

Tarisa Watanagase: Future regulatory challenges for emerging markets – a case for Thailand

Speech by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Association of International Banks (AIB) Dinner Talk, Bangkok, 19 October 2009.

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Chairman, Board members and members of the Association of International Banks, Distinguished Guests, Ladies and Gentlemen

First of all, I would like to thank you for inviting me to join you today. I welcome the honour and look forward to the opportunity of meeting you, especially at this important juncture in the history of global financial system development. In the past two years, we witnessed one of the most severe financial crises in modern time, and with it, a sharp impact on the global economy, especially after the demise of Lehman. Today, the global financial market has stabilized, albeit not having returned to normal, with many major parts still in retrenchment such as securitisation market.

Today, an almost one year anniversary of the global fallout, the Dow Jones once again retraced its step, and touched 10,000 points. There are increasing positive signs of global economic recovery. Nevertheless, there are still significant uncertainty and downside risk, going forward. These include uncertainty on the exit policy of stabilization measures of various countries, the differential speed of adjustment of various regional economies, and not least, the impending challenge of regulatory reform demanded by the public at large.

Throughout this turbulent period, Thailand's financial system has remained resilient and stable. Significant credit is, of course, due to your part, especially your ability and willingness to uphold normal service for your clients here, as well as your cooperation with your supervisors in ensuring strong risk-management. Going forward, we look forward to this strong and beneficial relationship, to help us meet the challenges posed by the global economic and financial developments.

Therefore, I would like to take this opportunity today to convey our appreciation, as well as to share with you the key challenges we see going forward, and to outline the reforms which in our views are key for Thailand and emerging markets in this context.

My talk today will be divided into two parts.

First, I will look at the current debate on regulatory reform, focusing on the **measures being discussed at the Basel Committee for Banking Supervision. I will highlight the key proposals, the timeline, and the process being discussed.**

Secondly, I will share with you **our input on the debate at global forums, and the reform that we consider to be our priority, going forward.** I believe our reform agenda will be useful for you as practitioners, as the global reform covers a very expansive and comprehensive set of policy, and for banks operating in many jurisdictions, the required adjustment to ensure compliance can be significant. This process can be facilitated by setting a clear and transparent priority.

Let me now turn to the first part of my talk, the update on global debate on regulatory reform.

While the current precept of risk-based supervision, as implemented by many, is still a robust and valid concept, there are many weaknesses when it comes to putting the precept into practice, as shown by the lesson of this crisis. These weaknesses include the inability to deal with complexity arising from such mechanism as securitisation, OTC derivatives, as well as the problem of procyclicality and systemic risk associated with valuation and performance management issues. Nevertheless, risk-base principle remains the key anchor to coherent

risk management and supervision, even more so given the increasing complexity of the financial market. So, we must remain anchored to its principles.

What then needs to be done is to strengthen risk measurement, management, and supervision, so that we can truly capture risk of individual institutions, overtime, and risk arising from interconnectedness of key components of the system, to safeguard financial stability. In short, we need to strengthen both micro- and macro-prudential regulations.

The shift in policy paradigm from this crisis has been the increasing acceptance of the concept of macroprudential policy, which takes into account the interconnectedness within the financial systems as well as between the financial system and the real economy, that is, the issue of systemic risk and procyclicality.

The proposals by G20, the BCBS, as well as international accounting standards are in line with the risk-based principle. While the range of policy is extensive, the key thrusts are strengthening of risk-based microprudential regulation, and emergence of the explicit importance given to macroprudential supervision to tackle the problem of procyclicality and systemic risk.

As we can see, there will be a new paradigm and context to international supervisory standard. While the macro orientation is in fact not new, and has always been in the classic tool-kit of central bank in ensuring financial stability, the current explicit articulation and specification of such tool as global standard is.

The key macroprudential policy framework that has received wide support to deal with procyclicality problems includes the followings.

First, there is a proposal on the build-up of capital buffer in the good times to be run down in the bad times and to prevent excessive credit growth. Second, as being discussed with accounting standard setters, provisioning should be linked with expected loss rather than incurred loss, which is the prevailing practice. Finally, the primarily simple and transparent "leverage ratio" should be applied as a complement to risk-based capital requirement under Basel II.

Implementation of many such policies is still subjected to significant work on calibration as well as qualitative issues such as consistency with risk-sensitive capital framework, and international level-playing field. Such problems magnify in the case of emerging markets, which face constraint on data and institutional capacity. Moreover, much of the work done on calibration would tend to serve the need of IRB rather than SA banks that are the core in emerging market. Thus, the reform agenda will need to pay proper attention to capacity building of banks and regulators. Nevertheless, there are warranted rationales for its use in financial stability tool kit in an appropriate manner, given national context.

In terms of measures to address systemic risk, the proposed ideas include systemic capital charge, capital for OTC derivatives, and cross-border bank resolution framework. Again, the same emerging market issue and dimension should be properly recognized.

Turning to the key microprudential policy framework currently being discussed at the international forums to ensure individual financial institution's stability, the BCBS has proposed a package to address previous shortcomings in risk-based supervision as follows. For Pillar I, regulatory capital for securitisation exposure is enhanced. In addition, the quality and transparency of capital is strengthened especially Tier I capital, which would consist mainly of common equity and retained earnings.

For Pillar II, supplemental guidelines are issued by requiring banks to manage firm-wide, concentration and reputational risks more effectively. Valuation and stress-testing practices are also improved. Moreover, compensation and bonus scheme should be aligned with long-term risk taking behaviour and performance.

