

**Creating One Asia Together – Asia Economic Community Forum**

*Financial supervision & regulation system after the economic crisis*

“Search for a better Asian financial and capital market regulatory regime after the Crisis”

Seoul, 11 November 2009

**How to create Common and Suitable Self-Regulatory Rules in Asian Capital Market?  
– For the recognition of the common infrastructure –**

Prof. Shigehito Inukai 犬飼 重仁

Waseda University 早稲田大学

# Index

1. Key Policy Goals of Financial Regulation
2. Four Approaches
  - The four principal models of supervisory oversight- G30 Press Release October 6, 2008 “The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace”
  - Twin Peaks Approach / Functional Approach / Integrated Approach / Institutional Approach / An Exception – US Structure
  - On-site Examination by the Bank of Japan

---
3. Were Asia’s High Savings the origin of the global financial crisis?
4. How can Asia contribute to normalize the global macro imbalances?
5. For the creation of an integrated Asian Inter-Regional Wholesale (Professional) Securities Market
6. What is CMAA?

# 1.

## Key Policy Goals of Financial Regulation

including:

1. Safety and Soundness of Particular Financial Institutions
2. Mitigation of Systemic Risk
3. Fairness and Efficiency of Markets; and
4. The Protection of customers and investors

Definition by the G30 report on October 6, 2008

## 2.

# Four Approaches

- The **G30 report** on October 6, 2008 compares and analyzes the financial regulatory approaches of seventeen jurisdictions, including the **United Kingdom**, the **United States**, **Australia** and **Japan**, in order to illustrate the implications of **the four principal models of supervisory oversight**:
  - (1) **the Institutional Approach**,
  - (2) **the Functional Approach**,
  - (3) **the Integrated Approach**, and
  - (4) **the Twin Peaks (objectives approach)**.
- The G30 report categorizes **Japan as Integrated Approach** which is **the same as in the U.K.**

Definition by the G30 report on October 6, 2008

# Twin Peaks Approach

- **The twin peaks approach**, a form of regulation by objective, is one in which there is a separation of regulatory functions between two regulators: one that performs the **safety and soundness supervision** function and the other that focuses on **conduct-of-business** regulation.

The two countries that use the Twin Peaks Approach are **Australia** and the **Netherlands**. A number of other jurisdictions are engaged in debates over the adopting this type of approach, including Spain, Italy, and France.

Definition by the G30 report on October 6, 2008

# Other Approaches

**The functional approach** is one in which supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business may have its own functional regulator.

The countries reviewed that use the Functional Approach are Brazil, France, Italy, and Spain.

**The integrated approach** is one in which a single universal regulator conducts both safety and soundness oversight as well as conduct-of-business regulation for all the sectors of financial services business.

The countries reviewed that use this approach are: Canada, Germany, (**Japan**), Qatar, Singapore, Switzerland, and the **United Kingdom**.

**The institutional approach** is one in which a firm's legal status (for example, a bank, broker-dealer, or insurance company) determines which regulator is tasked with overseeing its activity from both a safety and soundness and a business conduct perspective.

The jurisdictions reviewed that use the institutional approach are China, Hong Kong, and Mexico.

# U.S. structure – An Exception

- The U.S. structure is functional with institutional aspects, with the **added complexity** of a number of state level agencies and actors. The recent U.S. Treasury Blueprint recognizes the current weaknesses and advocates **a modified Twin Peaks Approach as a long-term goal.**

- Please refer Professor Uemura's Waseda GCOE Declaration.  
<http://www.globalcoe-waseda-law-commerce.org/purpose/index3.html>

# On-site Examination by the Bank of Japan

- **On-site examination** is the examination which the **Bank of Japan** carries out by **visiting the premises** of the financial institutions based on the contracts with them, in order to grasp their business operations and the state of the property (Article 44 of the Bank of Japan Act - 1977).
- The Bank of Japan contributes to the financial system stability by gauging each individual financial institution's business conditions, verifying their risk management and encouraging its improvement when necessary, through on-site examinations.



# On-site Examination by BOJ

- Amid the intensified global financial crisis, the importance has been reaffirmed for a central bank, which provides market liquidity and has the function of the lender of last resort, to have various communication channels with financial institutions, to accurately recognize the challenges of the financial system from micro- and macro-perspectives, and to carry out proper policy responses.
- The on-site examination is one of the important parts of the Bank of Japan's conduct of the policies and operations.

## Number of Financial Institutions Examined

	FY 2006	FY 2007	FY 2008
Domestic banks	43	39	52
Shinkin banks	73	66	46
Other institutions	15	14	30
Total	131	119	128

3.

Were Asia's High Savings  
the origin of the global  
financial crisis?

# What -FSA believes- went wrong?

## The Turner review-U.K. FSA

- **Drivers of the crisis**

The development of the global system of securitized credit intermediation was stimulated, by large global macro imbalances, by very low real interest rates, the desperate search for yield uplift.

