Introduction

Ramesh Subramaniam

It is cliché to note that financial sector development is a key ingredient for overall economic development and growth. However, there has been a long-standing debate on how critical it is for growth. Regardless, a well-designed, optimal, and effectively functioning financial sector regulatory and supervisory framework is important. Here again, what is the ‘optimal’ regulatory framework has always been under scrutiny, including most recently in the aftermath of the global financial crisis. Part V looks at various sub-sectors of the financial sector in the context of its broader development, as well as sector-related challenges in the Asia and Pacific region. This background note summarizes the key issues relating to financial supervision, with some discussion on regulation.

Table V.1 presents a qualitative assessment of the basic features of financial sector development across the sub-regions of developing Asia. The first point to note is that the region is not homogeneous. As a result, there is a fair degree of variation in financial regulatory and supervisory approaches in comparison with global standards. A one-size-fits-all approach may not work as policymakers need to balance between the development and growth of individual financial sectors vis-à-vis global requirements.

The GFC has clearly been a game changer. The excessive greed and short-sightedness of the private sector, on the one hand, and the failure of financial regulation and supervision, on the other, are now cited as the clear and fundamental causes of the crisis. As a result, while the 1990s saw major strides toward liberalization and financial innovation, the five years since the GFC have seen a radical shift in focus away from encouraging innovation providing short-term gains only for a few, toward achieving sustainable financial sector development that helps the population at large. The shift has implications for developing Asian economies, which were quite resilient in the face of the crisis, but whose growth momentum was affected by the GFC due to strong inter-linkages with developed economies.

The GFC has clearly demonstrated that rapid financial sector growth can be destabilizing. As a result, there is increasing evidence that the
<table>
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<tr>
<th>Sub-regions</th>
<th>Banks</th>
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<tr>
<td>East Asia and Southeast Asia (large economies)</td>
<td>Medium to large banking systems, with some institutions being global players</td>
<td>Strong equity and corporate and public debt markets</td>
<td>Concerted efforts to strengthen pension and insurance industries</td>
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<td>State dominance and gradualist approach to financial liberalization</td>
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<td>SME and trade financing is a prominent part of the sector</td>
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<td>Financial inclusion is a key reform agenda</td>
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<td>Southeast Asia (small economies)</td>
<td>Small and majority state-owned banking systems</td>
<td>Small equity markets with public debt markets emerging in a few cases</td>
<td>Very limited sector coverage</td>
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<td>Emerging support for SMEs and trade finance, and financial inclusion in general</td>
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<td>South Asia</td>
<td>Medium to large banking sectors, with state dominance (e.g., India)</td>
<td>Wide variation across the region in equity markets</td>
<td>Low levels of market penetration Gradual liberalization of insurance industries, with very initial moves to widen pension coverage</td>
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<td>High levels of financial exclusion, leading to strong public policies promoting inclusion</td>
<td>Fairly good public debt markets, with corporate debt emerging in many countries Nascent state of development in smaller economies</td>
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<td>Drive to boost manufacturing sectors leading to greater SME support</td>
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<td>Central and West Asia</td>
<td>Nascent but developing banking sectors, with focus on increasing financial access</td>
<td>Initial development supported by a drive to</td>
<td>Administrative reforms under way in public pension systems</td>
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sacrifice in growth required by new capital and liquidity requirements will be negligible in relation to their impact on welfare, and that any trade-offs between growth, equity, and stability will be felt only in the short run. However, for the economies – including the developed and developing economies of Asia – that did not contribute to the crisis, financial regulatory (and supervisory) evolution should adopt a proper blend of growth, equity, and stability concerns. Key questions include: where do we strike the balance between growth and stability? And, how much growth are we willing to sacrifice in order to buy insurance against financial instability?²

