
ASEAN-Japan Strategic Partnership on Global Issues: Global Financial Architecture

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AS OUTWARDLY ORIENTED entities, Japan and ASEAN member states have a deep and enduring stake in maintaining a stable, efficient, and equitable global financial system. As an international financial capital, Japan has an interest in ensuring that the networks of intermediation are secure from disruptions that adversely impact the real economy. Most ASEAN countries are capital importers and also have a great deal riding on the existence of a healthy and resilient global financial system. Both entities have suffered firsthand from financial volatility and upheavals.

A number of factors, however, continue to make the primary objective of a sound, functioning global financial architecture an elusive one. At the macro level, the system cannot operate independently of the world's largest sources of capital. The dominance of the US dollar as a global reserve currency makes all countries, not just Japan and ASEAN, highly sensitive to the actions of the US government and of the Federal Reserve system in managing its fiscal deficits, interest rates, and more recently, its bond buying and quantitative easing policies. Countries are, in effect, held hostage to US domestic interests, a point that has been repeatedly brought home in emerging economies.

The sustained increase in the supply of US dollars over the past decade has driven down the nominal cost of capital at the expense, of course, of creating ever-larger liabilities in the future. While this has no doubt helped sustain aggregate demand, the primary beneficiaries have been financial institutions and investors, who have used the liquidity to acquire investment assets, driving up their prices in the process. Banks and non-bank financial institutions (NBFIs) have been at the forefront of these efforts,

and concerns have been raised as to whether further large-scale financial instability and failures will occur when asset prices retrace downward, as they eventually must.

In the wake of the 2008 global financial crisis, countries—notably those in the G20 and others joining the voluntary Basel III framework—appeared to have the resolve to push through regulatory reforms that would stave off further crises and create much-needed confidence. Depending on where one stands, the resultant achievements— particularly those of the G20 countries—can be regarded either as patchy and below expectations or as in being line with the realities of international cooperation. It would be erroneous to say that nothing tangible has been accomplished, but there appears to be a degree of complacency and loss of momentum now that the immediate danger of another financial crisis is easing.

APPROACH TO COOPERATION

This chapter cannot address all or even most of the areas of global financial architecture cooperation. In any case, concerns about the macroeconomic management of global reserve currency countries lies outside the ability of any country or group of countries (with the possible exception of the People's Republic of China) to meaningfully address. It also does not appear to be highly productive to engage in a dialogue on issues of institutional reform given the entrenched interests of large stakeholders in preserving the present system of international monetary (dis)order. Any changes on this score are likely to continue to be superficial, *ad hoc*, or incremental.

The potential scope for ASEAN-Japan cooperation is more encouraging, although even here one should be wary of being overly ambitious and requiring wholesale changes in the way that countries operate. There is a tendency to devise grandiose-sounding themes and schemes to denote the importance and uniqueness of financial cooperation efforts, including use of the term “integration,” even though the actual details work out to be much less impressive. The so-called ASEAN Banking Integration Framework that was agreed to by the region's central banks, for example, appears highly impressive until one discovers that only a small number of qualified banks are involved. Even then, they will face market restrictions at the discretion of host countries and different regulatory environments.

Unless ASEAN and Japan wish to proceed down this road of hyperbole, efforts should be aimed at four fundamental practical areas that can contribute to overall financial stability and resilience. The first is cooperation to meet the requirements of the Basel III bank regulatory framework. This

is arguably one of the most important initiatives to emerge from the 2008 financial fiasco and promises to provide a solid foundation for greater stability. The second is cooperation to enhance the quality of bank supervision and prudential management in the region. With deeper regional economic and financial integration, national capabilities aimed at ensuring the health and resilience of the banking system are critical, especially for less-developed countries. The third area is closer monitoring of large global hedge funds and private equity funds. These non-bank financial intermediaries operate largely outside the scope of regulatory authorities and are active in emerging markets, including those of ASEAN. And finally, the fourth area is the management of capital flows—an area that is greatly pertinent, yet still problematic, since the 1997 Asian financial crisis. While countries will want to retain the ability to control inflows and outflows, the exact nature of the measures taken and when they are to be used are critical questions.

