



**Conference on
Global Financial Crisis: Financial Sector Reform and Regulation**

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Welcome Remarks

by

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Distinguished guests, ladies, and gentlemen. Good morning. Let me express my gratitude to all of you for taking time from your busy schedule to participate in ADB's conference on the ***Global Financial Crisis: Financial Sector Reform and Regulation***.

This conference will address various implications of the global financial and economic crisis for reforms and regulation of the financial system in Asia. I would like to discuss three major background factors behind this conference over the next three days.

First, even though the crisis did not originate in Asia and the Asian financial sectors were fundamentally sound, Asian real economies have been hit hard by the downturn in export demand. The sharp downturn raises concerns about risks to the region's financial sectors as a result of rising non-performing loans. The possible credit crunch could have disproportionately harmful effects on small and medium-sized enterprises. This suggests that Asia needs to improve financial supervision and regulation to mitigate such risks.

Second, the global financial architecture that evolved in the postwar period, with the establishment of the Bretton Woods institutions—the International Monetary Fund (IMF) and the World Bank—has reached a turning point. From the perspective of preventing and managing a global systemic crisis, the entire financial architecture needs to be redesigned from the ground up. This includes the strengthening of economic and financial surveillance of systemically important economies like the United States (US) and the European Union,

the role of the Financial Stability Board (FSB) in its global supervision of systemically important international financial institutions and markets, and global macro-prudential surveillance (or supervision) possibly organized around the IMF and the FSB. To complement such global efforts, Asian economies will need to improve their micro-prudential supervision and macro-prudential surveillance, at the national and regional levels, to ensure financial stability. This may support the establishment of an Asian Financial Stability Dialogue among the region's finance ministers, central bank governors, and supervisory agencies to promote regional financial stability.

Third, Asian economies benefited tremendously in recent decades from export-led growth centered on US and European markets. However, this growth model can no longer be relied upon to sustain the region's economic growth beyond the crisis. Asian economies need to take up the challenge of rebalancing growth toward greater reliance on domestic and regional demand. They need to deepen and strengthen regional financial markets to mobilize the high level of savings within the region to promote investment for infrastructure and for small- and medium-sized enterprises. Reforms in the financial system, including the further development and deepening of local-currency bond markets, can make an important contribution to achieving these goals.

How can Asian authorities strengthen their financial systems and regulatory regimes to reduce their vulnerability to economic and financial shocks, both internal and external? They need to study the approaches of the developed economies to reforming supervision of systemically important institutions and markets and implementing macro-prudential surveillance, but, ultimately, they must develop their own models which are most suitable for national and regional conditions. They will have to create their own frameworks of macro- and micro-prudential oversight.

I believe it makes more sense to create a consolidated regulatory structure that oversees a wide range of financial services from an integrated perspective, given the increasingly interconnected nature of various financial activities—partly due to the rise of financial conglomerate groups. However, we saw failures of not only the highly fragmented regulatory structures in the US but also the consolidated regulatory system, in the hands of the Financial Services Authority (FSA), in the United Kingdom. In Japan in the 1980s and 1990s, even though the finance ministry had all the regulatory authorities—including the power to administer the then non-independent Bank of Japan—it could not prevent the asset price bubble nor effectively manage the subsequent crisis that lasted more than ten years. What is important is to ensure that the regulatory and supervisory authorities do their best in

preventing and managing systemic crises by focusing on systemically important financial products, institutions, and markets and without leaving significant regulatory gaps, and that they do so by working closely with monetary and fiscal authorities. As the central bank is in charge of providing lender of last resort facilities, it may also have to perform some supervisory functions over banks. All in all, it is essential to create an environment where authorities—the finance ministry, often an independent central bank, and regulators if they are separate—could coordinate their efforts and policies for effective crisis prevention, management, and resolution.

In the United States, the Obama administration has proposed that these responsibilities largely be concentrated in the hands of the US Federal Reserve (the Fed). It proposes that the Fed tighten its supervision of “Tier 1 institutions”, regardless of whether or not they are banks in the traditional sense. The Fed is also being called upon to take charge of macro-prudential supervision, and to monitor any firm that could threaten financial stability, either because of its size or its interconnectedness. Finally, a new insolvency scheme modeled on that of the Federal Deposit Insurance Corporation (FDIC) for ordinary banks will cover all systemically important institutions. However, there has been virtually no proposal for rationalizing the current patchwork system of regulatory bodies and responsibilities in the US.

In the European Union, the European Commission has proposed establishing a European Systemic Risk Board that would be in charge of macro-prudential supervision, headed by the president of the European Central Bank. It has also proposed establishing a European System of Financial Supervisors in charge of coordinating micro-prudential supervision of big cross-border financial institutions, since these are not adequately covered at the national level. There have been independent proposals for establishing a European version of the FDIC as well. However, the coordination of the actions of national and regional institutions still presents many thorny problems.

In the United Kingdom, the challenge is how to strengthen both micro- and macro-prudential supervision, given that the FSA took an excessively loose supervisory stance, and the lack of coordination between the FSA and the Bank of England (BOE) left a large gap in macro-prudential oversight. The BOE will be tasked with statutory responsibility for financial stability, and will be given new powers to deal with banks and other big financial institutions that run into trouble. However, the BOE argues that it will not have sufficient powers to carry out this responsibility.

There are a number of other important issues to examine. They include the volatility of international capital flows, especially during times of crisis; the role of innovative financial products such as collateralized debt obligations and credit default swaps, and lightly-regulated investor groups such as hedge funds and private equity funds; the role of credit rating agencies in the development of the market for structured finance products; and problems associated with the pro-cyclicality of regulatory regimes. Much effort has been expended in the last two decades to develop the Basel I and Basel II capital adequacy frameworks for banks, but they still failed during the current crisis.

For Asia, the deepening and integration of regional financial markets can make a significant contribution to rebalancing Asian growth toward domestic and regional demand, especially investment spending. The key challenge is how Asia's financial system can channel the large savings in Asia to "bankable" investment projects in infrastructure and other areas, rather than allowing "round-trip" via financial centers in advanced economies. We need to understand practical steps to be taken to increase the attractiveness of local-currency bond markets to issuers and investors in the region.

I believe that these important subjects will be discussed here in the conference. Hopefully, these discussions can point toward key measures for reform and better supervision and regulation of financial markets to support balanced and sustainable economic growth for all.