Bandid Nijathaworn: The current financial crisis, lessons learned, and future implications

Keynote address by Dr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the 11th SEACEN Conference of Directors of Supervision of Asia-Pacific Economies, Bangkok, 29 July 2009.

* * *

Distinguished Speakers,
Participants, Colleagues,
Ladies and Gentlemen,

It is my pleasure to be giving this morning's keynote address for the opening of the eleventh SEACEN Conference of Directors of Supervision of Asia-Pacific Economies under the theme: "The Current Financial Crisis, Lessons Learned, and Future Implications."

This forum gives us an excellent opportunity, at this crucial juncture, to discuss the recent global financial crisis and to share amongst ourselves the experience as well as the lessons learned, so that we can further strengthen and improve our financial systems and supervision. Looking at the agenda, it is certain that the discussion in the next two days will be a most valuable one.

So far, the SEACEN economies, one way or another, have all been affected by the current global financial turmoil. As central bankers and regulators, we are faced with the important task of putting in place future regulation, and the obvious place to start is to ask the questions whether the crisis could have been prevented or mitigated in the first place, and how the lessons learned from the current crisis can be used to prevent the next crisis.

These are not easy questions to answer. We may be aided by our understanding of the common factors shared by past financial crises, and how lessons from the past have helped to shape the current policy. But always, there will be other or new challenges that will be difficult for us to anticipate or be aware of. With these in mind, let me share with you my thoughts on some of these issues.

First, on the causes of financial crisis. According to a well-known study by Reinhart and Rogoff in 2008, financial crises in the past, dated back to the 1800s, shared many common causes. Chief among these are macroeconomic imbalances and the roles played by large and persistent capital flows, asset price bubbles, and credit boom. Although, compared with the Asian financial crisis, the current crisis does differ in terms of the impact, the scale, and the role played by financial innovation, but the two crises, nonetheless, do share many of the common factors mentioned above.

For example, in the case of asset price and credit boom, the real house price in the U.S. increased by more than 40 percent between 2002 and 2006, while U.S. loan growth, particularly mortgage loans, accelerated during the same period. These signs were also present in East Asia before the 1997 crisis. In the current crisis, the securitization boom and the easing of monetary policy in the US helped fund the loan growth, while in the case of the Asian financial crisis, it was the large capital inflows in the form of direct borrowing that funded the credit boom. In both cases, however, poor underwriting standard by banks was an important common contributing factor.

Looking back, the Asian financial crisis has been an important turning point for policymakers in the region, as the lessons learned from the crisis had led to many important policy reform initiatives, all of which aimed at strengthening the robustness and the risk management discipline of the domestic financial systems, and this brings me to my second point.

In the case of Thailand, after having restored financial stability in the early 2000s, financial reform became a top priority, with emphasis on instilling prudent regulations and strong risk management. We adopted a macro-prudential approach in the early 2000s, in recognition of the systemic linkages between the financial system and the increasingly opened macro-economic conditions; utilizing our natural institutional advantage as we continue to oversee both monetary policy and financial institutions supervision. Hence, from 2003 to 2006, a series of macro-prudential measures were introduced, aiming at restraining then the rapid growth of credit, especially credit card loans and mortgage loans. The preventive measures that were introduced included placing limits on the loan-to-value ratio for luxury mortgage, raising minimum repayment requirements for credit cards and personal loans, and strengthening NPL provisions by fair valuation standards of IAS39. Looking back, these measures have been useful in curtailing excessive leverage and household indebtedness, thus helping to maintain stability in our domestic financial system.

Risk-based supervision was a key driving force to strengthen risk management practices of our financial institutions. Financial institutions and central bank laws have been overhauled to keep up with the increased complexity of the financial system. The new Financial Institutions Business Act, enacted last August, empowers the Bank of Thailand with the authority to regulate banks and non-banks under a consolidated supervision regime. Furthermore, risk management and governance practices of financial institutions have also been strengthened. Board of Directors are now held accountable by law for setting the strategic and policy goals of banks, while corporate governance guidance and notifications under the fit-and-proper rule for the appointment of bank management have been put in place. Financial institutions have been positive in embracing these changes, as they contribute to a more open, more accountable, and more transparent financial system.

