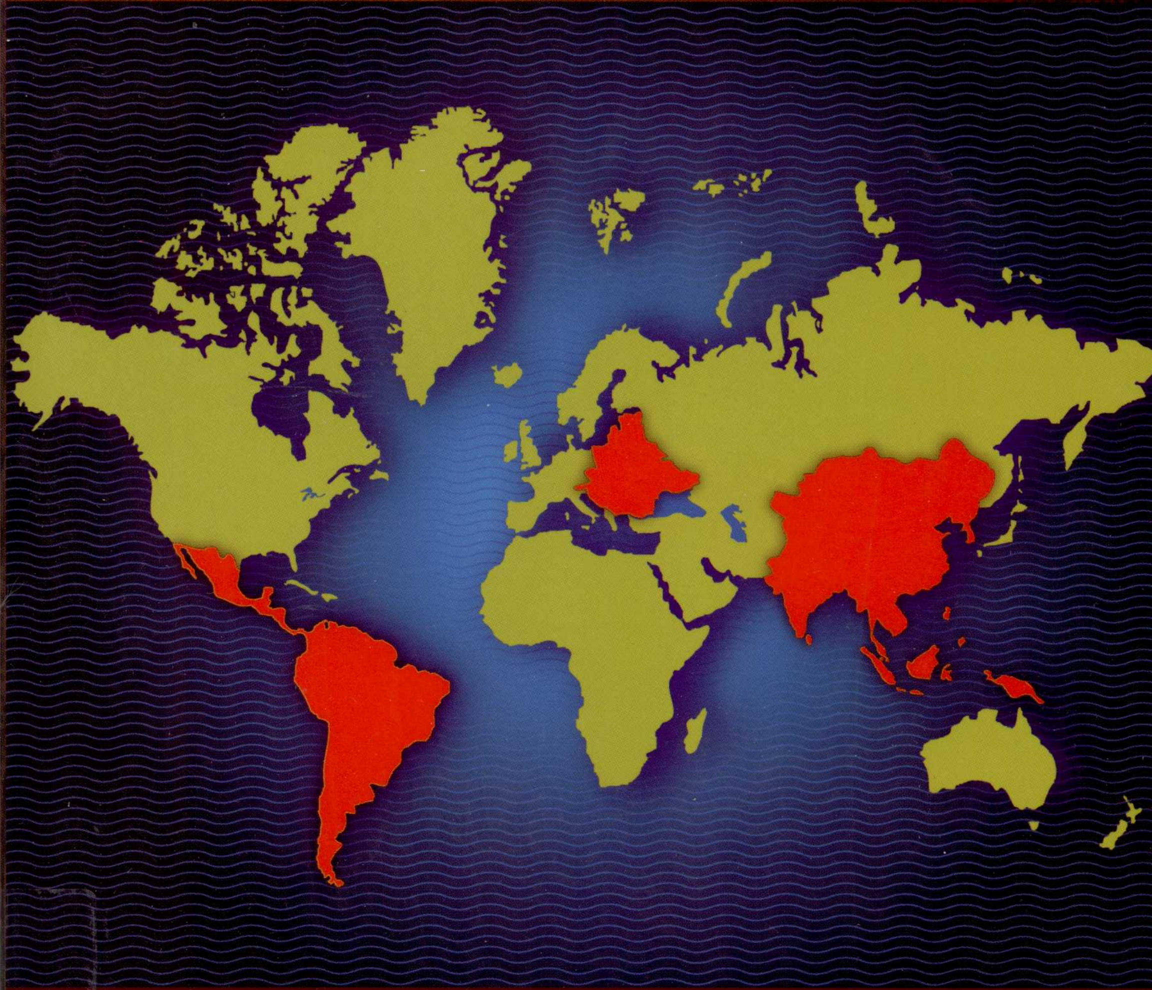
FINANCIAL MARKET REGULATION AND REFORMS IN EMERGING MARKETS



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Introduction

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The global financial crisis has necessitated the reconsideration of even basic principles of financial regulation. Meanwhile, the imperative of financial development remains as strong as ever in emerging markets, although the focus is more on basic elements such as strengthening of banking systems and widening the scope of the formal financial system, rather than sophisticated instruments and innovations. Remarkably, emerging market financial systems have in general proved to be more robust and less affected by the global turmoil compared to their advanced economy counterparts—it will be important to carefully filter out the right lessons from this outcome.

