Introduction

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Over the past 20 years, financial systems in East Asia have undergone a seismic period of liberalization, crisis and development (Liu et al. 2013). In the 1990s, prior to the Asian financial crisis of 1997–98, the emerging economies of East Asia rapidly liberalized their financial systems, aiming to integrate into the global financial system in order to support their continued development. This period of rapid liberalization ended with the Japanese and Asian financial crises of the 1990s. In the wake of the AFC, East Asian economies focused on reforming financial regulation, on building foreign exchange reserves, and on a range of regional initiatives to support regional financial stability, integration and development, all with the overall objective of enhancing economic growth in the region.

As a result of a decade of domestic and regional financial sector reform, East Asian economies faced the global financial crisis of 2008 and the Eurozone debt crisis of 2010 with well-regulated and robust financial systems. Nonetheless, while generally resilient, economies in East Asia have suffered some impact from these crises in terms of both trade and availability of finance. In the wake of the GFC, major economies have focused on reforming financial regulation globally through the Group of 20 (G20) and the Financial Stability Board (FSB), both organizations having significant representation of economies in the Asia-Pacific region. Global consensus through the G20 and the FSB today seeks to address four major objectives: fixing the problems which caused the crisis, promoting continuous financial market functioning, realizing the benefits of global finance, and supporting the real economy (FSB 2013a). In particular, the G20 and the FSB are coordinating reforms in ten areas, including addressing systemically important financial institutions, properly regulating 'shadow banking' and over-the-counter (OTC) derivatives, building macro-prudential systems, and strengthening implementation of international standards (FSB 2013b).

In East Asia, the overall objectives have remained the same: supporting financial stability and economic growth. However, following the GFC, East Asia – along with the rest of the world – has faced the need for a range of financial reforms stemming from the experiences of the crisis. In the context of this volume, Part II focused on issues of macro-prudential supervision, looking particularly to develop new ideas and new approaches based on innovative research, especially relating to non-core monetary aggregates and procyclicality of the financial system; non-core bank liabilities and vulnerability to crisis, with a focus on Asia and issues associated with monetary aggregates and global liquidity. The following chapters turn to issues of micro-prudential regulation and implementation, particularly relating to legal and institutional issues.

Part III begins with the issue of financial regulatory design, with Weber et al. in Chapter 6 arguing that economies in East Asia must look to the overall design of their financial regulatory systems in the context of the actual realities present in individual financial systems, particularly relating to systemically important financial institutions and shadow banking. In light of G20 and FSB initiatives to develop international regulatory standards and guidance towards financial regulation and stability in reaction to the global, Eurozone and Asian financial crises, Chapter 6 explores issues of financial regulatory design, particularly its relation to SIFIs, shadow banking and financial conglomerates, focusing on East Asian countries, which are typically characterized by relatively large, domestically oriented banks. This phenomenon means that the focus on cross-border finance of international financial regulatory standards is not a priority for many countries in East Asia.

Chapter 6, section 2, examines, in depth, the issue of financial regulatory structure, most importantly highlighting that a regulatory structure must vary according to the nature and size of its financial sector, its domestic and international importance, and the skills and resources of regulators and the particular government. Weber et al. note that for East Asia, the level of financial development across countries is far from uniform and the financial regulatory structure for each jurisdiction must be looked at individually. Subsequently, the chapter analyzes five common financial regulatory models – the institutional structure, the sectoral structure, the single integrated structure, the functional structure and the Twin Peaks structure – through dissecting their theoretical definitions as well as providing examples of countries that adopt the respective financial regulatory structures. The chapter further surveys countries in East Asia and their main regulatory agencies, and concludes that while no single model dominates the region, sectoral and single integrated structures are the most common. The authors also consider in great detail the impact of the different regulatory structures upon SIFIs, financial conglomerates and shadow banking. However, this section of the chapter concludes that there is no single best regulatory structure universally, and that much depends on the individual circumstances of the particular market, such as its stage of financial development, the nature of the large financial players, the level of internationalization, and so on.

