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Working paper summary

Aspects of regional financial stability: a policy approach

CIFR commissioned the Institute of Global Finance at the UNSW to undertake this research project

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Asian banks navigated the 2008 global financial crisis (GFC) relatively successfully. Nevertheless, the sovereign debt crisis in Europe, and the consequent withdrawal of funds from the Asian markets, highlighted the importance of resilient regional and national financial markets in Asia.

This paper analyses the examination of risk management strategies and its relevance to the goal of promoting greater regional financial stability, particularly in Asia.

The global financial crisis (GFC) of 2008 demonstrated that macro-economic stability and micro-prudential regulation were insufficient to secure overall financial stability. A key shortcoming of the financial regulation regime in place before the crisis was the failure to identify and address systemic risks. These ultimately led to a significant downturn in real economic activity.

The insights gained from the GFC have underpinned worldwide efforts to bolster the global financial system. Under the aegis of the Group of Twenty leading nations (G20), the Financial Stability Board (FSB) was established in 2009. The FSB is an international body that coordinates international standard-setters and policymakers, with the aim of formulating proposals that promote global financial stability.

The challenge facing the international finance community is how policy proposals associated with macro-prudential tools developed by major international institutions might be implemented. An associated requirement is the development of macro-prudential frameworks to complement what has traditionally been a micro-prudential approach to regulation.

Reflecting the increasing interdependence of the global financial system, regional financial stability is increasingly recognised as important in underpinning sustained economic and financial prosperity. In Asia, the region's capital markets have become more resilient since the GFC, yet global forces remain a significant influence on their development. Accordingly, formulating an assessment of the likely impact of proposed macro-prudential policies is one of the key challenges facing policymakers in this region.

Financial institutions whose market presence is sufficient to impact the wider global financial system are defined by the FSB as global systemically important financial institutions (G-SIFIs). Similarly, the Basel Committee on Banking Supervision has identified banks that, although not G-SIFIs, are nevertheless significant entities within their home markets. These are defined as domestic systemically important banks (D-SIBs).

Identifying G-SIFIs and D-SIBs is a precursor to the development of policies to forestall potential shocks to the global financial system. The G-SIFI policy framework explicitly prevents banks from taking on excessive

levels of risk by stipulating capital adequacy requirements that go beyond those set out in the package of reform measures contained in the FSB's Basel III framework. Boosting G-SIFIs' capital buffers clearly enhances their ability to withstand the impact of any financial shock. In the case of global banks, such buffers would correspondingly increase their ability to manage any large scale depositor withdrawals, and so reduce the likelihood of contagion. Similarly, the D-SIB framework imposes additional supervision and capital requirements on domestic institutions that sit outside the G-SIFI framework.

The FSB states that macro-prudential policy has three defining characteristics:

1. An objective to limit systemic risk. This is defined by the FSB as "the risk of widespread disruptions to the provision of financial services that have serious consequences for the economy at large".
2. A focus on ensuring the stability of the financial system as a whole, as opposed to solely the individual system components.
3. The use of prudential tools designed to address systemic risk.

These three characteristics provide a clear conceptual framework for macro-prudential policy. However, difficulties arise in translating this framework into practical policies. In particular, the supervisory oversight of regional and national banking systems, and the strengthening of regional financial stability represent the key challenges presently confronting Asian policymakers.

To measure systemic risk, this paper utilises the SRISK methodology, which measures a bank's capital adequacy in the context of its liabilities. This methodology shows that, as equity values progressively decline relative to outstanding debt during a crisis, the degree of banks' leverage correspondingly increases as they become financially distressed. Applying the SRISK ranking methodology in the three largest Asian countries, namely China, India, and Japan, the paper finds that only 4 of the world's largest 29 G-SIFIs are located in this region.

It is nevertheless important that any discussion of systemic risk in Asia recognises the increasingly prominent role of shadow banking in the region. This is particularly relevant in China, where previous studies have identified the comparatively stringent nature of policies related to interest rates, reserve requirements, and credit quotas for banks as factors that have contributed to the popularity of non-mainstream funding markets.

The extent of the growth in non-mainstream funding sources has reached a stage where it can no longer be regarded as peripheral to China's overall financial system. In fact, the scale of the country's shadow banking sector is such that if it were to experience a shock, the ramifications would promptly spread throughout the rest of the economy and around the world.

Reflecting the already significant, and growing, systemic importance of the non-mainstream sector, the FSB and the Bank for International Settlements are calling for greater operational oversight of non-mainstream funding providers. Specifically, they advocate the provision of relevant firm-level data to regulators. However, before this can be done, a decision must be made as to which statutory body will assume regulatory responsibility for these entities. The Chinese Banking Regulatory Commission (CBRC) presently oversees the country's banks, trust companies and certain non-bank institutions. However, there are many other non-mainstream institutions that do not appear to fall within the ambit of the existing regulatory framework.