Turning to Pillar III, focus is given to disclosure requirements to reduce uncertainties associating with securitization exposures. Additional requirements include, for example,

sponsorship of off-balance sheet vehicles, and resecuritisation exposures. On top of these, a new regulation on liquidity risk management, namely the so-called liquidity coverage ratio could be introduced, going forward, subjected to further work. This new regulation is designed to ensure that banks, particularly global banks, maintain adequate liquidity at all times, underpinned by longer-term structural liquidity ratio. In this regard, liquidity stress scenarios would be determined by supervisors.

The BCBS will issue concrete proposals on these measures by the end of this year, after which, an impact assessment and calibration exercise would be completed by the end of next year. For Thailand, implementation of these new international standards would depend on needs and appropriateness, based on our context.

Let me now turn to the second part of my talk, the Bank of Thailand's input on these ongoing regulatory debates.

It is true that many reforms being discussed are in the context of complex financial markets and institutions, much more complex than our markets, and that emerging markets were affected by indirect rather than direct impact of the financial crisis. But, market failures in key market structure, such as securitization, will in the future be our issues. Moreover, global standards will have an impact on risk management culture, as well as level playing field issue, globally. Thus, the Bank of Thailand gives high priority to the global debate and participates actively.

Through our involvement in various international forums, such as the bi-monthly BIS Governor Meetings, as well as Standard Implementation Group of BCBS, of which we are a member, the BOT has proposed that developing countries be invited to participate in the development process of these new standards right at the beginning rather than be informed of them at the very end. Moreover, the BOT has also voiced our concern over the use of a simple leverage ratio, which does not take into account inherent risk because this would tend to penalize banks in developing countries since they generally hold less risky assets compared to developed countries.

Recently, the BOT was invited to take part in the newly created Basel Consultative Group (BCG), which will meet for the first time during 28 to 29 October this year. The BCG's main agenda is to be a discussion platform for ongoing Basel Committee on Banking Supervision's prudential standards and their implementation issues, such as those mentioned earlier.

In this regard, our stance on the implementation of any new regulatory and supervisory change includes the following points.

First, regarding microprudential policy framework, the BOT already has the process to enhance understanding and adjustment of banks for the implementation of related standards, for example, through hearings. Macroprudential policy framework is a more challenging area, particularly in terms of data limitations and policy calibration. Despite this challenge, the BOT remains committed to maintain overall stability of the financial system. As such, we stand ready to guard against any build up of bubble and imbalance within the system.

Let me now share with you what I believe are our priorities, going forward.

Amongst these, Basel II implementation, especially adequacy of capital, ICAAP and stress testing practices is on top of our list.

The principles stipulated in Pillar II, which came into effect in September this year, are in line with the existing risk-based supervision used by the BOT, but places greater focus on the qualitative aspect of risk management and assessment of capital adequacy. For example, the role of the Board of directors and senior management in the assessment and formulation of strategy on capital management for the current and future periods, has been stressed.

In this regard, we hope that banks would ensure they have a good risk management system, with an ICAAP that covers all significant risks, including those stipulated under Pillar I as well

as other risks. These other risks should at least include credit concentration risk, interest rate risk in banking book, liquidity risk, strategic risk and reputational risk.

Moreover, it is desirable that banks maintain capital above the minimum regulatory requirement to withstand future losses both in normal and stress situations. To achieve this, banks should conduct stress tests and formulate capital plan in accordance with the stress test results, in a systematic and continuous manner.

We expect banks to be able to finalize and start using their ICAAP by the end of December 2010, with the first ICAAP Report submitted to the BOT within the first quarter of the following year. The BOT would then begin reviewing banks' ICAAP during bank examination that year.

In assuring adequacy of capital over the business cycle, we believe it is very important to focus on countering procyclicality by ensuring capital and provision buffer, as well as to introduce IAS 39 which incorporates correction from problem or procyclicality as being considered by international standard setters and BCBS. Importantly, we emphasise the importance of consolidated supervision to ensure adequacy not only in capital but also risk-management of the entire banking group, particularly liquidity risk. In this regard, with respect to foreign banks, an important issue to push forward, in our view, is that of crossborder supervisory coordination, particularly better information sharing between home-host supervisors should be warranted. This is particularly important as the current crisis shows that there is a need for home supervisor of global financial conglomerate and banks to recognizing that global bank's local operations may be systemically important for the host economies.

In closing, I would like to share with you what I believe are the key changes in our financial landscape, resulting from this global crisis.

First, bank business model would likely become more conservative, placing less reliance on wholesale financing and use of leverage, while focusing more on risk management and higher liquidity buffer. Consumers themselves would be more risk averse and prefer to stick with simple transactions and products. As mentioned already, regulatory framework would be strengthened, especially the use of macroprudential oversight that focuses on system-wide stability. As such, closer supervision of systemically important financial institutions, including non-banks, would be required. Finally, the microprudential oversight would also be strengthened to rectify previously identified shortcomings, particularly the Basel II framework, corporate governance, and incentive misalignment.

Though it looks as if we could be in the process of creating a "new world order", given what we have done so far in strengthening our financial sector resilience, I believe that this transition would be a smooth one and add further strength to our financial system. Needless to say, a strong financial system is the backbone of sustainable economic growth in the long-term.

Thank you for your attention.