MEETING BASEL III BANK REGULATORY STANDARDS

One of the chief responses to the 2008 global financial crisis was a renewed commitment to stemming any crises of confidence that might precipitate runs on banks and their eventual collapse—events that might, in turn, lead to financial contagion worldwide. Members of the Basel Committee on Banking Supervision agreed that the foundations of the banking system needed to be shored up, and in 2010 the committee introduced the Basel III Accord, even though many parties had yet to fully implement the Basel 2.5 standards. Basel III adopted stricter requirements, which G20 countries accepted and agreed to implement in order to send a message to the rest of the world. Many non-G20 countries have since announced their intentions to implement the Basel III standards as well.

Basel III has many complex requirements, but there are three main components: (1) capital requirements, (2) liquidity coverage ratios (LCRs), and (3) leverage ratios. Capital requirements encompass a number of aspects, including minimum capital requirement ratios, capital conservation buffers, and minimum Tier 1 capital requirements. The Basel Committee set 4.5 percent as the minimum Tier 1 capital requirement (of risk-weighted assets) in 2013, which increased to 5.5 percent in 2014, and from 2015 onward rose to 6.0 percent. The years 2013–2018, however, will be considered a transition period, with 2019 being the year for full implementation of the minimum Tier 1 capital regulations.

The capital conservation buffer, which can be considered a reserve for banks, will start at 0.625 percent and increase gradually to 1.25 percent, 1.875 percent, and finally 2.5 percent. The implementation of the buffer, however, will only start in 2016, and the period up to 2019 will be considered a transitional period. Thus, the total capital requirement for banks, including the buffers, is 8 percent from 2013 to 2016. The requirement thereafter will be 8.625 percent in 2016, 9.25 percent in 2017, 9.875 percent in 2018, and 10.5 percent, the final requirement, in 2019.

The LCR is defined as the requirement for banks to hold sufficient high-quality liquid assets to cover their total net cash outflows over 30 days. The requirement starts at 60 percent in 2015 and will increase every year by 10 percent until it reaches 100 percent in 2019. It should be noted that at the time it was imposed, the LCR was more pertinent to US and EU banks than to those in Asia, many of which had excess liquidity.

Basel III also has a leverage ratio requirement to avoid excessive leveraging by banks and the destabilizing deleveraging effects that inevitably follow. To comply with this requirement, banks must maintain a leverage ratio—defined as the capital measure (essentially Tier 1 capital) divided by an exposure measure—above a 3 percent minimum. The exposure measure includes both on- and off-balance sheet liabilities, derivatives exposure, and securities financing exposure, as defined by the Basel Committee. The 3 percent minimum will apply until 2017, after which time it will be reassessed with a view toward incorporation into the final measures by 2018.

The Basel III requirements attempt to combat problems commonly faced by banks and ensure greater banking stability. Depositors and borrowers should therefore have greater assurance in their dealings with banks.

By all accounts, Japan has made very good progress in the implementation of the Basel III Accord. An evaluation carried out by the Bank for International Settlements in 2012 indicated that, notwithstanding some non-material exceptions, Japanese banks were largely in compliance.

Unfortunately, while banks in advanced countries are in a good position to comply with the higher standards, those in developing countries typically face two sets of problems. One set has to do simply with the ability to raise the necessary Tier 1 capital required. Even banks in ASEAN countries that are well capitalized may have difficulty raising the required capital. A second set involves the ability of regulators and banks to implement the complex requirements and to bear the additional costs of compliance. ASEAN countries that do not have effective bank consolidation policies are unlikely to be able to meet Basel III standards.

ENHANCING BANK SUPERVISION AND PRUDENTIAL REGULATION

Given the recurring nature of financial crises, banks today accept that comprehensive, efficient, and systematic regulatory frameworks are needed in order to ensure that they operate soundly and profitably. The question is not whether but how much regulation is needed given the impact on compliance and operating costs. The higher numerical requirements of Basel III (which are nonmandatory) and enhanced bank supervision and prudential requirements to reduce systemic risks obviously pose problems for smaller banks and those in developing countries. As with many areas, ASEAN's financial system is only as strong as its weakest link.