It entailed rapid growth of risky lending and an explosion of financial innovation, the alphabet soup of structured credit and credit derivatives.

### **The Turner review-U.K. FSA**

A regulatory response to the global banking crisis

March 2009, U.K.FSA's Lord Turner published Review

# Global Macro Imbalance, Very Low Real Interest Rates

A **key driver** of those imbalances has been very high savings rates in countries like China; since **these high savings** exceed domestic investment, China and other countries **must accumulate claims on the rest of the world**.

But since, in addition, China and several other surplus countries are **committed to fixed or significantly managed exchange rates**, these rising claims take the form of **central bank reserves**.

These are typically invested not in a wide array of equity, property or fixed income assets – but **almost exclusively in apparently risk-free or close to risk-free government bonds or government guaranteed bonds**.

This in turn has **driven a reduction in real risk-free rates** of interest to historically low levels.

In 1990 an investor could invest in the UK or the US in risk-free index-linked government bonds at a yield to maturity of over 3% real; for the last five years the yield has been less than 2% and at times as low as 1%.

These very low medium- and long-term real interest rates have in turn driven **two effects**: (see next page)

# Two Effects

- **Firstly**, they have **helped drive rapid growth of credit extension in some developed countries, particularly in the US and the UK** – and particularly but not exclusively for residential mortgages – with this growth accompanied by a degradation of credit standards, and fuelling property price booms which for a time made those lower credit standards appear costless.
- **Secondly**, they have **driven among investors a ferocious search for yield** – a desire among investors who wish to invest in bond-like instruments to gain **as much as possible spread above the risk-free rate**, to offset at least partially the declining risk-free rate. Twenty years ago a pension fund or insurance company selling annuities could invest at 3.5% real yield to maturity on an entirely risk-free basis; now it would be only 1.5%. So any products which appear to add 10, 20 or 30 basis points to that yield, without adding too much risk, have looked very attractive.

4.

How can Asia contribute to  
normalize the global macro  
imbalances?