The crisis has highlighted the need for strengthening financial systems to make them more resilient to shocks. Emerging markets face particular challenges in stabilizing their nascent financial systems in the face of shocks, both domestic and external, and financial reforms are critical to these economies as they attempt to pursue sustainable high-growth paths. New paradigms for financial development and regulation will have to be suitably reframed for emerging markets, which have a number of varying institutional and capacity constraints. Low-income countries, where the breadth of formal financial systems is severely limited, pose an even greater set of conceptual and practical challenges.

Policymakers in emerging markets are grappling with a distinct set of issues, including the lessons the crisis can offer for the establishment of efficient and

We are grateful to Lei Ye for his help in producing this chapter. This book adopts some of the Asian Development Bank naming conventions used to refer to its member economies. The Brookings Institution takes no position on Taipei,China's legal status.

flexible regulatory structures, the avenues that should be pursued to enable effective regulation of financial institutions with large operations in multiple countries, and how to raise financial inclusion. A broad reconsideration of the optimal structure, and appropriate scope, of the regulation and supervision of financial institutions is needed for these economies.

In October 2009 a conference was held at the Brookings Institution in Washington, D.C., to bring together a group of academics, policymakers, and practitioners to discuss these issues and initiate an extensive research program. The conference objective was to make progress on framing the key questions in a sharper manner to enable progress on moving toward solutions. This volume brings together a selection of papers that were discussed at that meeting. The papers here attempt to outline the issues with clarity and collectively bring out the key connections among regulatory reform, financial development, and broader inclusion. They present a systematic overview of recent developments in regulatory frameworks in both advanced countries and emerging markets, and lay out the challenges to improving financial regulatory structures, functioning of markets, and access in emerging markets.

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A brief overview of the contents of the book follows below.

Part I. Overview

Chapter 1 by Eswar Prasad provides a synthetic overview of the main issues concerning regulatory reforms in emerging markets. The author discusses the complex conceptual and practical challenges that emerging market economies face as they attempt to improve their frameworks for financial regulation. These economies need to balance the quest for financial stability with the imperatives of financial development and broader financial inclusion. The author argues that these objectives can in fact reinforce one another. He also discusses aspects of macroeconomic policies and cross-border regulation that have implications for financial stability and the resilience of the financial sector in emerging markets. Thus, the chapter ties together the various themes of the overall research agenda that covers financial market development, regulation, access, and other related issues.

Part II. New Perspectives on Financial Regulation

What is the right way to approach financial sector regulation and supervision? A reconsideration of basic principles is needed to design an effective and flexible regulatory mechanism that is capable of dealing with financial innovations and systemic risks. The papers in this section provide an overview of the evolving debate on regulatory policy in advanced economies.

Chapter 2 by Viral V. Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter is on "Market Failures and Regulatory Failures: Lessons from Past and Present Financial Crises." The authors focus on four major market failures that precipitated the current crisis—excessive risk taking by financial firms under government guarantees; regulatory focus on individual institutions rather than systemic risk; lack of transparency of financial institutions; and proliferation of the shadow banking system. For each market failure, different policy options are discussed and compared. The chapter concludes with a discussion on the implications of these market failures for emerging markets, with a focus on government guarantees and systemic risk transmission. The authors stress that policymakers need to identify the source of market failure first and then design regulations to specifically address those market failures.