In all cases, bank supervision and prudential regulation are governed by national authorities, usually central banks or monetary authorities that are aided by additional specialized agencies as appropriate. Institutional arrangements and legal provisions tend to vary among countries, as does the quality of supervision and regulations, dictated by the human capital available. In no known cases are non-nationals allowed to participate in any active capacity in financial regulation. Increasing cross-border activities by banks (and borrowers), however, make the predominantly national approach risky, especially in light of greater regional integration.

The severe problems faced by EU banks highlight, in no uncertain terms, the lack of interconnectedness among banking regulatory regimes. This has led to the adoption by the 17 Eurozone members of the regionwide Single Resolution Mechanism and Single Supervisory Mechanism, which are the first steps in the creation of a banking union. Also in the offing are a single rulebook for banks and a common deposit insurance system. Additional measures have been proposed by the European Commission to ban proprietary trading and to require the transfer of high-risk trading activities to separate corporate entities of so-called "systematically important financial institutions" (SIFIs), otherwise known as "too-big-to-fail" banks. (The latter measure effectively mirrors similar developments in the aftermath of the 2010 Dodd-Frank Act in the United States.)

Despite efforts at creating an ASEAN Economic Community (AEC), member states are not likely to head in the EU's direction of regulatory integration. National approaches to financial supervision, prudential regulation, and crisis resolution are likely to remain within the ambit and capacities of national governments. Even if there were the political will—and this has never been stated to be the case—the vast differences in regulatory practices across the region render a common set of rules and procedures unfeasible and impractical. Banks, their clients, and investors in general are therefore

likely to continue facing individual country risks even as their operations grow in size and geographic location.

It should be noted that ASEAN does not have many large homegrown banks that can undertake the cross-border and complex nature of transactions that rival those of foreign banks. Instead, there are a limited number of mid-sized ones and a host of smaller ones catering mainly to domestic markets. Serious contagion effects may therefore be more likely to emanate from outside the region, and from large foreign banks in particular, as the global financial crisis demonstrates. The fact that there are not many local SIFIs and that the opportunities to exploit regulatory loopholes are limited does not detract from the argument that more coordinated regulatory approaches are desirable. While a single bank failure may have limited impact, the cumulative contagion effect, especially where many industry players are not well capitalized, can nevertheless still be substantial enough to cause a serious setback (as was the case during the 1997 Asian financial crisis).

This is all the more so when movement toward regional financial integration is taking place, leaving the region in a quandary. The AEC 2015 has quite ambitious goals in this regard and is being worked on by the ASEAN Working Committee on Capital Market Development. Banking liberalization has occurred to a limited degree, with new licenses being issued, particularly in less-developed member states. The ASEAN Trading Link, a common trading platform established by Bursa Malaysia, the Singapore Exchange, and the Stock Exchange of Thailand, has also begun operations. Over time, other ASEAN bourses may join. There is also building pressure for a more ambitious deepening of integration, as evident by the Asian Development Bank's study entitled "The Road to ASEAN Financial Integration" and the ASEAN Capital Markets Forum's "Capital Markets—Lifting the Barriers."

The backbone of ASEAN financial resilience—indeed, the component without which it cannot proceed—is its banks. Given that regulatory environments are unlikely to be harmonized any time soon, improvement in the quality of bank supervision would seem to be of paramount importance in allaying and detecting cases of financial distress. This is particularly true of countries with weaker institutional regimes.