**In order to do that**

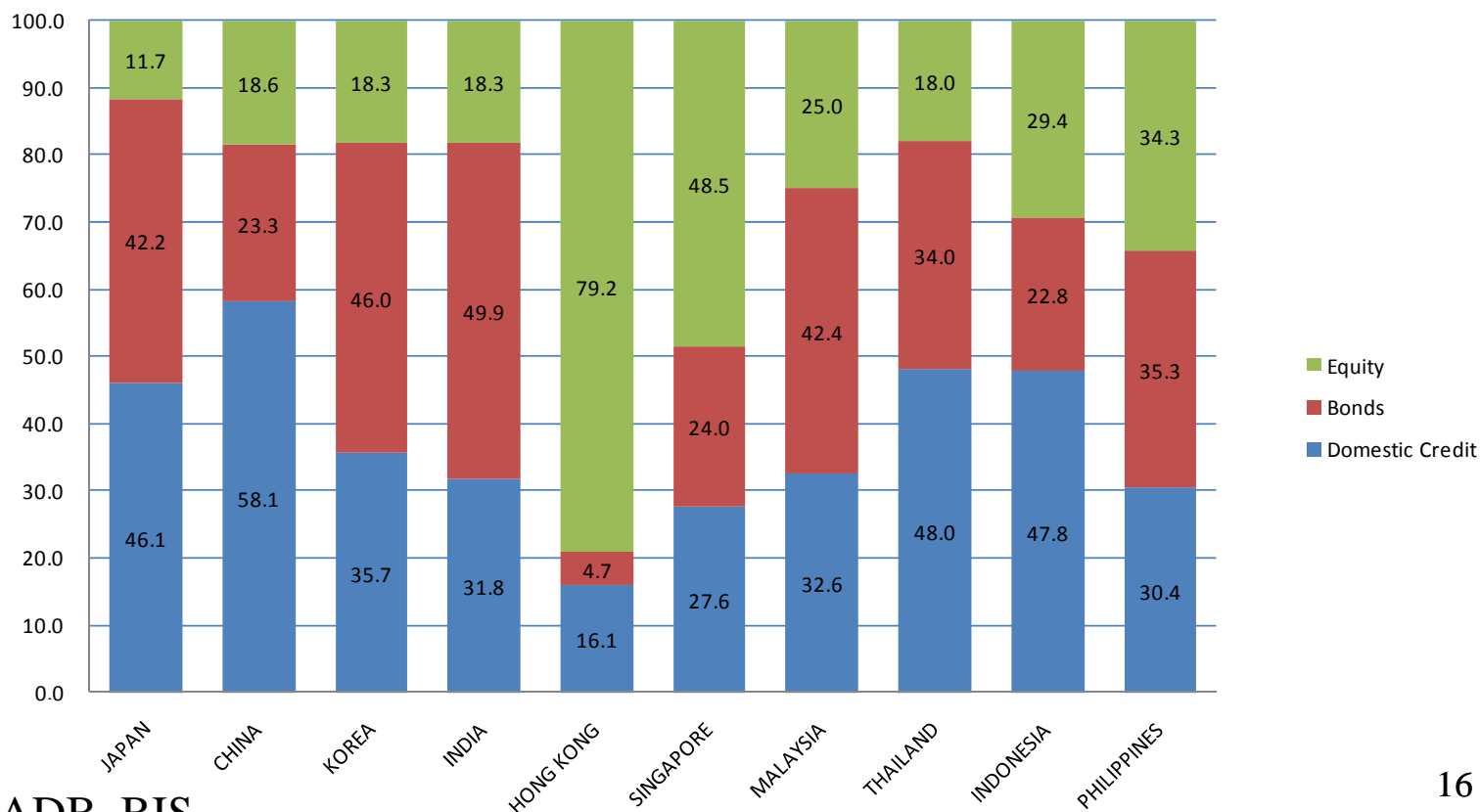
**--- we should create . . .**

An Asian Common and Suitable  
Capital Market, which would enable  
the abundant savings in the Asian  
region to be circulated within the  
region . . . .

# Features of Asian financial & capital markets

Asian markets are achieving a relatively good balance in their domestic financing profiles, despite the prevalence of bank-centered indirect financing systems in the region.

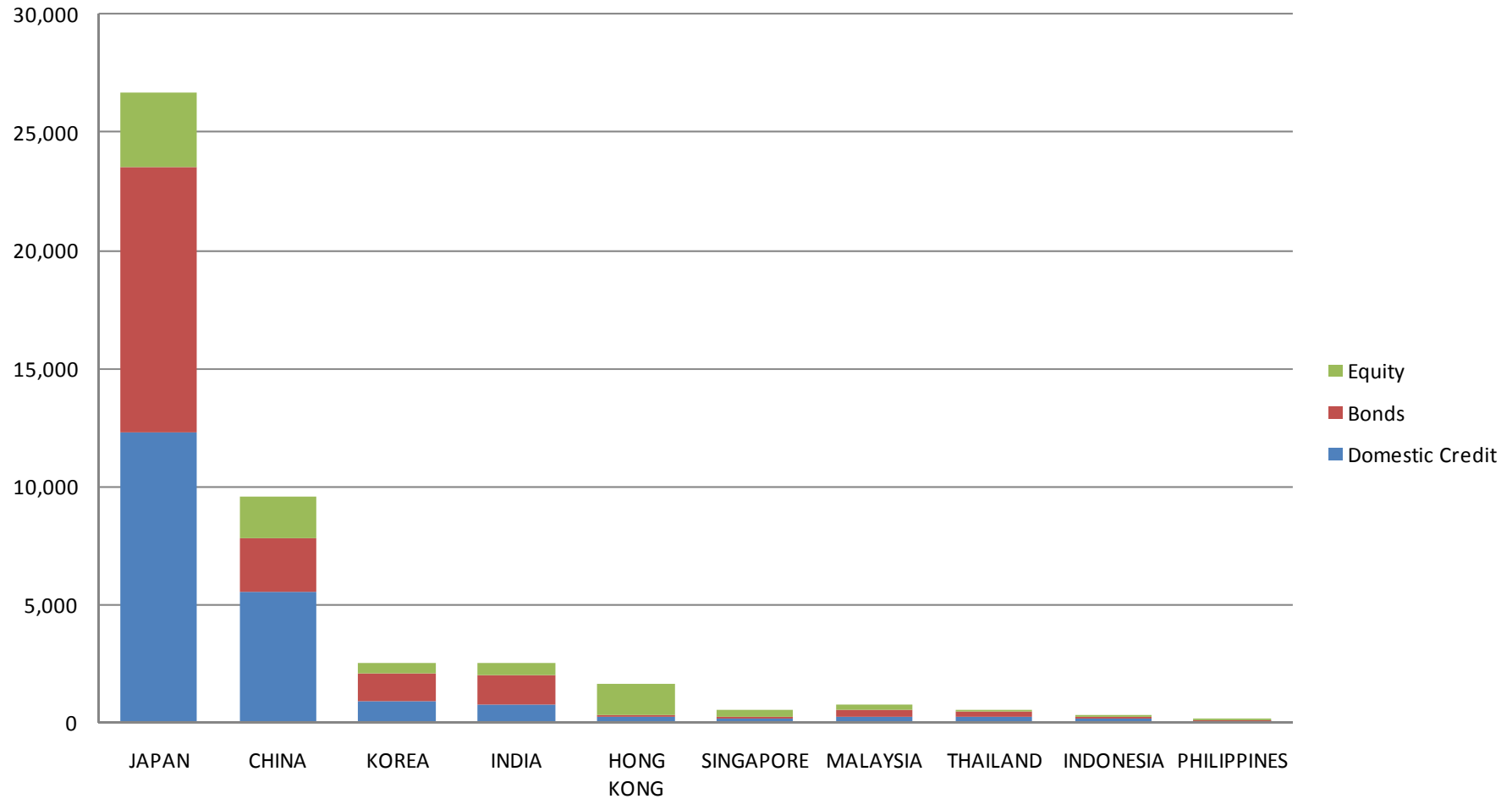
Domestic Financing Profile % (Dec 08)