Chapter 3 by Douglas J. Elliott is on "Evaluating the U.S. Plans for Financial Regulatory Reform." This chapter assesses various regulatory measures adopted (and under consideration) in the United States after the current crisis and draws out the implications of these policies for emerging markets. The author outlines some widely accepted fundamental premises of the U.S. financial system, such as financial regulators' political independence and the avoidance of overregulation. The author argues that the details embodied in the new regulations will be critical to their effectiveness. Furthermore, striking the right balance among factors such as systemic risk reduction, innovation protection, and political feasibility is an important priority for the design of these policies.

Part III. Regulatory Frameworks for Emerging Markets

Along with a reconsideration of basic principles, it will be important to think about how to adapt these principles to the particular circumstances of emerging market economies where there are significant institutional and capacity constraints. Although country-specific conditions cannot be ignored, it will still be useful to develop a framework for making progress on this issue. The papers in this section provide some emerging market perspectives—from India, China (People's Republic of China), and Indonesia—on these issues.

Chapter 4 by Rakesh Mohan is on "Emerging Contours of Financial Regulation: Challenges and Dynamics." The author frames the global financial crisis as originating from the interplay among excessive loose monetary policy in major developed economies, global imbalances, excessive risk taking by financial institutions, and lax financial regulations. The author argues that regulations were not adequate for dealing with exponential growth in derivatives and securitized credits in the past decade. The growing shadow banking industry contributed to the growing divide between the financial and real sectors. He articulates a number of policy priorities, including macro-prudential regulations that mitigate systemic risk, broader regulatory scope, greater capital and liquidity buffers, stronger international coordination, and more effective risk management.

Chapter 5 by Luo Ping is about "What Regulatory Policies Work for Emerging Markets?" The author compares and contrasts China's banking regulation and standards with that of the Basel Core Principles for Effective Banking Supervision (BCPs). The author first provides a brief overview of China's banking reforms. He then reviews major themes of the BCPs and examines China's practices in these areas. He characterizes China's practices as rules based, while the BCPs are seen as principles based. The author argues that China's regulatory standards, while significantly influenced by the BCPs, are more prescriptive and specific and that this approach is more suitable for emerging markets.

Chapter 6 by Anwar Nasution presents an overview of "Banking Supervision in Indonesia." The Indonesian banking sector faced a variety of problems in the past, such as a long period of financial repression, low transparency, and low asset quality. The author argues that further upgrades to Indonesia's market infrastructure and implementation of international standards are needed to address these issues. As a sound supervisory framework should be dynamic and reflect the realities of the financial sector for which it is created, best practices in advanced economies should be considered as a starting point for enhancing current supervisory frameworks, though one should also bear in mind that a single framework does not fit all types of financial institutions or systems.

Part IV. Financial Market Development and Stability

The financial crisis will shift the emphasis of the financial development agenda toward the basics of strengthening banking systems, developing basic derivative markets such as currency derivatives, and increasing the depth and diversity of corporate and government bond markets. The papers in this section attempt to redefine the objectives and avenues of financial development in light of recent events.

Chapter 7 by Masahiro Kawai and Michael Pomerleano is entitled "Who Should Regulate Systemic Stability Risk? The Relevance for Asia." The authors contend that financial crises can be prevented, even if their precise timing cannot be predicted, by identifying and dealing with sources of instability. Policymakers need to complement top-down macro-prudential surveillance with micro-prudential supervision. They argue for adequate provision of liquidity during crises and a clearly defined cross-border insolvency resolution mechanism for global financial institutions. At the national level, systemic crises are best managed by a strong and comprehensive systemic stability regulator. The authors support regional initiatives to improve financial stability.

Chapter 8 by Richard Reid is on "Financial Development: A Broader Perspective." The author examines the evolution of different financial systems and attempts to draw out practical policy lessons from varied historical experiences. He lays out a framework for classifying financial development, looking not just at the size of the financial system over time but also at the composition of instruments and institutions, the structure of financial flows, and the interplay of markets. These all have important regulatory implications. The author mentions that while it is difficult to characterize the notion of an optimal financial system, efforts such as broader flow of funds analysis will help countries identify whether a particular financial system is serving the needs of the economy well.