Policymakers around the world, including in developing Asian economies, have always had to grapple with the issue of ensuring growth with stability. The trade-offs and inter-linkages between the two in shaping financial regulation (and hence supervision) have been recognized for some time. In addition, in the aftermath of the GFC, meeting social equity goals has become another key concern, given the significant negative impact of the crisis on peoples’ welfare. A key question being asked across developing Asia is whether equity and inclusiveness should guide the shape of financial regulation, in addition to financial stability and economic growth? The answer appears to be affirmative, particularly with respect to ensuring access of the poor to finance.³ It is also important that the poor do not lose their savings, and that the lending instruments used by the poor (or those that are not financially sophisticated) are sustainable. In fact, some countries such as India have used regulation to ensure that financial institutions

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Table V.1 (continued)

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<tbody>
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<td>Pacific</td>
<td>Nascent but developing banking sectors, with the challenge posed by lack of adequate scale economies</td>
<td>Very nascent</td>
<td>Very nascent</td>
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Strong global linkages in the case of 2–3 countries
Economic diversification efforts may boost focus on SME lending
Kazakhstan has corporatize and privatize state asset ownership adopted the multi-pillar pension system
Lack of scale economies hampering strong capital markets

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behave in a socially optimal manner in order to promote financial inclusion. There is also another question if regulation should be light for microfinance institutions and banks who are lending to SMEs. The consensus answer to this question is negative, in view of the general principle that regulatory arbitrage is bad practice.

How the quality and effectiveness of financial supervision shape up to compensate for accommodative regulatory approaches is also critical. Deregulation to achieve growth or social objectives needs to be accompanied by effective supervision. Here, developing Asian economies have much to learn from the experience of developed economies in dealing with the GFC’s impacts. Specifically, the ‘too big to fail’ dictum has been proven to be mainly a passive conclusion owing to a lack of adequate resolution mechanisms for large institutions. Asia has accumulated considerable experience since the 1997–98 financial crisis. In the early 1990s, East Asia grew in a remarkable fashion, while facing instability in later years. The region responded by formulating more effective financial sector policies in response to the crisis. There appears to be a loose correlation between the pace and path of financial sector liberalization, and stability, as seen in Latin America, for instance. That region liberalized its financial sector more rapidly than East Asia, and has grown slower and seen more bouts of economic instability. Whether the model of more cautious liberalization and greater dominance of state ownership in the banking sector, and more directed public policies to achieve equity objectives, will lead to a more robust balance between growth, equity, and stability remains to be seen over the next 10–20 years. Regardless, we now have a body of rich evidence from the developed as well as the developing economies to shape the debate on policy, institutional, and regulatory architecture for the financial sector.

In summary, viewed from the perspective of developing economies, there are two specific sets of issues with respect to the articulation of new regulations for the financial sector. First, there are the implications for regulation and financial sector development in general, and the growth of specific critical segments of the sector, such as SME financing, trade financing, and long-term infrastructure investments. While there is a generally held view that developing economies will gain from any new global regulations through spillover effects, there is also serious concern that financial market growth will be stifled by new regulations. Therefore, special provisions may be needed for certain segments of the financial sector for all economies and for developing economies. The call to ring fence trade credit in the event of any disruption in global financial markets is one example.

Second, the implementation of any new regulatory norms needs to take into account the special circumstances of developing economies. Given the nascent state of the financial sector in many such countries, any new
regulatory framework should be easy to understand and straightforward to implement. This is critical to note, since the implementation of Basel II and III has already proven to be quite challenging for a large number of developing economies because of the lack of adequately robust risk management systems, and the lack of human and other resources. These lacunae need to be addressed gradually.

The five chapters in Part V address a host of developmental and regulatory challenges facing developing Asian economies. The first (Chapter 14 by Se Hee Lim and Noel G. Reyes) deals with regulatory issues relating to a select group of countries in the ASEAN. The second (Chapter 15 by Qifeng Zhang and Josephine B. Valle-Sison) tackles the challenging issue of financial inclusion, and thereby deals more squarely with the equity versus stability versus growth issue. The third (Chapter 16 by Shigehiro Shinozaki) looks at the financing landscape for SMEs. The fourth (Chapter 17 by Arup Chatterjee) focuses on the contractual savings industry, an area where not much has been written in the context of global regulatory reforms. Finally, Chapter 18 (by Steven Beck) presents the critical role of trade finance in the aftermath of the GFC, and the role of regulatory policy in sustaining adequate provision of trade finance support.