Source: ADB, BIS



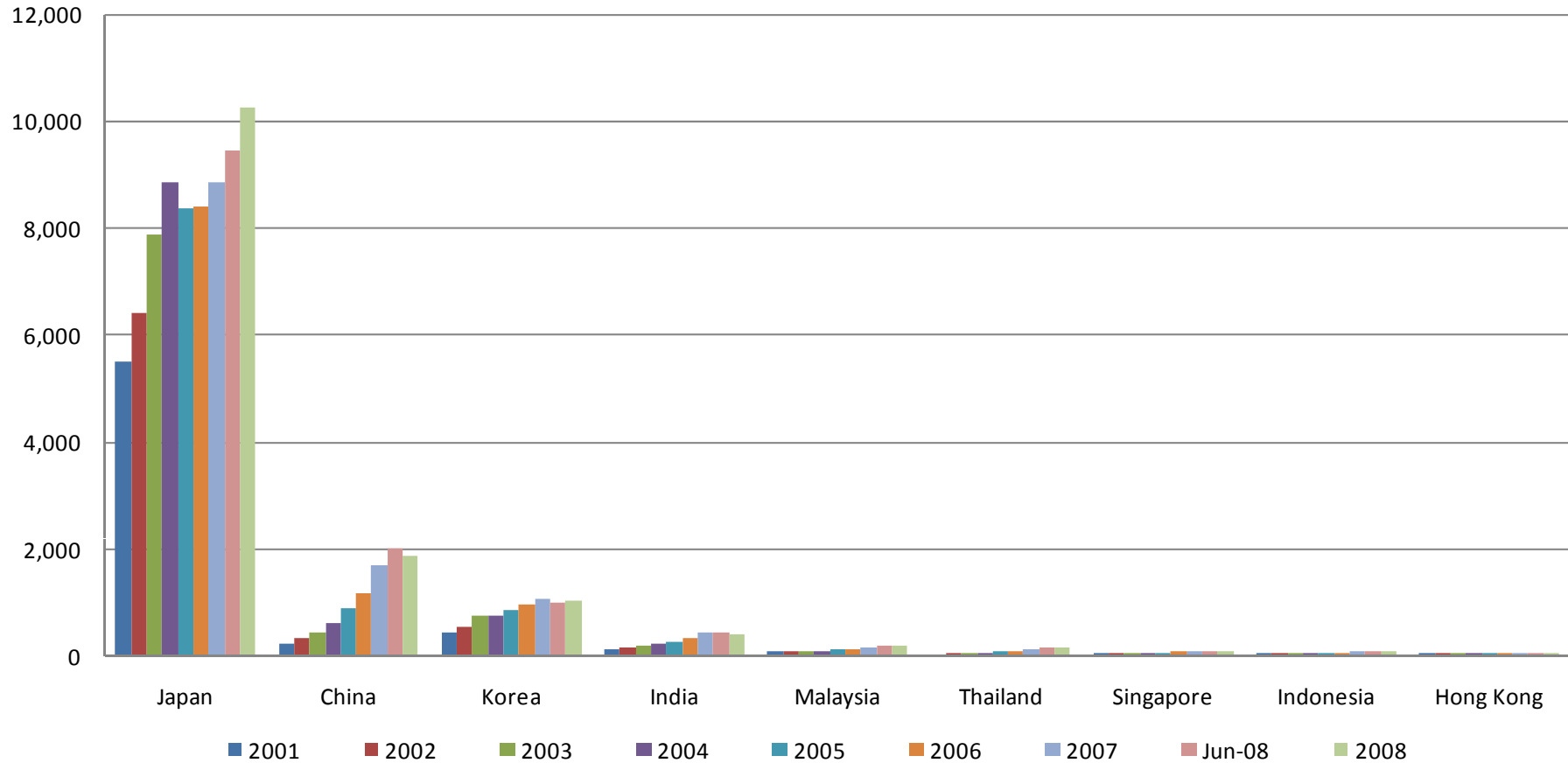
## Domestic Financing Profile in U.S. \$ Billions (Dec 08)