Chapter 9 by K. P. Krishnan is on "Financial Development in Emerging Markets: The Indian Experience." The author reviews the evolution of Indian financial markets, including securities, money market, foreign exchange, debt, insurance, and banking. He highlights the dualistic development of the financial sector in India—the stock market has blossomed while other parts of the financial system have progressed more slowly. This varying pace across sectors is attributed to the differences in each market's regulatory framework and public sector presence. The author sets out a road map for the future development of financial markets in India. He makes a case for reducing overlaps and gaps in regulatory structure, increasing convergence in financial market regulation, broadening financial services provision, creating an independent debt management agency, and enhancing interagency coordination.

Part V. Improving Financial Access in Emerging Markets

Financial inclusion is a critical part of the financial development agenda for emerging markets. A significant fraction of the population in these countries lacks access to the formal financial system. This affects economic growth and welfare in a variety of ways—by limiting access to credit (for households and entrepreneurs), sharing risks, and diversifying financial savings. Regulators sometimes see broadening financial inclusion as increasing risks to the financial system, but it could in fact be a key component of increasing rather than diminishing financial stability. The papers in this section analyze some key conceptual issues related to financial inclusion.

Chapter 10 by Suyash Rai, Bindu Ananth, and Nachiket Mor is on "Universalizing Complete Access to Finance: Key Conceptual Issues." The authors examine the issue of financial inclusion from the standpoints of welfare and financial stability and provide analytical perspectives on how potential tensions between broadening inclusion and ensuring stability can be managed. The authors discuss a variety of conceptual challenges including balancing simplicity and complexity, communicating clearly about product characteristics, and increasing proximity of access. The authors argue that customizing financial services that are tailored to each household would be more effective from the perspective of financial inclusion, as it allows for more support from providers and better takes into account behavioral biases and household characteristics.

Chapter 11 by Alfred Hannig and Stefan Jansen is on "Financial Inclusion and Financial Stability: Current Policy Issues." The overarching argument of this chapter is that financial inclusion enhances financial stability. The authors outline recent trends in financial inclusion in Asia, Africa, and Latin America. They then discuss micro- and macroeconomic evidence on the positive effects of financial inclusion, including microfinance, on individual and aggregate welfare. The authors remark that innovations in financial inclusion increase certain idiosyncratic risk but contribute relatively low systemic risk. The current crisis should be used as a catalyst to further develop financial inclusion policies that boost economies' resilience; innovations aimed at countering financial exclusion help strengthen financial systems rather than weakening them.

Part VI. Cross-Border Regulation

The global financial crisis is likely to result in a moderation of cross-border capital flows and other aspects of financial globalization. Nevertheless, the capital accounts of emerging markets have become more open over time and it is unlikely that this trend can be reversed once the incentives for cross-border flows return. Macroeconomic policies and financial regulation in emerging markets will have to deal with this reality. The papers in this section cover how policy and regulatory frameworks can deal with complications associated with open capital accounts.

Chapter 12 by Alejandro Werner and Guillermo Zamarripa is on "Cross-Border Regulation after the Global Financial Crisis." The authors describe the origins of the crisis and the market incentives that contributed to it. They identify four sources of contagion—toxic asset losses, mismatches between assets and liabilities, the financial market's decoupling and recoupling effects, and risk aversion of large conglomerates. The authors suggest that future regulatory design should embody elements such as a global perspective, broader information exchange across emerging markets, bankruptcy resolution mechanism for international financial conglomerates, and clear assessment of sources of vulnerabilities.

Chapter 13 by Jeromin Zettelmeyer, Piroska M. Nagy, and Stephen Jeffrey is on "Addressing Private Sector Currency Mismatches in Emerging Europe." The global financial crisis highlighted the problems associated with currency mismatches on the balance sheets of emerging market borrowers, particularly in emerging Europe. The mispricing of foreign exchange risk, externalities from foreign currency exposure, and weak macroeconomic and institutional credibility all contributed to financial dollarization. The experience of Latin America is then presented as a successful case of de-dollarization. Based on such experiences and emerging Europe's own circumstances, the authors recommend for emerging Europe a set of macroeconomic and institutional reforms, further development of domestic currency and debt markets, and common application of regulation across economies.