REGULATORY APPROACHES

Given Asia’s diversity, it is important to understand the implications of global regulatory reforms on large and small economies alike. Lim and Reyes (Chapter 14) look at the impact of global regulatory reforms on five selected economies that are all members of ASEAN. While these economies do not necessarily have the most significant financial sectors in the region, they hold considerable promise in sustaining Asia’s growth performance in the coming years. They include Brunei Darussalam, Cambodia, Lao PDR, Myanmar, and Viet Nam, and are known collectively as the BCLMV countries.

From the overview presented at the beginning of this part introduction, the diversity among developing economies in the regulatory arena is quite clear. What is also clear is that policymakers in developed economies – the starting point of the crisis and home to most of the world’s largest financial institutions – have been steering the post-GFC agenda for global regulatory reforms. As a consequence, the proposed reforms reflect developed economy weaknesses and vulnerabilities.

The GFC has proved the decoupling hypothesis wrong. Financial crises and domestic regulatory policies in any part of the world do have significant external spillover effects. Although many developing economies had
relatively better macroeconomic management, strong external reserves, and well-functioning banking sectors, they were still affected either directly or indirectly by the GFC. Needless to say, post-crisis regulatory reforms will have serious implications for all countries. Hence, it is important to look at some form of cross-border equity in sharing the burden of the impact of crises and policy responses. Yet, discussions on cross-border equity are not yet prominent in international forums. Hence, the overwhelming focus on developed economy sources of weakness leaves the proposed ‘global’ regulatory reform measures open to criticism that they fail to adequately address the distinctive risks and concerns of developing economies in Asia and elsewhere.

The burden-sharing concern is more pronounced after the GFC as the impact on developing economies has been more owing to exogenous or external shocks rather than systemic weaknesses in their own financial systems, unlike the 1997–98 Asian financial crisis. In such an environment, and in countries where the financial sector is still in the early stages of development, higher prudential norms may stifle (instead of support) the development of the sector. Hence, there is a strong call for a more Asian approach to financial regulation, although there is some recognition that the global regulatory reforms will benefit developing Asian economies. Regional groupings such as ASEAN promote regulatory harmonization in order to avoid regulatory arbitrage within their membership.

With these points as background, Chapter 14 examines the impacts of the proposed global regulatory reforms in the BCLMV countries, including: (1) the resilience of financial regulatory and supervisory systems, (2) compliance with capital adequacy requirements and liquidity management guidelines under the Basel reforms, (3) macro-prudential surveillance systems, (4) transparency and disclosure, and (5) capital flow management.

FINANCIAL INCLUSION

Equity considerations have become much more important after the GFC. However, there are vast differences between the concerns of developed and developing economies. In the former, the focus is on protecting those who already have access to finance but are vulnerable. In developing countries, the concern is how to address high rates of financial exclusion. For instance, in India less than 5 percent of the recognized 600,000 habitations have a commercial bank branch. In such an environment, adoption of pro-poor policies in the financial sector can be justified. The G20 has advocated wide-ranging measures to boost financial inclusion around the world (Box V.1). There is greater recognition that countries should support credit
allocation and pricing policies that are more favorable to the poor. At the same time, there is also increasing recognition that such support should not be through regulatory forbearance or less stringent regulatory requirements for supporting pro-poor finance. In summary, adequate regulatory incentives for financial inclusion are critical, while innovation to protect the poor through financial and social safety nets should be supported.

Zhang and Valle-Sison look at these considerations relating to financial inclusion in Chapter 15. Following a presentation of the various facets of financial inclusion, they highlight the special characteristics of the objectives and principles for regulation of financial inclusion. Specifically,

**BOX V.1  G20 PRINCIPLES FOR INNOVATIVE FINANCIAL INCLUSION**

*Leadership.* Cultivate a broad-based government commitment to financial inclusion to help alleviate poverty.

