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Asia and Global Financial Reforms

Financial systems in Asia have been remarkably resilient during the current crisis. This strong performance owes much to the significant structural changes following the Asian crisis, and demonstrates that traditional virtues—maintaining adequate capital, avoiding excessive reliance on short-term funding, ensuring proper loan underwriting, and following sound risk management—remain critical. These principles feature prominently in ongoing reform debates in institutions like the G-20, Financial Stability Board, and Basel Committee. As discussed in the IMF's latest Regional Economic Outlook for Asia and the Pacific (available at http://www.imf.org/external/pubs/ft/reo/2010/apd/eng/areo1010.htm), if managed proactively, the emerging new global regulatory landscape could even give Asia a competitive edge given its strong starting position.

Looking ahead, reforms will be important to ensure that the risk of systemic crises remains contained as well as to support rebalancing of demand to domestic sources. With capital flows likely to remain large in coming years, moving ahead with the development of Asia's financial markets will become even more important to contain potential risks to stability as well make the best use of the region's significant savings in support of domestic demand. Maintaining a strong supervisory regime, including by strengthening risk assessment capabilities as well as the macroprudential framework, is essential in this regard.

In this context, Asia will need to adapt to new global regulatory proposals. There is broad agreement on the key principles of reform in response to the crisis—widening the regulatory perimeter to include all systemically important financial institutions (SIFIs), bolstering supervision, improving the measurement and regulation of systemic risk, and strengthening crisis resolution mechanisms, particularly for "too-big-to-fail" institutions. In addition, there is recognition that risk taking needs to be curbed, notably through regulations designed to make financial institutions hold more and better quality capital, build buffers during good times, improve liquidity management, and curb excessive leverage.

In this regard, enhancements to the Basel framework were recently announced, including: (i) *Minimum capital ratios will be raised.* An additional countercyclical buffer of 2½ percent may also be applied by national regulators during periods of excessive credit growth. These changes will be phased in over several stages from January 2013, with full implementation by January 2019 and existing capital instruments grandfathered for 10 years; (ii) *A leverage ratio will become a requirement*, although the precise metric is yet to be finalized, with full implementation envisaged from January 2018; and (iii) *New global standards for funding liquidity are to be introduced* in the form of a 30-day liquidity coverage ratio (January 2015) and a net stable funding ratio to reduce banks' dependence on short-term funding (January 2018).

As a whole, Asia is likely to be relatively less affected by these measures than the United States and Europe, because its banks already tend to operate under tight liquidity and capital rules, with regulators adopting a conservative approach in the implementation of Basel II requirements. The new capital standards, for instance, may not be binding as average ratios in many Asian banking systems are already above the minimum thresholds that will apply in 2019. In addition, curbs on risky behavior may also have less of an impact, given that Asian banks typically have a different business model—one that relies on relatively more stable sources of funding and revenue, that is, deposits and interest income. That said, there could still be some impact, although it should be largely manageable. Reforms to the quality of capital would have implications for some Japanese and Malaysian banks that hold sizable deferred tax assets and hybrid instruments. In addition, new liquidity standards could affect some banks in Australia, Korea, and New Zealand with a relatively high reliance on short-term wholesale funding, and some banks in Japan and India could be impacted if leverage limits include government securities on the asset side.

The generally strong balance sheets and liquidity position of Asian banks should allow them to adapt quickly to the new regulatory requirements, perhaps even developing a competitive advantage over banks in other jurisdictions. Closer to home, the Philippine financial sector also withstood the crisis well and the sector has been relatively unaffected by the global market turbulence in recent quarters, as its direct exposure to Europe and reliance on foreign wholesale funding are limited. In recent months, banks' non-performing loan ratios have remained low and capital adequacy (including Tier 1) ratios high.

To further strengthen the banking supervision and regulatory framework, it remains critical that the proposed amendments to the New Central Banking Act (NCBA) be approved without further delay. The amendments would help supervisory authorities better fulfill their core mandates by providing them with greater legal powers and stronger protection from litigation. The amendments would also lift the remaining constraints imposed by bank secrecy laws on examiners, enhance the scope for risk-based supervision including the risk-based approach to capital requirements, and authorize the BSP to issue its own debt securities, which would further strengthen monetary management. In addition, the amendments would further strengthen the existing prompt corrective action framework.

Such a proactive strategy toward reforms could have significant payoffs: some analysts estimate that Asia could create the most value added in the banking industry over the next decade.

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