Contents

PART I
Overview

1

Financial Sector Regulation and Reforms in Emerging Markets: An Overview

ESWAR S. PRASAD

The speed and breadth of contagion from the U.S. financial crisis have dramatically demonstrated the degree to which national economies, developed and developing alike, are intertwined. Initially a problem confined to the U.S. housing market, the rapid spillover of the crisis to the rest of the U.S. financial system and then to the global economy left financial institutions in other advanced economies reeling. The crisis has highlighted the need for substantive regulatory reforms geared toward ensuring the integrity and resilience of financial systems in the advanced economies.

The macroeconomic consequences of the crisis have also affected emerging markets and other developing economies, even though these groups have rebounded more quickly and sharply from the crisis.[1] These shared ramifications have brought into even sharper relief the centrality of sound financial systems for emerging markets as well as low-income developing economies. Efficient and stable financial systems are essential for both emerging markets and low-income developing economies to achieve long-term balanced development and to absorb various types of shocks.

It is striking that the crisis emanated from the United States and hit a group of economies particularly hard, including that of the United Kingdom, that were once believed to have the most sophisticated and robust financial systems. These

The author would like to thank Parul Sharma for her comments.

1. See Kose and Prasad (2010).

developments have necessitated the reevaluation of basic principles of financial regulation. Clearly, existing regulatory models and frameworks need to be reconfigured and strengthened. The necessary paradigms are still evolving, although there appears to be a general consensus on some key principles that will be central to a major redesign of financial regulation.

Emerging market financial systems, including those in Asia, have generally proven to be more robust and less affected by the global turmoil than their more advanced economy counterparts. It will be important to carefully filter out the right lessons from this outcome. Meanwhile, the imperative of financial development remains as strong as ever in emerging markets, although the focus is more on basic elements, such as strengthening banking systems and widening the scope of the formal financial system, rather than on creating sophisticated instruments and innovations.

Emerging markets face particular challenges in stabilizing their nascent financial systems in the face of shocks, both domestic and external. These challenges occur at a basic level in emerging markets, many of which are at the point of creating sound banking systems, widening inclusion in the formal financial system, and creating and managing a broader set of financial markets (such as corporate bond markets and basic currency derivatives). Thus the regulatory challenges in these economies are more about risks emanating from underdeveloped financial systems rather than risks from sophisticated financial innovations.

New paradigms for financial development and regulation will have to be suitably reframed for emerging markets, which have a number of varying institutional and capacity constraints. Regulation in low-income countries, where the breadth of formal financial systems is severely limited, poses an even greater set of conceptual and practical challenges.

Policymakers in emerging markets will need to grapple with a distinct set of issues once the recovery in the global economy is entrenched and attention can turn to the steps needed to restore financial stability. The following are some of the key issues facing policymakers and regulators in emerging markets:

—What lessons does the crisis offer for the establishment of efficient and flexible regulatory structures? Even advanced economies have had to confront these deep structural questions, which tend to be more complex in emerging markets due to inadequate regulatory capacity and weak legal and public institutions.

—How can the regulatory and financial development agendas be reconciled in a manner that creates regulatory space for the introduction of standardized products and the development of broader financial markets while effectively managing the associated risks? The financial development agenda is an important one in emerging markets where efficient financial intermediation remains a major challenge, with implications for general economic welfare.

—Is broader financial inclusion consistent with financial stability? In general, *increasing financial inclusion—extending access to the formal financial system* to a greater swath of the population—is a key issue for emerging markets at this critical juncture of their economic development. Financial inclusion has many implications for allowing households to save and diversify their sources of income, enabling entrepreneurs to have access to financing, and creating a more efficient system of intermediating domestic savings into investment.