*Diversity.* Implement policy approaches that promote competition and provide market-based incentives for the delivery of sustainable financial access and usage of a broad range of affordable services (for example, savings, credit, payments and transfers, and insurance), as well as a diversity of service providers.

*Innovation.* Promote technological and institutional innovation as a means to expand financial system access and usage, including by addressing infrastructure weaknesses.

*Protection.* Encourage a comprehensive approach to consumer protection that recognizes the roles of governments, providers, and consumers.

*Empowerment.* Develop financial literacy and financial capability.

*Cooperation.* Create an institutional environment with clear lines of accountability and co-ordination within government, and encourage partnerships and direct consultation across governments, businesses, and other stakeholders.

*Knowledge.* Utilize data to make evidence-based policy, measure progress, and consider an incremental 'test and learn' approach acceptable to both regulators and service providers.

*Proportionality.* Build a policy and regulatory framework that is proportionate to the risks and benefits involved in such innovative products and services, and is based on an understanding of the gaps and barriers in existing regulation.

*Framework.* Consider the following in the regulatory framework, reflecting international standards, national circumstances, and support for a competitive landscape: an appropriate, flexible, risk-based anti-money laundering and combating the financing of terrorism (AML-CFT) regime; conditions for the use of agents as a customer interface; a clear regulatory regime for electronically stored value; and market-based incentives to achieve the long-term goal of broad interoperability and interconnection.

the chapter discusses regulatory implications of financial inclusion with a focus on nine major areas: (1) Basel III requirements, (2) expanding financial outreach, (3) pricing of financial products and services, (4) consumer protection, (5) consumer literacy, (6) promoting inclusion through branchless banking, (7) anti-money laundering, (8) informal finance, and (9) overall regulatory architecture for financial inclusion.

SME FINANCING

There are various reasons as to why SME financing is inherently risky even in normal times. Banks are reluctant to lend to SMEs, and are even more reluctant to reschedule their credit. In crisis situations, SMEs typically face serious liquidity constraints as trade flows dry up as a result of negative effects cascading down from larger to smaller firms. Developed and developing economies alike put in place special measures to rejuvenate SME financing in the post-GFC period to mitigate risks and deal with information asymmetries, including targeted credit programs, subsidies, more favorable regulatory provisions, and institutional measures to promote information sharing. There is a generally held market perception that adoption of Basel II and III may constrain the flow of credit to SMEs. A challenging question is whether prudential norms for SME lending should be relaxed. The answer is generally no, given that a better alternative would be to mitigate risks through guarantees and other measures. In parallel, continuous reforms will be required to promote credit ratings for SMEs as well as to improve their financial disclosure.

Shinozaki’s chapter examines the implications of Basel III for SME financing in the region. Given the correlation between global imbalances and lending to SMEs, the chapter proposes two key policy priorities to improve financial accessibility for SMEs: greater bank lending efficiency and the design of diversified financing modalities. The chapter adopts a premise that the regulatory framework should be designed in such a way as to reduce barriers for SMEs in entering formal financial markets and accessing innovative products, as well as to smooth the cash flow of growth-oriented SMEs. The chapter presents a useful analysis of benchmarks for financial regulatory targets under five categories: (1) supply side, (2) demand side, (3) range of products and services, (4) quality of financial infrastructure, and (5) conformity with global standards and principles. Chapter 16 illustrates the critical role of improved financial infrastructure for SMEs; innovative product design, including asset-based finance, credit score-based lending, SME cluster financing, crowd funding, and exit financing; use of credit guarantee systems; and maximizing the
role of public financial institutions in supporting SMEs. Other diversified financing modalities will also be required such as increasing the role that non-bank financial institutions can play in SME financing and promoting supply chain financing, factoring, and capital market financing for SMEs (including the social capital market).