MONITORING ACTIVITIES OF GLOBAL PRIVATE FUNDS

Discussion has thus far centered mainly on the banking system. For most ASEAN countries, this represents the major source of financial claims. Due in no small part to efforts by governments to rein in the riskier aspects of

banking activity through regulation, large global private funds have now emerged as significant industry players. NBFIs are financial institutions that do not have full banking licenses or are not necessarily supervised by national or supranational authorities. They may range from the simple neighborhood pawnshop, credit cooperative, or savings and loan society to pension and insurance companies and to some of the world's largest hedge funds and private equity funds. The primary concern here is not with domestic service-oriented NBFIs per se but the larger, more sophisticated ones that undertake complex global investment activities, often in concert with investment banks.

The general view about global NBFIs is that they are benign. They are regarded as offering supplementary channels of savings intermediation in the event of mass bank failures. Their role is considered supportive and productive in that they also offer competition to established banks, notably in corporate advising and wealth management. They can also undertake a wider range of services, from traditional mergers and acquisitions and underwriting activities to direct participation in proprietary positions and innovation of complex over-the-counter financial products. Most of these funds are structured as limited liability companies, which are not companies at all but partnerships with limited liability.

The paradox is that while the United States has no intention of regulating large private global funds, these very same activities being conducted within its banking system are considered too risky and have now been prohibited. One of the reasons behind the 1999 repeal of the 1933 Glass-Steagall Act in the United States, which separated banking from the securities industry, was that securities brokerage firms had "invaded" the markets of banks with money market mutual funds, cash management accounts, and so forth, which banks could not compete with. The provisions in the 2010 Dodd-Frank Act and the subsequent passage of the "Volcker Rule" now prohibit banks from taking proprietary trading and go some way toward reinstating important aspects of the Glass-Steagall Act. (This has had some consequences that are briefly alluded to below.)

A segment of NBFIs have evolved greatly in complexity, sophistication, and perhaps most of all, size. The last of these has often been through aggressive assumption of risks that banks are either limited in or prohibited from taking. The fact that they account for a significant and growing proportion of wealth, often with bank financing, and are supervised and regulated either lightly or not at all poses a source of systemic risk. The 1998 collapse of the Long-Term Capital Management (LTCM), a hedge fund manager, and its subsequent bailout due to fears of contagion, was a case in point. It should be noted that the LTCM's capital loss at that time was less than US\$4

billion, which is a tiny fraction of the bigger hedge funds that operate today. It is the sheer dimension of the scale of operations of the top NBFIs, along with the fact that they are largely unregulated, that concerns authorities in many countries, especially but not confined to emerging ones.

Hedge funds like the LTCM not only cause contagion effects when they fail but also are believed to contribute greatly to volatility, precipitating financial crises, and exploiting these crises for enormous profit. The United States, which has an interest in promoting global NBFIs, has for a long time maintained that regulating such institutions does more harm than good, that markets should be allowed to work, and that governments ought to practice good macroeconomic governance so as not to present opportunities for any exploitation in the first place. In any case, it is argued that there is little hard evidence that global NBFIs have been responsible for creating economic and financial turmoil.

Despite the fact that it is difficult to conclusively prove or disprove the role of global NBFIs in financial crises, regulatory authorities have been inclined to more closely monitor their activities, especially since the 2008 global financial crisis. Under the Dodd-Frank Act, hedge fund and private equity fund managers are also required for the first time to register legally as investment advisers. This requirement, tighter regulation, and in particular the Volcker Rule mentioned above, have reportedly led to an exit of bank proprietary traders to establish their own hedge funds and private equity funds, as these are outside the ambit of regulatory authorities.

Generally speaking, ASEAN economies fall into two categories. The first are those with capital account surpluses that have aspirations of being regional, if not international, financial centers. Others are emerging economies that are dependent on foreign capital inflows. Both categories have interests in open capital accounts and free movement of capital (although the second group may approach capital liberalization in a more deliberate and progressive fashion). Given the competition for capital, it would not be in the interests of countries to pose barriers to NBFIs, particularly those targeting emerging economies. NBFIs activities, however, need to be more closely monitored given that their actions are responsible in no small way for currency and capital market volatility in ASEAN countries.