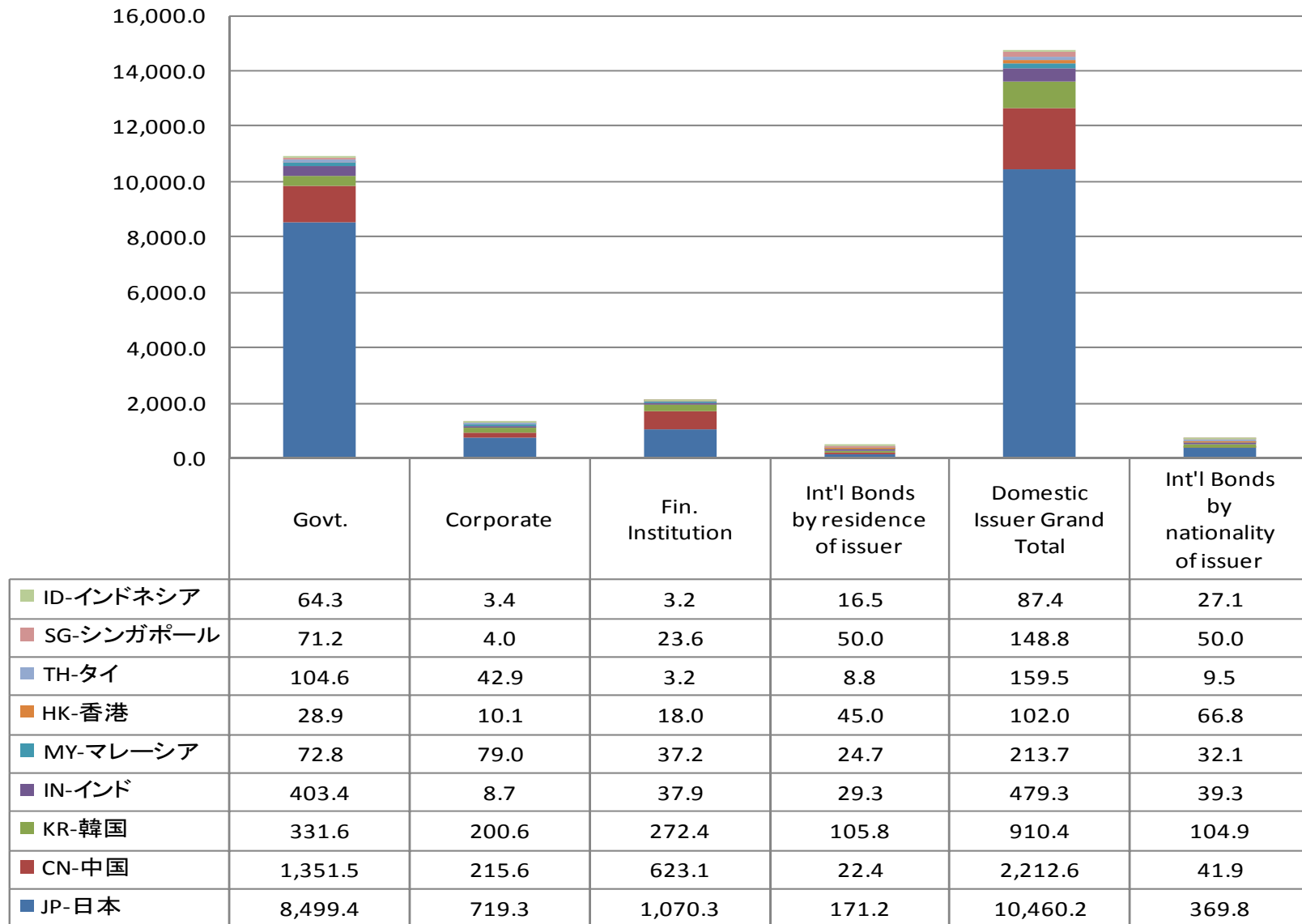
Source: ADB, BIS

# Domestic Bond Market Outstanding

Domestic Bond Market Outstanding (UNIT: U.S.\$ Billions)



## Asian Bond Markets by Type March-09 in U.S.\$ Billion



Source: ADB, BIS

## **The absence of common infrastructure**

- Asian Domestic markets have been evolving
- Asian Common infrastructure (= Int'l Bonds Market) needed to create/develop
- Self-Contained Asian Int'l Bonds Market is a common infrastructure within the region
  - Cooperation and alignment among -- Japan, Korea, China and India -- is key

5.

For the creation of an integrated  
Asian Inter-Regional Wholesale  
(Professional) Securities Market

# Asian investment banker's perspective

- Huge Asian capital reserves provide an opportunity for Asian financial institutions to take the lead in capital markets in Asia
- Asian financial institutions are **not** leading the market in terms of capital disbursement and price making – European and US financial institutions still dominate in this area
- Why is it that Asian issuers need to raise capital in London or New York?
- Advanced Asian financial institutions have a responsibility to take the lead
- Why not integrate Asian capital markets to create a viable option in addition to London and New York?

