FINANCIAL STABILITY AND FINANCIAL SECTOR SUPERVISION: LESSONS FROM THE PAST DECADE AND WAY FORWARD

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DISCUSSANT'S REMARKS

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Session 2

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Discussant's Remarks

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I. Introduction and background

This panel is comprised of four speakers, each of whom is a current or former senior official of a central bank or supervisory authority. In particular, we have individuals who discussed supervision and examination from the perspective of Japan, Korea, Malaysia and the Philippines.

After briefly summarising their remarks, I will try to highlight several common themes in supervision as conducted in these four jurisdictions. I will also try to identify emerging risks and areas of work for bankers and supervisors in Asia going forward.

II. Panellist Summaries

Mr Hirofumi Gomi, an advisor at Nisihmura and Asahi and former commissioner of the FSA, Japan, spoke first and described how the JFSA dealt with the high level of nonperforming loans in the Japanese banking system during the late 1990s and then restructured the banking system.

The Japanese banking crisis was brought about by a number of developments in the 1980s and early 1990s, most notable of which were a bubble in the real estate market, a low interest rate policy by the government to stimulate growth (and speculation in real estate) and a rise in the value of the Yen. This led, in the mid-1990s, to the collapse of the bubble economy, a subsequent sharp rise in the level of nonperforming loans held by banks and the failure of 180 financial institutions (1991 through 2001).

Mr Gomi described the various measures taken by the Japanese authorities to address the problems in the banking sector and to strengthen the financial condition of the banks. In particular, a financial reconstruction programme was announced, substantial capital injections into the banking system were made on five separate occasions, the Deposit Insurance Act was revised and the FSA was established. The objective of the financial reconstruction programme was to restore trust in the Japanese financial systems through a reduction of nonperforming loans and structural reforms (eg raising standards for asset valuation, enhancing governance) designed to strengthen the financial system.

Although the financial crisis in Japan was quite lengthy, nonperforming loans in major Japanese banks were reduced from 8.4% on 31 March 2002 to 1.5% by 30 September 2007. More importantly however, the financial sector more broadly has largely returned to a safe and sound condition.

Dr Lee Jang Yung, Assistant Governor of the Korean Financial Supervisory Service (FSS), described the supervisory reform that has taken place in Korea post-crisis and challenges going forward. With respect to supervisory reform, he noted that many people believe that ineffective regulation and political interference contributed to a weakening of the financial sector in the period leading up to the crisis. As such, in response to the crisis, the Financial Supervisory Commission (FSC) and FSS were established in April 1998 and January 1999, respectively. Previously, responsibility for supervision of the financial sector was shared by four bodies.

Dr Lee identified independence – in several forms – as one of the major challenges facing the FSS. In terms of regulatory independence, the Ministry of Finance and Economy initiates legislation. Moreover, the laws are written in such detail that the FSS has little room to interpret them in regulations. Institutional independence, including the appointment of senior officers also appears to be lacking. On the other hand, budgetary independence and supervisory independence, in terms of licensing and sanctions do not pose significant concerns.

Related to the issue of independence, Dr Lee cited the recent problems with credit cards (2002-2003) as an example of where the communication and differing views of the MOFE and FSS do not function as they should. In this case, the MOFE wanted to encourage credit growth to stimulate the economy while the FSS was concerned about a decline in credit worthiness of borrowers and its impact on the financial condition of credit card companies.

Apart from independence, transparency in the rule-making process has been strengthened and consistency in the enforcement process has improved. The examination structure and process has also been improved to maximize efficiency.

In October 2007, the FSS announced a “Roadmap for Advanced Financial Supervision”. This plan identifies three major areas where the FSS will be making changes to its approach to supervision. First, it will move to a more principles-based approach to supervision; second, it will further enhance its risk-based supervisory approach; and third, it will review its organisational structure and training to ensure the highest level of expertise and capabilities.

Like Dr Lee, the next speaker, Ms Nor Shamsiah Yunus, Assistant Governor, Bank Negara Malaysia, described the evolution of Malaysia’s approach to supervision over the past several years. Ms Yunus said that because the crisis in Malaysia was not as severe as it was in other Asian countries, the central bank could simultaneously address immediate needs while at the same time taking steps to strengthen the foundation for longer term stability. In terms of immediate needs, institutions set-up to deal with nonperforming loans have been wound-up, the prudential framework, including corporate governance and risk management, have been strengthened, and the banking industry was consolidated.

Complementary financial master plans for the financial sector (Bank Negara Malaysia) and the securities sector (Malaysian Securities Commission) have been developed and are being implemented. They call for a strengthening of the legal, regulatory and supervisory frameworks; place an emphasis on capacity building measures; and promote new growth areas. All of this is in the context of greater financial integration and innovation, as well as an increasing reliance in Malaysia upon market-based finance.

Like Korea, Malaysia’s approach to supervision is changing to one that is more principles based, reliant upon management of the financial institution to identify, measure, monitor and control their risks, places a greater reliance on market discipline and involves greater consultation with the industry in the formulation of prudential rules and policies.

A forward looking approach to surveillance of the financial sector, both from a micro and macro perspective, has also been developed and now forms an integral part of the supervisory process. Related to this, a crisis management framework, including the creation of a deposit insurance scheme, has been put in place.

The final panellist, representing Bangko Sentral ng Pilipinas, was Deputy Governor Nestor Espenilla. He began by providing an overview of the Philippine banking system and its performance over the past eight years. Like many other Asian banking systems, in the Philippines, capital ratios and profitability have increased while nonperforming loans have fallen.

In 2002, the Bangko Sentral ng Pilipinas underwent an assessment by the IMF of its compliance with the *Core Principles for Effective Banking Supervision*. Five key areas were identified as needed further strengthening and since that time steps have been taken to improve supervisory capacity in these areas. Specifically, the areas are: (1) legal protection for supervisors, (2) information sharing and communication with other regulatory authorities, (3) a framework for problem bank resolution and prompt corrective action, (4) appropriate standards for risk management, and (5) supervision of financial institutions on a consolidated basis. The Bangko Sentral ng Pilipinas is taking other steps that will strengthen the financial system, including the adoption of international standards such as Basel II and IFRS, and enhancing corporate governance and anti money laundering requirements.

III. Common themes

According to the panellists, the banking systems in all four jurisdictions have strengthened significantly over the past ten years. At the same time, the supervisory regimes have also been enhanced and it is fair to say that these improvements have contributed to the aforementioned strengthening of the financial systems. More broadly, it seems that across Asia financial systems are markedly stronger, safer and sounder than they were ten years ago.

Taking a broad view of the presentations by the panellists, there are five themes that all four countries have in common. First, is a concern over political interference and the impact that this can have on the authority's ability to fulfil its supervisory responsibilities. Admittedly, this seemed to be less of a concern with the Bangko Sentral ng Pilipinas and Bank Negara Malaysia, probably because central banks generally enjoy more independence that a supervisory authority.

The second consistent theme is that of a move to risk-based supervision and one that is driven by principles rather than rules. This trend is in fact global in nature and at least in the case of risk-based supervision is considered best practice. It reinforces the concept that bankers must manage the bank and be able to identify, manage, monitor and control the risks that their institution faces. The role of the supervisor is to assess the adequacy of this process.

Strengthening of corporate governance in financial institutions was also cited as an important aspect of financial sector reform.

Finally, the need to provide training to enhance the skills of knowledge of supervisors is an ongoing challenge. The types of products and activities in the market today are becoming increasingly complex and without a thorough understanding of the risks inherent in these products and activities, supervisors cannot properly fulfil their responsibilities.