MANAGEMENT OF CAPITAL FLOWS

Capital account liberalization is widely considered a necessary component of reforms leading to rapid economic growth, but it is one of the most controversial policies of the day. In a nutshell, while unobstructed

capital flows theoretically enable more efficient resource allocation and higher welfare effects, the presence of other intended or unintended market distortions or asymmetric information can mean that freely mobile capital does not always end up benefitting countries. Critics would argue that increased volatility occurs because of capital liberalization, while defenders would claim that destabilizing volatility arises because of incomplete liberalization.

Whatever the precise merits or demerits, the trend has been toward capital account liberalization, albeit with reservations on the part of some countries. As a result, ASEAN countries have had to regularly deal with the macroeconomic effects of capital surges and with the accompanying currency strengthening, money and credit expansion, and asset and consumer inflation, as well as the debilitating effects of sudden withdrawal. The International Monetary Fund has now accepted the need for emerging economies “under certain circumstances” to impose capital flow management measures (CFMs). These, however, should be a last resort and undertaken only after macroeconomic stabilization policies and targeted and non-discriminatory CFMs have been applied. While the interests of the country concerned have to be taken into account, so must those of investors who expect, and should be given, the protection of a predictable and stable policy environment.

The emphasis on careful and judicious use of CFMs is particularly important where there is deepening economic integration. Most ASEAN countries continue to have CFMs, especially those targeted at controlling outflows (as opposed to inflows). The effect has therefore been to restrict capital movements among the region’s members, while encouraging capital flows from abroad. The presence of these controls on the books is obviously inconsistent with the grand aims of greater economic financial integration in the region. Accordingly, countries should move toward developing a harmonized, nondiscriminatory, market-based regime to be activated during times of financial emergency.

DIRECTIONS FOR ASEAN-JAPAN COOPERATION

As stated at the outset, ASEAN-Japan cooperation should focus on the practical and substantial. Rather than requiring radical changes that countries will take a long time to make (or will not make at all), efforts should be aimed at a series of achievable targets that are designed to promote financial stability and resilience and that are consistent with those being made at the global level. It is important to emphasize the latter so

that the region does not create a sui generis system that deviates from international norms and standards. This would not be in the interests of the entities concerned.

On Basel III, it is clear that while some ASEAN countries are well positioned to meet the higher standards, others are not. Of those that have made commitments to doing so, Singapore and Indonesia are obviously on board by virtue of their membership in the G20. Singapore is likely to adopt the standards even before the end of the transition period in 2019, but Indonesia appears to have a long way to go, as it has not even complied with the publication of final rules under the Basel 2.5 requirements. Other ASEAN countries that have agreed to adopt Basel III standards are Malaysia, the Philippines, Thailand (these three are members of the Basel Consultative Group), and Vietnam.

As members assessed to be compliant with Basel III, Japan and Singapore should take the lead to (1) establish a regular consultative forum for the exchange of information, mutual learning, peer review, and feedback; (2) provide technical assistance to members requesting it; and (3) encourage other members to comply with some or all of the standards by 2019. The goal should be for ASEAN countries (or at least a significant majority of them) to be compliant with Basel III standards by 2019. This would go a long way toward ensuring that the ASEAN financial sector is not regarded as a weak and vulnerable link.

One issue for discussion in the region that arises from the adoption of Basel III standards is the higher weights that must now be used to calculate risk-weighted capital as a result of the capping of credit risk at the maximum for a country's sovereign ratings. Previous practice had been to rely just on the corporate ratings given by rating agencies. Banks in ASEAN countries with lower sovereign ratings will have to provide more capital, and potentially at higher costs, than those with higher sovereign ratings. This could be a relevant issue for banks operating across ASEAN, and it would be worthwhile for the consultative forum to seek to provide feedback to the Basel Committee on Banking Supervision.

Enhancing the quality of bank supervision and prudential regulation is an important and related task. The objectives here are essentially twofold: (1) adoption of best regulatory practices and (2) capacity building. One best regulatory practice that would be worthwhile to seriously consider implementing is periodic systemic risk surveillance through financial institution stress testing. The aim is to detect any systemic problems in transmission channels under various top-down financial, economic, and geopolitical scenarios both within countries and across the region. This information would be very useful to regulators if not to the financial institutions themselves.

