that they are designed to redress weaknesses that caused the crisis by enhancing capital and liquidity, while addressing the problems of procyclicality, and too-big-to-fail of SIFIs. For this, their merits are well recognized. But these reforms will reshape the global financial landscape and raise cost of financial intermediation. They will also have implications for cross-border level playing field, regulatory arbitrage, and alter risk profile of banks. Therefore, we need to recognize the unknown element, that is, we don't know their full impact on the financial market and global economy.

The latest review of the Financial Stability Board of potential unintended consequences of regulatory reforms pointed to these concerns. Emerging markets have raised some concerns about the ***Basel III capital and liquidity frameworks***. These may have negative impact on domestic financial markets, increase banks' cost, and thus reduce credit and financial market liquidity. In particular, the liquidity standard, which is not yet finalized, the calculation in the framework may not accurately reflect emerging market's financial market, and the implementation could distort local financial market. There have also been concerns about the treatment of traditionally low-risk ***trade finance in leverage ratio*** which may impact growth and development. Emerging Asia is predominantly bank-based; thus, Basel III will affect its financial intermediation relatively more than in the West, just at the time when financial intermediation is critical to support economic development and integration. Some of these standards are still under discussion, and thus Asia-Pacific region already has a proactive regional strategy to help steer these regulatory reforms, such as through EMEAP forum, to reflect our economic and financial market context.

With regard to the ***OTC derivatives reform*** which aims to move OTC derivatives trading on to exchanges and cleared through central counterparties. There are concerns regarding inconsistency of regulation between countries, infrastructure that is needed, and cost for users. For example, if national central counterparty is not a viable and efficient model for a small economy, then the cost of hedging would increase with higher risk weight under Basel III. Meanwhile, if derivatives are cleared overseas, through regional or global central counterparties, we need to consider implication for cross-border supervisory coordination, financial stability, and development of local financial market and competition. On a related issue of ***Dodd-Frank Act***, restriction on proprietary trading of US bank could impact the liquidity of US dollar markets abroad, as well as liquidity of foreign government bond markets which are the back-bone of their monetary policy operation.

Another key issue going forward is the balance of authority between Home and Host regulators. There are concerns about the proposal of Financial Stability Board on cross-border resolution of Global Systemically Important Financial Institutions, or ***G-SIFIs***. The concern is that some Host regulators may not be included by the Home regulator in the Crisis Management Group or resolution planning, even if the institution is systemically important in their jurisdictions.

We are glad to see the FSB taking initiatives to identify potential problems. Now it is the time to work together on solutions in an inclusive manner. This is because the inclusiveness of the process assures acceptability and commitment, and reduces the uncertainty from unilateral action of individual countries. These international regulatory standards have no direct international enforcement power. Before the global crisis, the governance is based on discipline which came from the market discipline, but now market discipline has diminished.

Also the influence and discipline from the IMF program or FSAP may have been somewhat countered by growing importance of regional financial assistance mechanism with their own governance. Each country or region would be more likely to adopt these new standards if they buy-in to the rationale of the reform. ***Inclusiveness and coordination are therefore keys for commitment, and the pillars of the new governance*** for bodies such as the Basel Committee and Financial Stability Board; this is perhaps the new Bretton Woods.

Turning to longer-term challenges and strategy, Asia's increased economic importance will rise as a consequence of its development efforts in liberalizing the economy and the financial system, allowing market forces to enhance efficiency and productivity. These forces will accelerate with increased integration of the ASEAN Economic Community, ASEAN plus 3, and plus 6.

For intra-Asia's financial flows, Asia is not "homogenous" – the "North Asia" and financial center economies are developed, and some are mature economies facing their own challenges. The rest of Asia is emerging economies, some facing middle income trap, and some facing the transition challenges from centrally planned to market economy. "North Asia" will tend to have savings surplus, and need growth potential and to export of FDI. "South Asia" will need savings to finance investments. There is a natural synergy in resource allocation, industrial and logistic linkage. Thus, regional financing and growing role of regional-centric financial services would naturally follow.

The most critical challenge emerging Asia faces is to build economic and financial infrastructure fast enough to properly harness the growth energy and put these capital into productive use. Without adequate financial infrastructure, namely market and legal infrastructure, and financial literacy, there is potential risk that emerging Asia cannot absorb such flows. This could result in misallocation of resources, including asset bubbles and instability. In parallel, public investment in infrastructure projects, as well as social investments in education and healthcare, are keys for increased productivity and economic upgrade. The challenge lies in getting the right balance between growth and stability, in managing large and long-term financing, increasing public investment, while keeping financial discipline.

These are complex issues on how to ensure efficient resource allocation. A key strategy is to enhance the role of the market mechanism of the financial sector in Asia to rise to the challenge, and to act as check-and-balance on public policy.

In closing, we are at an important turning point where we face paradigm shift. This is one of the realignment of relationship between the market, regulators, and society. In crisis countries, the balance of the relationship between the financial industry and the society shifts because the cost of financial crisis is born by the society. In emerging Asia, public policy including financial regulation comes under pressure from social demand for financial access as well as consumer protection. These naturally accompany the take-off in growth as a result of economic and financial liberalization.

Both banks and regulators need a proactive strategy to deal with social and political environment that will shift banking environment and regulatory paradigm. Thus, the strategy for banks going forward must also include ***proactive governance and accountability framework that seeks to restore trust in market mechanism, and improve the social and political environment in which they operate***. Failing to recognize the powerful social forces will result in less than optimal regulations. S***imilarly, the strategy for successful global regulatory reform is to assure an inclusive process, to garner commitment and credibility for the reform.***

In concluding, the key strategy for dealing with this paradigm shift of known-unknown is based on ***3 Cs***. ***Coordination*** to deal with our interconnected financial stability. ***Commitment*** forged by ***inclusive*** global reform process. And, ***Communal responsibility***, or governance, that can regain trust of society in market mechanism, so that we can rebuild market discipline as a key governance and pillar of the financial system. These are our best hope for striking the right balance between risk and return, growth and stability, and regulation and market discipline at a time of known-unknown.

Thank you for your attention.