THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Responding to the Challenges of the Global Financial Crisis

EXECUTIVE SUMMARY OF THE 5TH SEACEN/ABAC/ABA/PECC PUBLIC-PRIVATE DIALOGUE FOR THE ASIA-PACIFIC REGION

27-28 July 2009
Bangkok, Thailand

Office of the Advisory Group Chair

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The aftermath of the global financial crisis carries a number of implications for ongoing efforts to strengthen financial systems, including the need to update regulatory regimes and improved industry standards. These issues were the focus of the 5th SEACEN-ABAC-ABA-PECC Public-Private Dialogue for the Asia-Pacific Region, which was held on 27-28 July 2009 in Bangkok, Thailand. This year's dialogue, involving monetary, financial regulatory and supervisory authorities and representatives of international institutions, private sector organizations and the region's financial industry, dealt with the theme *Responding to the Challenges of the Global Financial Crisis*, and examined current proposals being discussed in the G-20 to reform regulatory frameworks in response to the lessons of the crisis. The key messages are as follows:

- The capacity of advanced economies to soon revert back to their previous roles as principal providers of final demand for the global economy is now in doubt, with consumers expected to undergo a long process of de-leveraging to rebuild savings, while the corporate sector re-sizes and restructures in the face of changing patterns of demand and banks repair their balance sheets. Continuing growth of unemployment amidst uncertainty over the sustained recovery of asset prices over the coming months will likely exacerbate these trends. Given these prospects, developing economies will need to seriously re-examine their strategies, as the export-driven growth model becomes less viable under current conditions.

- There is considerable potential for inducing the growth of domestic demand in developing economies, particularly in Asia, where there is a considerable pool of savings and financial systems remain relatively healthy. In many of these economies, however, domestic consumption and investment are constrained by various factors. Unlocking the region's huge savings will require reforms and capacity-building in a number of areas to broaden the economic base, expand consumer finance, facilitate the growth of infrastructure and mobilize domestic savings to provide more local-currency funding for public projects and corporate expansion. The success of this undertaking will not only promote recovery, but will also help address the imbalances that have led to trade frictions in the region and provide a more sustainable basis for global economic growth in the future.

- The crisis has underscored the interconnection between monetary authorities' financial stability and price stability mandates. In particular, it has led to a re-evaluation of current approaches to deal with asset price bubbles. Until the crisis, the prevailing sentiment was against intervention, in view of potential costs of deflating a false bubble, given the difficulties in ascertaining its existence. The crisis has demonstrated that bubbles may not deflate in an orderly way and can cause much damage when they do so. Consequently, monetary authorities are beginning to consider a paradigm shift on whether it might be necessary to act against possible bubbles without having to wait until full information becomes available.

- The crisis has also underscored the importance of addressing systemic risks. Financial regulatory authorities are being encouraged to strengthen both macro-prudential (focused on the system) and micro-prudential (focused on individual institutions) policy frameworks. Efforts are underway to ensure that regulation covers systemically important institutions, markets and instruments, improve prudential standards on capital and liquidity, better coordinate international standards to ensure a common coherent international framework, and enhance supporting policies and infrastructure (accounting standards, credit ratings, compensation schemes).

- Governance failures in financial institutions played an important role in the genesis of the crisis, particularly with respect to compensation and risk management policies. Regulators and the financial industry are focusing on addressing four key structural gaps: weak compensation governance (limited board oversight, limited links between risk and compensation, insufficient bottom-up risk controls to limit excessive risk-taking, and limited public disclosure around compensation practices); poorly designed compensation systems (mismatch between front office and middle/back office control functions and lack of linkage to firm-wide results); limited use of risk adjustments in determining compensation (limited risk adjustments in bonus pool sizing and allocation and lack of long-term risk accountability in performance measurement); and weaknesses in payout mechanisms (such as use of short-term metrics used in long-term incentive programs, mismatch between deferral horizon and risk-holding periods, and limited ability for claw backs on deferrals). However, caution is needed in introducing regulations (such as compensation caps) that could result in increased risk-taking in unregulated or lightly regulated sectors as rewards are shifted to those sectors or regulations that are too complex for institutions to comply with.

- International coordination and cooperation among regulatory authorities need to be improved to effectively address systemic risks, as well as to ensure that compliance requirements for financial institutions do not unduly increase the costs of delivering financial services and restrict innovation. However, while coordinated international responses should be consistently applied on a global basis, mechanisms should be identified and put in place to allow more effective regional contributions to regulatory arrangements that reflect assessments of region-specific prudential interests.

- Cooperation and dialogue with the private sector is important in designing new regulations in a way that achieves a balance between promoting stability of financial systems and ensuring the efficient delivery of financial services and continued innovation in the financial sector. Such cooperation is especially needed under current conditions of continued financial system fragility and uncertainty about the sustainability of economic recovery, where the introduction of measures such as increased capital requirements and other regulations that would have the effect of further restricting bank lending could undercut efforts to revive financial markets and stimulate economic activity.
- Valuation of complex securities and illiquid products during times of stress became an important issue as markets for certain securities were significantly affected by the crisis. This has resulted in calls for global accounting standard-setting bodies to enhance guidelines for valuation of financial instruments, especially illiquid products. Efforts toward this objective would need to be seen in the broader context surrounding the implementation of IAS 39 (establishing principles for recognizing and measuring financial assets and liabilities as well as contracts to buy or sell non-financial items), as this involves governance (particularly the roles, responsibilities and accountabilities around the function of risk management), system changes in both sources and consolidation, and the need to develop integrated reporting approaches and effective decision-making. It impacts the way companies recognize, measure and present their financial instruments.
- Within the region, financial institutions face various challenges in the implementation of IAS 39. These include the challenges of coping with general requirements, such as sufficient disclosure standards on valuation techniques and the need to reduce complexity of accounting standards and improve presentation standards to make them useful to users of financial statements. They also include significant challenges for banks in the region owing to particular conditions in Asian emerging markets, such as those related to using the fair value option for embedded derivatives, impairment measurement of loans in economies with high inflation, the high base costs of implementation for small banks, tax regimes that will result in higher taxes with IFRS implementation, and lack of knowledge and skills among banking practitioners, external auditors and regulators. Finally there are challenges in the transition to fair value accounting, where unfavorable economic conditions could have substantial impacts on balance sheets of banks and the perception of depositors with insufficient understanding of the impact of changes in accounting standards on the presentation of profits and losses.