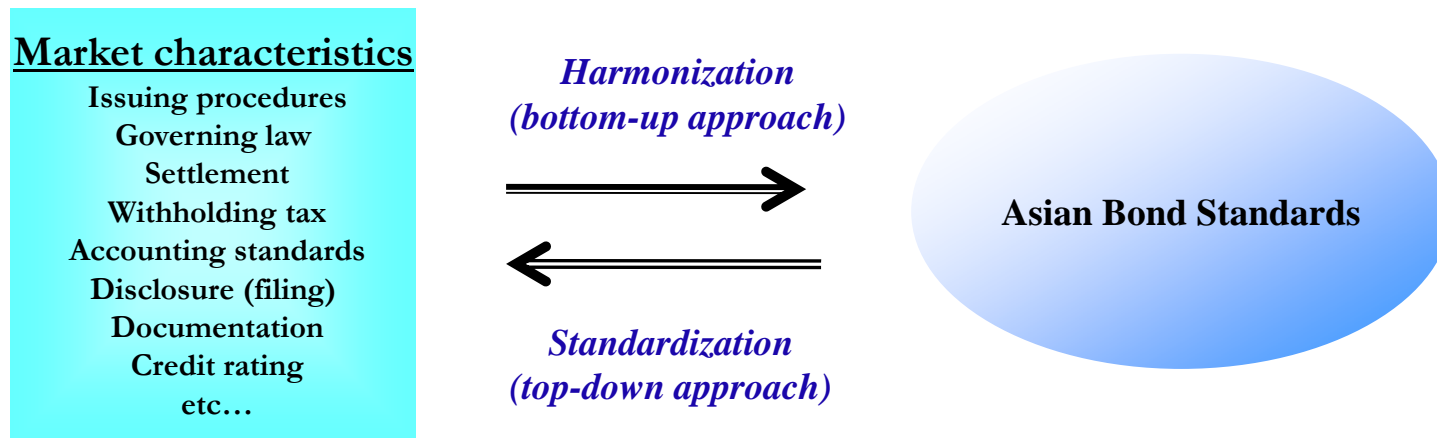
# Integrated Markets ----- Common Infrastructure?

- Need to recognize **diversity** in Asia
- Integration – what degree is required?
- Important Elements of the market to be developed . . .
  - Focus on common infrastructure, i.e. a cross-border (Inter-Regional) wholesale (= Professional) securities market accessible by Asian countries market professionals
  - The concept of an integrated Asian Inter-Regional Wholesale (Professional) Securities Market (AIR-PSM) as a self-contained market, enabling savings accumulated in the region to circulate within the region
  - Suitable Self-Regulatory Rules for the market

# Fragmented Asian Markets and Harmonization

(Dr. Hyun Suk of BOK and Prof. Inukai)

- Fragmented financial and capital markets in Asia
  - different regulatory and legal systems
  - different stages of market development and economic size
  - different taxation, capital control and currency restriction etc.
- Asian common set of rules and standards
  - in line with global best practices
  - facilitate cross-border capital flows and financial integration
  - ex) ASEAN and Plus Standard, Harmonization of Bond Standard in ASEAN+3





## Why Do We Need Regional Framework for Securities Regulation?

(Dr. Hyun Suk of BOK and Prof. Inukai)

- Given the diversity of socio-economic condition and financial developments and increasingly inter-connected financial markets in the region, we need to consider regulatory approach more suitable and applicable to the heterogeneous markets in order to efficiently facilitate cross-border transaction and financial integration in Asia.
- It is not realistic to harmonize all regulatory standards without a central political body like European Commission. Therefore it is necessary to coordinate and cooperate with different regulatory agencies at the regional level as well as the domestic level to bridge large differences in regulations.
- The extent and structure of securities regulation and supervision vary substantially from country to country and besides the regulatory responsibilities and roles among different agencies are very fragmented and over-lapped.