Section 3 of Chapter 6 looks specifically into issues surrounding how to supervise SIFIs – categorized into domestic (D-SIFIs), regional (R-SIFIs) and global (G-SIFIs). This is a significant issue as the failing of a SIFI can result in severe financial instability impacting a nation's financial system and economy and further spreading into global and regional financial systems. Weber et al. note that in East Asia, most significant institutions are D-SIFIs, with only a handful of G-SIFIs. However, a growing number of D-SIFIs are increasingly transforming into R-SIFIs that will increase the cross-border operations in East Asia. The authors identify that to effectively manage the risks posed by SIFIs, there needs to be a system that addresses the issues of macro-prudential supervision, capital and liquidity requirements, resolution and insolvency. In particular, the authors analyze the detailed requirements of Basel III on capital and liquidity requirements for D-SIFIs and G-SIFIs, and note that in East Asia, G20 and FSB members (such as the PRC, Hong Kong, China, Japan, the Republic of Korea, and Singapore) as well as other more developed jurisdictions have strong capital positions to meet the higher capital requirements for Basel III, but that these higher requirements are a concern for other developing jurisdictions in the region.

The authors of this chapter also explore the topic of effective resolution of an SIFI if its collapse is imminent and supports the FSBs' recommendation that a designated resolution authority should be appointed in all jurisdictions, with powers to take over the running of the SIFI in order to maintain the economic and financial viability of its core functions while looking to spin off saleable parts of its operations. Recovery and resolution plans of SIFIs aimed at reducing risk, conserving capital, restructuring disabilities, and divesting business lines are also explored. In designing the resolution system, it is important to remember that its principal objective is not to expose taxpayers to loss while protecting the SIFIs' economic functions. Importantly, this chapter highlights that SIFIs should be subject to cooperation agreements with resolution authorities across all jurisdictions that it operates in, which clarify respective roles and responsibilities in planning and managing its resolution.

Chapter 6 goes on to note that the FSB and the Basel Committee's focus on higher loss absorbency based upon capital adequacy has a strong balance sheet focus, which allows for potential balance sheet manipulation. These higher standards also encourage some SIFIs to divest non-bank business lines to reduce its systemic importance and, therefore, the level of prescribed capital adequacy or liquidity. This chapter also notes that divesting certain non-banking businesses does not necessarily decrease the systemic risk of an institution. Thus, a 'one-size-fits-all' rigid supervisory approach is not recommended. The authors further consider that Basel III only partially addresses risk management for SIFIs, and a supervisor must proactively identify, assess, and mitigate any emerging systemic risks. Thus, the regulators should adopt both a micro-prudential and a macro-prudential approach simultaneously in order to more effectively evaluate the SIFIs systemic importance.

Section 4 of the chapter addresses shadow banking. It highlights the FSB's two-step policy towards regulating shadow banking involving enhancing system-wide monitoring, looking at all non-bank credit intermediation and adhering strictly to the five policy measures of focus, proportionality, forward-looking and adaptable, effectiveness and assessment and review. Specifically, the authors noted that capital adequacy and liquidity requirements that apply to banks under Basel III will also apply to shadow banking institutions which undertake bank-like activities. The authors further suggest that the banking regulator which oversees the implementation of Basel III should also oversee the regulation of the shadow banking sector because many aspects of the risks that they pose are analogous. Furthermore, the proliferation of credit enhancement products such as CDS offered by shadow banks make these institutions susceptible to systemic disruptions, instability and heighten procyclicality within the financial system. This justifies regulation for shadow banking both on the national front and also from a cross-border perspective. For East Asia, where the shadow banking system is much less developed than in the western world, the authors see the primary need as having a full understanding of the types of financial activities and institutions available and design regulatory systems accordingly.

In Chapter 7, Buckley et al. highlight the need for financial innovation in light of the specific needs of economies in the region in order to support future growth, particularly in areas of trade finance, shadow banking, and mobile finance. This chapter examines the issue of financial liberalization and innovation in East Asia in light of the previous Asian financial crisis and global financial crisis, exploring the role of regulation and institutional infrastructure to facilitate financial development while limiting the ramifications of financial crises. This analysis is done against a backdrop of financial innovation no longer being seen as clearly desirable after the most recent global and Eurozone financial crises, where financial systems that were more heavily regulated (such as those of Australia and Canada) or arguably less innovative (such as that of East Asia) performed far better than the more innovative financial systems such as those in the UK and the US. More specifically, this chapter argues that instead of characterizing East Asia as lacking in financial innovation, their approach toward innovation is better understood as a pragmatic and cautious strategy that focuses on supporting real economic activity. In particular, this chapter looks at specific types of financial innovation that have had significance in East Asia: mortgage markets, SME finance, non-bank finance, trade finance, and mobile financial services.

Section 2 of Chapter 7 looks at the history of financial innovation in East Asia and questions the characterization that East Asia lacks financial innovation and only copies innovations that were successful in the western world. The authors have a strong view against this label and point to numerous examples, such as microfinance by Bangladesh and the model of the development state by Japan, in support of their position. However, the authors caution that more innovation is not necessarily better in the world of finance – overdevelopment will pull resources away from other sectors, lower real growth, and shift resource allocation and distribution in a sub-optimal way.