**CONTRACTUAL SAVINGS**

Pension and insurance coverage has in general been so low in the developing economies of the Asia and Pacific region that they have not had any systemic relevance thus far. In many parts of Asia, life insurance coverage is less than 10 percent while non-life coverage is even smaller at less than 3 percent. With large segments of the population employed in informal economic activities, pension coverage in developing Asia is much smaller than in developed economies, and in fact may be smaller than in developing Latin American economies that have the advantage of early-stage reforms in this area.

Against this context, Chatterjee’s Chapter 17 takes an innovative approach and looks at the conditions under which pension and insurance industries in the region could become systemically relevant. First and foremost from a developmental perspective, insurance and pension sectors must become more relevant by supporting the development of a broader range of financing options for healthcare, education, retirement, and climate-related disasters, and expanding access to insurance. Second, from a regulatory perspective, there are two important issues to consider. In the insurance arena, the reliance on external reinsurance coverage will most likely continue in the foreseeable future. For this, the region needs to harmonize its regulatory frameworks with international financial and regulatory standards. Further, even with the current low levels of penetration in the sector, it is conceivable that the industry can engage in non-core activities that are close to quasi-banking and speculative trading. In order to effectively deal with such a prospect, the region’s regulators need to consider a range of reform measures to revise solvency standards and governance norms.

**RING FENCING TRADE FINANCE**

The GFC significantly impaired access to trade finance globally, including in developing Asian economies. In a region that pioneered production networks, the disruption of trade finance considerably affected the ability
of Asian economies to supply intermediate inputs after 2008, and it hurt the real sector the most. Almost from the beginning of the GFC, there was widespread concern that the requirements of Basel II and III would have a negative impact on trade finance by increasing an institution’s cost of funds as a result of higher capital requirements. There is an emerging consensus that it is beneficial to regulate trade credit so that it is ring fenced in a period of crisis, in much the same way the integrity of payment systems is assured globally.

Beck’s chapter presents a snapshot of the impact of the GFC on trade finance. Citing recent survey evidence, Chapter 18 notes that there is a fairly significant gap in the availability of trade finance in the Asia and Pacific region, which impacts growth and job creation. The gap is partly due to regulatory requirements; besides, Basel, AMF–CFT, and know-your-client requirements also make it harder for banks to lend for trade finance. The gap is further aggravated by weak banking systems and a lack of transparency in some parts of the region. Risk management units in global financial institutions become averse to the provision of trade finance guarantees in the absence of certified financial statements or of adequate regulatory oversight. Chapter 18, while arguing that prudential requirements may need to be revisited, also notes that there is a case for making the supervision of banks and financial institutions stronger in the region, particularly in many of the frontier economies.

The chapters presented in this part essentially look at how to level the playing field, in terms of developing financial sectors as well as strengthening regulatory and supervisory frameworks. On the developmental side, a key point to note is that Asia is not homogeneous, with different sub-regions displaying widely different characteristics. In this context, the equity debate that has emerged globally takes a different perspective in developing Asia, and that centers on how to boost financial inclusion. A general trend that has emerged is that some form of regulatory accommodation complemented by sound supervision will be required to increase formal financial sector coverage. Another dimension that has emerged in the region is the need for developing Asia (and other developing economies elsewhere in the world) to take a stronger role in shaping the global financial sector’s regulatory architecture. The five chapters attempt to take this debate forward by presenting the huge potential for growth, as well as articulating what the region needs to do to ensure stability with equity.
NOTES

1. The views expressed in this note are solely those of the author and do not represent the position of ADB, its management, or the Board of Governors.
2. ‘Financial regulation for growth, equity and stability in the post-crisis world’, paper by Dr D. Subbarao, former Reserve Bank of India Governor, see BIS Papers No. 62, January 2012.
3. See Sriram, Chaturvedi and Neti ‘Too big to fail versus too small to be counted’, in BIS Papers No. 62 (footnote 2) for a useful discussion on equity considerations.