# Sequence for Asian Bond Markets Development

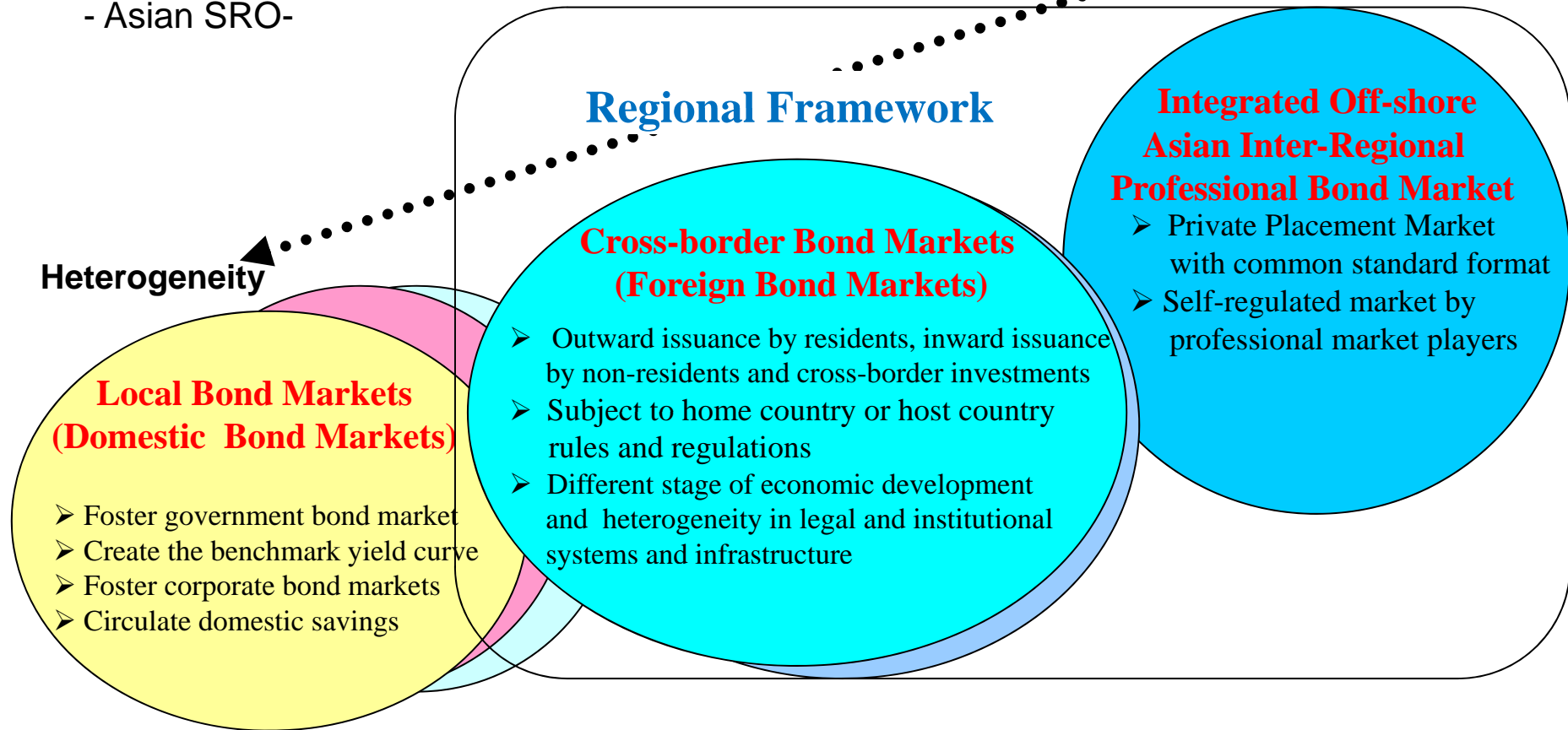
(Dr. Hyun Suk of BOK and Prof. Inukai)

How can we establish a common set of standards and regulation to promote cross-border and off-shore markets in Asia?

- Asian Supervisory Authorities-
- Asian SRO-

Homogeneity

Heterogeneity



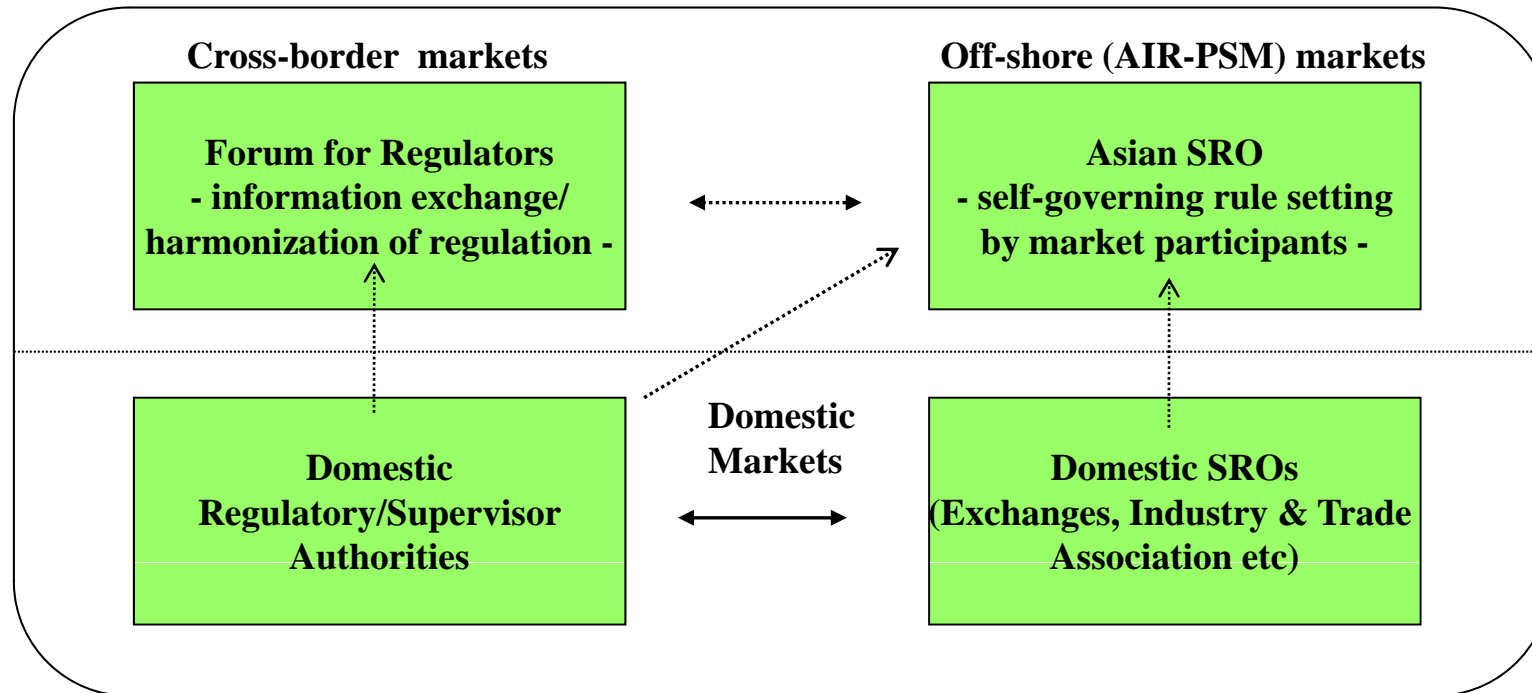
## Effective regulations on Cross-border Transaction