Given the dynamic changes in the financial system, it is important for risk management and supervision to be forward-looking, and recognize margins of error from risk models. Thus, it is sensible to adopt the conservative approach. Here, let me also highlight the importance of "stress-testing" as a risk management and supervisory tool. During the past four years, we have conducted stress-testing, both top-down and bottom-up by requiring local banks to do the same, for risk management and capital planning purposes. Currently, stress-testing has become an integral part of our supervisory process. From the experience so far, we find stress-testing to be an extremely useful process and dialogue for identifying potential weaknesses of banks in a forward-looking manner, as well as in alerting bank management to take the necessary corrective actions.

As a result of the macro-prudential framework implemented and the emphasis of supervision that has been placed on improving risk management of banks, Thai financial institutions, so far, have remained resilient to impact of the global financial turmoil. I believe this is a common experience here in SEACEN.

Ladies and gentlemen.

Looking ahead, once the global economic and financial system recovers, many important issues will require answers on how to move forward from the point of view of regulatory guidance. On this, the key issues that will be most relevant to our region in my view will include: first, large capital inflows and their implications for risk management capacity of the financial system; second, the issue of procyclicality and how to deal with it effectively in the context of bank regulation and supervision, and third, managing the cross-border spillover effects that potentially can be a source of systemic risk.

First, on the issue of capital flows. At this time, given better growth prospects for emerging markets in the near-term, there could be a resurgence of strong capital flows to emerging markets once the current global crisis subsides. As large capital inflows are known to be one of the key contributing factors of many financial crises in the past, preparing the economic and financial system to effectively intermediate it and manage the associated risk to maintain financial stability, will be the first and foremost challenge for SEACEN regulators and policymakers. In the past, what happened was that, in response to the strong capital inflows and abundant liquidity, banks tended to relax their underwriting standards, which gave rise to the formation of asset price bubbles. Therefore, going forward, risk management of banks must continue to be strengthened and regulators must be prepared to use macro-prudential measures proactively as necessary to reduce such risk. This means credit standards and bank capital rules must remain vigilant regardless of the abundance of liquidity.

Second, the issue of procyclicality has gained the attention of regulators and the banking industry for quite some time in the context of Basel II. Since then, especially at the start of this crisis when credit crunch has slowed economic activities, a number of proposals have been put forward to deal with this issue. So far, the debate remains open. The issues now range from the choice between the use of rule versus discretion on bank capital, to the use of leverage ratio, and to the implementation issue that includes how to exercise the measures effectively in the context of a financial system that is non-complex, as is the case of the SEACEN economies. On this, I have a view that vigorous stress-testing by supervisors and banks can help keep the effects of procyclicality manageable. I hope this conference will further discuss this issue.

Finally, the complexity and cross-border linkages of financial systems will continue to increase, not decrease, following this crisis. On the other hand, the right and effective global regulatory and supervisory structures to handle cross-border implications are still evolving, while information flows and cooperation among regulators and supervisors, at this time, continue to be limited. It is clear that without significant improvements in both information flows and cooperation among supervisors, it will be difficult to prevent or contain future financial crisis spillovers effectively.

Ladies and Gentlemen, this eleventh SEACEN conference provides us with an excellent opportunity to discuss these current and important issues. Our challenges are similar, and through our coordinated views and collaborated efforts, the SEACEN economies collectively will be in a stronger position to address these challenges. I wish all of you a successful conference with a fruitful exchange of ideas and a wonderful collaboration. And last but not least, I would like to acknowledge our appreciation to the SEACEN Centre and to our fellow supervisors for providing the key supports to this great forum.

Thank you.