Section 3 considers financial innovation for the future in East Asia. This section attributes financial innovation as part of the effect of financial liberalization in recent decades and highlights that not all innovation is good – though financial liberalization promotes more growth compared with a repressed economy, it also increases market uncertainty and the chances of severely damaging crises. This is particularly so if liberalization is done without adequate prudential regulatory structures that give adequate regulation and supervision. The authors regard East Asia's pragmatic approach (as opposed to an overly market-focused theoretical approach), in addressing specific market conditions, effective in mitigating the losses from the GFC compared to the approach of the western world. However, the authors realize that East Asia's financial systems span a range of development levels and there is no 'one-size-fits-all' mold that would suit the entire region.

Overall, using trade finance, mortgage markets, SMEs, non-bank finance, and mobile finance as examples, this chapter addresses key issues in financial liberalization and development in East Asia, and countered the idea that more financial innovation is always better. Furthermore, this chapter posed strong evidence of the success of Asia's pragmatic approach towards financial liberalization, where its more cautious stance compared to that of western nations softened the adverse impacts of the global financial crisis. This is a trend away from the many mainstream commentators that suggest that East Asia was lacking in financial innovation or was merely following in the footsteps of western countries with a lag.

The final chapter of Part III, Chapter 8 by Moshirian, attempts to measure banks' systemic risk in Asia, using the methodology that has been developed by his collaborators at New York University. In doing so, the chapter first defines issues related to systemic risk. The author states that 'Systemic risks originate from two primary causes – common exposures to aggregate risks, such as common exposures to the real estate market built up through the propagation of subprime mortgage related assets through the US financial system in the years leading up to the 2007–08 financial crisis, and/or the distress or failure of any large/complicated/highly interconnected financial institution that may lead to runs on other solvent institutions, fire-sale liquidations and heightened counterparty risk. These insights into systemic risk have underpinned global attempts to redress regulatory failures that allowed them to build up in the first place'.

Moshirian then highlights issues that are important in analyzing factors that contribute to regional and global financial stability. To this end, the author discusses the relevance of G-SIFIs and D-SIBs, and the way the global economy has to respond to these major financial institutions. It appears that the author is keen to highlight the role of interconnectedness and of global and regional supervision for large international banks around the world. The college of supervisors and their future role in this process may well be an important factor in enhancing the effectiveness of the supervision of large banks. Moshirian discusses the conceptual framework for measuring systemic risk. He argues that the financial sector imposes real costs only when it is undercapitalized as a whole, and these costs are a linear multiple of the extent of undercapitalization of the financial sector. Then, each firm's contribution to real-sector costs is related to its own undercapitalization in those states of the world where the financial sector is undercapitalized as a whole. Moshirian refers to a proxy called SRISK. This proxy (SRISK) calculates the contribution of each bank to overall global systemic risk in the system. Moshirian uses 40 percent as a proxy to capture major shock to the global financial system. In this process, the author is able to provide some measures of banks' capital shortfall should the stock market decline by 40 percent. This measure is calculated based on an initial market shock of 2 percent that can then be extrapolated to a large market decline in the wake of a major financial crisis. Using some data from the Volatility Institute at New York University, the author is able to provide some useful information on banks in Asia and why some of the banks are doing better than others. The author is able to provide this information for both single countries and countries forming ASEAN. The live data used to measure systemic risk is able to shed some light on the factors that may contribute to some signs of systemic risk build up in a number of banks in Japan and China. It appears that Japanese banks, which have been holding their government bonds on their balance sheet and at the same time are facing less demand for credit in their domestic market, should do more to ensure greater capitalization and also a more diversified business model. In the case of China, the state-owned enterprises (SOEs) appear to form a large part of the debt held by Chinese banks. Any signs of delay in repayment of the debt by Chinese SOEs could give a negative signal to the market. This chapter is able to provide the rankings of banks in major Asian countries, based on their contributions to overall regional systemic risk. Regional financial stability and a sound banking system are important aspects of creating a more resilient regional financial system. Any financial model or method that can shed more light on the way large global and regional banks contribute to the overall stability of the regional financial system is welcomed by market and policymakers. The author of this chapter argues that while large banks' operations should be supervised more effectively, in the final analysis, banks are getting larger and so a more effective global and regional supervision of G-SIFS, D-SIBs will be important in the medium term.

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