(Dr. Hyun Suk of BOK and Prof. Inukai)

- Cross-border transactions in the region are very limited due to capital control and FX control. Some countries have quota; some countries have exchange controls in which foreign exchange (FX) transactions must be substantiated by actual transactions.
- However, as the regulations move to liberalization and regional investors expand, cross-border transactions will increase, and then we need to think effective regulation on cross-border transactions.
- We can think two approaches to rule setting in cross-border transaction.
  - Firstly, we need to establish a forum for regulators in setting the effective regulation which is consistent across the jurisdictions.
  - Secondly, and equally, we need to have a regional forum for market participants to set regional self-regulatory rules for offshore transaction which is not subject to specific country's regulation with their expertise and deep knowledge.
  - This forum may evolve to a Asian Supervisory Authorities or Asian SRO if it is deemed to be suitable for the region.

# Feasible Framework for Securities Regulation in Asia

(Dr. Hyun Suk of BOK and Prof. Inukai)



## 6.

# What is CMAA?

## (Capital Markets Association for Asia)

### **Purpose of CMAA**

- **Formulate proposals for the self-governing rules and recommendations for issuing entities and other users of the Asian regional financial & capital markets**
- Coordinate opinions regarding legal systems and rules
- Foster dialogue with CMAA participants
- Conduct research, formulate proposals, increase awareness
- The ultimate purpose of the CMAA is to increase the reliability and convenience of all financial and capital markets in Asia and to establish appealing markets for all users

# About the CMAA

**Name:** Capital Markets Association for Asia (CMAA)

<http://www.cmaa-group.org/>

**Status of the Group:** A voluntary organization bringing together participants who agree with the purpose of establishment of the CMAA.

Basically, members join in an individual capacity, but corporate entities are not prevented from joining.

**Membership fee:** No membership fees

**Admission to the Association:** Admission of new members is decided by the Officials Meeting based on the recommendation of several existing members.

**Inauguration:** The inauguration of the CMAA was officially announced at the “General Meeting for the Establishment of the Capital Markets Association for Asia” held on June 19, 2007.

**Chairperson:** Nobuyuki Idei, CEO of Quantum Leaps Corporation, Ex. Sony CEO

**Secretary-General and Executive President:** Shigehito Inukai, Professor, Faculty of Law, Waseda University

# For the creation of the Asian version of the IPMA\* Handbook



- ICMA(The International Capital Market Association ) kindly provided CMAA their self-regulatory handbook for further study.
- CMAA and Waseda University have been making the joint effort to create and propose Waseda/CMAA Handbook for Asian capital market players.

\* IPMA was the main trade organization concerned with new issue procedure in the Euromarkets. IPMA's original core role was the harmonization and the establishment of accepted best practice in the primary markets. IPMA merged with the International Securities Market association (ISMA – the successor to the AIBD) in July 2005. The merger created the International Capital Market Association (ICMA). ICMA is a trade association and a self-regulatory body for the secondary markets. ICMA is the representative body and voice for all capital market constituencies with a European focus.

<http://www.cmaa-group.org/home>

<http://www.globalcoe-waseda-law-commerce.org/>

<http://sites.google.com/site/profinukaiswebsite/>