—What avenues should be pursued to enable effective regulation of financial institutions with large operations in multiple countries? Foreign banks and other financial institutions have become key players in many emerging markets and have provided a number of direct and indirect benefits to local financial systems. However, in times of externally induced crises, they may prove to be a source of contagion.

This chapter focuses on evaluating the lessons from the crisis and on designing effective strategies for maintaining the momentum of financial development and inclusion in emerging markets, with a particular focus on Asian emerging markets. It attempts to assess the implications of the financial crisis for the design of regulatory frameworks and models, taking into account the specific constraints in emerging markets. The main areas covered in this paper are:

—*Basic principles of financial regulation: synthesizing evolving paradigms on* the key characteristics of optimal regulatory structures to promote financial stability.

—Financial regulatory reforms in emerging markets, with a focus on emerging Asia: dealing with the challenges of limited institutional development and regulatory capacity.

—The financial development agenda: improving financial intermediation and creating space for the development of broader financial markets, including basic derivative products.

—Financial inclusion: how to increase the access of households and entrepreneurs to the formal financial system in emerging markets and considerations of whether greater inclusion is consistent with promoting sound regulation.

—Optimal macroeconomic policy frameworks to enhance financial stability: challenges in designing robust monetary policy frameworks, particularly in light of de facto increasingly open capital accounts.

—Cross-border financial regulation and, more broadly, regulation of financial *institutions that have a substantial presence in emerging markets.*

Basic Principles of Financial Regulation

Before the financial crisis, the debate about optimal regulatory structures was focused narrowly on a few issues. One aspect of the debate was whether the United Kingdom's single regulator model, as embodied in the Financial Services

Authority, was better than the multiple regulator framework of the United States, where different agencies have varying jurisdictions. The crisis has exposed gaping weaknesses in both models. The Financial Services Authority was responsible for overall financial stability but appears to have regulated with a "light touch," allowing large levels of systemic risk to build up in the system. In the United States, regulatory failures were compounded by gaps in the overall framework for supervision and regulation that left some products and markets relatively unregulated and created large opportunities for regulatory arbitrage.

A different angle to this issue is the contrast between rules-based and principles-based regulation. Rules-based regulation, which emphasizes getting the regulated to obey the letter of the regulation, typically involves more direct control by the regulatory authority and has been the preferred mode in emerging markets. It had been argued that principles-based regulation, which emphasizes getting the regulated to adhere to the spirit of the regulation, is more appropriate for advanced financial markets. But it also may be relevant for emerging markets looking to develop their financial markets by opening them up to more innovation and risk taking. The crisis has shown that both approaches, which tend to be based on microprudential regulation of individual financial institutions, may be insufficient for dealing with systemic risk.

A reconsideration of basic principles is needed for designing an effective and flexible regulatory mechanism that is capable of dealing with financial innovations and systemic risks. In the wake of the financial crisis, a number of reports have been commissioned from various bodies to look into regulatory reforms. These reports generally agree on some core principles that will have to be emphasized in any set of reforms.[2]

Higher Capital Requirements

One clear impact of the crisis has been to increase the desirable levels of capital buffers held by financial institutions. The U.S. Treasury has enunciated a set of core principles for capital and liquidity requirements for financial institutions, including the following three principles:

2. In the discussion in this section, I mainly draw upon the following reports: the *Report of the High-Level Group on Financial Supervision in the EU* (de Larosière Group 2009), the Group of Thirty report on financial sector reforms (Group of Thirty 2009), *The Turner Review* from the United Kingdom (Financial Services Authority 2009), the report on "Enhancing Sound Regulation and Strengthening Financial Transparency" (G20 Working Group 1 2009), the report on "Reinforcing International Cooperation and Promoting Integrity in Financial Markets" (G20 Working Group 2 2009), and the U.S. Treasury white paper on financial regulatory reform (U.S. Treasury 2009). Other relevant reports and papers are listed in "Additional Sources" at the end of this chapter.