Bottom-up approaches could also be utilized to yield information as to how financial institution failures can be transmitted. Japanese assistance in helping to organize and conduct stress tests—perhaps initially as a pilot project with a limited number of countries, such as Japan, Singapore, Indonesia, and Malaysia—may be invaluable in this regard.

Another measure that would be worthwhile to consider is the establishment of a regional financial crisis protocol. Without such a protocol, governments would still communicate with each other, but responses would undoubtedly be more ad hoc and possibly less effective than might otherwise be the case. Although ASEAN+3 finance ministers have been meeting regularly and exchanging information since the 1997 Asian financial crisis, measures taken in the wake of the 2008 global financial crisis were nonetheless uncalibrated and uneven. Goeltom and Harun (2010) point out, for example, ASEAN countries announced a commitment to deposit insurance, but coverage levels differed from full to only partial guarantee. Ones that had lower protection levels were still exposed to the risks of capital flight. The development of such a protocol is greatly facilitated by the fact that the crisis measures following the 1997 Asian financial crisis and 2008 global financial crisis are already known and the fact that what needs to be done is to work on designing a set of procedures.

Given the strategy of the AEC to increase the openness of the region to the global market, in addition to improving financial strength, resilience, and regulatory quality, the governments and financial authorities of ASEAN nations have to pay careful attention to risk exposures stemming from cross-border financial transactions. Meetings among the ministers of finance, governors of central banks, and their senior officials can help to some extent by ensuring that information exchange and consultation occur, but these meetings are too infrequent and formal to be of use in risk surveillance. In order to build trust and facilitate working relations, there would seem to be a need to have more frequent working-level interactions among banking and securities supervisors.

Supporting efforts by institutions such as the ASEAN+3 Macroeconomic Research Office (AMRO) are to be greatly commended. Nevertheless, a stronger role by Japan and ASEAN seems to be warranted given the fact that these institutions have yet to reach its full potential. AMRO should be elevated to a more capable frontline institution in helping members to prevent not just macroeconomic but financial instability. After all, if and when the Chiang Mai Initiative Multilateralization swap agreement is activated, a full-blown crisis would already be in progress, and preemptive efforts would be too late. Given that AMRO is not a regulatory agency, its role would be one that is advisory and coordinative.

First, AMRO should take a more proactive approach by issuing timely alerts to policymakers to prompt action. This would increase its relevance to central banks and finance ministries in the region. Second, another action that would help is the regular dissemination by central banks of one another's bank directives, circulars, and guidance. This information can be a useful basis for calibrating supervisory measures even if not arriving at a uniform response. Third, the region would benefit from instituting a single centralized real-time monitoring system for currencies, interest rates and bond yields, equity prices, and other critical market information. Currently available online dashboard software makes this a relatively simple and cost-effective tool to develop and disseminate.

On the issue of global private funds, Japan and ASEAN should not pre-judge but should launch an in-depth multicountry investigation into the involvement of such funds in the region and, in particular, the degree to which they have or have not contributed to financial volatility. There have been a host of critics of global private funds (including no less than the Deutsche Bundesbank), but there are no assurances that direct regulation is highly desirable or would even prove effective. Greater transparency and understanding of their activities would give authorities a better idea of how they work, what their effects are, and how better to monitor them. As it stands presently, it is very difficult to ascertain how highly these funds are leveraged or the positions they hold in various asset classes (either long or short).

Finally, Japan and ASEAN would do well to continue considering putting in place procedures to control capital flows into, as well as out of, countries in the region. Measures to restrict capital movements are of course not conducive to greater financial integration. Oftentimes, these measures may play a part in resource misallocation and create problems. Sound macroeconomic policies, accompanied by effective bank supervision and prudential actions, must be regarded as the primary weapons against capital flight, financial distress, and contagion. CFMs, however, may still be needed, and a common understanding as to when and how they will be used will go a long way in helping to ensure the financial stability desired.

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